OFFICIAL REPORT
AITHISG OIFIGEIL

Finance and Constitution Committee

Wednesday 27 January 2021

The Scottish Parliament
Pàrlamaid na h-Alba

Session 5

Wednesday 27 January 2021

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FINANCE AND CONSTITUTION COMMITTEE
3rd Meeting 2021, Session 5

CONVENER

*Bruce Crawford (Stirling) (SNP)

DEPUTY CONVENER

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

COMMITTEE MEMBERS

*Dr Alasdair Allan (Na h-Eileanan an Iar) (SNP)
*Tom Arthur (Renfrewshire South) (SNP)
*Jackie Baillie (Dumbarton) (Lab)
*Alexander Burnett (Aberdeenshire West) (Con)
*Patrick Harvie (Glasgow) (Green)
*Dean Lockhart (Mid Scotland and Fife) (Con)
*Fulton MacGregor (Coatbridge and Chryston) (SNP)
*John Mason (Glasgow Shettleston) (SNP)
Anas Sarwar (Glasgow) (Lab)

*attended

THE FOLLOWING ALSO PARTICIPATED:

Richard Hughes (Office for Budget Responsibility)
Andy King (Office for Budget Responsibility)

CLERK TO THE COMMITTEE

Jim Johnston

LOCATION

Virtual Meeting

Scottish Parliament

Finance and Constitution Committee

Wednesday 27 January 2021

[The Convener opened the meeting at 09:00]

United Kingdom Economic and Fiscal Outlook

The Convener (Bruce Crawford): Good morning, and welcome to the third meeting in 2021 of the Finance and Constitution Committee. We have received apologies from Anas Sarwar.

Today, we will take evidence from the Office for Budget Responsibility on its United Kingdom economic and fiscal outlook. I am pleased to say that we are joined by Richard Hughes, the chair of the OBR and the budget responsibility committee, and Andy King, a fiscal expert with the OBR. I warmly welcome our witnesses to the meeting and invite Richard Hughes to make a brief opening statement.

Richard Hughes (Office for Budget Responsibility): It is a pleasure to be before the committee. My predecessor, Robert Chote, was a regular witness, and I look forward to continuing the close engagement that we have had north of the border with your committee, the Scottish Fiscal Commission and the Scottish Government. One day, once we have had all our jabs, I hope to do so in person rather than virtually.

The EFO that we published on 25 November was my first forecast as the new chair of the OBR. Perhaps I can start by giving the committee a sense of how events have unfolded relative to that forecast. I stress that what I say now is without prejudice to the official Scottish forecast that the SFC will produce tomorrow, alongside the Scottish Government's budget. I am sure that we will get into the issues around relative timing and timetables, which I know complicate this committee's work and the work of the Governments on both sides of the border.

I will begin with how things have developed since our forecast in November. At that time, there was—as there continues to be—an extraordinary degree of uncertainty about the economic and fiscal outlook. That uncertainty originates from two sources. One is the path of the pandemic, which has conditioned all our thinking since it started, back in February, and the other, to a diminishing but still significant extent, is uncertainty about our trading relationship with the European Union.

To reflect that degree of uncertainty, our November EFO included three potential scenarios—an upside scenario, a central forecast and a downside scenario—for the economy and public finances. Those depended on the course of the virus, the effectiveness of public health interventions in containing its spread and the pace of the roll-out and the effectiveness of the vaccines. When we were putting our forecast together, in late November, the vaccines had yet to be approved and we were still awaiting the results of clinical trials.

We also presented alternative scenarios for the outcome of the Brexit negotiations, which was also unknown at the time. As it turned out, of course, we got a deal on Christmas Eve. That avoided a downside risk to our forecast, which had assumed that we would find and conclude a deal with the EU before the transition period ended, on 31 December. I will update the committee first on the pandemic and then briefly on Brexit.

Concerning the path of the virus, the news since 25 November has been largely negative for our economic prospects. The emergence of a more infectious and virulent strain has required the reimposition of a nationwide lockdown to keep the R number below 1. That is, basically, what we assumed in our downside scenario, which saw a further contraction of economic activity in the first quarter of 2021 rather than the resumption of a recovery that had gathered pace during the rest of the year.

One bit of positive news that we have had in the near term is the fact that the economy shrank by only 2.5 per cent in November. That compared favourably with a much bigger fall that had been assumed for November because of the second lockdown, and it suggests that consumers and businesses are becoming better adapted than we thought to lockdown conditions and to operating under those conditions.

That bit of positive news in the near term helps to outweigh the largely negative news that we are back in a nationwide lockdown for the moment—at least until the review point on 15 February. It means that economic activity was only about 8.5 per cent below pre-pandemic levels during the second lockdown, in November, which compares favourably with the fall in output of about 20 per cent that was seen during the first lockdown. That gives a sense of how much the economy is now able to adapt to lockdown conditions. There were some differences between the first and second lockdowns. Schools were open during the second lockdown but were not open back in April. There seem to be strong suggestions that we are becoming economically used to living under lockdown conditions.

As we look ahead to the rest of 2021, vaccine roll-out is proceeding apace. That is good news compared with what we forecast. It gives some hope that public health restrictions could be gradually eased to allow economic activity to return, in the medium term, to something closer to our central scenario. However, with a new and more infectious strain of the virus in circulation, the number of people who must be inoculated before general public health restrictions can be lifted will also be higher.

In our central scenario, we assume that that point will be reached some time in the second half of 2021, once a sufficient number of people have been inoculated to allow a lifting of general public health restrictions. We will have to revisit that assumption in the light of our discussions with the Government's public health experts as we update our forecasts ahead of the UK budget on 3 March.

Regarding Brexit, our November forecast assumed that the Government would reach a trade agreement with the EU before the end of the transition period, on 31 December. A deal was concluded on Christmas Eve, which helped to avoid the further 2 per cent fall in output that our forecasts had said was associated with a no-deal Brexit. That downside risk was avoided. We will look at the details of the agreement and will update our estimates of its economic impact in our updated budget forecast.

There appears to be more short-term disruption at the border than we had anticipated in our central forecast. Truck volumes at the narrow straits are down by about 30 per cent, and there is evidence of additional costs and frictions—even beyond what some had anticipated—that are associated with trading with the EU. We do not yet know how much of that is temporary and how much will be a permanent feature of our trading arrangements with the EU. We also do not know how much of it is Covid-related and is about health checks at borders rather than linked to Brexit.

Since the EU referendum, our forecasts have factored in a long-run loss of output of about 4 per cent, which would have been associated with leaving the EU with a deal. We will reassess that 4 per cent estimate of the output loss that goes with the change from being a member of an EU state to leaving the EU with a free trade agreement. So far, independent experts, including the governor of the Bank of England, have commented that they think that that estimate is broadly correct. We will look at the detail of the agreement, but we must also assess that in the light of what we have seen at the border in the past month.

The deal largely covers trade in goods; it remains to be seen what arrangements and agreements are reached regarding trade in services and the future alignment of standards in the trading of services across the border. Those matters are still to be discussed.

We will produce a fully updated economic and fiscal forecast alongside the UK Government's budget on 3 March. I hope that I have given you a sense of where things stand at the moment.

The Convener: Thank you. I am sure that some of us will seek a little more clarity after that helpful opening statement.

As you say, there are significant differences between the OBR's central forecast and its upside and downside scenarios. Those differences apply both to the economy and to public finances. What are the main factors that will affect the path that we are on? How could Government policy and any fiscal stance that is taken in the budget play into that?

Richard Hughes: The most important issues are the pace of vaccine roll-out and how effective the vaccine is in reducing transmission, infections and fatalities. We are gathering evidence on that all the time. The roll-out and the effectiveness of the vaccine will dictate how quickly public health restrictions can be removed. Those are the main drivers of the economic activity behind the forecast.

You asked what Government policy can do to mitigate the impact of lockdowns or of any public concern about engaging in economic activity while the virus is around. Support for viable businesses, such as the furlough scheme and Government-guaranteed loans, has kept the economy on life support while economic activity has been restricted. The Government has extended that support periodically as lockdown and other public health restrictions have had to remain in place. It has, no doubt, avoided what would otherwise have been deeper economic scarring in the labour market and on the business side.

All those measures make a difference in avoiding long-term unemployment and business failures that need not happen to businesses that are fundamentally viable. As we approach the budget, we will have to wait to see the extent to which those schemes are extended even further and what impact that will have. It stands to reason that, the longer the pandemic lasts—and, therefore, the longer restrictions remain in place and economic activity is suppressed—the greater is the chance that there will be longer-term impacts such as structural unemployment in the labour market, more business failures and fewer businesses resuming operations as soon as the lockdown ends.

The Convener: That is a very useful description of where we are.

I want to have a quick discussion about the interplay between the OBR and the SFC, particularly at this time. The SFC's forecasts for Scottish income tax will be published tomorrow. Those forecasts will significantly inform the size of the Scottish Government's budget for 2021-22, along with the OBR's income tax forecasts from November, which inform the adjustment to the block grant. Those forecasts will have been published a couple of months apart. Should we have any worries about them, given the levels of uncertainty and volatility that inevitably exist in the world that we inhabit today?

Richard Hughes: The OBR and the SFC have always produced our forecasts at different times, although it is a bit unusual for the SFC to go first and the OBR to go second. To be frank, that is probably not an ideal sequence, but we are not in ideal circumstances. As we documented in our economic forecast, there were 14 different fiscal events south of the border. Since then, there have been one or two more major fiscal policy announcements outside the context of a fiscal event. That is the necessary artefact of the very difficult circumstances that we are in across the country and, indeed, around the world.

In normal times, it would not be ideal for a subnational Government to produce its fiscal forecasts before it got an updated view of what the national picture looked like, because a lot of the inputs that the SFC uses come from the OBR's forecasts. The SFC will have the privilege of being able to take advantage of the latest economic data as well as the latest information about the course of the virus and the Government's public health restrictions. As I mentioned, in the near term, that information has been, on balance, negative.

The SFC will update its forecasts tomorrow, and the OBR will take that into account when we publish our updated forecasts in March. I do not think that it is ideal, in relation to how we conduct business, to have such stuttered steps in producing forecasts, but I hope that that is just an artefact of the difficult times that we are in.

The Convener: It is challenging.

It is not entirely clear where we will be at the beginning of March, when the next round of OBR forecasts will be published. You have said that we are out of sync. Given the uncertainly and volatility, there will be concern about the level of risk to the Scottish budget of having the SFC and OBR forecasts at different times. What discussions have been held between the SFC and the OBR about such matters, to ensure that the risk is mitigated to the greatest degree possible?

Richard Hughes: We have worked quite closely with the SFC in producing our forecasts. At the beginning of my tenure, Susan Rice and colleagues in the SFC were some of the first people to whom I spoke about how we would manage the relationship and co-operation.

In the beginning, we were concerned about two risks—which, so far, have largely not materialised—from the point of view of keeping our forecasts consistent. The first related to the different sectoral composition of the economies north and south of the border, which meant that the economic impact of the virus in Scotland would be different from that in the rest of the UK. However, as we said in our devolved taxes forecast document, although there are differences in the sectoral composition of our economies, they are almost entirely offsetting. In coronavirus terms, there are as many relatively benighted sectors as there are blessed sectors north and south of the border. Down south, a few more people work in sectors that were hit harder, but there are other sectors north of the border that were hit less hard. In that sense, as it turned out, the balance between sectors that were hard hit by the pandemic and those that could survive the pandemic relatively untouched just about evened out across the border.

09:15

The other thing that concerned us was the possibility that there might be relatively tighter restrictions in Scotland, England or Wales, meaning that we would have to take account of different levels of restrictions in different parts of the economy. However, as it has turned out, over the course of the pandemic, things have evened out. There were tighter restrictions in Scotland for part of 2020, but we had tighter restrictions in England for other parts of 2020, and, in the end, the net impact on economic activity, as the committee has shown in its report in preparing for the 2021 budget, is that Scottish and UK gross domestic products have moved closely together over the course of the pandemic. There have been a few differences, but those have oscillated within a narrow range of 1 to 2 per cent difference in any given month.

We await the SFC's verdict on whether it sees a Scotland-specific shock on the basis of the data that it is looking at. However, so far, much of the UK has moved more or less in lockstep over the course of the pandemic.

The Convener: Thank you.

Murdo Fraser (Mid Scotland and Fife) (Con): Good morning, Mr Hughes. My questions follow on from the last point that the convener asked about. Of key interest to this committee are the differences between the impact of the Covid-19 pandemic in Scotland and its impact in other parts of the UK, because the fiscal framework, which determines the size of the Scottish Government's budget, is based on the performance of devolved tax revenues—principally non-savings, non-dividend income tax—relative to what is happening south of the border. In that respect, how income tax performs in Scotland is important in so far as it relates to what is happening elsewhere.

Given that, can you tell us anything from your findings about how you think the Scottish economy—and, by derivation, tax revenues—is likely to perform differently from what is happening elsewhere?

Richard Hughes: So far, we have not seen big divergences in overall gross value added or non-savings, non-dividend income on either side of the border. As ever, our view is subject to the data that we can collect in real time. We await what the SFC says, and we will look at those matters in more detail tomorrow.

In making our forecasts, we look at the differential impact of the coronavirus shock on different sectors of the economy, because, without understanding that, we cannot see the overall big-picture impact on GDP. It is clearly the case that economies that are more dependent on hospitality, accommodation, tourism and face-to-face interactions are more vulnerable to the economic shocks that are associated with the coronavirus, whereas economies that rely more on services that can be delivered at a distance, including financial and professional services, are relatively insulated.

When we looked at the sectoral composition of Scotland versus that of the rest of the UK, we found that some sectors made the rest of the UK look favourable relative to Scotland. In England, more people work in professional services and information and communications technology, which means that they are more insulated against the coronavirus shock. At the same time, in Scotland, more people work in the health service and in public services, and that countervailing factor has meant that Scotland is more insulated from the coronavirus shock because most of those people are still working and being paid, which means that they are paying income tax. Once we looked at that on balance and tried to draw a regression line through what we would expect in terms of the net overall impact on Scottish GDP versus UK GDP, we found a completely flat line.

That was reproduced in our devolved tax forecast. There were offsetting changes in the sectoral composition of the Scottish economy and the rest of the UK economy that meant that, on balance, we would not expect the tax take in Scotland to be dramatically different from that in England purely on the basis of the impact that coronavirus might have had on our respective economies.

Murdo Fraser: Thank you. I am afraid that I had a connection issue, so I lost some of that answer, but I think that I heard most of it.

I have one follow-up question. Your answer was helpful and comprehensive. However, in your report, you refer to the fact that, at various points, lockdown restrictions were tighter in Scotland, Wales and Northern Ireland than they were in England. Is that likely to have any impact at all on the economic situation and on tax revenues, or will it make no difference?

Richard Hughes: We do not think that it will make a major difference, for two reasons. First, over the course of the year, different parts of the country have been locked down to different extents. For example, Wales had a much stricter lockdown in the autumn, but it then lifted its restrictions quite dramatically. We think that, on balance, over the year, the relative stringency of lockdown restrictions in different parts of the country has more or less evened out.

A second consideration, which is equally—if not more—important, is how adaptable our economies have proved to be to lockdown conditions. As I mentioned, the fall in output that we saw in the first lockdown was nearly a quarter of the total output activity in one month. During the second lockdown, we saw a tiny fraction of that fall, as output was down by only about 8 per cent.

The impact of lockdown in our economy is diminishing over time as we adapt more to operating under these circumstances, although there are obviously limits to that. For example, if you are in the restaurant or theatre business, it is very hard to provide services to clients online at the volumes and intensity that you would have done if the restrictions were not in place. Nevertheless, it looks as though, in all parts of the country, we are adapting to living in these conditions.

Andy King (Office for Budget Responsibility): I want to add one point, convener. The most timely information that we have about tax receipts is not actually from the economy but from tax receipts themselves, which we can see virtually in real time. They are telling the same story that Richard Hughes has told. We see that in the pay-as-you-earn system, in which there are no obvious regional or national differences in the amount of tax that is coming in. It is a similar story with the furlough scheme: the differences are small relative to the large movements overall.

The Convener: Thank you. That was a helpful supplementary point on the process.

Patrick Harvie (Glasgow) (Green): Good morning to our witnesses. As my committee colleagues know, I like asking questions about tax, but I want to go beyond income tax and the look back at tax information to see what is happening in the economy and think about tax policy going forward. In that respect, my questions are on two levels. The first is about what may be likely to happen with reserved taxes, and the Scottish Government's ability—or inability—to do anything with its devolved powers. The second is about what the implications would be if there were to be unanticipated changes in reserved UK tax policy, given that—as I think we all acknowledge—we have a fairly fragile fiscal framework that is not as robust a piece of work as it should have been.

Most of the ideas that I hear being talked about, which might be under consideration, relate to reserved matters. There are short-term measures such as a windfall tax on companies that have done very well as a result of the pandemic or a correction to self-employment support, which has benefited some people, whose income has actually gone up, while leaving others excluded. I understand that a correction to that support could also raise significant revenue in the short term. There are also longer-term ideas such as recouping at least some of the past decade's reduction in the corporation tax rate. Those are all reserved measures, and they could have short-term or long-term roles to play, either in dealing with immediate issues or in future consolidation.

Will the witnesses tell us what their perspectives are on the tax policies that will be necessary—even if they are perhaps not desirable to some—either to respond to the immediate challenge, or in fiscal consolidation, or for reinvestment in vital public services that are currently stretched to breaking point?

Richard Hughes: I should probably preface anything I say by pointing out that, as the Government's official economic forecaster, it is explicitly outside our remit to give the Government advice on fiscal policy—be that tax policy or spending policy—and we are prohibited from doing so.

What I can say—this speaks to your point in macroeconomic terms—is that, in our central forecast for the end of the medium-term forecast period in five years' time, when we hope that the effects of the pandemic will have largely abated and worked their way through the economy and public finances, the Government will still be left with a significant deficit of about 4 per cent of GDP. That is well north of any definition of fiscal sustainability or balancing the books that either the chancellor has expressed or economists have in their own minds.

There was about £40 billion-worth of deficit reduction that needed to be found at the end of the forecast period in our EFO before the Government took policy measures on the spending side to try to reduce the deficit. The Government cut around £10 billion of spending in the last spending review, which reduced the level of spending. That £10 billion reduction in the £40 billion gap still leaves about £30 billion that would need to be found in fiscal consolidation of some sort to deal with the structural hole left in the public finances. That is relative to the most generous definition that one might have of fiscal balance by the end of the forecast, which would be to balance current revenues against current spending but allow some amount of borrowing for investment. Roughly speaking, that is also the amount of deficit reduction that is needed in order to stabilise the debt to GDP ratio, which has featured in previous Government fiscal frameworks and is one definition of debt sustainability. Based on our forecasts and some conventional definitions of sustainability and balance, some fiscal consolidation is needed over the medium term. How the Government decides to do that—whether it does it on the tax side or the spending side, and what measures it uses—is a matter for it. It would not be for us to comment on that.

Patrick Harvie: I entirely appreciate that it is not your place to recommend one policy or another, but surely part of your role is to discuss or consider the implications of one choice or another. There seems to be some discussion at the UK level and internationally about the corporation tax option and whether there would be agreement among Organisation for Economic Co-operation and Development countries on establishing a minimum floor for corporation tax so that, for example, the big transnationals can start paying their share instead of jumping from one tax jurisdiction to another and managing to get out of it.

Is there a prospect that corporation tax could play a significant role in the short term, or is that entirely a longer-term consideration? Is the OBR in a position to consider what the implications are for the Scottish fiscal framework? We have already seen that the framework is not well designed for unexpected events. That may be inevitable but, if decisions about what the balance should be between tax policy and spending policy continue to be made at the UK level, where does that leave Scotland's ability to make any decisions at all or even to satisfy what now look like fairly petty considerations, such as whether Scotland should raise a comparable amount of money to what it spends?

Richard Hughes: I will say two things on that point. First, the fiscal gap that is left at the end of our forecast as a consequence of the coronavirus shock is around 1 per cent of GDP. That would be a very big hole to try to fill just with corporation tax if that is what the Government were to try to do. If the Government wanted to fill that by tax alone, it might want to visit some of the larger tax heads. Corporation tax not only raises much less revenue than income tax, national insurance and VAT, for example; it is much more sensitive to international investor decisions and decisions about where corporations locate. Therefore, if rates change, it is much more subject to avoidance and evasion than other taxes. Capital is naturally more fleet of foot than—

09:30

Patrick Harvie: That is the case in the absence of international co-operation but, if there is the prospect of more international co-operation, that effect could perhaps be balanced.

Richard Hughes: That is true, but that still leaves the challenge that it just does not raise as much tax as VAT, national insurance or income tax, and there is a decent hole to fill by the end of the forecast period, if what is wanted is either to balance the current budget or to stabilise debt. Doing that may require something more comprehensive.

So far, the Government has revealed a preference to continue cutting spending rather than to raise taxes as a way of improving the medium-term fiscal position. Since the start of the pandemic, the Government's only real consolidation measure has been a £10 billion cut to non-Covid spending. It has not said where it will find that, beyond saying that part of it came out of the overseas development assistance budget and part of it came from a reduction in grants to local authorities. We do not know where the rest of it will come from. However, for the purposes of our forecast, that provides £10 billion-worth of deficit reduction every year to the end of the forecast period. Like the committee, we wait to see what the Government's actual policy package looks like in the next budget as well as in future budgets.

Dr Alasdair Allan (Na h-Eileanan an Iar) (SNP): I want to turn to the other big factor that is, as you have acknowledged, affecting the economies of the UK and of Scotland: the impact of Brexit and particularly the Brexit deal. Most of the material that the committee and most other people are dealing with in order to analyse that was written pre-deal. I want to press you for views on how what is in the deal is likely to affect the Scottish economy. Obviously, there has been a great deal of focus on certain sectors that are affected by the deal, some of which—the fishing sector, for example—are important to many people in Scotland. More broadly, can you say anything about the impact of the deal on the Scottish economy and on our economic situation going forward?

Richard Hughes: As I mentioned, our forecast has assumed that, since the referendum, the UK has concluded with the EU a trading agreement that is broadly in line with the average sort of free trade agreement that advanced countries have concluded with such institutions. Based on what we have seen so far—I should say that we are still going through the details—things look broadly in line with what we have assumed in our forecast, which is a long-term loss of output of around 4 per cent relative to what would happen if we were an EU member state.

That is related to the fact that there is now grist to the mill. There are costs at the border from trading with the EU, not from tariffs but from paperwork, delays and compliance with things such as phytosanitary regulations. All those things act as deterrents to trade in the near term `and the medium term, and they have consequences for things such as investment and productivity.

In our forecasts, we did not assume—although other forecasters did—some near-term disruption to economic activity associated with getting from our previous arrangement to the new agreement. We had assumed that, given that both the UK and the EU would negotiate the deal, there would be forbearance on both sides about its implementation. At the moment, it appears that a lot of the checks are being applied relatively stringently, especially on the European side of the border. In addition, the degree of business preparedness for the new trading arrangements has been less than we might have anticipated.

It appears that, on the European side, fewer companies than might have done have registered with Her Majesty's Revenue and Customs for VAT, which means that they add VAT to the price of goods when those arrive in the UK. That has been reflected in some news stories. It also appears that businesses are not applying the rules of origin but are, instead, just applying customs tariffs for goods that might have originated outside the EU. Those factors have added to the cost of goods as they arrive in the UK.

Finally, as we can see in the daily lorry volumes, trading volumes across the border have reduced by about 20 or 30 per cent over the past month or so. We are not yet sure how much of that is temporary for the next few months while businesses on the UK and EU sides become more familiar with the arrangements and overcome the one-off costs of adjusting their systems and getting to know how to fill out the forms. We will look at that as part of our forecast. We need to look in more detail at how much of that will prove to be permanent.

One thing to stress is that there is still quite a bit of uncertainty about other aspects of our trade with the EU. Goods account for about half of our trade with the EU; services account for the other half. A memorandum of understanding on trade in services between the UK and the EU is under negotiation, and we do not know where that will end up. There is a deadline of the end of March to come to some kind of agreement. That will continue to be a source of uncertainty in our outlook for trade in services.

Dr Allan: You mentioned some of the differences between Scotland and the rest of the UK. They are not huge, but there are differences in the emphasis on the impact of Covid. Are there any differences in the Scottish and UK economies that might account for a different response to or impact from the situation that you have described around the Brexit deal?

Richard Hughes: There might be some differences but, if so, they are not enormous. The biggest differences between the sectoral composition in Scotland and that in the UK are in the areas of information technology, professional services and healthcare, most of which are largely unaffected by the trade deal or cross-border frictions. Those are largely either non-tradable services provided to our own population or services that are outwith the deal. There are some small differences in the proportions of agricultural output and fishing but, with regard to overall GVA and what really matters for Scottish gross domestic product and the tax take, those are not large. However, we will await the more detailed assessment of the Scottish Fiscal Commission, which comes out tomorrow.

Looking through a Brexit lens at Scotland's sectoral vulnerability versus that of the rest of the UK, those differences do not seem to be material. However, the sectors that are affected by Brexit are different from those that are affected by coronavirus. Coronavirus affects non-tradable services that are provided to our own population; Brexit affects tradable goods, traded across the border to other countries' populations. Their impacts are additive but, based on what we have seen about Scotland's and the UK's relative share of those vulnerable sectors, it does not appear that there will be much of a material difference in their impacts on either side of the border.

Dr Allan: In part, my question is prompted by the fact that I represent a constituency in which fishing is a major industry and in which people regularly tell me about the 50-page form that they now have to complete. That does not take away from the truth of what you have said.

Concern has been expressed in many quarters that the impact in the medium term and the longer term of Brexit, the Brexit deal and the fallout of that might be as big as the impact of Covid. Do you have a take on that, as it applies to the UK or Scotland?

Richard Hughes: Based on our own forecast and what we have factored into our projections, the impact of leaving the EU and going from being a member state to trading on the terms that it appears that we will be trading on under the deal will be a long-term reduction in output of around 4 per cent. Our central forecast is that the impact of coronavirus on our economy in the long run—the long-run scarring effect—will be about 3 per cent. Whether you conclude that those impacts are roughly in the same ballpark or that one is bigger than the other is a matter of perspective. They are both significant, long-run shocks to the UK economy, with long-term consequences.

There is a lot of uncertainty about both estimates. For coronavirus, we have provided a range of scenarios. In one scenario, there is a highly effective vaccine that allows the economy to quickly get back to normal this year, and we would perhaps not see any scarring at all. If there are vaccines that are less effective, particularly in reducing transmission across the population and reducing hospitalisation and mortality, we could see the need to have social distancing rules in place over a period of years, which would have a much more serious effect on labour markets and businesses, with much more scarring than we have in our forecast.

Dr Allan: Mr Harvie asked about the decisions that the UK Government might feel that it needs to make in the future in order to cope with some of the longer-term consequences that you have just described. I appreciate that it is not for you to make those decisions, but do you have a view on the timing of any such decisions that the UK Government might feel that it has to make? The options are cutting public spending, which many of us would question the wisdom of doing in the middle of a situation of this kind, or putting up taxes. Understandably, you do not want to take a view on which of those should happen, but can you say any more about the likelihood, timing or urgency of any such decisions that have to be made?

Richard Hughes: The decisions, including their timing, are all for the Government, but I can say two things. First, at least until now, the Government has continued to loosen fiscal policy, or at least it has spent more money from one fiscal event to the next, because it is dealing with the pandemic and an on-going economic shock. Up until the November forecast—we have seen further instances since then—the Government was still in rescue mode, as opposed to thinking about what it needed to do to consolidate the public finances. The important exception is the £10 billion-worth of non-Covid spending that it has taken out of its medium-term spending plans. A small down payment on the longer-term consolidation was made, albeit rather quietly, at the time of the spending review. On top of that, the Government continues to extend the coronavirus job retention scheme and further support to businesses during lockdown. For the moment, the Government is in countercyclical fiscal policy mode rather than thinking seriously about consolidation. When the Government comes to do that is a matter for it.

At the moment, Government borrowing costs are extraordinarily low, which alleviates pressure on Governments around the world to do anything about their fiscal positions. There is essentially no pressure from markets on Governments to do anything about their deficits or debt levels, and the signal that markets are giving Governments is that they are happy to lend them the money that they need for the support that they are providing to employers and businesses to get us through the pandemic. There are no signs of near-term pressures on Governments from financial markets to do something about their fiscal positions. Traditionally, such factors have put pressure on Governments to act quickly—sometimes more quickly than they would have chosen to—either economically or politically, to address the kind of deficits that we have seen in the wake of the pandemic.

Dean Lockhart (Mid Scotland and Fife) (Con): My question follows up on what we have just heard about financing the UK Government debt. In recent years, the Bank of England has played an increasingly important role in financing the UK Government's spending, especially the exceptional levels of spending on the Covid response. Can the witnesses briefly explain the Bank of England's role in helping to finance the United Kingdom Government's response to Covid and say whether that gives the UK Government greater flexibility in relation to when it might have to consider fiscal measures to address the deficit?

09:45

Richard Hughes: You are right that quantitative easing by the Bank of England and central banks around the world has provided some indirect support to Governments in raising the finance that they need to fund the very large spending programmes that they have had to introduce in the wake of the pandemic and in the face of falling revenues.

It is important to stress that that has been indirect and through the secondary debt markets, rather than direct. It is not the sort of monetary financing or money printing that we have seen in countries such as Venezuela or Zimbabwe, where the Government just goes to the central bank and asks it to lend cash directly. The intervention in the UK is happening through the gilt markets. The Government is issuing large amounts of debt in order to finance its current very large deficit. The Bank of England is then intervening in the secondary market and buying up some of that from the primary purchasers.

The net effect of that has been threefold. One effect is that it has helped to ensure the continued smooth functioning of the gilt market, which is important to everyone, including the Government. It is a national asset and keeping it liquid and having the Bank of England as a backstop to ensure functionality is very valuable to the UK economy, as it would be to the economy in any other country.

A second effect is due to the fact that the Bank of England finances its purchase of Government debt by creating its own liabilities in the form of central bank reserves, which have a much lower interest rate than the debt that the bank is buying up. The bank is buying up long-term Government debt of a 10, 15 or 30-year maturity, with a higher interest rate, and financing that by issuing its own liabilities of central bank reserves, which have a much lower interest rate and a maturity that is much shorter—it is effectively overnight.

The net effect on public finances is twofold: it reduces the Government's overall debt servicing costs, because higher-interest longer-term debt is replaced by lower-interest short-term debt and goes from being a liability of the Treasury to a liability of the Bank of England; and it dramatically shortens the overall net maturity of the public sector's debt, because the higher-rate longer-maturity Treasury debt is replaced with lower-rate shorter-maturity Bank of England debt.

That leaves the public sector more exposed over time to changes in interest rates. If the bank rate has to go up to fight inflation or to normalise interest rates back to more historical levels, that will suddenly and more dramatically hit the Government's borrowing costs. The Bank of England's liability is that interest rates can change overnight, unlike with Government gilts, which have a maturity of 10 or 15 years, so it takes time for the outstanding liabilities to be extinguished and replaced by new ones.

In summary, it is much cheaper for the Government to borrow now, thanks to the help of the Bank of England, but it means that the Government is much more vulnerable to any decision that the bank might have to make to raise interest rates in future, because that would immediately raise its interest payments, which are increasingly held in the form of central bank reserves.

Dean Lockhart: That interesting and insightful response stresses the important role that the Bank of England is playing in all this. I will turn to another issue in a moment, but first I have a further brief question on the budget deficit. Can you comment on the expected level of the UK budget deficit in the current year or do you have to keep that in reserve for later?

Richard Hughes: That is one of the big bits of news coming out of our 3 March forecast, so I think that we will have to keep it back until then. I should say that we are only in the early stages of our forecast process, so it would be too soon to provide even an early comment.

Dean Lockhart: I understand.

You touched on the different sectoral components of the economy in Scotland and the fact that the public sector is a larger percentage of the economy in Scotland than it is in other parts of the UK. By and large, public sector employees have not been furloughed at 80 per cent of salary but have continued to be paid at normal salary levels. Will that dynamic have a positive relative impact on Scottish income tax receipts when compared to those of the rest of the UK, where the private sector is larger and therefore, proportionally, a higher number of people have been furloughed at 80 per cent?

Richard Hughes: I will bring in Andy King on that, because he has been looking at the real-time information in more detail than I have.

Andy King: That comes back to the discussion that Richard Hughes had with your colleagues about the fact that, although the public sector is cushioning the blow in Scotland, sectors such as IT and professional services are cushioning the blow in other parts of the UK. Those things really net off; we are seeing that in the sectoral GDP data and in the real-time information from the PAYE system. At the whole-economy level, whether in Scotland or the rest of the UK, those things are netting off.

One interesting thing that surprised me over the course of the year was that the proportion of employers who furloughed at 80 per cent—as opposed to those who furloughed at 100 per cent and paid the top-up themselves—was lower than I expected; more employers continued with full pay and reclaimed just what the Government was offering.

Dean Lockhart: I have a final brief follow-up question. Richard Hughes said earlier that we might be looking at a five-year period before the economy fully recovers from Covid. Is that baked into the official numbers that the OBR is working on, or is that just your personal reflection of how long the economy will take to recover?

Richard Hughes: That was more in relation to the horizon that we look at in doing our forecasts.

One benchmark that we use in trying to think about where the economy gets to a different point is to think about when the level of economic activity gets back to where it was pre-pandemic. As I mentioned, in November, we set out three different scenarios for the course of the pandemic and public health restrictions. In our most optimistic scenario, the economy is back to its pre-pandemic level by the end of 2021.

In our central forecast, which underpins and will be a comparison for the SFC's forecast, the economy has not recovered its pre-pandemic level of activity until the end of 2022. That assumes a roll-out of the vaccine that reaches about half the population by the middle of this year. Perhaps the Government is a bit ahead or behind with that timetable; a lot depends on the interaction between the rates of inoculation and how much we need, given the more infectious strain of the virus. On our central forecast, the crossover point of pre-pandemic levels of activity is reached at the end of 2022.

In our downside scenario, where the vaccines are ineffective in reducing infection and fatalities—either because they prove less effective in the field than they did in clinical trials or because there are mutations and variants that are vaccine resistant—we do not reach the crossover point until the end of 2024.

Therefore, it depends on how effective the vaccine is in allowing economic activity to normalise. However, based on our central forecast and on what we knew on 25 November, we will have that crossover point at the end of 2022.

Dean Lockhart: Thank you for those answers.

John Mason (Glasgow Shettleston) (SNP): Richard Hughes has talked about balancing the public finances and about the fact that the Government is not in that mode at the moment. Does that impact on the recovery? If the Government tried to balance the finances sooner rather than later, would growth be reduced, or is it not as simple as that?

Richard Hughes: In some ways, it is as simple as that. We apply a fiscal multiplier to fiscal policy, which takes account of the impact of fiscal policy on the economy. Obviously, the dramatic loosening of fiscal policy since March has supported economic activity and meant that, as bad as the recession that we have faced over the course of the past year has been, it would have been a lot of worse had fiscal policy not provided support to consumption and business activity. Therefore, in that sense, fiscal policy really does matter for growth and the economic outlook.

Were the Government to decide to focus on deficit reduction and to raise taxes and cut spending in the near term, that would have consequences for economic activity through the multiplier effect on incomes, consumption and investment. However, how the Government does that matters. We do not apply a single multiplier to all tax and spending; the composition of spending matters. If the Government were to cut investment, that would have a much bigger multiplier effect than that of cuts to Government spending or benefits. Therefore, the composition of the adjustment matters to its economic effects as much as the timing does. However, all fiscal decisions have economic consequences because, ultimately, they take money out of the pockets of people who would otherwise have it as income and there to spend.

John Mason: That was my second point. Taking money out of people's pockets has an impact, but there can also be an impact from savings. There have been some reports that people are saving more, which is presumably because of uncertainty. They are also, I presume, spending less, which means that money is not feeding through the economy. Is that significant, and does it have a big impact?

Richard Hughes: The level of savings has been significant. We have seen higher savings rates in this country than we have for decades, and probably since savings rates began being recorded. Savings rates went up very high—into double digits—during lockdown. People were either still working full time or were being supported by the furlough scheme and were not able to consume, so they built up large bank balances.

Some of that unwound at the end of the first lockdown, when people who had delayed social consumption, such as going out to restaurants, started doing that, or people who had delayed purchases of consumer durables went out and purchased those things. Some of the pent-up savings fed into a surge in demand and a faster recovery of the economy after the first lockdown than we initially anticipated. Some of that was because of people using up the savings that they had built up. We might well see something similar—a savings-fuelled mini consumption boom—as restrictions are eased during the course of the year.

However, three things need to be counted against that. One is the fact that those savings are largely being built up by wealthier households that have been able to work more or less full time during lockdown. Those people have a lower marginal propensity to consume—they tend to save more, anyway—so they will be less inclined to spend the savings balances that they have built up.

The second thing to bear in mind is that everybody is scarred by this experience and that people might want to hold on to a higher level of precautionary savings in the longer term. That is because, suddenly, more people have experienced periods of worklessness, there is uncertainty about the future course of the pandemic and we do not know what further shocks might come down the road. People might want to hang on to a higher level of savings in future than they have in the past.

The third thing is that an economic recovery that is fuelled by people running down savings is not fundamentally sustainable. It can boost the economy for a few years but, once savings are run down to the level that people want to have for precautionary purposes, it runs out of fuel.

Traditionally, for a sustained recovery, we look for recoveries in investment, because that supports the long-term productive potential of the economy. Since the middle of the last decade, we have not seen a significant recovery or strengthening in business investment growth. It was initially hit by the EU referendum and again by the pandemic. For a sustained recovery, we do not want a surge in consumption coming off of the back of temporary savings; instead, we want a recovery in business and household investments.

John Mason: That was a helpful answer.

The final area that I want to ask about is—

The Convener: John, can you hold on for a second? Andy King wants to make a comment.

Andy King: There are two things that I thought I might add. One is in response to John Mason's first question, which was about withdrawal of very large fiscal support.

In the three scenarios that we presented in our November report, it could be seen that the timing of the withdrawal of the furlough scheme—which is the biggest scheme—was commensurate with our assumptions about the public health restrictions on the economy in the upside scenario. However, in the central scenario, the scheme switched off before we assumed that public health restrictions would switch off, which led to a spike in unemployment. In the downside scenario, those things were very much out of kilter and unemployment spiked to a very high level. You can see in the way that we tried to do the calculations that lining those things up is important for the economic outcomes.

10:00

My other point is on savings. House prices are rising very quickly across the country, which I suspect is more down to people finding a—quote unquote—home for their excess savings than it is being driven by the temporary tax holidays.

John Mason: That is helpful.

In the report in November, you made the point that UK output had fallen, saying it was

"its sharpest contraction on record and one of the largest among advanced economies."

Has that changed in the past couple of months, compared to Germany, France and other such countries?

Richard Hughes: We will have to see. The UK experienced quite a sharp contraction in economic activity. Given that we are back in nationwide lockdown and that we are experiencing some of the highest case numbers of the virus around the world, and given that there is a relationship between cases, lockdowns and economic activity, I suspect that we will continue to suffer some of the bigger economic consequences of the pandemic compared with the rest of the world.

We will have to see what happens, including in light of international comparative GDP numbers. On the basis of the numbers that we saw in November, we appeared to have faced a bigger economic hit than other countries. That was partly because we locked down later than other countries, which meant that we had to lock down for longer to get case numbers down to levels that allowed the reopening that happened over the summer. We have now had a much bigger second wave than we have seen so far in other European countries, although obviously we are all looking at the numbers with the same degree of trepidation. That suggests that we face much tougher economic consequences of the pandemic than other countries.

There are some measurement issues with GDP, which have received coverage in the financial press and attention from Parliament in Westminster in the form of an inquiry. We measure GDP a bit differently from some European countries. In our measurement of GDP, we pick up the facts that we closed schools and that there has been some diversion of activity in the health service, because we measure the output of the education sector and the health sector in activity terms rather than spending terms.

In the UK, if teachers are getting paid but they are not teaching, the fact that they are not teaching is reflected in a lower GDP. In other countries, if they close schools but pay teachers, GDP is not affected, because they count education GDP as spending out the door—salaries paid—not as lessons delivered. That makes a bit of a difference in international comparisons between us and Europe, but it does not really explain the big gap between our economic performance in 2020 and that of many other countries on the continent.

Tom Arthur (Renfrewshire South) (SNP): Will Richard Hughes comment on the OBR forecasts and how borrowing has developed over the past couple of months in light of developments with the new strain of the virus and the second lockdown?

Richard Hughes: Andy King might want to comment on that as someone who looks closely at the fiscal numbers.

Andy King: The key point, which Richard Hughes made at the start of the session, is that, given the impact of the virus and the health restrictions, the situation that we are in right now looks a lot more like our downside scenario than our central scenario. However, the data point on public finances since our previous forecast is more positive—or less negative, depending on how you think about it—than we had assumed that it would be, which continued a pattern and is consistent with the fact that the November GDP did not fall as sharply as we thought that it would. Therefore, the starting point might be a touch less negative than expected in economic and fiscal terms. However, that is only one month of data in the middle of dramatic swings during a pandemic, and one would be unwise to place too much weight on anything.

Richard Hughes: The other thing to bear in mind is that most of the increase in borrowing over the past year was discretionary fiscal loosening. The Government spent more in order to deal with the consequences of the pandemic; whereas, in previous economic shocks that we have faced, borrowing has resulted from their being a smaller economy and shrinking tax receipts.

One of the risks relating to the borrowing outlook is that, if things turn out worse on the economy side, the Government will end up spending a lot more to cushion the economy by extending the furlough scheme, business loans and tax reliefs. The Government has been making such decisions month to month.

Our forecasts for spending in 2021-22 are based on the Government's current policies, but they do not build in any anticipated reaction to what is going on at the moment, such as lockdown lasting longer, restrictions potentially being in place for longer and the additional support that might be needed to support the economy in the light of that.

Tom Arthur: I will continue on that theme. Earlier, you highlighted that the signal from the market suggests that it is content with current levels of borrowing, and that there is no signal that that will change in the near to medium term. Paragraph 1.39 of the executive summary of the OBR's economic and fiscal outlook refers to

"increased ... vulnerability of the public finances to future ... shocks"—

I will just complete the sentence in order to provide clarity and for the benefit of the *Official Report*—

"in particular to a sharp increase in short-term interest rates."

Is that just a contingency? Earlier, you suggested that, in an extreme downside scenario, social distancing rules could be in place over a period of years. Clearly, we hope that that will not be the case. However, if such an eventuality were to unfold, is there general confidence that the levels of debt and borrowing could be sustained in order to maintain the existing measures that are in place, or would we reach a point at which something had to give?

Richard Hughes: I will say two things on that. First, this is a global shock—or, at least, it is a shock that is affecting most advanced economies not equally but certainly severely. Given that it is a co-ordinated shock, so long as the same things are happening to all advanced economies, and the UK's economic and fiscal prospects are not dramatically different from those of other advanced economies, financial markets that are looking to invest in advanced economy debt will not view the UK as different from any other country. In that sense, we are seeing a global reaction to the pandemic and a global flight to safety.

Were the UK's experience of the pandemic to become different from that of other economies, we might have to worry about interest rates rising or UK-specific financial market effects, and about whether investors would look at UK gilts as an investment relative to US Treasury bonds or Japanese Government bonds and liked the outlook for the UK economy relative to that for other countries. At the moment, there is a co-ordinated global shock, so everybody is more or less in the same boat, but that is not to say that we might not end up having different experiences of the pandemic from here on in.

Secondly, our vulnerability to interest rate changes is an artefact of the interaction between quantitative easing and the Government's borrowing programme. In essence, QE refinances the Government's debt from long term to short term; it buys up long-term debt and replaces it with short-term debt. Whatever happens to interest rates, we are more exposed to interest rate changes in any given year.

I will give the committee a sense of the magnitude of that. Before the financial crisis, taking into account Bank of England liabilities and outstanding Treasury liabilities in public hands, about a quarter of our debt had a maturity of less than one year. Since the financial crisis, and since the pandemic, when QE has picked up in earnest, the share of our debt with a maturity of less than one year is now around half of our debt. That means that you would get about half the impact on the public finances within the space of twelve months of any change in interest rates.

At the moment, interest rates are extraordinarily low and have been falling. We have seen a huge and rapid benefit from that, because we have been refinancing our debt at shorter and shorter terms of maturity. If things start to go in the other direction—if interest rates start to rise—we will start to feel the opposite consequence, in that interest rate changes will feed through much more quickly to our debt interest costs, because more and more of our debt has a maturity of less than one year so is that much more sensitive to the prevailing market interest rate.

Tom Arthur: I have a final question. Were a differential to emerge between countries in the efficacy of their public health responses to Covid, how long would that take to feed through to market decisions?

Richard Hughes: I would hate to hazard a guess about how markets look at countries' differential pandemic performance. That lies somewhere between financial market experts, economists and public health experts, I am afraid, and I am none of those.

Tom Arthur: I just wondered whether that would feed into the OBR's considerations as we progress through the year. If a differential emerges, for example, because the UK is outperforming the rest of the world as a result of having in place strict restrictions around international travel, or the converse applies and we see significant suppression of the virus in the eurozone, the United States emerges later than the EU, or we have a different scenario within the UK, what lag, if any, would you anticipate between that becoming concrete and evident and its affecting market behaviour? However, if you feel that that is not an appropriate question to answer—

Richard Hughes: It is one on which I would be loth to hazard a guess.

Tom Arthur: I appreciate that. Thank you very much. I have no further questions.

Fulton MacGregor (Coatbridge and Chryston) (SNP): My question picks up on an earlier response to Murdo Fraser. We have received data that suggests that the total earnings of employees who are subject to PAYE in Scotland fell by 1.4 per cent between April and

October 2020 relative to the same period in 2019. Has there been any change in that figure since October because of the further restrictions that have been put in place? What might be the implications for Scotland's income tax revenue?

Richard Hughes: Do you want to have a go at that one, Andy?

Andy King: I do not have more up-to-date data in my possession than you have. The data that we used from the real-time information system in November 2020, as we have discussed previously, showed very similar performance in Scotland to that of the UK as a whole. Indeed, when we were doing the same job for the Welsh Government, it showed similar performance in those areas. We come back to the point that it seems that the shock has been equally painful to the respective economies and tax bases. That is the basis on which we have been producing our forecasts.

The latest UK-wide data on average earnings growth from the PAYE system show that there has been a drop in the number of employees who are on payrolls but quite a sharp increase in the average pay of those who remain on payrolls. That is partly to do with all the support that has been thrown into the economy and partly to do with the shock hitting hardest at the bottom of earnings distribution. The lost jobs, or the lack of job creation, has been among those with below-average wages. That pushes up the average wage of everyone who is left. That can also be seen in the Office for National Statistics measures. I think that it said that, roughly speaking, pay growth is running at 4 per cent but it would be running at 2 per cent without that change in composition.

As to what that means for Scottish income tax revenue, particularly relative to the rest of the economy, we are still of the view—we will need to look again for March—that the shock is, to all intents and purposes, symmetric.

10:15

Fulton MacGregor: Earlier, there was a comment about Scotland's workforce having more people in the health service and public services generally, which is well known. Is there any inherent advantage in that? I do not necessarily mean in comparison with other UK countries, but for Scotland? As we try to bounce back from Covid, are there any positives to be taken from the fact that a lot of people work in the public sector, particularly the health service, given that we are in the middle of a health crisis and responding to it?

Richard Hughes: There probably is a need for reflection on how much countries around the world have invested in their public health systems and in spare capacity in health services. Going into the pandemic, we had among the lowest numbers of hospital beds, intensive care unit places and diagnostic equipment per capita of any health service in the OECD. A lot of the extra spending by the Government since the pandemic started has been to expand that capacity rapidly.

The fiscal legacy of this crisis will require a set of decisions around what standing level of capacity is needed in the health service to deal with surges in demand from pandemics or other sources and the longer-term legacy of the healthcare needs of people who recover from the virus. A big question for our forecasts and for the Government when it makes its fiscal policy decisions is how close to the limit of capacity a health service should run at in normal times in order to be able to anticipate the surges in demand that it faces at times like this.

The Convener: I am conscious that we are getting close to half past 10, and Andy King needs to leave before then. Does either Jackie Baillie or Alexander Burnett still have questions at this stage, or are they content?

Jackie Baillie (Dumbarton) (Lab): I will run all my questions together, if that helps. I have just a couple and they require only brief answers.

I do not envy you your jobs. The uncertainty in forecasting at the moment is a real challenge. Thank you for sharing your knowledge with us. You talked about the adaptability of the economy and I am keen to understand more about that because I think that we will face restrictions for many months to come. You talked about a drop in GDP of 25 per cent in the first lockdown and 8 per cent in the second. Are the numbers similar in Scotland? There is concern about a differential impact here.

Also, you seemed to suggest that borrowing is currently very affordable and that that will smooth the recovery from Covid. What I did not hear, which is obviously more difficult for you to tell me, is over what timescale you think that the honeymoon period for borrowing is likely to last.

Finally, UK spending envelopes obviously have a consequence for our Barnett formula. I do not know what the UK Government is doing. Is it providing additional funding across all public services or is it likely to target some, such as the national health service? That would potentially have a knock-on effect for other public services, which could mean cuts.

Richard Hughes: I will take the questions on adaptability and borrowing costs and ask that Andy King comes in on the third question about the composition of spending and what that means for Barnett consequentials.

On adaptability, we have seen a process of increasing adaptation during the pandemic, which started in construction and manufacturing. From the very beginning, some sectors continued almost as normal, including professional services. Economic forecasters such as us did not find it all that hard to continue to work online, and we have all got used to Zoom, BlueJeans and other ways of interacting. People working in the services sector who do not provide face-to-face services to clients have found it relatively easy to adapt to working during the pandemic. Manufacturing needed to do some adaptation of its workplaces to make them Covid secure, but we saw a pretty strong recovery in manufacturing output during the pandemic, even during lockdowns, and it was a similar situation in the construction sector.

The sectors that are continuing to struggle are hospitality, accommodation, entertainment and transport, which will also be affected by any restrictions that might be introduced on travel. In those sectors, we have not seen the level of activity recover much, relative to where it was in April 2020 as we went into lockdown.

There are limits to the adaptability of the economy. If we look at the adaptability in sectors, the big question is whether, over time, we will start to see adjustment across sectors. Will capital and labour start to move from sectors of the economy that cannot operate at 100 per cent capacity into those sectors that can operate above 100 per cent capacity during lockdowns? Such structural adjustment issues start to come into the frame if it looks as though social distancing or public health restrictions need to be in place over the longer term. What Governments can do to facilitate that adjustment, and how many employees get lost along the way and end up inactive or Covid unemployed, are big questions for policy as well as for the forecast.

On the question of how long the honeymoon will last, low interest rates for Governments are partly a phenomenon of the pandemic, but they have been low for decades. Equilibrium interest rates for Government borrowing have been falling since the 1970s, which is an artefact of a range of factors, including the fact that we basically whipped inflation, such that inflation expectations are permanently low. People believe that independent central banks and inflation targeting are effective in keeping inflation under control, which reduces inflation risk and keeps borrowing costs low.

It is also an artefact of the fact that there is a large supply of global savings from both the demographic bulge of people who are still contributing to pensions in advanced economies and not yet drawing them down in retirement, and a large and growing volume of savings in Asian countries, which are those of people who are saving to buy property and for their own retirement. In that sense, there is a large supply of savings that is looking for safe, diverse investments not only where the savers are, but in assets around the world. That factor could also continue to support favourable borrowing conditions for Governments for some time to come, but it is a temporary phenomenon. Those people will retire and want to enjoy retirement, so they will draw down their savings. Therefore, at some point, all those beneficial forces might go the other way.

It is too soon to say that the honeymoon will be over any time soon. Some of the factors that have reduced interest rates are permanent, so long as monetary policy credibility remains, but some other factors are temporary. For the moment, there is a large supply of savings around the world, but that might not always be the case in the decades to come.

Andy King: In terms of the composition of spending on the Covid response, unsurprisingly, spending is concentrated in health services. Based on the Treasury’s numbers, just over £50 billion of the £114 billion that it described as Covid departmental spending has gone on health. The other big numbers are in transport, but a lot is being held in reserve to deal with issues are they arise. With regard to next year’s numbers, about half is for health, and about half is in reserve and therefore unallocated. Those allocations will presumably be made over time.

On the pressures beyond that, as Richard Hughes said, there are a lot of interesting questions about the spare capacity that we want to hold in different services. There is an open and difficult question about how railways are funded and operated, and social care is an issue that has been on the Government’s to-do list for many years. There are still a lot of open questions.

I take this opportunity to apologise for having to run. It is fun doing this job in a pandemic, but not with two small children at home and two full-time jobs. I will miss the final question—apologies.

The Convener: No problem. Many people have childcare responsibilities in these circumstances, so thank you for your contribution—it is valuable.

Alexander Burnett (Aberdeenshire West) (Con): I completely understand why Andy King has to drop out. My question was probably more directed to him, but I am sure that Richard Hughes will be able to answer it—and another question after that.

You mentioned the composition of components of people not being able to consume, which Andy King countered by saying that house prices were rising—I should note my entry in the register of members' interest around construction at this point—and you also have the real-time information on tax receipts. If you had to pick one of the composition of components that we should focus on to encourage your forecasts, which one would that be?

Richard Hughes: Do you mean which one has the biggest bang for your buck in terms of fiscal policy?

Alexander Burnett: Yes.

Richard Hughes: When you look at the multipliers that we use for Government spending—where you get the most bang for your buck in output terms from Government intervention in the economy—by far the biggest multiplier that you get is from public investment. That is partly because that gets spent on non-tradable goods in the economy rather than leaking outside, and it is partly because it gets spent directly. If you give money to households, they save part of it and spend part of it; they do not spend it immediately, although they may end up spending it over the longer term. In that sense, you get the biggest multiplier effects from public investment.

The perennial challenge for Governments is that, although they get the biggest bang for their buck from public investment, that also takes the longest to organise and get going, especially if it is being spent on infrastructure schemes, because there is a large amount of planning, procurement processes, land purchases and so on. There is a trade-off between the bang that you get for the money that you spend and the speed at which it can have that effect on the economy.

Alexander Burnett: We are seeing healthy activity such as people buying houses and house prices rising, and the private sector—dare I say it?—is doing its share of lifting the economy by making those investment decisions. To come full circle to the point that you opened with, your forecast scenarios were made on 25 November and a lot has changed since then—I do not envy you in that regard. The Brexit figures seem to be correct and factored in, and you say that people are working better than expected in the conditions. Those factors, and the one around construction and manufacturing, imply some positivity. The International Monetary Fund has slightly upgraded or improved its take on the UK's figures for this year and slightly upgraded them for 2022, with the caveat of your differences in GDP measurement. Of the three scenarios, would you err towards the upper or more positive scenario?

Richard Hughes: All that remains to be seen. In the near term, because we in the UK are coping with a more infectious strain of the virus and we have had to reintroduce a national lockdown, I would say that the economic conditions are closer to our downside scenario, but the pace of the vaccine roll-out, which is the longer-run determinant of the level of economic activity more than anything that happens in the nearer term, is unfolding more or less in line with, if not a little bit ahead of, what we assumed in our forecast back in November. That is clearly a piece of good news about the medium term and offers us some hope to get back to something closer to our central forecast over the medium term.

However, the big risk is the variants of the virus that have emerged. Variants that are deadlier or more transmissible pose challenges for how quickly you can release public health restrictions, depending on the pace of the roll-out of the vaccine, because, obviously, if a variant is more infectious, you need to vaccinate a larger proportion of the population before you can be confident that you have reduced levels of transmissibility below the levels that allow economic activity to start to normalise.

We will have to look at the balance between the more infectious strains of the virus and a potentially faster pace of the vaccine roll-out than we had anticipated to see when that cross-over point is reached where Government feels confident to lift which restrictions at what point during the medium term.

At this stage, it is too early to say in relation to the medium term whether we are in the upside, central or downside scenario. Clearly, if more variants emerge, or the variants are more infectious or more virulent than we thought, that would be bad news for what we assume about how much economic activity we will be able to engage in beyond the current lockdown.

Alexander Burnett: Thank you very much. I have no further questions.

The Convener: I warmly thank Richard Hughes and Andy King for their extremely helpful and interesting contributions.

That was our only agenda item. I thank everybody for their involvement.

Meeting closed at 10:30.

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Published in Edinburgh by the Scottish Parliamentary Corporate Body, the Scottish Parliament, Edinburgh, EH99 1SP

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