OFFICIAL REPORT
AITHISG OIFIGEIL

Finance and Constitution Committee

Wednesday 6 June 2018

The Scottish Parliament
Pàrlamaid na h-Alba

Session 5

Wednesday 6 June 2018

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FINANCE AND CONSTITUTION COMMITTEE
18th Meeting 2018, Session 5

CONVENER

*Bruce Crawford (Stirling) (SNP)

DEPUTY CONVENER

*Adam Tomkins (Glasgow) (Con)

COMMITTEE MEMBERS

*Neil Bibby (West Scotland) (Lab)
*Alexander Burnett (Aberdeenshire West) (Con)
*Willie Coffey (Kilmarnock and Irvine Valley) (SNP)
*Ash Denham (Edinburgh Eastern) (SNP)
*Murdo Fraser (Mid Scotland and Fife) (Con)
*Emma Harper (South Scotland) (SNP)
*Patrick Harvie (Glasgow) (Green)
*James Kelly (Glasgow) (Lab)
*Ivan McKee (Glasgow Provan) (SNP)

*attended

THE FOLLOWING ALSO PARTICIPATED:

John Ireland (Scottish Fiscal Commission)
Derek Mackay (Cabinet Secretary for Finance and the Constitution)
Dame Susan Rice (Scottish Fiscal Commission)
Professor Alasdair Smith (Scottish Fiscal Commission)
David Wilson (Scottish Fiscal Commission)

CLERK TO THE COMMITTEE

James Johnston

LOCATION

The David Livingstone Room (CR6)

Scottish Parliament

Finance and Constitution Committee

Wednesday 6 June 2018

[The Convener opened the meeting at 09:34]

Economic and Fiscal Forecasts (May 2018)

The Convener (Bruce Crawford): Good morning and welcome to the 18th meeting in 2018 of the Finance and Constitution Committee. The first item on our agenda is to consider the Scottish Fiscal Commission's economic and fiscal forecasts, which were published last week to accompany the Scottish Government's medium-term financial strategy. I welcome to the meeting Dame Susan Rice, who is the chair of the commission, David Wilson and Professor Alasdair Smith, who are commissioners, and John Ireland, who is the chief executive. I invite Dame Susan Rice to make an opening statement.

Dame Susan Rice (Scottish Fiscal Commission): Good morning, and thank you for asking us back.

Last Thursday, we published our second report, which contains our economic and fiscal forecasts for the next five years. You might hear other numbers this morning, but five is the number to remember, because the report is five pages shorter than the previous report. For the avoidance of all doubt, I am not about to forecast a trend in the size of our reports.

With this report, we mark another milestone, as it is our first summer report—that is all part of the new budget process. Our winter forecast, as you know, will be used by the Government in preparing its budget, and our summer forecast can be taken as the first step in looking ahead to the next year's budget, but it does not in itself affect the current year's budget. "Winter forecast" and "summer forecast" are two new terms to remember, alongside the number five.

We will also continue to publish our forecast evaluation report every September, and we anticipate that the upcoming report this year will be especially interesting, as Her Majesty's Revenue and Customs will publish its first full estimates of outturn income tax liabilities for Scotland over the summer. We will analyse that and incorporate it into our September report.

Turning to the current report, which lays out the central forecasts for use by the Government, all the forecast tables and charts, in spreadsheet form, are posted on our website, so all of you can go in and play with them in your spare time, if you would like to. I would like to highlight a few headlines from the report.

Last December, we described the outlook for growth as subdued. Our view now of the overall outlook is broadly unchanged from December. The economy is growing, but the rate of economic growth has been slower over the past decade than it has been, on average, historically. Our view remains that that pattern of slower growth is likely to persist over the next five years. Nevertheless, unemployment is expected to remain low, with employment continuing to increase over the same period.

Since our previous forecasts, we have done further analysis of wage growth in Scotland. Real wage growth has been weak over recent years, and real wages are now lower than they were a decade ago. As a result of that new analysis, we have revised down our outlook for real wage growth in Scotland. Real wages are anticipated to fall by 0.5 per cent this year, before gradually levelling off in 2019 and then starting to grow very slowly from 2020 onwards.

In line with that revision to the outlook for wages, our income tax forecast has also been revised down from our previous forecast by £209 million in 2018-19. That is about 1.7 per cent of total liabilities. Members should keep in mind that that is against an income tax intake of about £12 billion.

The report also contains detailed forecasts for tax receipts and devolved social security spending, including our first costing of the Scottish Government's planned expansions in social security. The carers allowance supplement, which is now planned to increase in line with inflation, will cost £46 million by 2023-24. When the Scottish Government provides further details on other benefits that are to be devolved and expanded, we will cost those.

We have also been supporting the Scottish Parliament in its scrutiny of Scottish Government tax changes. Most recently, we published a costing of the change to group relief at the same time as the relevant secondary legislation, and we will continue to operate in that way.

Finally, the commission is also required to assess the reasonableness of the Government's borrowing plans. On the basis of the information that the Government has provided to us, together with its projections, the plans are within the limits that are set out in the fiscal framework. However, we note in our report that the Government can continue to borrow at the rate that it has done only until 2022-23. Thereafter, the aggregate cap of £3 billion will be reached, which will limit future borrowing.

Those are our headlines. We are happy to take your questions.

The Convener: Thank you very much for your opening statement.

We need to put some stuff on the record. We have heard the narrative on the substance of your report, but your income tax forecast for 2018-19 is now £209 million lower than it was in December, just four months ago. What has changed?

Dame Susan Rice: What has changed is that, for the December report, we spent a lot of time analysing productivity, which is one of the big factors that influence the economic forecast, and since then we have done a lot of analysis of wage growth. I mentioned some of the understanding from that analysis, which is that wage growth is really quite low. When that affects the overall economic forecast, it necessarily feeds into the income tax forecast, because if earnings are lower, less tax is paid—that is a simple way of putting it.

The Convener: Can we get underneath that analysis a bit, so that we can understand a bit more clearly why the projection on wage growth is lower? What data drove the outcomes and judgments?

Professor Alasdair Smith (Scottish Fiscal Commission): There are two main elements to this. One is that we have done further analysis of wage growth within the macroeconomic forecast, reflecting the fact that wage growth has been low since 2008 and is lower than one might expect. In our previous report, we put a lot of effort into discussing productivity. As we have looked further at real wage growth, we have observed that it has been low even relative to what one might expect in relation to productivity. The overall picture over the past 10 years is one of very low wage growth, and we have taken that more fully into account in this forecast than we had done previously.

The second major element is that, in the past year, real wage growth has been particularly low—indeed, it has been negative. For the next couple of years, that is our starting point.

Those are the two elements of further analysis and recent data that pushed us in the direction of expecting real wage growth to be lower than was anticipated in previous forecasts—not by a huge amount, as Susan Rice said, but sufficient to have that 1.7 per cent effect on the income tax forecast.

The Convener: When you came before the committee after publishing your December report, I remember the committee asking about wage growth, because you had projected better wage growth in Scotland than in the rest of the United Kingdom, the overall impact of which was that Scotland was in almost the same position as the rest of the UK in terms of tax take. I still do not have a feel for what has changed between December and now in the data that you have been looking at. What analysis was done? I want to understand a bit more clearly what is going on, because although the difference is only £209 million out of £12 billion, it still represents £209 million of potential public expenditure in Scotland in the longer term.

John Ireland (Scottish Fiscal Commission): Perhaps I can add a bit of detail. One of the issues that we face with wages in Scotland is data availability. There is no headline series for real wages, so we have to use a number of different sources. If you look at figure 2.3 in our main report, you will see that we have plotted some of that data for Scotland, using the two measures that are available for Scotland and two similar measures for the UK. It is a matter of interpreting two or three different sources of wage data. We also had new data—an additional data point—which we took into account.

However, the main thing that is driving the analysis is that we spent some time looking at how real wages have moved in relation to the standard things that drive real wages in economic theory, which are productivity and labour market slack. We have done work to look at how real wages respond to labour market slack or the extent of unemployment, and to productivity changes. We have also thought about whether there are other brakes on the evolution of real wages.

The work that we did to give us a sense of that allowed us to reconsider our forecast. If you look at the main report, you can see that figure 2.5 tries to capture that information.

The Convener: I am looking at that now. I will bring in Murdo Fraser.

09:45

Murdo Fraser (Mid Scotland and Fife) (Con): In December, the Scottish Fiscal Commission said that it expected wage growth in Scotland to match that in the rest of the UK. The commission has now revised that view, because it has accepted that gross domestic product per capita and productivity will grow more slowly in Scotland than they will in the rest of the UK. That seems quite a radical change to make in quite a short space of time. Can you explain the reasons for that revised view in a bit more detail?

Dame Susan Rice: The simplest way to explain it is that we have analysed further the information to hand, and we have made judgments based on that information. A change has come about because we have more information and evidence on which to base our forecasts.

Murdo Fraser: I understand that. However, the consequence of the revision downwards, combined with the revisions in the Office for Budget Responsibility figures, which affect the block grant adjustment, is that, in the current financial year, the Scottish Government's budget faces a black hole of nearly £390 million, which is a substantial chunk of money. We know that that does not have to be met in this financial year, because there is the opportunity to defer it until the final figures are available. Nevertheless, that is a real challenge for the finance secretary, whom we will hear from shortly. Do you have any reflections on that process? What will it mean for the future of forecasting and its impact on budget decisions, given that such a large differential can appear in such a short space of time?

Dame Susan Rice: I will ask David Wilson to provide more detail, but that is the nature of forecasting: changes will be made up and down. That has happened in the OBR forecasts, and it will happen in our forecasts, too.

David Wilson (Scottish Fiscal Commission): I will build on what Susan Rice said. In its most recent forecasts, the OBR amended its income tax forecast by about 2 per cent—we amended ours by 1.7 per cent. In most contexts, a revision of a forecast by 1, 2 or 3 per cent would not be a major or significant issue. In the Scottish context in which we are dealing with about £12 billion of income tax, a revision will inevitably have a significant headline number. We fully acknowledge that.

To respond more directly to Murdo Fraser's question, we recognise that we have made a downwards revision to our income tax forecasts. As my colleagues have said, that very much reflects the further analysis that we have been able to do and our further understanding of the full implications of our wider economic assessments, including our GDP forecasts, and how those will affect our income tax forecasts. Further analysis, further data and improved assessment on our part have led to the downgrade.

On the specific issues to do with the budget, I should clarify the nature of our forecasts and of the medium-term financial strategy. They are the first stage in providing the setting for next year's budget. In themselves, the forecasts will not affect the funding that is available to the cabinet secretary during the year, because the setting of budgets will be based on our next forecasts in December.

We fully acknowledge that we have downgraded our assessment. In doing so, we have taken into account better information to provide a more accurate and fuller assessment. It is not the case that the forecasts will mean that the Government needs to find additional money or adjust the budget, because the forecasts are part of the initial process in the new budget arrangements.

Murdo Fraser: I completely understand that. However, if your forecasts are correct, when the outturn figures come out, there will be a reduction in the amount of money that is available of about £400 million, which is a chunky sum of money even in the context of the Scottish budget. Either this finance secretary or a future finance secretary will have the job of trying to address that problem.

Professor Smith: Yes, but it is worth emphasising that the outturn figures for 2018-19 will not be available for two years. We have to be realistic. There will be further forecast revisions between now and then.

Murdo Fraser: So it could get worse.

The Convener: Or better.

Professor Smith: As Susan Rice said in her introduction, we will have outturn figures for 2016-17 and 2017-18 before then, and they will feed into our forecasts. To pick up on what has been said, I hope that, if it turns out in two years' time that the outturn is £200 million down, as we have forecast, you will congratulate us on being two years ahead of the game in alerting the Government to the fact that the forecast is a bit more negative than we previously thought.

James Kelly (Glasgow) (Lab): I am still not totally clear about what has driven the change in the wages forecast. The cabinet secretary is in quite a serious situation. Although, as Mr Wilson has pointed out, that does not change the budget allocations for this year, if the figures turn out to be accurate, a combination of the income tax change plus the OBR forecasts means that, in effect, the cabinet secretary will be nearly £400 million down on where he started when he allocated his budget. It is therefore important that the forecasts are robust.

Table 2.5 in the report sets out four sources for the calculation of wage data. In effect, there are four surveys. Will you talk us through the changes in those sources that have driven the changes in your assumptions on wage growth?

The Convener: I suspect that that is a question for John Ireland.

John Ireland: Yes—I was just thinking. Table 2.5 is key in illustrating the issue. We have four different sources of wage data, all of which collect data in different ways. They have different strengths and weaknesses, and they produce quite a divergent picture of wage growth. We could be quite simplistic, average those figures and come up with a number, or we could make a judgment.

We looked at the evolution of that data over a number of years. The data go back a long way—in some cases, to 2000 and prior to that. We looked at those four data sources and at how things have changed over a long period of time and over a shorter period of time, and we came to a judgment about the underlying change in real wages. That analysis, combined with our judgment, has led to our having an understanding of the evolution of real wages. As I explained earlier, we did further work that tried to link that to conditions in the economy—to how much demand there is for labour and to what extent that is bidding up the price of labour or real wages, to what extent productivity increases are driving the change in real wages, and to what extent other factors might be influencing real wages.

There is an awful lot of analysis. We have a lot of data in alternative data sources, and there is no definitive series of data. It is not like GDP, on which we can point our finger and say, "It's that one." We have to look at all the sources and reach a judgment and, in essence, that is what we have done.

James Kelly: I am still not clear about what new data has emerged in the past four months to change the forecast.

John Ireland: That is down to a combination of things. We have had new data from an extra quarterly observation. Such things come along at different frequencies. There is some new data, which has helped to inform what we think is going on, but the principal thing is that we have looked at existing data in much more detail. We have thought about productivity growth, which is the key factor that drives the Scottish economy. We examined that in December, and we spent a lot of time in the run-up to the December forecast looking at that. We have now changed our focus. Between December and now, we have put a lot of our effort into looking at the evolution of real growth. Therefore, a combination of new data and additional analysis is responsible for the change.

James Kelly: I will ask my question in a slightly different way. The four sources for wage growth data for 2017 vary from the labour force survey's forecast of a reduction of 1.5 per cent to the forecast in the annual survey of hours and earnings of an increase of 3.2 per cent. That is quite a range. Your report says that your primary source of data, which I assume gets the priority in your modelling, is "Quarterly National Accounts Scotland", which forecast an increase of 0.8 per cent in 2017. That is much less than the top two forecasts—from the ASHE, at 3.2 per cent, and the real-time information, at 2 per cent. Will you explain why you gave more weight to a more pessimistic view about wages?

John Ireland: If you want to use the optimistic or pessimistic flagging, I will talk about two data sources—the LFS and QNAS. Our judgment is that real wages declined in 2017 by about 1 percentage point. We gave more weight to the combination of LFS and QNAS than to the other two sources because our judgment is that LFS and QNAS capture what is going on better than the other two do.

Professor Smith: I will reflect on an earlier reference by John Ireland. The strongest statistic to focus on is in figure 2.3, which uses several measures to show the pattern for real wages. The story is that real wages now are lower than they were in 2009. That is a virtually unprecedented economic picture. We should focus on the story that real wages have not increased for 10 years—they have not even been in line with productivity. That analysis drives the figures, rather than a focus on what happened in one year of statistics. What happened in the one year played some role, but the long-run story about real wages is the most important thing to focus on.

Adam Tomkins (Glasgow) (Con): As Dame Susan Rice said in her opening remarks, the process is new for us all. As can be heard from the tenor of the questions, we are still trying—or struggling—to understand the great science of economic forecasting, and even whether it is a science at all. I am not an economist; I am a simple lawyer, so I will ask a simple lawyer's question about what the witnesses just talked about with James Kelly and Murdo Fraser.

We are interested in what has changed since your previous forecast. Have the facts changed? Have you changed your mind about the existing facts? Have you realised that you spent an awful lot of time thinking about productivity and not enough time thinking about wage growth, so you are catching up with additional work that was not done last time? Which of those three is it? I hope that the question is not unfair; I am trying to understand how the forecasting process works.

Dame Susan Rice: It was a good lawyer's question, which is fine. As John Ireland said, we had a few more data points, although not a lot, and they did not change the perspective.

You talked about the science of forecasting. It is part science and part imagination—I like to use that word because it partly involves judgment. We make a judgment at a particular point in time.

Since the committee previously had forecasts from us, we have seen what the OBR issued in the middle of March. What it says has an impact on our judgment in our forecasts, so that is new data in a more general sense. We are looking at no change in the rather uncomfortable numbers about wage growth—any new pieces of data about Scottish wage growth have not gone in a positive direction.

We use a combination of those aspects and not just one thing. It is not the case that we missed or forgot data that were out there. Back in December, the committee showed interest in real wages, which we are interested in, too, so we thought that it was worth doing a deeper and fuller analysis. The analysis was done by our colleagues in the commission and discussed at length with us as commissioners. The judgment is what we have come out with.

10:00

Patrick Harvie (Glasgow) (Green): What do you think is going on underneath the overall level of wage growth that you are forecasting? You have identified factors that suggest that, although we will see very low wage growth over the next few years, wage growth will rise from 2019-20. You said that higher public sector pay awards and increasing productivity, for example, will lead to stronger wage growth from then onwards. What is the reason for assuming that those factors will start to kick in at that point? I should have said that I am looking at page 55 of the main report.

David Wilson: We are learning as we go, to get a fuller and better understanding of what is a changing situation. We are conscious that what happened in 2015-16, which is coming through in the data, is one thing, and trying to interpret what is currently going on is another.

The core part of our forecasts is that the period of low real wage growth and subdued GDP that we have seen since the financial crash is continuing longer than anyone reasonably expected it to do and is expected to continue for a few years yet. At the core of our forecast is that once we get towards the second half of the five-year period of the forecast, we are forecasting increased productivity. When we look at some of the numbers inside our assessments we find quite a sharp increase in productivity, compared with what we have seen over the past few years, which will lead to real wage growth.

You asked why that is. Most people are coming to terms with the fact that economic growth has been disappointing for at least 10 years and we are not getting back to the rates of growth that we saw before the financial crash. Fundamentally, everyone who is in the business of forecasting thinks that things must get better than they have been; the debate is about whether and over what time period we will get back to earlier rates of growth.

Our assessment is perhaps a middling one for the latter part of the period. Whether we are talking about artificial intelligence, digital changes or boosts to and significant productivity improvements in manufacturing, there is a range of positive developments in the economy that are being hidden—in the context of the overall numbers—by the continuing overhang of what happened in the financial crash. We expect that to come through towards the latter half of the five-year period, and that is what is impacting on increased real wages and increased GDP at the end of the period.

Patrick Harvie: I have not heard many people suggest that automation is a factor that should make us optimistic about wage growth.

David Wilson: It might well do. There are people who are creating the algorithms, manufacturing robots and so on. The distributional impact is a major issue, but technological change will lead to overall improvements in productivity, and that will impact on real wage growth at some point. That is what we expect to see.

Patrick Harvie: I hope that the algorithms do not start making themselves.

I wanted to ask about distribution. On the same page, you suggest that there are factors that impact more or less at the higher or lower end of the income scale. In order to be able to link the wage growth projections to the income tax projections, you will have to have a fairly clear sense of what you think the distribution of incomes will be. Can you say any more about that? Can you publish any more information that would allow us to generate some projections on the impact on income inequality in Scotland?

David Wilson: Formally, we do not, at present, plan to publish a full assessment of the distributional implications of our forecasts, which would be a possibility. We must take the distribution of incomes into account, because it is a factor that has a material effect on our forecasts. We could certainly consider drawing that out in a further publication. We are not preparing such a document at the moment, but we could consider doing so.

Patrick Harvie: If that is a factor that has to be taken into account, such an assessment must exist.

David Wilson: It is one of the many factors that are implicit and partly explicit in the modelling work that we put together. Over the five-year period that we are talking about, we would not expect the extent of any shift in the distribution of incomes and earnings returns to be a major factor, but we could do some further work on that, which we could share with the committee.

Patrick Harvie: Thank you.

Willie Coffey (Kilmarnock and Irvine Valley) (SNP): I want to stick with the issue of the wage growth forecasts. Are you saying that your forecast has been downgraded mainly because the LFS downgraded its forecast? I think that Mr Ireland said that greater weight was placed on that.

John Ireland: No. I said that we looked at all four measures in the table in question, and the two that we put greater weight on were the LFS and QNAS. It is much more a judgment of how all four have moved over time.

Willie Coffey: I am looking at the data that might be responsible for the downgrading of the LFS forecast. The Office for National Statistics has a table that shows that there has been a bit of volatility in the Scottish figures over the past year, but the ONS says that the LFS forecast is perhaps the least reliable of all the forecasts. It refers to the LFS data as being "self-reported by employees" rather than being reported by employers, which makes it a bit less reliable. In addition, the LFS data can be "supplied by proxy", so it does not need to be supplied by employers or employees. The ONS says that the LFS forecast is probably less reliable than the others. Does that not call into question your judgment in using it as one of the major reasons for downgrading your forecast?

John Ireland: No. I have tried to make it clear that we look at all four of those surveys, each of which has different strengths and weaknesses. You have identified one of the weaknesses of the LFS, but it has strengths that are related to things such as sample size. All four have strengths and weaknesses, so it is a matter of looking at the evolution of all four of them.

The other important point to make is that it is not one quarter's figure that is important, but how the figures have moved over time. Figure 2.3 looks at the evolution over time of the various measures of wages and the extent to which they have moved together or differently. We have looked at four very long data series; we have not looked only at one observation. We have looked at how all four of those have moved and the extent to which they have moved together or differently. That is how we reached our judgment. It is a case of using the data, which is imperfect. Each of the four sources has strengths and weaknesses, and we try to balance those out.

It just so happens that that was the ranking in the year that we were talking about, but it would be incorrect to say that that is a simple one quarter or one year thing. It is much more about the evolution of all four series over time.

The Convener: A couple of members said that they wanted to ask supplementary questions. I thought that we might have exhausted this area, but that is not the case.

Ivan McKee (Glasgow Provan) (SNP): Oh no. I thank the panel for going through the report with us.

I would like to clarify a few points that have emerged in the discussion. I have a question about the data sets in table 2.5 and figure 2.3. Is it the case that that data is what the organisations in question thought that the outturn was, not the forecast, because we are talking about 2016 and 2017?

Dame Susan Rice: Sorry?

Ivan McKee: In terms of wage growth percentages, you have a table with different organisations and different percentages.

John Ireland: Do you mean the surveys?

Ivan McKee: Yes, the surveys.

John Ireland: Table 2.5 is actual end data.

Ivan McKee: Thanks; it is actual data. There may be some confusion there when we are talking about forecasts.

There are four surveys there talking about what they think has actually happened in the past, not what they think is going to happen in the future. Even so, the variation between what they think has actually happened is greater between the biggest and the smallest than the variation of 1.7 per cent that you are talking about in your forecast accuracy. Even looking at that, and saying what happened, we do not know what has happened looking backwards, never mind looking forwards.

Professor Smith: It is important to notice that the surveys are not looking at the same variable. The real-time information series is looking at average annual earnings, ASHE is looking at gross hourly pay, and LFS is looking at gross weekly earnings for full-time workers only. Each of them is different. It is not that they are giving four different answers to the same question.

Ivan McKee: I understand that but, notwithstanding that, we are measuring wage growth only as a proxy, because what we really want to know is what the impact on income tax receipts will be, because that is what goes in the budget. Wage growth does not go in the budget; income tax receipts go in the budget. The only reason for measuring wage growth is so that we can figure out what income tax receipts will be.

Dame Susan Rice: It is one of the factors that impact the income tax forecast. As I said before, less earned, less tax paid.

Ivan McKee: Notwithstanding the fact that the surveys are all measuring something different, you have to find out the relationship between what each is measuring—they also all give a wide range of numbers—and what will happen in future. My point is that, given that lack of stability in what has happened in the past, it is not surprising that your forecast accuracy will have a variation of up to 1.7 per cent.

John Ireland: It is even more complicated than that.

Ivan McKee: We live in unprecedented times, so you cannot even rely on things that have happened in the past.

John Ireland: It goes to the data that we have on income tax and income tax payers. We have another data source—the tax records of individual taxpayers and the survey of personal incomes. That is the data that lies behind our income tax forecast. We have a lot of data on individual people. It is much less timely—the data is much older—and that is what we use to generate our income tax forecast. The data about real wage growth is used to update that rather old, but very detailed data, and that allows us to have a sense of where income tax is now. Then our forecasts of wage growth are used to project that individual, detailed microdata into the future.

There are a number of steps in the process. What gives me a greater degree of confidence is the fact that we have individual taxpayer data, dated though it be, and that allows us to get a better and richer understanding of income tax receipts. That also relates to some of the questions that Mr Harvie was asking earlier about the distributional effects. The important point on the data on wage growth is basically about how to project that individual data forward.

Ivan McKee: Given that we are struggling to know what happened in the past, it is not surprising that you are struggling to tell us what will happen in the future.

John Ireland: That is the science—or the art, or even the dark art—of forecasting.

Ivan McKee: The stack tolerances are even more difficult, because there are a number of different factors involved. Okay, that is clear.

Given that we are going to have unpredictability, the question then is how to deal with that. You said that 1.7 per cent is not unusual when talking about forecasting errors, and that the OBR had a 2 per cent error in the current time period. Is there something fundamentally different at UK level? Is the OBR just used to having to deal with that, so it manages it better, or does it have extra powers and the ability to deal with those shocks and forecast issues, compared with what is available to the Scottish Government?

Dame Susan Rice: The 2 per cent was 2 per cent up, and ours was 1.7 per cent down. Its error might be down the next time.

Ivan McKee: I understand that, but that is not the issue. The issue is that you will get variability, and sometimes it will be up and sometimes it will be down. The question is how you deal with it.

Dame Susan Rice: Everyone wants to speak now, but let us hear first from David Wilson.

10:15

David Wilson: I will go first. It is clear that, at the UK level, there is much greater experience of undertaking budgets and managing and varying income and expenditure. The fiscal framework in Scotland is newer, and we are all learning as part of the process. I am grateful for your acknowledgment that the task is difficult, but that is the task that the Scottish Fiscal Commission was set up to do.

If it is not inappropriate to quote the Government's numbers rather than ours, the uncertainty that it models in the medium-term financial strategy in respect of the potential highs and lows of income tax is clear. Our central estimate is used in that document. The Government says that net spending power could be between £400 million below and £1.4 billion above our central estimate. That is the range of uncertainty.

Ivan McKee: Whose data is that?

David Wilson: That is in the MTFS. Those are the Government's figures. There is a significant range of potential income. Our role is to seek to give the best current estimate of that, and that is what we are trying to do.

Ivan McKee: I suppose that the question was—

The Convener: We will have to move on a bit. You should make this question your last one.

Ivan McKee: Absolutely. The UK Government has more powers, a wider tax base to get different taxes coming in, more economic levers, and more borrowing powers. Is it therefore better able to deal with natural forecast variations than the Scottish Government, with its limited scope of borrowing powers?

Professor Smith: The short answer to that is that the UK Government's fiscal framework is different from Scotland's for a number of reasons. The borrowing powers are one reason for that. If there are forecast errors for Scotland, the reconciliation is two or three years ahead, as opposed to its coming along at once. The frameworks are very different, and the Governments' abilities to adjust to changes in income tax are different as a result.

Neil Bibby (West Scotland) (Lab): If hourly earnings are slowing, but there is still strong growth in the number of hours worked, what does that say about living standards? Can we assume that there has been a relative reduction in living standards?

Dame Susan Rice: We have stated that real wages are lower than they were a decade ago. Real wages are what is left to spend once inflation has been stripped out. You can draw a conclusion from that.

However, there is a partial upside. Employment is very strong—in fact, it is growing—and unemployment is decreasing. There seem to be jobs out there for people who are willing and able to work. It is conceivable that, if employment is even fuller, wages may rise, as there will be pressure there.

The downside of having high employment and lowering unemployment is to do with capacity. If there was a lot of investment and a need for more new jobs, which would ultimately improve wage growth, people would be needed to take those jobs.

The Convener: My question is not directly related to wages. Paragraph 24 of the summary document deals with real household disposable income. Obviously, there is a challenge in that area in the early years of the forecast. A couple of weeks ago, the governor of the Bank of England, Mark Carney, suggested that, as a result of the vote on Brexit, household incomes were already £900 less than they had been. I do not want to make things worse and be even more pessimistic, but has that sort of description been built into the forecasts since the Brexit vote? We do not yet know what the final deal will look like, but there has been a £900 reduction in spending power per household since the Brexit vote. Was that factored into your material?

Dame Susan Rice: We looked at Brexit as one of the background factors in the economy forecast. We have made some general judgments, but we can incorporate information only when we have specific policies and data to hand. There is a lot of uncertainty.

The impact of Brexit is that there is a lot of uncertainty, which might lead to less confidence in business investment. We have not picked up the figure that the governor stated—I do not know the basis for it, or whether colleagues do. Brexit is a background factor that is creating a bit of drag on future investment.

The Convener: I do not imagine that the governor of the Bank of England would have made his statement if the bank had not done some analysis.

David Wilson: The bank's role is different from ours. We have not made and would not make an assessment that was based on Brexit versus a no-Brexit counterfactual. We do not do such calculations. However, broadly speaking, it might be worth looking at table 2.2, which is on page 42. That sets out our estimates of household consumption as a result of our modelling work. As with real wages, the figures show limited increases over the forecast period, which is exactly what would be expected given the overall assessment—there are pressures on household consumption as well as wages.

The Convener: I am not thinking about what is coming; the governor's comments were about what has happened. I assume that your forecast in December will look at Brexit in more depth.

Professor Smith: As we expect to have a lot more information about how Brexit is likely to unfold, we intend to incorporate in the December forecast a much fuller analysis of the effects of Brexit. We assume that we will have a much clearer picture then.

The Convener: We need to move on.

Ash Denham (Edinburgh Eastern) (SNP): We have spent quite a bit of time on talking about the impact of wages on the public finances. That is underpinned by the working-age population. The proportion of the population who are of working age is important in economic terms, and that group is not growing as quickly in Scotland as it is in the rest of the UK. Your report says that that

"places a ... drag on growth in GDP in Scotland."

It is difficult not to conclude that it might be beneficial, at least economically, for Scotland to control migration, but I do not expect you to comment on that.

Your report says that, for your calculations, you

"use the 50 per cent net EU migration variant of the ONS 2016-based population projections for Scotland, whereas the OBR has continued to use the principal projection for the UK."

What is the difference between the projections and why did you use the variant that you chose?

David Wilson: We use the main ONS and National Records of Scotland population projections, but they produce a variety of variants of their projections, and we chose to use the 50 per cent EU version. The forecasts are not ours; we chose one of the variants.

The background is that Scotland's population has not grown as quickly as that of the rest of the UK. In 2017, we tipped into a period of natural decrease in the population—in simple language, there were more deaths than births. The population is important to our forecasts, and Scotland has some differences.

The key factor that has driven faster population growth in the UK than in Scotland is different levels of in-migration. I looked back at the numbers. Back in 1997, there was a net outflow of about 7,000 people from Scotland. In 2006, there was a net inflow of about 30,000. We now have significant levels of in-migration.

You asked me to explain our choice of forecast. The principal projection for Scotland from the ONS and NRS assumes average net in-migration of 15,000 people, on the basis of recent historical trends. Given the Brexit vote, it is possible that there will be a change in behaviours and a tighter immigration regime. Only part of that 15,000 figure is due to EU migration. The assumption is that that portion that is due to EU in-migration and EU out-migration will be halved. That is where the 50 per cent comes from. It is not the case that there will be no EU in-migration or out-migration, but there will be a significant reduction in the changes. That means that, instead of a net in-migration of 15,000 per annum, there will be a net in-migration of 9,000 per annum, and that works through the numbers going forward.

We felt that that was a recognition of the downside risks for Scotland's population of the vote to leave the EU. We put that in our December forecasts, and we have not changed our view on that in the forecasts that we are discussing today. The situation might turn out differently, but that is the forecast that we use at the moment.

Dame Susan Rice: You mentioned the so-called "working-age population", which is people aged 16 to 64. People are working beyond that, but the people in that group are the primary wage earners. That population is beginning to shrink—it will start to shrink a little this year and we envisage that shrinkage continuing a little way into the future. That, too, has an overall impact. On top of that, our birth rate is not high enough to compensate for what is happening at the other end. There are various factors that affect population.

Alexander Burnett (Aberdeenshire West) (Con): I refer to my entry in the register of interests in relation to house building.

I have a few questions about land and buildings transaction tax. There has been a modest increase in the revenue from that, but there are a couple of anomalies. There has been a huge increase in sales of properties with a value of more than £325,000. Some commentators attribute that to the result of the UK general election, which they concluded gave some people greater confidence, because the prospect of indyref 2 was diminished. Another anomaly is the fact that just four postcodes in Edinburgh account for nearly 20 per cent of all LBTT receipts. However, the overall trend has been that the number of transactions has dropped, contrary to the Fiscal Commission's prediction.

Against a backdrop of stagnating wages growth and the continuing fall in gross weekly earnings that is revealed in figure 2.3, why do you persist in forecasting an increase in the number of transactions, albeit a slightly smaller increase than the one in your original forecast?

Dame Susan Rice: I am sorry—I thought that your question was going in a different direction, so I do not have an answer to that. Perhaps someone else would like to pick that up. In the numbers, we reflect the fact that there have been more higher-value transactions, which seemed to be rather muted in the recent past. There has been an increase in the number of those transactions, which has increased the tax revenue that has come in, although there have been fewer transactions at the lower end of the housing market. Those things might even out over time.

Professor Smith might have a better answer.

Professor Smith: I do not have a better answer, but I will supplement that by saying that the housing market is inherently volatile and difficult to forecast, which means that LBTT is difficult to forecast. One forecasts it by looking at a mixture of long-run averages or trends and short-run behaviour. When we get new information that says that the housing market has behaved unexpectedly—prices have been unexpectedly high, the number of transactions has been unexpectedly low or the number of transactions at the top end of the market has been unexpectedly high—that will feed into the forecast, because it would be foolish to ignore that and to assume that what happened in 2017 was a one-off. It would be natural to think that it might well continue in 2018. However, at the same time, we do not throw away the long-run information. New information shifts the forecast for the next period, but one year of new information does not have a big impact on the long-run forecast.

To pick up what Alexander Burnett said about transactions, we are not going to completely change our view of what a sensible forecast is for transactions because of one year's data. That shifts the forecast, as has been reflected, but we still give a lot of weight to the long-run averages of both prices and transactions. That is the way that such statistical modelling works.

10:30

Alexander Burnett: So you are not seeing a relationship between transactions and earnings.

Professor Smith: Not in a formal sense. I am looking to John Ireland to correct me if what I am saying is not right or to add to it. The housing market model is essentially a self-contained one that is driven by data in the housing market. There is not a big feed into it from the rest of the economy.

John Ireland: That is right.

Emma Harper (South Scotland) (SNP): Good morning, everybody. I am interested in the landfill tax. I am aware that that is an environmental tax that is intended to incentivise the reduction of waste disposal in landfill sites. Your report shows that for all taxes, with the exception of the landfill tax, the take is supposed to increase. I know that there is not just a standard rate for waste disposal—it is not as simple as that—and that incineration is involved in your forecast. Will you clarify whether the landfill tax take will continue to reduce?

Dame Susan Rice: We believe that it will continue to reduce. One of the key factors that influence that is the rate of development of incineration in Scotland. Incineration takes a lot of what would have gone to landfill in the past. That development means building kit. There is a construction project for each incinerator, which involves time, construction, planning and so on. Therefore, the trajectory is not absolutely certain.

The other issue is the ban on biodegradable municipal waste going to landfill. That is bound to have some effect. That waste is mainly from households. All the councils have to find a way to avoid putting BMW—I suppose that that has another meaning—into landfill. Various things can happen if the incineration facilities are not ready. That waste can be exported, for example. If the incineration facilities are ready, it can go there.

Therefore, there are some uncertain factors and uncertain timings, but we believe that that take will go down over time. That is what we want, of course.

David Wilson: To build on what Susan Rice said, the report shows that the landfill tax is working very effectively in reducing the waste numbers. However, there is a bit of a decline in the rate of the fall—I hope that saying that does not confuse things—because of a delay in developing incineration facilities. However, the overall trend is quite strongly downwards.

We have not yet made a specific judgment on the further reductions that will result from the BMW ban; we will do that once the full regulatory framework to put that ban into place is set out and we have all the information about that. We hope that that will be in our December report and that it will show significant further reductions.

The Convener: I thank the panellists very much for coming to the meeting. I do not envy their job. Forecasting is not an easy thing to do, particularly when a new process is being dealt with. It is inevitable that there will be unintended consequences. We have a fiscal framework that has a significant reliance on forecasting from two different bodies, and it is inevitable that that will produce a lot more risk and turbulence. At some stage, we will need to have a risk analysis of the process rather than the numbers. Maybe the committee will need to think about that for the longer term.

I suspend the meeting for five minutes.

10:34

Meeting suspended.

10:39

On resuming—

Medium-term Financial Strategy

The Convener: Item 2 is consideration of the Scottish Government's medium-term financial strategy. I welcome to the meeting Derek Mackay, the Cabinet Secretary for Finance and the Constitution and, from the Scottish Government, John Nicholson, deputy director for financial scrutiny and outcomes; Aidan Grisewood, deputy director of the fiscal responsibility division; and Simon Fuller, deputy director of economic analysis.

I invite the cabinet secretary to make an opening statement.

The Cabinet Secretary for Finance and the Constitution (Derek Mackay): In view of the fact that I have given a statement to Parliament and taken questions, and the fact that members have now had more time to read the medium-term financial strategy, I propose that we go straight to questions.

The Convener: That is very helpful.

Emma Harper: I am interested in the Office for Budget Responsibility's forecasts, which say that productivity is expected to be slow. What levers are at the Government's disposal to boost the economy?

Derek Mackay: The difference between the analysis of the OBR's predictions for the UK economy and the SFC's predictions for the Scottish economy is interesting. Part of that difference is driven by their different assumptions and methodologies. The OBR has taken a top-down approach to the Scottish economy; the SFC, as it argued this morning, has taken a bottom-up component approach to the Scottish economy.

Productivity is clearly a challenge. Since 2007, and over the period of devolution, we have a strong track record of improving productivity in Scotland. No one has been able to quite identify the reasons for the divergence in productivity over the past couple of years, but the SFC report touches on that issue. Where we can, we, as a devolved Government, are delivering support to improve and enhance productivity through some of our interventions, such as investing in skills, innovation and enterprise, and through our economy strategy. That strategy is about high-quality industrialisation, which will be helped by the proposed national manufacturing institute for Scotland, as well as by all the other investments relating to upscaling business growth, internationalisation, innovation hubs, connecting our universities with business functions and the new south of Scotland enterprise agency. We will take a range of economic interventions that will be good for the economy and economic growth, as well as for productivity.

Participation is also important to productivity. It could be argued that the productivity challenge in Scotland was due in part to the downturn in oil and gas, which has had onshore impacts as well as affecting offshore tax take.

We have a population challenge, which has been discussed and is now well understood. We have a shrinking and an ageing population. It is great that people are living longer, but that has an impact on earnings, productivity and other factors. The change in the working-age population—people aged from 16 to 64—has had an impact on the productivity drivers, too.

We are doing as much as we can through the Government's interventions. I have tried to explain in the medium-term financial strategy, and in many other places, where we do not have control and why factors relating to population and participation are so important. It is not just about throwing money at such issues; it is about understanding the composition and demographics of our nation, and then being able to respond to those issues. That is why immigration, which is not within our control, is a factor in the productivity challenge.

We should reflect on the positives. We have enhanced a lot over the period, but there is more that we can do through our economic interventions, which I have just described.

Ash Denham: We heard about immigration from the Scottish Fiscal Commission. The SFC used a slightly different population variant from another one that was available, which might have led to its forecast being a bit more pessimistic. The size of the working-age population is very important for our tax receipts, which feed into the public finances.

There is a section on immigration in the medium-term financial strategy, and I will run through a couple of its conclusions. It says:

"The 'Brexit' effect of reduced migration could reduce Scotland's GDP"

by up to

"4.5 per cent per year".

On top of that, there is the fact that the UK Government has additional net migration targets, which, if they were reached, could result in Scotland's GDP being

"9.3 per cent lower by 2040",

which would result in

"£10.2 billion of lost GDP"

to Scotland. Clearly, that is significant to the Scottish budget but completely outwith Scotland's control. What can be done?

Derek Mackay: Naturally, I would argue that it would be better for us to have more controls around immigration. It is clear that the Government is trying to help get the UK Government in a better place in relation to the Brexit negotiations and, beyond that, the immigration targets. There is an impact on the whole of the UK, but a specific—and, I would argue, disproportionate—impact on Scotland, for the reasons that you have given. All the Brexit scenarios were bad enough in terms of their impact on our GDP, population, working-age population and specific sectors, such as the national health service; a range of sectors is affected.

10:45

Beyond that, reducing immigration to the tens of thousands, as the Prime Minister has spoken about, would be singularly unhelpful to Scotland's economy. We need to grow our economy, grow our population, grow our working-age population and of course make the best use of those who want to enter the labour market. Those are clear economic challenges for Scotland. That is an area on which there is a lot of consensus in Scottish politics—certainly in the Parliament. Every parliamentary party pretty much agrees on the needs of Scotland's economy with regard to immigration.

The UK's one-size-fits-all policy is not appropriate. It is counterproductive to our ambitions in this country. There is also the social side of immigration and how it enhances the diversity of our country, but from just a hard-headed economic point of view, the UK policy will subdue our potential economic growth as well as present a host of other challenges.

What can we do? We are running a promotional campaign on Scotland being a great place to live, work and invest in. We have those international efforts going on, but we want Scotland to be seen as attractive within the UK as well. We have a far more welcoming and positive case to make around immigration. All that helps, but given that we do not set the numbers or the attitudes on some of this, we certainly have an issue. That is a reason for the Scottish Parliament to have more control over immigration, so that we can better use those levers to support our economy and the needs of our nation.

Immigration generally is positive for the country. The figures that you quoted on GDP and economic performance in a global context are correct. Per head, for every EU migrant to Scotland, the net contribution to GDP is something like £30,000. The figure for the fiscal tax take is about £10,000. Drawing up the drawbridge, putting up barriers and telling people that they are not welcome is most unhelpful given Scotland's economic needs.

Ash Denham: The policy obviously has a big impact on Scotland's economic needs. I know that the Scottish Government has continued to make the case at UK Government level about Scotland having a bit more control over immigration. Are conversations on that topic on-going?

Derek Mackay: They are. There are a range of conversations on the EU negotiations, Brexit and the constitutional arrangement. Looking at the fiscal framework, the Smith agreement and the Scotland Act 2016, it is clear that the time has come to look again at what further powers Scotland should have. If we collectively accept that there is a challenge to Scotland's economy, surely it follows that we should have the appropriate levers to put us in a better position. The time has come to look again in a positive and constructive way at what other levers or differential approach Scotland could use to enhance our economic position. That can be in the context of Brexit. We tried to do that in "Scotland's Place in Europe".

In any event, we should have much deeper conversations with the UK Government around what powers we could have. We are trying. Clearly, we are a maximalist Government—in our view, the more powers that come to Scotland the better. We have our own constitutional view, but immigration is a case in point as to how the current system and current UK economic model just do not suit Scotland. We could do better if we had more levers, and that case is made by the increasing body of evidence that we have.

The Convener: We turn to scrutiny areas.

Adam Tomkins: I welcome the publication of the Scottish Government's medium-term financial strategy. Of course, the strategy was a key component of the recommendations of the budget process review group, which was assembled partly by this committee, with the assistance of the Scottish Government, to improve parliamentary scrutiny of the Scottish Government's budget; it was one of the first things that we had exchanges about in the chamber a couple of years ago. How will the publication of the strategy document assist the Scottish Parliament in holding the Scottish Government to account for its financial strategy?

Derek Mackay: That is an excellent question. This is the first time that we have done the financial scrutiny collectively. I am open to suggestions about what else could be included in the strategy and how it could evolve. The production of the strategy document was a reflection of the timetable for the Scottish budget, because it is now accepted that the Scottish budget can only follow the UK Government's budget. The UK Government's rhythm of business has changed and we are now to have a UK budget in the autumn—although it is strange how autumn is defined in that context. However, there is a UK budget in the autumn, then a UK spring statement. Given that rhythm of business, the Scottish Government is compelled to produce the medium-term statement—it is also an outlook of what lies ahead of us—and to be open to questions on it.

The statement and the questions from parliamentary scrutiny of it allow us to look in more depth at the fiscal outlook and what the key principles and factors are for the Government and Parliament to wrestle with. Crucially, of course, the statement coincides with the publication of the Scottish Fiscal Commission's latest forecasts, which inform the debate. For all those reasons, I think that this committee scrutiny is a good opportunity.

I will, of course, return to the Parliament with information on outturn figures and the implementation of Scotland Act 2016 provisions, as I have done previously. There will also be the fiscal framework reporting, which will reflect on the outturn figures from those arrangements.

This engagement with the committee is very helpful for the whole Parliament. As the Parliament's powers mature and the committee undertakes serious fiscal scrutiny of the Government, Opposition members should take seriously their responsibility, as the Government does its, to look at all the issues and take a responsible approach to balanced budgeting now and in the future.

Adam Tomkins: Clearly, the committee must play, and will continue to play, a lead role in budget scrutiny. However, one of the themes that runs through the budget process review group's recommendations is that the Parliament's subject committees need to play a greater role than they were previously able to play because of the very constrained timetable that was available for parliamentary scrutiny of the Scottish budget, for the reasons that you just outlined. What is there in the strategy document that is new, and which we did not previously know about, that will help the Parliament's subject committees to scrutinise the Scottish Government's budget?

Derek Mackay: I am sure that there is a paragraph in the conclusion to my medium-term financial strategy that says that the strategy does not present new policies. It was never intended to do that. The medium-term financial strategy is based on the fiscal position at this time and the latest SFC forecast, and it brings together in one place what the Government sees as its priorities, given that context.

There are new statements in the strategy document, but there are no announcements of new policies on whatever it is or whatever it could be. However, I have put in the public domain real-time, current suggestions about how we could address some problems at source. For example, if the UK fiscal path were to change as I have suggested in the document—I said this in the chamber—that could unlock, as a minimum, £60 billion for the UK's economy and public expenditure and, in turn, £5 billion for Scotland. So, that is a new political argument in the document.

The policy context of the strategy is that it brings together what already exists, refined by the latest figures and analysis. If I had not published scenario plans, I am sure that the committee would have asked me to do so; I have therefore included scenarios to illustrate what we could be looking at.

I listened to the SFC's evidence to the committee and heard it describe the strategy document as the starting point for the budget. It is good to be in a position in which the whole Parliament is thinking at this stage about what our priorities should be. The strategy document is useful, but it was never intended that new policies would be launched in it. However, it has set out new information, fiscal paths, illustrative examples and the financial context that we are working in.

As Patrick Harvie said in a question that he asked about the strategy last week, it was never expected that it would set out detailed portfolio spending plans. It would not be appropriate for it to do that, because such forecasts would all be subject to change. However, if the committee has further suggestions to make about how the document could be further refined, I am open to that.

Adam Tomkins: We are the Finance and Constitution Committee, but how will the document help the Health and Sport Committee to scrutinise the medium-term financial stability of the NHS in Scotland? If you do not like that example, I could ask the same question about the committees that deal with education or policing and justice. How will the content of the medium-term financial strategy help to enhance effective parliamentary scrutiny of your Government's budget proposals over the remainder of the parliamentary session? That is the bit of the puzzle that I think is missing.

Derek Mackay: That is a very fair question, to which I have a clear answer. The medium-term financial strategy sets out the Government's principles and its key commitments. When Government ministers make statements in the chamber about what our commitments are, those statements are obviously very important, but setting out our commitments in a financial strategy shows that we are serious about delivering them. In setting out our priorities, the strategy describes the challenge that we face, because not everything can be a priority. As well as setting out the share of the budget that would be involved in meeting our key commitments, it provides greater certainty that we are serious about those key commitments, which I think is important.

Any committee of the Parliament can do what this committee is doing at the moment—every committee can scrutinise the spending plans of the appropriate cabinet secretary. That is the purpose of all-year-round scrutiny. Committees should not just wait for the three-week period between the UK budget and my announcement of the draft Scottish budget. All-year-round scrutiny means that cabinet secretaries and ministers can be called to account for what is happening in real time.

You mentioned the Health and Sport Committee; you gave other examples, but I will take that example, because it was the first one that you gave. The Government is committed to providing more financial detail on how to meet the health challenges, recognising the demographic challenges, the higher expectations and the higher cost of providing services. The publication of a medium-term financial strategy specifically for the health service is imminent. We have committed to doing that. Mr Tomkins was referring to my medium-term financial strategy, but we said that we would provide more detail on the need for investment in the on-going process of transformation in health. The Health and Sport Committee can scrutinise that, as can the Finance and Constitution Committee. Those documents will work in tandem with each other. A specific look needs to be taken at health spending, because it accounts for the lion's share of the Scottish Government's budget, for good reason. The illustrations of scenarios show just how dominant it will be in future spending if we are to meet the commitments that have been made on health. The medium-term financial strategy refers to the increase of £2 billion in spending on health, which the Government committed to in its manifesto, but more detail will be provided in the document that will be specifically about health.

Mr Tomkins asked what the medium-term financial strategy says to the committees that deal with education, policing and justice. It says what our key commitments are. It was never meant to be a document that dealt with the operation of each part of the public sector. It sets out how we propose to invest in those areas. As well as reinforcing a real-terms increase in resources for the police, it refers to the VAT issue, which sits within the justice portfolio. It also sets out the principle of access to education, the use that will be made of the pupil attainment fund and the commitment of around £0.75 billion to tackle the attainment gap in Scotland

The medium-term financial strategy represents an update of the budget. It is a forward look and it sets out the fiscal position as we see it at the moment. It includes a lot of policy content, but the committee can come back on any particular strand on which it would like more information.

Alexander Burnett: We have probably touched on this a bit already. Adam Tomkins mentioned the budget process review group. There were four elements to its recommendations, one of which was about the need for clear policies, as you have mentioned. The conclusion says that no new decisions or policy commitments are set out. You said that that was not the intention, but is the opportunity available to you to do that in the light of the new dramatic change in projections? If this is not the opportunity, when would you do that?

11:00

Derek Mackay: The Government can announce new policies any time that it likes, in accordance with parliamentary protocol. This is an opportune moment to reflect on the current SFC forecast, as it comes out at the same time as the medium-term financial strategy. If we had chosen to change policy, I could have done it at that point, as part of the statement and part of the document. I have chosen to re-emphasise the Government's priorities and I have made fiscal suggestions as to how we can enhance our economic position. I have referred to austerity, Brexit and caps on migration, I have covered the Government's fiscal plans and I have reflected on the fiscal forecasts, so I think that there is quite a lot in the strategy.

If I had one wish for what could come out of the document—I have many wishes, such as that the UK Government would change course on a whole host of things—it would be that something comes out of the helpful debate that is emerging on immigration, such as a consensus on immigration and how important population is for Scotland's future. We need those powers and access to those levers now. I am hearing a consensus across the Parliament on immigration—there might not have been a policy announcement, but we may have found a new consensus that we can take forward. There is an increasing body of evidence about how important immigration is to our economic prospects now and in the future, for all the reasons that the committee has exhaustively explored. There might not have been a new policy announcement, but it is an aspiration that I think is finding a great deal of consensus.

The big moment for new spending plans is the budget. As a minority Government, we have to work with other parties to secure the passing of the budget. Our First Minister's programme for government is a key point for policy intervention as well. However, I think that this medium-term financial strategy delivers what was asked of me by the budget process review group.

The Convener: Let us move on to income tax forecasts. When you first saw the Scottish Fiscal Commission's figures for income tax, that must have been an uncomfortable moment for you and the Government. As we heard earlier from the Scottish Fiscal Commission, the tax forecast for 2018-19 is £208 million lower than it was in December. In addition, the OBR projections in relation to the block grant adjustment are further challenges for you, with a potential shortfall of close to £400 million. I realise that we are in a new process with turbulence in its forecasting and that forecasts are just forecasts, but it would be helpful for the committee to understand what you think the impact of those forecasts will be on your budget.

Derek Mackay: There will be no immediate impact, as the committee will be aware, because the numbers in the forecasts are locked into the budget setting itself—it is worth reinforcing that point.

My second point is about methodology. The OBR and the SFC use different methodologies and have different approaches. I am the finance secretary in the middle who has to use the OBR's forecast, because it is the driver for the block grant adjustment, and the SFC's forecast for what can be drawn down from the Treasury. We all knew that the situation would be complex. There is complexity from the fiscal framework and complexity because of the forecasts. I get an end-of-process update from the chair of the SFC, Dame Susan Rice, and we have challenge meetings at which civil servants and our economists come to understand the SFC's thinking and how it arrived at those numbers.

On first seeing the numbers, I was as surprised as the committee that there is such a difference between the December forecasts and what we see now. The SFC has described the change as an evolution of its judgment, and it explained some of that to you this morning. The SFC's substantial report points out the risks of forecasting and how it is rare for any forecaster or economist to get anything absolutely right. However, we are reliant on SFC and OBR forecasts to lead to our numbers.

My first reassurance is that the Government always competently balances the books. As finance secretary, I assure you that I will balance the books and we will deliver sound, competent government despite the challenges that the economy faces. The UK and Scottish economies are subdued in the EU context, partly because of what we have discussed around participation, productivity and population.

It is curious that the analysis of the impact on wage earnings, which is a key issue, was not fully explained by the SFC. The SFC simultaneously says that its economic forecasts for GDP have not changed—in fact, they have gone up in some years—and attributes the 1.7 per cent downgrade in its income tax forecast to the wage earnings issue, which it has analysed. It is not necessarily the case that anything has changed in the economy, because, according to the SFC's five-year forward look, GDP is broadly the same. Some people have described the OBR as quite optimistic and the SFC as quite pessimistic, and the gap between the forecasts increases the volatility that we are dealing with.

Another reason for me to be cheerful is that they are not the final forecasts. Near the end of the year, just before the budget, we will get the SFC's and the OBR's latest forecasts, which will drive the block grant adjustment and UK Government decisions. The OBR already has to revisit its figures because outturn is different from what it forecasted. We already know that the OBR has got it wrong, so it is just a matter of time. We will have the best, up-to-date information closer to the time of the UK and Scottish budgets, and we will have more hard data, which will be better than having just forecasts, which is what we have now.

I hope that that provides reassurance about the forecasting and the methodology.

How does a finance secretary respond? We have levers at our disposal. The currently devolved taxes can be managed in-year or the year after, because of their nature. For income tax, there are the outturn figures, which are for two years, and the knock-on effect of those figures in the third year. Taking 2017-18 figures as an example, it will be 2020-21 before any required change takes effect. The forecasts give us time to prepare, if that is what we are preparing for. The levers that we have at our disposal are to try to stimulate the economy and support economic growth. If required, we can use the Scotland reserve—the budget exchange mechanism, as it used to be known, for the carry-over. There are also borrowing powers that may be used, if required, to address a forecast error that is known about at the point of outturn. In all that, the GDP forecasts represent a growth outlook, although it is subdued, so there is still real-terms economic growth.

I have a final point to make on income tax. Notwithstanding the fact that the forecasts for LBTT, in particular, and landfill tax have improved, when the SFC revisits its forecasts, it must see any downgrade figure in the context of income tax revenues still increasing year on year in Scotland. As a consequence of the tax decisions that the Government—and, ultimately, the Parliament—took in the budget, we are £2 billion better off even according to the latest forecasts. That is an important figure, because it is the sum that we would have been down by if we had not made those decisions in relation to income tax. My important point is that, year on year in Scotland, income tax is still going up and GDP is still increasing.

The SFC is revisiting its forecasts, which means that I need to prepare for a range of scenarios, including the current forecasts coming to pass. However, I have a great deal of evidence to suggest that they will change before the budget.

The Convener: Cabinet secretary, you have hinted—in fact, you did more than hint—at the HMRC figures that will be published in the summer. Paragraph 31 of the summary of the commission's report says that, because those figures are not yet available,

"there remains significant uncertainty over the measurement of the Scottish income tax base".

It seems that, come the middle of the summer, we will begin to have some certainty. I know that the Scottish Government has to rely on the forecasts that are made in December, but, for the first time, we will have hard numbers to put out against some aspects. I recognise that you have to rely on forecasts, but, if the numbers start to tell you that you have a problem at that stage, what will you do?

Derek Mackay: I cannot answer that question in isolation, because it relates to the OBR and we know that the OBR was too optimistic and that the actual outturn figures for the UK are different. We also know that the key determinant in our final figure is about to change anyway. Therefore, even if the SFC is right, at this stage we know that the OBR is wrong. The position is complex. Even if it comes to pass that the SFC's forecasts are correct, what I have to spend will still be determined by the OBR number for the block grant adjustment.

No matter what, the Government will continue to focus on growing our economy and making the right interventions to keep unemployment low. Something else that has been lost sight of in the debate over the past few days is the fact that the SFC also forecasts that unemployment will remain at a near-record low and that employment will remain at a record high level. There is an issue for us about having the capacity to grow our economy within those economic parameters. Returning to the example of immigration, the answer to the question of how we expand our capacity is that we bring more people into the labour market, expand childcare, have people with the appropriate skills, upskill the workforce, support business growth and internationalise. The Government is already making that range of economic interventions. However, the numbers will change.

The SFC's report touches a number of times on how population and productivity are important even in relation to its own forecasts. I was drawn to page 29 of the report, which says, on the limitations of forecasting:

"Forecasts cannot perfectly predict the future".

It goes on to say, at paragraph 1.6:

"Forecasting is an on-going process of intelligence gathering, learning from previous forecasts, reflection and refinement. Judgements will be made on the basis of the best evidence and intelligence available at the time of publication, but may change from one forecast to the next as the economy evolves and our understanding develops along with it."

The final point reflects on the OBR and on the OBR reflecting on itself. At the bottom of page 29, the report quotes the OBR as saying that

"'the likelihood that any given forecast will turn out to be accurate in all respects is essentially negligible'",

which is not very helpful in guiding us.

We will prepare for a range of scenarios. We see a clear need to continue to grow our economy, which is why we have a range of strategies and interventions so to do.

The Convener: We are in a new process and, as I said to the Scottish Fiscal Commission, there will be unintended consequences. In quoting those paragraphs from the report, you have said, in effect, that the forecasts on which the fiscal framework is built are never accurate. How the process operates and its complexity are becoming more and more visible. What risk analysis is the Government planning to undertake in that regard? The committee will undoubtedly come back to that.

Derek Mackay: The risk analysis is in the document, which gives the central scenario of the funding that we would have available and then gives the upper and lower ranges. That sets the parameters and shows where we think the risks are.

The Convener: I meant the risk in the process that we are dealing with.

Derek Mackay: There is to be an independent review of the process, which will lead to the UK and Scottish Governments revisiting it in 2021.

I return to the point about our needing more powers—as a nationalist minister, I would make that point—and the fact that even well-established forecasters with well-established institutions and methodologies have stated that they cannot get the forecast exactly right every time. The difference between us and the UK Government is that the UK Government has more levers. We have only some of the levers to handle any economic crisis and volatility. We need more flexibility in the event of a worst-case scenario. We need more levers in addition to the borrowing powers and having a reserve, because there are caps on how much I can draw down from that reserve.

11:15

I give the committee a clear assurance that we will set a balanced budget, but more fiscal flexibility would allow us to tackle the challenges in positive and constructive ways. That is why I leaned quite heavily on some of the choices that the UK Government can make right now—for example, in its approach to austerity, Brexit and the borrowing powers. There are other powers that we could have that would put us in a stronger position. We would act responsibly, and we would be able to tackle the risk.

You touch on a fair point, convener, about the potential volatility that stems from forecasters saying different things.

The Convener: It might have been a fair question, but you have not given me an answer. I wanted an answer on whether the Government intends to undertake any risk analysis of the process that we are involved in and, if so, when that is likely to happen. I know about the 2021 review. Are you going to start work on that early to ensure that we can sort out the outcomes?

Derek Mackay: Our current analysis has gone into the strategy that we are discussing, but it is right to ask whether we should develop our thinking on the approach that is taken in the budget and beyond. We can undertake further analysis and, if you wish, convener, we can present that analysis to the committee and, ultimately, the UK Government well in advance of 2021. The answer to your question is yes—we can do more of that work.

The Convener: Thank you.

Murdo Fraser: Cabinet secretary, it is absolutely fair that you talk about the fact that we are discussing a forecast that is subject to change and it may be that talking about a £400 million gap in the current year's budget is to be unduly pessimistic—

Derek Mackay: That would be unlike you, Mr Fraser.

Murdo Fraser: I was going to say that it may prove to be unduly optimistic—we simply do not know, although it will become clear nearer the time. We will not know the figures until June 2020, so it will be the budget for 2021-22 that will need to take account of that gap. I assume that you do not intend to leave a note for your successor saying, "Sorry, there's no money left." I assume that you are doing some contingency planning in the interim. However, there is nothing in the document that you published last week that suggested any contingency planning. In terms of your answer to the convener, can you flesh out the timescale that we are looking at in order to give us some understanding of how the gap will be filled? The implication of your document is that you are not planning any tax changes. Is that a fair understanding of that document, and if so, does that mean that there will need to be changes to spending patterns?

Derek Mackay: I will address the point about tax first. We have a settled structure for income tax and it is the right one. The changes that we have introduced, including the five bands, mean that our tax structure is supportive of the economy and supports lower-income earners by using the tax system in a more progressive way—we have struck the right balance.

The issue of scenario planning relates to the question of multiyear budgeting. If the UK Government commits to a spending review in 2019—I think that it has—and gives us enough certainty, at least we will have a clear line of sight of what the block grant should look like, which is important as it is still a substantial part of the Scottish budget. If the UK Government does a multiyear spending review and we can have that certainty, my intention is to emulate that and to try to have a multiyear spending review for Scotland.

There are a lot of dynamics in that, such as the fiscal framework and the issues that we have discussed around tax forecasts and other determinants. However, I would try to deliver a multiyear settlement because that would be good for planning; it would be good for everyone—although it would depend on the settlements.

I suppose that that takes us back to the scenario planning about which the convener asked. If I had that certainty in the spring of 2019, we would probably be able to set out more clearly the fiscal outlook over whatever period the UK Government chooses. However, that then takes us back to the complexity point. All paths lead back to London, Westminster and the Treasury, because whatever we do on tax and the resources that we have at our disposal are relative to what the UK Government does on tax, too. Whether we are talking about the block grant or our own tax decisions, because of the fiscal framework, all is relative to that aspect.

If the UK Government gives us certainty and we have clarity on its tax position, we will have deeper clarity on which to plan. Of course, there is some debate about departing from the current position on tax, even in the Conservative Party. I know what its manifesto position is, but I am hearing different positions, including from Ruth Davidson, on tax and how it relates to public expenditure.

If we are to set out our tax plans more clearly, it would be helpful to have the UK Government's tax plans, too, because of the nature of the fiscal framework. Within that context, I am trying to describe a range of determinants, including those key drivers coming from the UK Government, that lead us to a place where we can more accurately show you what the scenarios look like.

In relation to tax and spend, tax is a settled position. In relation to the structure on expenditure, I have set out the challenges, the determinants and the key policies within the document. This is the start of the process leading to the Scottish budget, and potentially a UK spending review, which has been announced for the spring of 2019.

I hope that that response is more helpful.

Murdo Fraser: What I take from that is that spending is more likely to change than taxation.

Derek Mackay: We have to spend within the envelope that we have set out in the scenarios. In the document, I have tried to define how we deliver our key commitments and what issues need to be addressed within that.

I am quite clear about the range of issues that need to be addressed: efficiency; the transformation of public services; digitalisation; and some of the expectation and demand issues for public services. For example, the NHS budget is predicted to increase, because there is a clear commitment to the NHS and there are clear demands on it. The document characterises the shape of the budget in that regard. The document sets out public expenditure, as well as the current position on tax.

Murdo Fraser: I have one more question, which relates to the issue of immigration, which you have mentioned a couple of times in response to questions from Ash Denham and the convener. In the past two decades, the UK has had relatively high levels of immigration, yet the proportion of immigrants coming to Scotland has been relatively low—it has certainly been lower than our overall population share. There are a lot of issues to reflect on in relation to why we have been relatively poor at attracting immigrants to Scotland within the current constitutional arrangements.

Andrew Wilson's growth commission proposes offering tax cuts to immigrants to attract them to come here. What is your view on that policy? Do you accept the premise that higher taxes deter people from coming to Scotland?

Derek Mackay: Nice try, Mr Fraser. Mr Fraser and the committee are well aware that, as well as being the finance secretary, I was a member of the growth commission and I am also the convener of the Scottish National Party. Therefore, I am in a curious position.

The growth commission report is a great piece of work. Maybe we will discuss it more fully at some point. It raises the issue of people, participation and productivity, and immigration is a key issue within that.

The point about the growth commission report is that we can do some things as a devolved Government, but we can deliver the package of measures only as an independent country, with all the resulting levers and tools and democratic fiscal opportunities. As part of that whole package, you can take the right set of approaches to be able to attract a range of people. As it stands, many people want to come to Scotland, but they cannot because of the UK regime, and it will get harder because of the proposed UK regime.

Population growth was predicted to happen in Scotland only because of positive inward migration—that is how important migration is to us. That is even without the tax incentives. The point that the growth commission report makes is that we could do more if we had all of those levers.

Incidentally, how we connect transaction taxes, such as LBTT, for example, with wealth tax or income tax is quite interesting. To have a proper package for attracting people, we would want to be able to align all of that, but we cannot. We just set the rates and the bands, not the definitions or criteria.

We cannot define what wealth is and, therefore, we do not directly control the agencies that carry out the administration. As a devolved Government, we cannot properly connect things and join the dots to make such a package work in the way that we could if we were an independent Government. However, I am not one just to hope that we will get more powers; we have to do what we can right now.

I agree that we should look further into how we can encourage more immigration to Scotland. The experience is very positive. The trajectory for population growth in Scotland was largely down to inward migration. People are coming here and they find that Scotland is a welcoming and attractive place to live, work and invest in, but we could get more people across a range of skills, whether in farms and agricultural opportunities—of which Mr Fraser will be well aware—financial services or whatever it happens to be.

There is a need for immigration of highly skilled people across a range of sectors. We could do even more if we were independent, but the current policy of the UK Government is economically catastrophic.

The Convener: I think that that will do. I understand the temptation, cabinet secretary, but that was quite a long answer.

James Kelly: Good morning, cabinet secretary. You said earlier that you were surprised when you received the forecast from the Fiscal Commission. In truth, you must have been absolutely raging.

Derek Mackay: He knows me so well.

James Kelly: When you published your draft budget in December, the tax policy changes that you announced were going to release an additional £164 million into the budget. In taking out £209 million—not from the actual budget, but from the forecast—these latest forecasts effectively blow a hole in your tax policy.

Derek Mackay: I am raging at those comments and that characterisation. This is my raging face.

James Kelly makes a good point, and asks a good question. I watched the evidence session earlier and saw that you quite rightly probed that issue, convener. I was as surprised as you were. How can the forecast change within five months without any major economic difference? The GDP and drivers were broadly the same, so I had the same questions as you and, without speaking out of turn, my civil servants had those same questions, as did economists.

I also had some of those questions when I saw the original figures last year, and I probed some of them then. I remember raising with the committee the fact that there was an almost inexplicable enhancement. I said, "If these are the numbers I have to go with, haud me back!", but I am a responsible and sensible finance secretary who will make sure that we use the resources prudently.

That said, on being challenged about the numbers in a constructive fashion, the SFC has described how it is about methodology, deeper understanding and all the rest of it. We will revisit the forecasts when we have more data, information and actual outturn and then we will get closer to real life. However, we are still reliant upon forecasts.

On the term "budget impact", there is, of course, no budget impact because the numbers are locked in. Arguably, our pay policy, economic interventions and what we have done around non-domestic rates, innovation, education and capital infrastructure all represent wise spending to help stimulate our economy. The SFC acknowledged that that would have a positive impact, even if we just take the impact of pay policy on wages.

In our forward look on the budget we will keep a close eye on the forecasts. The change is only 1 per cent. A key point to remember about my tax policy is that the take from taxes other than income tax is forecast to increase above previous forecasts. They have improved—we did not read about that, but those forecasts have been upgraded.

Another key point is that, every year, income tax is still generating more money in Scotland, so every year there are more tax receipts in Scotland; it is just that it is less than the forecast that the SFC gave us in December, for the reasons that it has given. The tax decisions that I encouraged Parliament to take have made us £2 billion better off as a consequence. I think that that has vindicated my tax policy.

11:30

James Kelly: Your answer to Murdo Fraser was interesting, in the sense that you were basically indicating a no-change position in relation to tax. The focus of the forecasts has been on this year's budget, but it is the trend that is really concerning. When it comes to income tax, the cumulative impact of the forecasts on the tax changes is that you will have £1.75 billion less by 2022-23. If you are signalling a no-change policy in relation to taxation, you are really signalling massive cuts to public spending and public services being put under real pressure.

Derek Mackay: That is not an accurate characterisation at all. In fact, that characterisation suggests that James Kelly might need to get a slightly deeper understanding of the forecasts. You say "less", but we have to ask, "Less than what?" Being less than a previous SFC forecast is quite different from being less than the budget, or there being less money. There is a world of difference between those interpretations.

The point that I made at the outset in relation to forecasts was that the OBR forecasts—which are a key determinant—are already wrong. That is just a matter of time, because the OBR's reporting timescale flows into its outturn. The SFC has changed its forecast, and that is a matter for it. The tax take from income tax in Scotland is still up. The key determinant for us is the outturn from income tax in the rest of the United Kingdom. That is what we need to understand, as well as the SFC forecast.

The block grant adjustment and the actual tax take are what will determine our budgets, but our budget forecasts are projected to increase overall. It is necessary to look at everything. We have characterised income tax only in relation to the SFC forecast. As far as the impacts that James Kelly has suggested that that might have are concerned, Parliament and Government have choices. We have to prioritise and to make choices, and there are different levers in terms of tax and other things that enable us to do that.

There is something that I want to correct in relation to tax, which follows on from Murdo Fraser's point. He asked me whether the tax position was broadly settled. I said that, when it comes to structure, it is. We have a five-band system that is broadly settled. The Government conducted the exercise through a consultation paper that set out four key principles—to protect the economy; to protect lower-income earners; to use the system in a more progressive fashion; and to invest in public services—and we have delivered on those. I propose to continue with those principles in relation to tax, as well as the Adam Smith principles of certainty, efficiency and proportionality. I want to give people a greater degree of certainty in these uncertain, turbulent times. That is why I said that the structure is broadly settled. That is as much as I will say on the matter.

The Convener: That was quite a lot. Please try to cut some of your answers down if you can, cabinet secretary.

Patrick Harvie: As you mentioned earlier, I said in the chamber last week that nobody expected the strategy document to include blow-by-blow, budget-line-by-budget-line projections. If people wanted that, they would, in effect, be asking for draft budgets for years in advance, and I do not think that anybody expected that.

However, I would like to ask about a couple of things that are not in the document that I would have expected to be there. The first of those concerns local government, which you know that I am interested in. The scenario graphs that start on page 61 include specific Scottish Government policy commitments on health, social security, the police, attainment and so on. A very large, light blue chunk of those graphs is left to represent other expenditure. Almost all of that other expenditure—the large bulk of it—must surely be expenditure on local government, given the scale of what is spent on local government.

On page 58, following on from the setting out of the Government's policy commitments, there is a section entitled "What this means for spending elsewhere", the first part of which is about local government. All that it says is that we spend some money on local government and that the amount that is being spent on it in 2018-19 includes the general revenue grant, NDR and specific revenue grants. It does not say what the context for those policy commitments and scenario plans means for local government. What does that mean for local government in relation to the five-year plan?

Derek Mackay: That is a fair question. I make the technical point that the scenario charts include expenditure on early learning and childcare, which is a function that is largely delivered by local government. That is a small point—I know that ELC represents a tiny part of the charts. I just make the point that there is other funding that does not necessarily—

Patrick Harvie: But the large bulk of that light blue chunk is expenditure on local government.

Derek Mackay: Yes, I take that point. I am just saying that it is not exclusive, as other elements of Government funding make their way through local government.

I said at the outset of the session that I was not launching new Government policy. If I had changed the position on local government funding, I suppose that that would have been a new policy initiative. The fiscal plans in the medium-term strategy represent the Government's manifesto and programme for government positions and reflect key announcements that have been made since our re-election in 2016. I accurately and fairly describe the composition of the Scottish budget if we protect those key commitments that the Government has set out, including the investment in the national health service, the police, education as it relates to attainment and the other commitments. We should not forget social security, which is an emerging new power.

With regard to local government, my track record—to which Mr Harvie has been a contributor in the budget negotiations and, ultimately, the parliamentary votes—has been to ensure that local government has had a better settlement than it was forecasting and preparing for, including in the current financial year, in which it received a real-terms uplift. It is true to say that I have not set out a fiscal path for local government but, to answer the question about what the strategy document means for local government—I know that the convener wants me to be more concise—my track record as finance secretary is that I have tried to give local government the best deal possible in the circumstances, and I will continue to do that.

I have set out clearly what the Government's key priorities are. If other parties have other key priorities, I ask them to negotiate with me through the course of the budget, which, ultimately, will be what Parliament approves, or not.

Patrick Harvie: I appreciate that you have said that the medium-term strategy is not a document for launching new policies; however, surely it should set out the implications of your existing policy for other areas. It is not a party manifesto; it is a Government financial strategy, and a major area of Scottish Government expenditure is the contribution to local government and to the local services that it provides. I simply suggest to you that the question of "What this means for spending elsewhere" remains entirely unanswered to anybody who has read the document.

Derek Mackay: I take that point on board, but the document sets out the Government's key priorities and shows what the shape and composition of the Scottish Government's budget will look like as a consequence of those priorities. That is what it tries to do. I make the technical point that that element of expenditure is simply expenditure that goes to local government by way of financial support; it does not touch on council tax, for example, which is a matter for local government. I take Mr Harvie's point, but there is, of course, more to local government finance than things such as the revenue support grant and NDR that come via the Scottish Government.

Patrick Harvie: I have a question on capital as well.

The Convener: James Kelly has a question on local government, after which we will come back to Patrick Harvie.

James Kelly: Thank you, convener. I will follow on from Patrick Harvie's comments. At the weekend, Professor John McLaren warned that the fact that local government was not one of your six priority areas would mean cuts for local government services. Do you agree with that analysis, or will you commit to real-terms increases in future budgets for local councils?

Derek Mackay: I have not seen that analysis, so it would be wrong for me to prejudge it and say whether it is right or wrong.

I have set out my position with regard to local government. I have done my best to give local government the best settlement possible in the circumstances. I have live and on-going discussions with local government on a range of matters, including housing investment, investment in early learning and childcare—on which we have reached a satisfactory conclusion—and health and social care integration, which is incredibly complex.

As I approach the budget, I will engage with the Convention of Scottish Local Authorities, as well as with other political parties. The local authorities also have options around their council tax function and they are lobbying hard on discretionary taxes. I have not set out a commitment to a specific real-terms increase, but I have negotiated on a case-by-case basis to reach a satisfactory conclusion.

A substantial case was made in relation to early learning and childcare, for which councils now believe that they have the resources to deliver the policy. That is fundamentally a local government function that is funded by the Scottish Government, and it is an example of how we operate together. I do not accept the characterisation that has been offered.

Patrick Harvie: This question relates to you saying that the medium-term strategy is not a document in which to set out new policy. On the capital side, there is an existing policy commitment that you made this year to increase the proportion of the capital budget that goes towards low-carbon infrastructure relative to the proportion of it that goes towards high-carbon infrastructure every year for the rest of the current session of Parliament. The closest reference that I can find to that is the statement that

"The following guiding principles are applied to infrastructure investment",

one of which is

"managing the transition to a more resource efficient, lower carbon economy".

In a financial strategy for the years ahead, I expected to see a bit more detail about how the Government will meet its existing policy commitment to increase the proportion of the capital budget that is given to low-carbon infrastructure. Has the Government done the detailed work on how that will be delivered? When will you be in a position to include that in the information that you publish about your financial plans?

Derek Mackay: For the avoidance of doubt, I affirm that the policy continues. It would have been helpful to have included the commitment in the document to avoid that question, so that is a wee learning point for me for future years. However, I do not think that the medium-term financial strategy is the appropriate place to publish the full infrastructure investment plan. That should be published elsewhere.

The principle continues, and the workings were developed in the course of preparing the 2018-19 budget. I can certainly revisit the trajectory for that, but it will be more appropriate and pertinent to do that for the next budget. I will evidence how that direction of travel is being delivered, as well as the infrastructure investment plan. If the policy needs to be reaffirmed in future equivalent documents, that is fair enough, but I do not think that documents such as the one that we are considering today are the place for the detail. However, it certainly should be published somewhere.

Patrick Harvie: I look forward to seeing more detail in due course.

The Convener: Does Ivan McKee have a question on VAT?

Ivan McKee: I want to touch on the forecast process, which is probably more pertinent, given where we are now. Earlier, we heard from the SFC about forecast accuracy, and we explored in some detail the make-up of the forecast and why it is unreasonable or unexpected for it to be out by the amount by which it is. In fact, the absolute error in the SFC forecast is less than that in the OBR forecast over that period. I would like to get your view on that, given that that seems to be the way in which forecasts play out in the real world. The OBR and the UK Government are able to deal with that. What do they have that enables them to do so, which you do not have?

Derek Mackay: A key point in revisiting forecasts is whether, given that the position changed within five months, the position will change again before the Scottish budget, if there is more information. The SFC has described to me how it arrives at the numbers. It carries out a bottom-up analysis of the Scottish economy. The OBR describes its process as taking a UK-wide approach and then saying what it thinks Scotland's share is. The two bodies use different methodologies, which is a challenge in itself. We have to derive our numbers from the difference in those figures.

11:45

Having more data will help us all and will lead to firmer forecasts, which will mean that the economists will all be a bit more satisfied and comfortable and, in turn, so will we. We did not have outturn data before the Scottish rate of income tax came in. When we have more real figures and can see what is actually being raised in income tax in Scotland, that will put us in a much stronger position. However, that said, the closer we get to the budget, the firmer the forecasts will be, and then both the SFC and the OBR will look again at their numbers. Will it not all come out in the wash where we are dependent on those outturn figures?

Ivan McKee: We have talked about income tax at length this morning. I want to move on to talk about VAT, which is coming down the track. When we look at the process for VAT, it seems to be even less grounded in reality than that for income tax, because we do not even have outturn data to look at. It is a case of using forecasts versus estimates and whatever else. What are your reflections on how that process might pan out? What problems might it cause us, given what we are learning about the income tax process?

Derek Mackay: I am sure that economists and accountants across the land must be saying, in relation to Scotland, that independence must be easier than this, given the complexity of the fiscal framework and how we use forecasts to derive numbers, which we then revisit.

However, having gently made that point, as I said to the committee the last time I was here, I think that VAT needs more work. We will have more data than we had before, because of the size of the sample, but we want to make sure that the methodology, the starting point and the benchmarks are absolutely right. When we are at the point of agreeing methodology, we will do so through the joint exchequer committee, so the UK Government Treasury and I should sign it off. However, I want to be totally satisfied—as the committee would also want to be—that we are making the right decisions in that regard. Of course, the process is only assignation; there is no tax lever there. Surely we all want to make sure that that will be in Scotland's interests.

As I see it, we are no further forward on the issue since I gave evidence to the committee a few weeks ago on the implementation of the Scotland acts. However, I want to make sure that we are absolutely robust on the matter before we trigger the analysis and implementation. I said that I would return to the committee when I had more information on the issue. As things stand, I do not.

Ivan McKee: Thank you.

The Convener: Can I push you a wee bit further on that, cabinet secretary? We have had experience of the fiscal framework and the complexity around income tax but—I am being careful in how I phrase this—will you pull the plug on the assignation of VAT if you think that it will not work and will not benefit the financial settlement of Scotland? As Ivan McKee has described, the possibility that this area might rely on forecasts and not outturn is of real concern.

Derek Mackay: That would be very bold, convener. Clearly, we want tax powers. I do not see this one as being a tax power, though; it is just assignation.

The question that I would put back to the committee is—

The Convener: That is not a committee view, by the way—it is Bruce Crawford asking you the question, as I have not shared my view with anybody else.

Derek Mackay: Equally, I would try to get the transfer into a shape that suits Scotland. I simply ask committee members what they would do if they were in my position and felt that the methodology was not right. We might get their methodology, but if it were not robust enough to reflect accurately what VAT has been accrued in Scotland—and, even more importantly, if it is only assignation and Scotland takes an unnecessary financial hit just because of a point in time—what would any reasonable finance secretary for the nation of Scotland do? Discuss.

I have not come to a conclusion, convener, but I will return to you on that.

The Convener: I think that you can be sure that the committee will be all over this issue.

Derek Mackay: I appreciate that. My principle will be to try to achieve a successful transfer, as agreed, but I want to be reassured that it is the right thing to do.

The Convener: You will have to reassure us as well as yourself, which might be an even harder task.

Neil Bibby: I want to ask about air departure tax, which is mentioned briefly in the medium-term financial strategy. Last week, in your letter to the committee, you announced your intention to defer introduction of ADT beyond April 2019. When do you expect to introduce air departure tax? Are you still committed to your policy of cutting air departure tax by 50 per cent and then abolishing it altogether?

Derek Mackay: Yes. It is still the Scottish Government's position to reduce air departure tax by 50 per cent and to abolish it when resources allow. I have written to the committee and answered a parliamentary question on the issue of deferral.

I expect air departure tax to be switched on in Scotland when we have a resolution to the Highlands and Islands exemption issue, which the committee is well sighted on. I will not switch on the tax in Scotland with defective devolution and before the issue is resolved. I will not impose the tax for the first time in the Highlands and Islands and I want a like-for-like exemption. I am working constructively with the UK Government to find a resolution, and I continue to engage with airports, airlines and other stakeholders in relation to aviation policy in Scotland. The tax can be switched on only when we have a resolution to that issue.

Neil Bibby: You have confirmed that you are still committed to cutting ADT by 50 per cent, and then abolishing it altogether, but you will have to cost that policy. It does not appear that the cut in ADT has been costed as part of the spending commitments in the medium-term financial strategy. What is the latest cost for the policy?

Derek Mackay: The last time we looked at it, the overall potential tax take was about £320 million so, if you reduce that by 50 per cent, you will have the broad figure. We will cost it at the point at which it is about to be implemented and I will give you those figures at the time.

In principle, we are not switching on air departure tax in Scotland and, therefore, the UK Government has just written to me to confirm that it will not switch off air passenger duty—the equivalent UK tax—so there is no negative impact to the block grant adjustment. I would not want the UK Government to remove it from our finances through the block grant adjustment and for us not to have the option. We will use the figures from the appropriate period, which will be as close to the time of the decision as possible.

Neil Bibby: Obviously, £320 million is a huge figure and, with the growth in passenger numbers, the tax take could be even higher. Do you accept that, given the budgetary position that you are in, with more cuts to local and other services on the way and a potential reduction in the funds that are available to Government, to keep pursuing tax cuts for frequent flyers is the wrong priority?

Derek Mackay: The key priorities of the Scottish Government, which are set out in the five-year financial strategy document, are to invest in the national health service, education, housing and digital skills, to grow the economy and to support businesses. I am sure that Neil Bibby welcomes the key commitments that are published here.

We have published clear evidence—I was asked to produce it in relation to the economic and environmental benefits—that air departure tax would grow the economy, retain and grow more routes into Scotland, help to retain jobs and support airports such as Glasgow airport, in which I am sure Neil Bibby has an interest. Some airports are doing better than others—they say that air departure tax would make Scotland more attractive as a destination and enhance their economic position. In turn, it would suit the economy because it would raise extra revenue.

The Government still supports the policy, but I am not switching the tax on until the Highlands and Islands issue is resolved and devolution is delivered as it was intended to be.

The Convener: You mentioned digital; Willie Coffey has questions on that.

Willie Coffey: I have a couple of quick questions. Page 60 of the document talks about European funding and states that the value of those programmes to Scotland is about £5 billion in the current funding round. When do you have to start to reflect in your financial planning the impact of any reduction in the UK Government's commitment to that level of funding when we leave the European Union?

Derek Mackay: Different cabinet secretaries are already doing that work. The figure is correct—we have been the beneficiary of EU funding to the tune of roughly £5 billion over the period. We do not know from the Brexit negotiations what the figure will be in the future, because the UK Government does not know and it is arguing on our behalf. What guarantees has the UK Government given to Scotland in that regard? It has given none or very few. All that we have at the moment are some time-limited commitments to some farmers.

We need longer-term certainty about EU funding. We have been a beneficiary—the funding has helped in so many different areas, including with infrastructure and agricultural policy. Greater certainty from the UK Government would allow us to plan better and make clear the resources that I and other ministers have available for our portfolios. For example, farm payments are worth half a billion pounds, but farmers have no certainty beyond a certain timescale about what funding they might get. We need to address the problem at source—that is, the UK Government, because it is not giving us clarity.

Ministers can try to prepare their portfolios, but we do not know what the settlement from the UK Government will be. I consider that—and the committee should support us on this—as a minimum, we should continue to get the full benefit of the resources that we got from being part of the European Union. We deserve better than a slogan on the side of a bus. The NHS will not be getting the promised £350 million a week. If the UK Government insists on tearing us out of the European Union and getting the worst deal possible, we should get the streams of funding from which we benefited.

Ministers will have to plan their portfolios. Brexit inevitably means fewer resources for structural programmes, skills and, potentially, farm payments, if the UK Government does not give us the certainty that we need. We cannot go further without knowing the successor arrangements, which are in the hands of the UK Government.

Willie Coffey: I want to ask about digital, which is an area that you have mentioned a few times. We know that the UK Government plans to leave the digital single market, which is estimated to be worth €400 billion a year across Europe. You could make a reasonable estimate that it is worth €4 billion a year to the Scottish economy. When will you have to begin to factor in the impact of that loss? Leaving the digital single market must be one of the most monumentally stupid things that a Government could do.

Derek Mackay: The UK Government's position is the height of economic recklessness. It is no wonder that UK Cabinet members are at war with one another, never mind with European Union negotiators. Whether it is aviation agreements, digital, a customs union or the single market, the effect on the economy will be profound and we are trying to get the UK Government into a better place.

The UK Government is upscaling the civil service. The health service is not getting £350 million a week extra, but the civil service is expanding, so that there are enough people to do all the bureaucratic work that needs to be done. Clearly, the Scottish Government will have to respond to the legislation that affects us, and digital is just one area in a whole plethora of agreements, treaties and regulations that will need to be addressed. Notwithstanding all that uncertainty, the Scottish Government is getting on with the £600 million reaching 100 per cent—R100—programme to improve our digital infrastructure. We have a separate, but aligned, strategy on skills, compliance and interconnectivity.

The Convener: I thank the panel for being here. We need to get on with the rest of our business, so I ask that those who are not involved in the next agenda item leave the table as we continue.

Subordinate Legislation

Scottish Fiscal Commission (Modification of Functions) Regulations 2018 [Draft]

11:58

The Convener: The Cabinet Secretary for Finance and the Constitution and Aidan Grisewood have remained for item 3. Before we consider whether to agree to the motion on the regulations, do you want to make an opening statement, cabinet secretary?

Derek Mackay: If the committee is informed of what we seek approval for, I do not need to make a statement.

The Convener: The appropriate paperwork has been put in front of us and we have had the chance to read it. As no member has a question to put to the cabinet secretary, we move to item 4, which is consideration of motion S5M-12320.

Motion moved,

That the Finance and Constitution Committee recommends that the Scottish Fiscal Commission (Modification of Functions) Regulations 2018 [draft] be approved.—[*Derek Mackay*]

Motion agreed to.

The Convener: In the coming days, we will publish a short report to Parliament setting out our decision on the instrument. I thank the cabinet secretary and his official for attending this morning.

12:00

Meeting continued in private until 12:05.

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