OFFICIAL REPORT
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Finance and Public Administration Committee

Tuesday 14 December 2021

Session 6

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Pàrlamaid na h-Alba

Tuesday 14 December 2021

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FINANCE AND PUBLIC ADMINISTRATION COMMITTEE
14th Meeting 2021, Session 6

CONVENER

*Kenneth Gibson (Cunninghame North) (SNP)

DEPUTY CONVENER

*Daniel Johnson (Edinburgh Southern) (Lab)

COMMITTEE MEMBERS

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

*attended

THE FOLLOWING ALSO PARTICIPATED:

Professor Francis Breedon (Scottish Fiscal Commission)
David Eiser (Fraser of Allander Institute)
John Ireland (Scottish Fiscal Commission)
Dame Susan Rice (Scottish Fiscal Commission)
Professor Graeme Roy (University of Glasgow)
Professor Alasdair Smith (Scottish Fiscal Commission)

CLERK TO THE COMMITTEE

Joanne McNaughton

LOCATION

The Robert Burns Room (CR1)

Scottish Parliament

Finance and Public Administration Committee

Tuesday 14 December 2021

[The Convener opened the meeting at 10:00]

Budget Scrutiny 2022-23

The Convener (Kenneth Gibson): Good morning and welcome to the 14th meeting in 2021 of the Finance and Public Administration Committee. Today, with the Scottish Parliamentary Corporate Body's agreement, we are meeting in hybrid format due to the timing and nature of our budget scrutiny. Additional mitigations are in place, with fewer people attending the meeting.

The only item on our agenda today is evidence from two panels of witnesses as part of our scrutiny of the Scottish budget for 2022-23. First, we will hear from the Scottish Fiscal Commission, and we will then hear from David Eiser from the Fraser of Allander Institute and Professor Graeme Roy from the University of Glasgow.

Our first panel is from the Scottish Fiscal Commission. We are joined remotely by Dame Susan Rice, chair; John Ireland, chief executive; and Professor Alasdair Smith and Professor Francis Breedon, who are commissioners. We have up to 90 minutes for this discussion. I remind members that our broadcasting team will operate their microphones.

I would now like to hear an opening statement from Dame Susan Rice.

Dame Susan Rice (Scottish Fiscal Commission): Thank you very much, convener, and good morning to the committee.

Last week, the Cabinet Secretary for Finance and the Economy presented the medium-term financial strategy for the next five years alongside her budget. Over the coming months, she will be preparing Scotland's first multiyear resource spending review for a decade. As usual, our reports include forecasts for the next five years. I thought that I would draw out specifically some of their implications for the longer-term public finances.

I will start with our economic forecasts. We continue to expect a strong recovery. With Scottish gross domestic product growing by 10.4 per cent in this financial year, we will return to pre-pandemic levels of economic activity by the second quarter of 2022. However, despite the pace of the recovery, there is some evidence that the Scottish economy is lagging behind that of the United Kingdom. Looking back longer term, I note that since before the pandemic struck, employment and earnings have been growing more slowly in Scotland, with important implications for income tax.

As members will know from our previous reports, the Scottish Government's income is largely driven by the UK Government's spending decisions. Nevertheless, the Scottish Government's tax policies and social security commitments play an important role in determining the overall picture.

We expect Scottish tax revenues to increase by 20 per cent over the next five years, but the net effect on the budget will be negative in every year with the exception of 2024-25. That is because the positive contribution from Scottish tax revenues will be outweighed by growth in the block grant adjustments. As defined by the fiscal framework, that is the amount that is removed from the Scottish budget for each tax. The slower employment and earnings growth that I mentioned results in a shortfall of £190 million in 2022-23 and £417 million in 2026-27.

Last January, we highlighted a reconciliation risk arising from income tax funding in 2021-22 due to timing differences in our and the Office for Budget Responsibility's forecasts and the considerable uncertainty around Covid-19 then. We now anticipate that there will be a negative reconciliation of £469 million due in 2024-25. The fiscal framework requires that that reconciliation be managed within the Scottish budget.

We are all aware of the significant reforms that the Scottish Government is making to social security payments. Existing payments that are administered by the Department for Work and Pensions on behalf of the Scottish Government are gradually being replaced by new payments, and the Scottish Government is also introducing brand new, uniquely Scottish payments. Next year, the biggest payment—the adult disability payment—will be launched, and there will be an expansion to the Scottish child payment. By 2024-25, we therefore expect spending on the Scottish Government's largest social security payments along with completely new payments to be around £750 million more than the corresponding funding that is received as part of the block grant, which will reduce the funding that is available for other priorities.

I will mention just one component of the 2022-23 budget. The Government has assumed that it will receive an additional £620 million of resource income from a number of sources. We have reservations about the likelihood of the amount of income that is available from some of those sources materialising during the financial year. On balance, however, we consider the Government's assumptions to be reasonable.

The Convener: Thank you. I will start by asking about the £620 million, which you ended on. You said that you have some doubts about whether that £620 million will arrive in the Scottish Government's coffers. In your report, you refer to annex A of the budget document as detailing that, but I wonder whether you could go through what the sources are and what the likelihood is of that £620 million coming to the Scottish Government.

Dame Susan Rice: I have lots on my screen, but not the table to which you refer, so I will turn to one of my colleagues who has their hands on it. There are five different sources for the £620 million, one of which involves a discussion about the settling of a number that has been going on for some years. For different reasons, it is uncertain when the money from each of those sources may materialise.

Francis, are you able to speak about that?

Professor Francis Breedon (Scottish Fiscal Commission): I do not have annex A in front of me, but I can talk about the various elements. There is the potential for extra funding from supplementary estimates for the UK, which is quite a common factor, and there is the additional funding from the spring UK fiscal events. Susan Rice mentioned the reaching of an agreement on the funding transfer spillovers, which is an issue that has been outstanding for some time. There is concern about whether this year will be the year in which that is resolved. There is also income from the offshore wind leasing, which is a more certain source of income.

Overall, even though any one of those four sources might not deliver the amount of money that it is expected to deliver, we think that the £620 million figure is reasonable, because more money could come from one of the sources than is expected. Similarly, some funding could come from other sources, such as historical underspends in the Scottish budget that have not been factored into this one.

Although we have concerns about the individual elements, we came to the judgment that, overall, the £620 million figure is reasonable because we feel that it is possible that other sources could fill in gaps in the sources in question, or that a number of the sources could deliver more than is currently planned. I can see why you might think that it is a slightly odd way of putting it, but our argument is that we think that the overall number is reasonable even if we have concerns about the individual elements.

The Convener: I have to say that it is all a bit vague. I think that colleagues will want to explore the issue in some depth, because there are no numbers against the £620 million to explain how it comes together.

With regard to your forecasting, how has your thinking evolved since August? Why have there been changes in your judgment over that period? One of the main surprises that came out of the budget was the £190 million reduction in the net tax position, relative to your previous forecast. Will you talk us through how you arrived at that?

Dame Susan Rice: What we have typically done, and have been asked to do by the committee's predecessors, is to compare the budget with previous budgets. We make a lot of comparisons with the January budget, which is the last time that there was a Scottish budget, but we can also comment on what has changed or moved since January. One thing that is a bit more normal is that we are much closer to the OBR on the budget than has been typical in the past. We have looked at a variety of factors, and a number of them have not changed significantly since August.

John Ireland might have some detail in front of him that he would like to pull through.

John Ireland (Scottish Fiscal Commission): I am looking at the various bits that fall into the income tax forecast. Compared with August, our GDP forecast is pretty similar. It tails down a little bit more at the end, because we have a little bit more information on population growth or, more exactly, population fall.

On inflation, which is obviously important, our December forecast has a little bit more inflation than the August forecast—the inflation forecast has gone up between August and December. We are still forecasting in line with the OBR on inflation. The interesting thing about inflation is its cause. Back in August, we thought that it was a combination of supply chain issues pushing prices up and labour shortages, but our thinking is now that it comes much more from international supply chain issues and energy prices and much less from labour shortages.

The story behind inflation has changed a bit, which is important because of average nominal earnings. Back in August, we thought that the labour shortages were pushing earnings up, but we are now taking a step back on that. We have reduced the pass-through of domestic inflation into nominal wage growth because of our view on the source of inflation, which is less about labour shortages and more about energy prices and international prices going up. That, in turn, means that we have downward revisions to our average nominal earnings growth between August and December—earnings grew less than we thought in August.

Turning to the other part of the picture, I note that employment is a bit lower towards the end of the forecast than it was in August. Again, that comes from demographic factors.

Taking all those things together, although our December forecast for income tax is much higher than January's, which related to the previous budget, it is lower than our August forecast. That starts to explain the nature of the income tax gap.

The Convener: Yes. It is significantly lower than what the OBR and the Bank of England anticipate. I will be interested to follow that and see what happens.

In the weeks ahead, MSPs will no doubt battle over the numbers in the chamber. In your report, you say that, overall,

"the Scottish Budget in 2022-23 is 2.6 per cent lower than in 2021-22",

or 5.2 per cent allowing for inflation, assuming a deflator of 2.6 per cent.

We have been bombarded with a plethora of figures. For example, the Scottish Government's budget says:

"In practical terms, between 2021-22 and 2022-23, resource funding is 7.1% less in real terms."

It goes on to say that

"The equivalent reduction for Scotland's capital budget grant funding",

which seems to be a less controversial figure,

"is a 9.7% real terms cut between 2021-22 and 2022-23."

Why did you come to your conclusions on those figures as distinct from figures that, for example, include Covid spend and predict a real-terms increase in the budget? Will you talk us through the figures?

Dame Susan Rice: Does one of my colleagues want to comment?

The Convener: Do not all rush. Eeny, meeny, miny, moe. Yes—Mr Ireland.

John Ireland: The thing to focus on is the figures for growth in the budget, which you quoted. We are saying that, between 2021-22 and 2022-23, the budget will fall by 5.4 per cent in real terms, and the Scottish Government is saying that it will fall by 7.1 per cent. The difference arises because we focus on the size of the whole budget, whereas the Government focuses on something slightly different, which is the UK funding. We take a more holistic approach than the Government does in those headline figures, which explains the difference. If you wish, we can go into more detail on the various components.

10:15

The Convener: I am sure that colleagues will want to press you on that. I am just firing out questions on all the different areas that we want to cover. There is so much to cover and there are so many issues to raise.

I will raise another important issue. You predict a £417 million shortfall in income tax by 2026-27. How much, over and above United Kingdom productivity, must the Scottish economy grow in order to negate that figure, so that we do not end up reaching it?

Dame Susan Rice: That is an important area to focus on. It is difficult to answer the question specifically, but I point to the fact that, since August, we have taken the view that the decline in labour market participation will increase, which will obviously have a direct impact on income tax and the future with regard to that particular forecast.

I think that Alasdair Smith would like to comment on that.

Professor Alasdair Smith (Scottish Fiscal Commission): Convener, I cannot answer your question directly and say how much productivity growth will be needed to reverse the income tax shortfall. The shortfall is explained by relatively low growth in Scottish earnings, which derives from productivity, and by the lower level of labour force participation in Scotland than in the rest of the UK, which exists partly because of the greater proportion of older people in the population and partly because the proportion of young people in the labour force in Scotland has declined.

I apologise for not giving a direct answer to your question. However, given all those factors, I emphasise that the effects are relatively long term. We have seen them develop over the past few years, and they will not be reversed quickly. They might be reversed in due course, but it would not be sensible to think that there will be a quick miracle next year that will completely reverse the income tax position. If it happens, it will be a slow process.

The Convener: The decline in the number of younger people in the labour force has come up quite a lot. We discussed it to some extent in our private session before the meeting. What is the reason for that decline? Is it that more young people are in higher education? Is it our lower birth rates, or the fact that there are fewer young migrants in the population? Why is the situation here so different from that in the rest of the UK?

Dame Susan Rice: As with most questions, there are multiple reasons. Looking ahead, we expect that, over the five years of our forecast, the number of children under the age of 16 will fall by around 60,000—that is the number that we have pinned to that particular cohort. However, if we look at the younger population overall, we see that it is not growing, and therefore fewer people are going into jobs.

In addition, a lot of younger people have typically worked in the retail, hospitality and leisure sectors, which are fairly big in Scotland. Because of the pandemic, those sectors have been quite slow or dormant for a good bit of the past two years, so there are fewer opportunities for some young people. Those are two reasons why we are seeing a decline. There is less opportunity and, slowly but inexorably, the population of those who are ready and looking for work is reducing.

The Convener: Page 22 of the budget document mentions that poundage is below the rate of inflation for the next year. However, your assessment suggests that non-domestic rates income will increase by 25 per cent from 2022-23 to 2026-27, to more than £3.5 billion, when the economy is expected to grow by about half that amount. What is the reason for that? Is it just inflation, or are there other reasons why you expect that income to grow?

Dame Susan Rice: Francis, were you wanting to come in on this question or on the previous one?

Francis Breedon: It was on the previous one.

It is true that, generally, property has done relatively well, so that is a factor here, but—[*Inaudible*.]

Dame Susan Rice: [*Inaudible*.]—hospitality and leisure reliefs between England and Scotland, for instance. The relief that is offered in England at this point shows for the full fiscal year 2022-23; the Scottish version lasts for the first three months of 2022-23. There is a difference there. Both reliefs are set at the same level, which is at 50 per cent. Otherwise, the reliefs are fairly much in parallel, but that is one element. Neither applies to aviation, which they did previously; they apply only to the retail, hospitality and leisure sectors.

I invite Alasdair Smith to put some flesh on that.

Professor Smith: I will just add one point. Like many other aspects of the economy, non-domestic rates revenue fell in the Covid-driven recession, and it has bounced back. Part of the growth that we are forecasting for the next year is explained by the bounce-back from previous levels that has taken place and continued. It is part of the general bounce-back of the economy from Covid.

The Convener: If we take the nadir of business rates to 2027, the growth will be 69 per cent. That is why I did not take the nadir: it was from 2022-23 to 2026-27. I discounted what was an unusual year, but there is still a 25 per cent growth in rates, which is quite a lot for the business community to cough up. That is why I was wondering about your view on where that money will come from. Is that increase being driven by inflation? It is at twice the level of growth. Why are you predicting an increase from £2.8 billion to £3.5 billion over that four-year period? It seems quite a big increase in a relatively short period.

Dame Susan Rice: John Ireland may wish to come in on that.

John Ireland: One way of thinking it through is to compare our budget forecast last year with our budget forecast this year. The thing that is driving the biggest increases in revenue here is inflation, basically. If we let the forecast increase by inflation, that adds about £137 million to the forecast by the end. That is the biggest driver, if we separate the forecast into its various components. Remember that the tax base is fixed. It has quite little to do with economic activity, given the nature of the tax.

Inflation is a really big driver. The Scottish Government has increased poundage not by the amount of inflation but by just under that and that takes a little bit off that increased revenue. However, the biggest driver here is probably inflation.

The Convener: I was just wanting some clarification, so thank you for that.

You are predicting that, by 2024-25, there will be a £764 million shortfall in social security spending. Looking at that figure, I think that it is obvious that some measures are fixed and will remain in the budget, but surely the idea behind some of the measures that are being introduced to try and drive down levels of poverty is to reduce the number of people who are eligible and who are claiming benefits. Has any of that been taken into account in assessing the figures?

Dame Susan Rice: I will make a couple of comments before I turn to my colleagues. The figure that you gave is the one that we have reported, but it is probably somewhat of a conservative one in the sense that we have added up the forecasts over the next five years on the biggest social security payments that have, or will have by next year, transferred to Scotland and on the brand-new payments such as the Scottish child payment.

Given Social Security Scotland's formal undertaking that it will try to increase uptake of benefit payments, the arrangements for some payments—some of which have been devolved to Scotland for a couple of years—have been tweaked, changed or recast in Scotland. There are various ways of doing that. In some cases, it might be easier for people to apply, or things might have been made easier in relation to renewal and the restatement of eligibility. The advertising to attract people to apply might be more expansive than it would have been under the DWP. All that means that the number of people who receive some of the other benefits will increase. By way of background, I just want to clarify that the number that you gave is a somewhat conservative one.

Professor Smith: I will use two examples to try to answer the convener's question. First, in our projections for the cost of the Scottish child payment, we allow for the fact that the number of families that are eligible for that payment is likely to fall a little in the near future, but such effects will be, frankly, dwarfed by the costs of doubling the Scottish child payment, which the Government has announced that it will do. Any effects from a welcome reduction in family poverty will be relatively small compared with the costs of doubling the payment.

The other big element in our social security budget predictions is the cost of the adult disability payment. That payment will not change very much based on what is going on in the economy, particularly in relation to family poverty, because individuals' eligibility for the payment is driven not by their economic circumstances but by their typically long-standing disabilities, whatever they are.

Therefore, for different reasons, neither of those payments, which are the two biggest items in our social security budget predictions, will shift very much in response to any welcome changes in family poverty that take place in the next few years.

The Convener: I will ask a final question before I bring in my colleagues around the table. At paragraph 42 of your report, you say:

> "Over the next five years we expect capital funding to fall in both cash and inflation adjusted terms, primarily because of reduced UK Government funding."

What are the implications of that on Scotland's borrowing limit and its ability to take forward capital projects?

John Ireland: Between the first year of the budget and the final year of our forecasts, there is a 15 per cent fall in the capital budget that is available to the Scottish Government. A lot of that is driven by falls in UK Government capital spending, which are passed on to the Scottish Government. However, you are perfectly right to draw attention to the issue, because it is true that, given that the Scottish Government always plans to borrow the maximum amount that it can on the capital side—£450 million a year—it is heading towards its borrowing limit. Given that the Government will probably be approaching its borrowing limit towards the end of the forecast period, we think that it will be able to borrow less. The upper limit on capital borrowing will certainly start to bite before the end of the forecast period.

One caveat to that is that, although each year the Government says that it will borrow £450 million, quite often it borrows slightly less, so perhaps we will hit the capital limit slightly later than Government plans indicate that we will.

10:30

The Convener: Thank you for that. I will bring in committee members who want to ask questions.

Liz Smith (Mid Scotland and Fife) (Con): I thank the witnesses for giving us a bit more information about the trends.

You have been predicting a fall in income tax receipts; I want to ask, first, about data. Economists talk about the Laffer curve. The Laffer curve has been a bone of contention politically, but it is important, because it is the relationship between the tax rate and the revenues that are actually collected. In your updated data, do you have information about taxable income elasticity—in other words, the change in taxable income in response to changes in the rate of taxation? The issue is obviously important for policy; do we have good data on it?

Dame Susan Rice: Over to you, Alasdair.

Professor Smith: This is an issue on which it is hard to get good data but which has been extensively studied in a variety of countries with a variety of fiscal arrangements. In our predictions, we assume taxable income elasticities that have an impact on Scottish income tax revenue as Scottish rates rise or as they diverge from the UK rates. We have taken into account taxable income elasticities at a level that is in line with other studies.

To be frank, those kinds of effect are not the big factor in driving our predictions of Scottish income tax revenue. It is interesting to talk about Laffer effects and all that, but that is not at the heart of what is going on here. What is really going on here, as I said in answer to the convener's previous question, is that our income tax predictions are driven by Scottish earnings growing a little less fast than earnings in the rest of the UK, which is partly to do with the decline in the oil and gas sector and partly to do with the buoyancy of the UK financial sector in London and the south-east; it is also driven by a decline in labour force participation relative to the rest of the UK. Those are the big impacts on our tax projections, not the behavioural, tax elasticity effects.

Liz Smith: Notwithstanding what you said about the big factors, is it not the case that those effects have considerable implications for the amount of tax take that comes to Scotland and that, therefore, when a Government decides on its tax policy, the projections that you are giving about revenues in relation to the factors that you just mentioned are extremely important?

Professor Smith: They are certainly important and they might be particularly important in the Scottish environment, where it might be relatively easy for some higher-rate taxpayers to choose residence in the rest of the UK rather than in Scotland. That might be particularly easy when someone switches jobs and could move their primary residence into or out of Scotland. I agree that those factors are important; we have taken them into account and we have built them into our forecasts.

Liz Smith: Thank you for that—

Professor Smith: Sorry, let me make one more point. I think that those factors have influenced the Scottish Government's policy, in that the divergence in tax rates between Scotland and the rest of the UK has been relatively modest. In particular, I am thinking about the 1 per cent divergence in tax rate. It is a question for the Scottish Government rather than us, but I am sure that it has been influenced by concern that if the tax rates were pushed too far away from UK rates for higher-rate taxpayers, the effects that you are concerned about would get larger.

Liz Smith: As you say, it is maybe an issue for the cabinet secretary in due course.

I will ask about what you said regarding the oil and gas situation. You said that it was one of the big factors affecting matters. To what extent to do you think that the decline in the oil and gas sector is having one of the biggest effects on reducing the tax take?

Professor Smith: I hesitate to try to rank the different effects, but the decline of the oil and gas sector means that there are fewer higher-rate income tax payers in the Scottish economy than there were a few years ago, which has had a significant impact on the Scottish tax take. In the economy section of our report, we have looked at regional differences in Scottish incomes, and the most striking regional decline in Scotland is in the north-east, which seems to be driven by oil and gas.

Liz Smith: Would it be fair to say that, given the transition to net zero and the prediction that the oil and gas industries will diminish further, the result will be on-going issues for the tax take. Is that your prediction?

Professor Smith: Yes, although one has to be careful and think about timescales. Our tax predictions are for the next five years. If there is—and we ought to expect there will be—a long-term decline in the oil and gas sector due to climate change concerns, the effect on the Scottish economy will happen over a much longer period. I am not at all downplaying it, but it is a long-term issue for the Scottish economy and is not reflected much in our forecasts. The current decline in the Scottish oil and gas sectors is largely driven not by climate policies but by the gradual decline of resources in the North Sea.

Liz Smith: My final point—

Dame Susan Rice: Forgive me for interrupting, but I think that Francis Breedon has a follow-on response to that question, if you do not mind.

Professor Breedon: I want to slightly move away from oil and gas, because the other thing that you see from the regional chart in the documents is that all regions in Scotland have underperformed relative—[*Inaudible*.] Although oil and gas is a factor, I would not put it in as the number 1 factor. The two participation effects are the keys ones. I wanted to highlight that.

Liz Smith: That leads into my final question, which is about the participation rates and the changing demography in the labour market. There are concerns, particularly in relation to the number of young people, who perhaps have more transferable skills for the future, coming into the market. To what extent do you feel that those are significant issues with regard to projections for the future?

Dame Susan Rice: I will give you a quick answer and then see whether anyone else wants to follow up. The labour participation rate, which has been declining over a number of years, is a significant factor. At the same time, the overall population of Scotland is not projected to grow—in fact, the working-age population is to come down over the next five years by about 50,000. Therefore, there are more people at the older end, and fewer who are active.

Earlier, the convener asked a question about what it would take in Scotland in terms of difference in productivity rates. I could not answer that question directly, but it is worth considering that, if we are already lagging behind to some extent, our productivity, even if it were on a par with that of England or the rest of the UK, would not catch us up, because we would not be there yet, if you see what I mean. Our productivity would have to go up quite significantly in order to decrease that comparative difference.

I think that Alasdair Smith wants to come in on that point.

Professor Smith: Susan Rice already responded to the convener's question about young people's participation. The other big factor in Scottish participation rates is the ageing of the population, which is fundamentally driven by the fact that Scotland has, for quite a long time now, had relatively low birth rates. That feeds into a demographic picture in which the older part of the population constitutes a larger percentage than it would in a population that had a higher birth rate. That is a really long-run effect.

I fear that, whatever we might hope to see in future—there are reasons why we might expect young people's participation to change, possibly, if various things change—the demographic effect of Scotland having a relatively high proportion of its population over the age of 65 will be with us for a long time.

John Mason (Glasgow Shettleston) (SNP): I will follow up on that point. I will not ask you whether we are sending too many young people to university, but am I right in saying that, if we sent fewer of them to university and had more working, and maybe doing apprenticeships, that would—although it might have a more damaging effect in the long term—boost the economy in the short term?

Dame Susan Rice: That point could be argued in different ways. If it led to an increase in the number of people who were actively working and employed, it would have a short-term positive impact. However, given that apprenticeships are not necessarily the highest-paid roles, and given the number of young people who might go through that kind of programme, the change in balance between those who went to university and those going straight to apprenticeships would not be huge, so I am not sure how much of an impact it would have.

I would have thought—this is a personal view—that more young people getting more education, and university education if that is possible and relevant, would be better, because they may be better able to find a range of jobs. The emphasis on different types of jobs and different industries ebbs and flows, and they might well be higher earners in the longer term as well.

I am not sure what you are suggesting. Rationally, it makes sense, but I am not sure that it would make a lot of impact, or at least enough to suggest that we should do it.

Alasdair Smith may have a view on that.

Professor Smith: First, given that the panel includes two professors, the proposition that too many people are going into higher education is not one with which we would readily agree.

A serious point is that Governments do not directly control what young people do with their education and their lives. Young people choose to go to university or into other forms of further education, or into apprenticeships; it is not an instrument that we have available to us.

There may well be a strong case for making more vocational forms of education more attractive to young people, but that is what we have to do—we have to encourage them to choose that option. As Susan Rice said, they will choose the path that seems right for them, rather than the path that we, whether we are professors or politicians, would like them to take.

John Mason: Thank you for that. I do not want to spend too much longer on the subject, but I highlight that one of my nephews, who is aged 22, did not go to university but has done extremely well and has bought his own house.

The main point that I want to discuss concerns the GDP growth rates. We have an interesting paper from the Scottish Parliament information centre that contains predicted growth rates. Those predictions have been made over a relatively short time, but I accept that timing might be part of the issue.

10:45

According to the paper, the Scottish Fiscal Commission's prediction is for a 3.8 per cent growth in GDP in 2022; the Fraser of Allander Institute's is for 4.8 per cent; the Office for Budget Responsibility's is for 6 per cent; the National Institute of Economic and Social Research's is for 4.7 per cent; the Bank of England's is for 5 per cent; and HM Treasury's is for 5 per cent.

The OBR's prediction seems to be a bit of an outlier, as it is quite high. It was made in October, which was only two months ago, and your prediction is more recent. Can you say a bit more about those differences? Obviously, the issue has a real effect on our budget, and the OBR's prediction seems very high.

Professor Breedon: The table in our document is slightly different from yours, which might cause a bit of confusion. We have the OBR predicting 6.5 per cent for 2021 and 6 per cent for 2022, which is roughly in line with the average of forecasters, which was 7 per cent and then 5 per cent.

Given how volatile the economic circumstances have been in the past few years, there is a remarkable consensus among forecasters, who are roughly in the same place. All those forecasts were produced before omicron took hold, which means that all of us might have to make significant revisions if the situation worsens.

John Mason: I take that point, but it seems to me that the issue is having an effect on our budget in the short term, although I accept that it will all come out in the wash in the long term. Previously, we had the Scottish-specific economic shock—I hope that I have got those words right—which was really a timing issue between your forecasts and those of the OBR. I simply wonder whether we are seeing the situation in reverse at the moment, with the OBR having made, in October, an optimistic forecast for the UK of 6 per cent, and you predicting, in December, growth of 3.8 per cent. Is this just a timing thing, or is it a mixture of timing and reality?

Professor Breedon: It is a mixture. I would say that our forecasts are relatively close this time and, unlike the previous occasion, where a lot happened in between our forecasts, this time, not a lot happened and, indeed—[*Inaudible*.]—as I mentioned, so I think that it is slightly different.

Part of the issue is to do with the fact that, as we have been discussing, we generally think that there is slightly slower growth in Scotland than there is in the rest of the UK. However, fundamentally, differences in forecasting approaches will always cause some differences in forecasts. Of course, as you know, all of that comes out in the wash with reconciliations.

John Mason: I will move to a slightly different point. In paragraph 39 on page 14 of your report, you say that we are heading towards a £469 million reconciliation for 2024-25. You make the point—it seems to be common sense—that any Government that knew that it was doing that would slightly underspend each year. However, you highlight that there is a problem, in that we cannot save up that money in preparation, because of the rules around the Scotland reserve. Could somebody expand on that and explain it to me and others?

Professor Breedon: This is something that we have tried to highlight quite a few times. I know that there are concerns about the borrowing limits, but any upside is also constrained in the fiscal framework. For timing reasons, as you have rightly pointed out, we had the Scotland-specific economic shock, and that continues to affect the rest of borrowing—[*Inaudible*.]—and the reserve limits will carry on until 2023-24. That has given the Scottish Government more flexibility to borrow and put money into the reserve.

However, there is an unfortunate timing issue, because that flexibility rolls off in 2024-25, when the borrowing limit will be only £300 million against a reconciliation that we think will be bigger than that. Moreover, the annual drawdown from the reserve is £250 million, and the limit on the reserve is £700 million. As we have seen in the past, the money in the reserve is almost always used to manage underspends and departmental spending issues, so there is not much capacity left over for reconciliations, too. Therefore, the big reconciliation that we are looking at in 2024-25 might well result in potential one-off changes to spending or excess to deal with, because the capacity of the system to absorb that type of thing is limited.

John Mason: It all gets quite complex, and I presume that that will be one of the issues that will be discussed in the review of the fiscal framework.

My final question is linked to that. In paragraph 2.35 on page 29 of the report, you talk about "average underspend" with regard to the Scotland reserve, and you say that

"the utility of the Reserve"

has been reduced from 2.1 per cent to 1.5 per cent of the budget. Can you explain why that is happening, Professor Breedon?

Professor Breedon: The key factor that I would highlight here—someone else might wish to make another point—is the fixed nature of the limits in the framework. The combination of inflation and the real-terms growth in the budget means having to manage a bigger and bigger budget within what are nominally fixed limits, and that will become increasingly difficult over time. It is not as if we can say that the limits are fine because they were fine in the past; they will actually become more and more constraining in the future. As the budget grows, the size of the underspends and reconciliations will naturally grow with them.

Daniel Johnson (Edinburgh Southern) (Lab): Before I ask about regional comparisons across the UK, I wonder whether we can get some extrapolations with regard to the implications for the funding envelope in the medium term. What took most people by surprise was that the net tax position reduced available funding by £190 million instead of adding to the funds, and a deeper look at your report suggests that the issues that that has caused the Scottish budget are only going to increase.

What are you actually saying the implication will be? According to figures 2.1, 2.3 and 2.4 in chapter 2 of the report, you seem to be saying that the block grant is essentially going to stay flat over the next five years and that, by 2026-27, there will be a negative net tax position of -£355 million and—critically—new social security spend and other additional spending will have resulted in a negative position of -£764 million. Is the implication that, in the next five years, £1.119 billion will have to be found in the Scottish budget to cover that? Is that the correct analysis of the trends with regard to the block grant, the net tax position and social security spend?

Dame Susan Rice: That is not the exact lens that we have taken to the matter. I am looking for one of my colleagues to lean forward and give you the answer, and I think that that colleague might be Alasdair Smith.

We simply highlight that, since the Scottish budget has to be balanced every year, and since there is a commitment to spend more through social security payments to benefit society as a whole, those additional outflows of money will have to be balanced against other spending priorities. That is the kind of take that we have brought to the area. Alasdair may want to come in with a more specific response.

Professor Smith: I agree in broad terms with the question, which Susan has responded to. Although I do not want to bandy numbers around, broadly speaking, the picture is right. We predict that devolved taxes will contribute less to the budget than in the past. In addition, the block grant is constrained and social security expenditure is predicted to increase. Pressure is therefore coming at the budget from two or three sides, and a balanced budget will put pressure on non-social security expenditure. The facts are—[*Inaudible*].

Daniel Johnson: That is a helpful and important answer. If we are looking forward to a comprehensive spending review halfway through the next calendar year, that gives a picture of the overall envelope that it will have to work within.

The next key question touches on the point around the net tax position. Why is Scotland performing less favourably compared with the rest of the UK? For me, the big change is that that comparison is not only with London and the south-east—as the cabinet secretary has alluded to—but with every other region across the UK.

I said to committee members during our private session before the meeting that my rough rule of thumb is to assume that we will always be behind London and the south-east, that we will be somewhere around the south-west, and normally a bit better than places such as Wales and Northern Ireland. However, that is not the case when we look at our net income tax position; indeed, every single Scottish region is lagging behind pretty much every single region in the rest of the UK. Why are those impacts so much more significant in Scotland in comparison with places such as the north-east of England or the midlands that might—one would suppose—have comparable demographics to Scotland?

Professor Breedon: One point to make is that the chart in the document relates to only one year—February 2020 to September 2021. Although that is key for this budget and our analysis, we have a snapshot of a particularly unfortunate combination for Scotland. If I recall, the longer-term trends are probably more of the type that Daniel Johnson talked about.

However, that does not take away from the point that we have raised, which is that, in terms of labour market participation and the oil effect in particular, things are going on in Scotland that do not seem to be going on as much in the rest of the UK. The demographic effect is UK wide, but Scotland seems to be particularly affected.

Daniel Johnson: It strikes me that this area requires much more attention from the Government and, indeed, the Parliament. I include in that the specific point about labour market participation, but I struggle to understand how that explains the issue in its entirety, given that you would have thought that the demographic challenges would appear in other UK regions. Scotland is not so different from places such as the north of England or Wales. Where should we look for that explanation, or should further analysis be done so that we can adopt the right policies to address the issue?

Professor Breedon: I would certainly agree that the issue is worth a lot more thought. Again, I would emphasise my point that Scotland's position versus that of the rest of the UK will look very different, depending what window of comparison you use. I would therefore not necessarily say that Scotland has suddenly got a lot worse and will remain a lot worse; using different windows will give a more balanced picture. However, I agree that those participation effects are important. The key question is whether they are cyclical—particularly the youth participation one—and will just resolve themselves over time, or whether they are structural and will continue. Obviously, that has huge implications for future budgets.

11:00

Daniel Johnson: One of the explanations is to do with relative performance of the financial services sector in the rest of the UK compared with that in Scotland. My understanding has always been that we have a strong financial services sector in Scotland. Why would the financial services sector in Scotland be underperforming that in the rest of the UK?

Dame Susan Rice: I was going to say something about your earlier question, rather than giving you detail on the financial services sector. However, it really is booming. That is mainly in and around London, and is for various reasons. A number of international or global financial institutions have a continued interest in being in the UK, and London is a real financial centre for them. The issue perhaps also reflects some of the shift in what we used to think of as Scottish financial services to being managed and operated outside Scotland.

The question is a little broader than just one sector. We say in the report that part of the difference is because the financial services sector is booming in London. It is fine in Scotland, but it is not booming or growing to the same extent. There is a difference in expansion of the sector.

The other side, which we have mentioned, is the oil and gas sector. Right now, it is in the doldrums—that is not a technical economic term, but the sector has slowed down. In trying to find an answer to your question, I suggest looking at what is happening in the major sectors. We have pulled out the two that I have mentioned, and there might be other activity that affects other areas.

Your question had a regional lens. Many of the financial services firms that are booming in the London and greater London area have intentionally established quite a significant presence in other parts of England. For example, one of the biggest banks has a huge centre in Birmingham. The issue is not just about London—as those firms grow, they expand employment elsewhere.

Daniel Johnson: “Doldrums” might not be a technical economic term, but it is a good descriptive one.

The Convener: Indeed.

Ross Greer (West Scotland) (Green): I want to return to the point that Daniel Johnson explored about the income tax deficit. In figure 4 in your report, the broad trend from 2021-22 to 2026-27 is pretty clear, but I am interested in what you project for the year 2024-25, where the gap closes considerably and then begins to widen again for the rest of that period. What caused that change in direction in your projections?

Dame Susan Rice: Again, I have other documents in front of me, so one of my colleagues who has that table can perhaps come in. Alasdair Smith seems to be ready.

Professor Smith: Our prediction for 2022-23 is a natural follow-on from the position in the current year. We expect the net position to deteriorate by almost £200 million over that two-year period. Your question about the next year gets us into complications—well, it makes the explanations more complicated, rather than being inherently complicated. The UK Government has announced that it will freeze the higher-rate tax threshold for several years ahead. We make our forecasts on the basis of announced Government policy, and that is an announced UK Government policy.

The Scottish Government has committed to freezing its higher-rate threshold for only one year ahead, so we are assuming that two years ahead the Scottish higher-rate threshold will rise with inflation, which reduces the policy gap between Scotland and the rest of the UK. We are not certain that the Scottish higher-rate threshold will rise, but the assumption reflects the fact that the Government has not made an announcement about that.

The years beyond 2022-23 start to involve assumed differences between Scottish and UK policy, which might just be announcement differences, whereas for 2022-23 the position is clear. The big differences between Scotland and the rest of the UK are the tax rates in Scotland, which will not change, and the difference in the higher-rate threshold, which difference will not change next year. Going further ahead, there are more moving parts, so we are a bit less certain about exactly how the numbers will turn out.

When we look at the years beyond 2022-23, the divergences that we are projecting have a bit less certainty about them because they are policy dependent, but the persistence of the general pattern is testament to the fact that the forces underlying the negative and declining net income tax take for Scotland are long-run forces. The arithmetic might vary a bit, but the issue will be pretty persistent.

Ross Greer: That is a useful clarification. Sticking with Alasdair Smith for a moment, I am looking for a small point of clarification to your answer to the convener about your projections for the cost of the Scottish child payments. You said that those numbers take into account a slight fall in the number of eligible children. Is that because the population of children will shrink or because of an assumption about reductions in child poverty levels, or is it both?

Professor Smith: It is largely driven by the demographics of the population of young people, which will decline. Therefore, the population of young people in families that are eligible for the Scottish child payment will decline. It is perhaps worth saying that some forces push us slightly in the opposite direction, because there is an interaction between eligibility for the Scottish child payment and universal credit.

The change in the taper rules for universal credit means that a number of families who were not previously eligible for the Scottish child payment are now brought into eligibility, not because they have become poorer but because of the UC taper. The existence of a double Scottish child payment gives an incentive for people who might not have claimed universal credit before to make sure that they claim, because the benefits of claiming are now greater.

The straight answer to Ross Greer’s question is that the decline in numbers is largely driven by demographics, while some of the other factors affecting the Scottish child payment go in one direction and some go in another. We are not assuming that there will be a big reduction in family poverty in the short run that would affect eligibility for the Scottish child payment.

Ross Greer: Thank you. I will stick with the issue of demographic change but ask about a different aspect, following on from John Mason's question about falling labour market participation by young people. In part, that is due to falling birth rate, which is a long-term problem that we are familiar with in Scotland. However, we will face a significant difference in the next five years compared with the previous 15 because of a change in immigration policy post-Brexit. To what extent are you building in an assumption of a change in the number of young people in the workforce based on immigration changes as compared with that long-term issue of birth rate that we are familiar with?

Dame Susan Rice: I was going to say that our Brexit assumptions, which we have shared for a number of years, are built into this work and are implicit in it. We have been thinking about that particular factor for a while; it is not a new factor that we have suddenly considered but has been there as part of our underlying considerations.

Alasdair, did you want to say something about this?

Professor Smith: I would just add that our population projections assume that Brexit and other factors will affect international migration into Scotland, and that it will decline. The effects of Brexit will be smaller than the effects of demographic change. They are a factor, but in demographic arithmetic, they are not as big a factor as a declining birth rate.

Ross Greer: On another point, Susan, I recognise that you are dealing with different papers, but figure 3.16 in our papers looks at the changes in pay-as-you-earn employment between the start of last year and October this year. We have already discussed the significant regional effect in the north-east, where there has been a significant decline in the number of employees in the oil and gas industry.

However, the other area that is in decline is eastern Scotland. Can you talk a bit about the particular regional forces that are driving that? We are all familiar with what is going on in the north-east, but I am interested in hearing an explanation of why eastern Scotland is also in quite a different position to the rest of the country.

Dame Susan Rice: Francis Breedon wants to come in on that.

Professor Breedon: I was actually going to answer the previous question, but in response to this question: it gets much harder when you get down to a regional level. When we do our forecasts, we are not building up for regional—[*Inaudible*.]—forecasts we absolutely do so. When we talk about individual regions, it gets increasingly difficult to tell. We can try to tell the stories about why they are different, but it gets increasingly difficult to pinpoint the key factors, because different parts of the economy just perform differently.

Ross Greer: You said that you were looking to come in on the previous question as well. If you have something to add on that, feel free to do so—do not feel that we have cut you off.

Professor Breedon: I was going to give you the numbers on migration, if you are interested to hear them. We have our own operational assumptions, including on migration. We have zero for net in-migration in the previous year, and then we have a deficit of 4,000 in the future. That just reinforces Alasdair's point that these are pretty small numbers compared with the overall demographic effects.

Ross Greer: Thanks very much.

Douglas Lumsden (North East Scotland) (Con): As a new committee member, I just want to check something that is on the income tax table in figure 4. Am I right in thinking that, if we had not had devolved income tax, the Scottish taxpayer would be £742 million better off and the Scottish Government £190 million better off? Is that right, or am I missing something?

Professor Smith: That is not quite right, because that £740 million figure is calculated on the assumption that there had been no Scottish policy changes. The effect of devolution is not only that Scotland can introduce its own active income tax policies but that it no longer follows UK policy. When we do our arithmetic and we look, for example, at the effect of Scotland setting a higher-rate threshold, we are defining Scottish policy as being a higher-rate threshold that does not go up with inflation. The rest of the UK has had a policy of pushing the higher-rate threshold up to a level way above an adjustment for inflation.

When thinking about what would happen if income were not devolved, the better figure would be the effect if Scottish income tax policy were the same as UK tax policy. For 2022-23, that number is not £742 million—although we do not have a prediction for it for that year, because that is not what we looked at. SPICe predicted a number for the divergence for 2021-22, which is -£530 million. Predicting forward with the arithmetic that produces that number of £530 million, the number for 2022-23 would not be £750 million; it would be more like £800 million.

11:15

I am sorry: that is a long answer to make a small adjustment to your figure. The important part of the answer to your question is yes. Those numbers mean that, if Scottish income tax had not been devolved and had stayed with UK income tax policy, it would have made a difference of between £750 million and £800 million to the Scottish budget.

Douglas Lumsden: Is that just to the Scottish taxpayer, or would the Scottish Government have extra money as well because of the block grant adjustments? I guess there would not be a block grant adjustment, in fact.

Professor Smith: No—that is after the block grant adjustments for income tax. The Scottish Government's position is not as negative as that £750 million or £800 million would imply; it is because Scotland has raised some of its higher tax rates and has frozen the higher-rate tax threshold. That has generated income from Scotland, but we are predicting that, in future years, that extra income from increased taxes in Scotland will not be sufficient to make up for the loss of income through the block grant adjustment.

Douglas Lumsden: I turn to another question. There was no mention of council tax in your report. Is there a concern that the council tax cap being removed would bring an overall burden to the taxpayer—that it would increase our overall level of tax—and that that could have a damaging impact on the economy?

Dame Susan Rice: Without meaning to avoid the question, council tax is not part of our remit at all, so we have not explored or examined it. That is why we do not address it in any full way in our report. You might get more depth of response in another suite of evidence sessions. We do not look at that.

Douglas Lumsden: Okay. I will move on. When I was reading the report, it seemed—as I think Daniel Johnson mentioned earlier—that tax earnings are falling compared with the rest of the UK, social security charges are rising compared with the rest of the UK, the working population is falling compared with the rest of the UK, economic growth is lower than it is in the rest of the UK and recovery is slower in Scotland.

When I read about all that, I was concerned about how sustainable everything is. Would action need to be taken in the short term to try to stop some of the figures that we are seeing coming through?

Dame Susan Rice: That is the correct kind of question, in general, to be asking. If the plan in Scotland is to spend more for social benefit, that would take priority over other possible expenditures. It is a matter of balancing how to make the discrepancies come out whole at the end of the day. If you spend more here, you spend less there. That is the right point to be focused on—that there is growth or decline in different directions. Parliament should quite rightly be thinking about that.

Douglas Lumsden: Are there any other comments from anyone else?

I think that is a no.

Michelle Thomson (Falkirk East) (SNP): Good morning. I want to go right back to where we started, Professor Breedon. I could not quite hear your answer on what, specifically, was contained within the £620 million other income. I heard "spillovers" and "underspends", but I could not hear what you said.

What estimates have you included and at what levels? I suspect that we will also want to probe the Scottish Government about what is included in that amount. If you do not mind, I ask you to run through that. In particular, I am also interested in whether and how you have factored the health and social care levy into your projections and whether you estimate that the Scottish Government has done the same. I understand that the Treasury says that the levy is in the figures, but I do not have a tangible sense of at what level in the budget.

Professor Breedon: I could not find the right page so I will try to do this from memory.

There are the supplementary estimates at the time, which will come back to February, and the UK fiscal events, so those could generate extra funding. For both of those elements, there is an assumption that something will come. Then there is the resolution of the spillover question, which could generate income. If the spillover case is resolved this year, that will generate income for the coming year. Finally, there are the leases for offshore wind, which are a long-term factor.

We see our role as highlighting the numbers and what I have just explained. We are not the experts on those figures; the Scottish Government is the expert. I recommend that, as you said, you ask it more about that than us. We are the messenger in this case. We wanted to highlight the large amount of funding and the sources that we were told it came from.

That is as far as our message has gone. It is to say that something is going on in the background that, historically, might not have become so public. We are pleased that we have been able to highlight the fact that there was an issue because the more transparent the budget becomes, the better. We are clearly still not the experts in any of those four elements.

Michelle Thomson: I sense that you are laughing. I apologise if that was an unfair question but we will follow it up with the Cabinet Secretary for Finance and the Economy. My understanding is that the UK Treasury says that the health and social care levy is included in Barnett consequentials but we do not have a sense of the exact amount. Is that correct and is it the assumption that you make?

Professor Breedon: I think that that is correct. I will highlight something else about those extra effects. It would be nice to be able to say that they are a little bit uncertain and we do not quite know their scale so we will be a bit cautious and put in small numbers. However, because of the way that the fiscal framework works—we have just discussed this—having too much money come in at the last minute is almost as problematic as having too little money come in at the last minute. Therefore, even though you think that that money might not arrive, it might also be more than you say.

Unfortunately, there is nowhere in the budget to put extra money, so the Government has had to make a shot in the middle of where the numbers are. That is one of the background issues that the Government faces in trying to project the numbers. It cannot be cautious; it must aim for the middle on each occasion.

Professor Smith: The health and social care levy should be seen as distinct from the £620 million because the levy is a reserved UK tax and the UK Government's plans to spend on health and, in subsequent years, social care will have fed through the Barnett formula like the other effects of the UK budget. That funding comes down that route and is not involved in the £620 million.

I will add only one point to what Francis Breedon said about the £620 million. He said that it is good that it is out in the open and able to be discussed. We—and, I expect you as MSPs—expect the Scottish Government to report as the fiscal year proceeds on how that additional income has materialised. We expect to keep track of it in our fiscal updates during the year and keep the Parliament informed.

Michelle Thomson: I have another small question. Mention has been made of demographics and the anticipated reduction in immigration. I appreciate that Alasdair Smith said that the demographic situation had much bigger implications than the reduction in immigration, but from your modelling, do you have any sense of the reduction in tax take from the reduction in immigration? I think that Dame Susan Rice mentioned a figure of 50,000. What does that cost the Government in tax take? I do not know whether you model that or whether you just have basic numbers. I am not sure who would be best placed to answer that.

Dame Susan Rice: I am sorry—could you repeat the question? Was it about the reduction in tax take on the back of population change?

Michelle Thomson: I am trying to work out the cost to the tax take of the Scottish Government of the reduction of up to 50,000 immigrants. I do not know anything about the nature of how much tax they paid or whether you would average it. I want to get a sense of the cost of that in budgetary terms.

Dame Susan Rice: Thank you. I think that Francis can respond to that.

Professor Breedon: I will start off, then I will hand over to Alasdair.

Year-on-year migration numbers do not make a huge difference, because they are relatively small. However, as your question implies, and this is where things get more difficult, migration of 20 years ago has an impact on tax take today. The utility of migrants is another factor that has an impact on tax take. Unravelling the migration effect within tax is extremely complicated. As Susan Rice said, we have not done that, because it is very difficult to unwind the effects of migration. It has a long, slow impact, but although it impacts the structure of the labour force very slowly, that builds up to become a large factor over long periods.

The Convener: I thank the Scottish Fiscal Commission for its evidence and for producing such an excellent and detailed report.

That concludes this section of our evidence taking. We will reassemble at 11.37.

11:27

Meeting suspended.

11:37

On resuming—

The Convener: For our second panel on the Scottish budget 2022-23, we are joined by David Eiser, senior knowledge exchange fellow at the Fraser of Allander Institute, and Professor Graeme Roy, dean of external engagement and professor of economics in the college of social sciences at the University of Glasgow. I welcome you both to the meeting.

I remind members and witnesses that our broadcasting team will operate the microphones. We have up to 90 minutes for this session.

Before I open up the discussion, I ask Professor Roy to start us off with some opening remarks.

Professor Graeme Roy (University of Glasgow): Thank you, convener, and thank you for the opportunity to come through and give evidence today.

I have three brief points to make about what jumped out at me from the budget. As usual, much of the debate will focus on whether budget lines are going up or down, what is happening to the income tax threshold and so on. However, if we take a step back from that, some interesting and crucial reflections were made during your earlier discussion about the overall trends in the public finances in Scotland. As you discussed with the Fiscal Commission, there are huge uncertainties, but it is important to discuss the overall trends and think about what they might mean for public services and the public finances.

The first thing to talk about is Scotland's economic performance relative to that of the rest of the UK, which you have just had a conversation about. That has been in the system and in the numbers that we have seen since the middle of the decade and—depending on which way you look at it—even going back to the period after the financial crisis, when the Scottish economy was growing more slowly, on a per capita basis, than that of the rest of the UK.

The question that we have had in previous budgets has been about whether that is temporary or whether it is more structural. The numbers from the Fiscal Commission seem to suggest that something more long term is driving those numbers. We have had three years of negative income tax reconciliations, and another two years are forecast in the next round. The committee has just had a discussion about the relative tax gap between Scottish income tax and the block grant adjustments, which is now negative. The key thing is what is driving that. We understand that the technical reasons for that are weaker earnings growth and weaker participation, but what is driving that? Is it challenges in the North Sea? Is it weaker growth more broadly in the economy? What, if anything, can the Parliament do about it? That is the first broad issue that it is important to focus on.

The second issue relates to the pressures that we are seeing coming through on public spending. To take social security as an example, there is divergence—because of policy choices, primarily—between the commitments that we are making on some elements of social security and the block grant adjustments. That is not to say that the policies are not right, but they come with an opportunity cost, and if the tax base is not growing as strongly as we hoped it would, that money will have to be found from elsewhere.

My third point is about the pressures on public spending more broadly. Public services have been under huge pressure through the Covid crisis, and that is particularly true of the health budget. There have been some big increases there, but are they enough to cope with the legacy of the crisis and the reforms and structural changes that need to be made in relation to our future health projections?

The key message that jumps out from all those questions is about the importance of the discussion that we had a month or so ago about public service reform and the fundamental value of that in enabling us to manage our way through the crisis. It is really good that the Government is now looking to have the spending review next year. The questions that will be asked as part of that on issues such as prevention and greater collaboration across Government are exactly the right questions to ask. In the next couple of years, the big focus will have to be on how Parliament copes with managing the pressures on the budget through genuine reform that means that we can continue to deliver the public services that we all want and all depend on.

The Convener: David Eiser, I do not think that you want to make any opening remarks, but you can if you so wish.

David Eiser (Fraser of Allander Institute): No, thank you.

The Convener: In that case, we will go straight to questions. I will base my initial questions on the statement that Professor Roy has just made. You basically said that we must look at public service reform, and that we must be genuine in that reform. However, the issue will be about how we bring in genuine reform and move towards prevention, more efficiency and better use of the public pound, and whether such reform will be seen simply as cuts, and so on. Could you address how we can approach that?

The second issue is, regardless of whether we do that and regardless of whether it is successful, there is still a long-term issue around the sustainability of the public finances and the relative divergence in tax revenues between Scotland and the rest of the UK. Following on from that—I will ask David Eiser to comment on these matters, too—what can we do to reverse some of the issues with productivity that we have in Scotland? If the economy was 1 per cent more productive per year than it is now, for example, we would not face this problem for much longer. How do we address those broad issues? I ask those questions before we get into the meat and drink of the budget itself.

Professor Roy: They are great questions; I will respond to the second one first. When the fiscal framework was signed up to and we agreed to have greater devolution, there was an acceptance that risk would be built in around Scotland's economic performance relative to that of the UK. What has been striking is that, since that devolution of taxes, that risk has all gone in a negative way, in that Scotland has been underperforming relative to the UK as a whole.

There is a genuine question to be asked about what we can do to address that. Is that within the gift of policy makers? Is it within the gift of Scottish policy makers? Do we have levers that we can use to change the situation or do we need to make more structural changes to our economy? Earlier, we heard about demographics and the decline in the North Sea. It is very difficult for policy makers to make different choices about such areas. The North Sea will naturally decline as a major economic sector in Scotland. We can do things to try to replace that sector with the growth of renewables and so on, but we must recognise that it will be a fundamental structural change in the Scottish economy that will always be there.

We can then think about where we can make a difference in boosting productivity and what the potential options for that are. The Government will shortly publish its next economic strategy, for economic transformation. There are questions about how we, as a country, can become more productive. That links in with the issue of our skills gaps and where there are potential skills mismatches in our economy.

11:45

When we look at productivity, we typically think of the top end and how we can become more productive in terms of having the best-performing companies. However, if we look at all the evidence, we see that, in Scotland, our core business base is naturally less productive, less entrepreneurial and less innovative than that of many of our key competitors. What can we do, therefore, to shift the dial so that our core business base becomes more productive? That is less about the next generation of new technologies and more about using existing technologies better. What can we do to boost the overall core skills base and the digital base of our economy?

On your first question, which was about the spending review and the challenges around cuts, it is—as we discussed four weeks ago—really hard. As we discussed then, the Christie commission was a point in time when the independent budget review was saying that these things—the pressures on public services and the challenges around demographics—were going to happen. We jump forward 10 years, and they are now here. It is an opportunity to undertake a significant review of how public services are delivered and what we can do in order to do what the Government is talking about, through greater collaboration, reform, prevention and so on. That will involve difficult choices, but that is ultimately what the Government has to do in order to make the public finances sustainable.

The Convener: You touched on the issue of demographics, which was discussed a lot in the session with the previous witnesses and in the pre-meeting private session.

David Eiser, perhaps you could touch on that. I would also be happy for you to respond to any of the points that have been raised. We discussed, for example, the fact that immigration is down, perhaps because of Brexit; the birth rate is down; and even the number of younger people who are in tertiary education is down. However, we still have a high—in fact, a record—number of vacancies in Scotland. Around 100,000 people, or roughly 4.5 per cent of the working population, are unemployed. If those people were in productive employment, that would make a difference. What could we do to upskill those people in order to improve market participation and reverse some of the trends that we currently see?

David Eiser: The unemployment rate is currently remarkably low, considering where we were a year ago, when most forecasters expected that we might now be looking at an unemployment rate of 7, 8 or 9 per cent. The fact that the economy has recovered so much more quickly than anyone was forecasting this time last year is also remarkable, which reflects the success of the vaccination programme and the economic support measures that have been in place during the pandemic.

However, you are right to highlight that one of the reasons that unemployment has remained low is that inactivity has increased. It is higher than it was among the young, which is partly because of an increase in participation in education, but it has also increased among some of the older age groups.

To a large extent, that reflects the fact that we are still very much in the early stages of the recovery, and the economy is going through a structural shift. Although the economy as a whole is expected to be back at pre-pandemic levels in the second quarter of next year, some sectors are not expected to get back to pre-pandemic levels for a significant time after that. There are obvious reasons for that, which we can all see as we go about our daily lives.

There is a role for the public sector to play in supporting the transition to a new economy with a different structural make-up, and the Government is already doing a lot of the things that it should be doing, such as focusing on employability and skills.

I go back to the question of whether we are doing enough to ensure that we capture the outcomes of that activity, and that it is delivering the types of outcomes that we want. Those are difficult questions, but the stated aim of the spending review is to get to grips with those issues and to plan spending policy by taking an evidence and outcomes-based approach. On paper, that is certainly the right thing to do.

The Convener: One of the issues that we have with this budget is the plethora of different figures. For example, the Scottish Government is saying one thing about figures and the Scottish Fiscal Commission is saying something slightly different. Of course, the UK Government is probably saying something different again, depending on whether Covid figures are included.

Where do you and the Fraser of Allander Institute stand on the figures that we are dealing with? On page 2 of the budget document, which you have seen, the Scottish Government says:

> "In practical terms, between 2021-22 and 2022-23, resource funding is 7.1% less in real terms."

The key words are "In practical terms". It goes on to say:

> "The equivalent reduction for Scotland's capital budget grant funding is a 9.7% real terms cut between 2021-22 and 2022-23."

From the figures that others have presented, the second figure appears to be less controversial. Where do you feel that we are on those figures? Obviously, when we scrutinise the budget, we have to look at the figures and see where we are and what room for manoeuvre the Scottish Government has.

David Eiser: It makes sense to focus on the block grant from the UK Government, because that remains the key determinant of the Scottish Government's overall spending envelope. Obviously, because of the pandemic, the past two years have been exceptional; they have also been fiscally exceptional, because, on top of the usual core block grant, the Scottish Government received around £8.6 billion of Covid funding in 2020-21 and £4.9 billion of Covid funding in 2021-22 from the UK Government. That Covid funding will drop out of the equation in 2022-23, and we will be left with a core block grant that is significantly higher—about 8 per cent in real terms—than it was pre-pandemic. However, the overall level of resource from the UK Government will be 7 per cent lower in 2022-23 than it was in 2021-22.

Those two figures are factually correct comparisons that we can make. In some ways, neither figure is all that helpful, because it is all very well to say that the core block grant is 8 per cent higher than it was pre-pandemic, but the pandemic continues to have a substantial legacy effect on public services, so I am not entirely sure how meaningful that figure is. On the other hand, to say that the total block grant is 7 per cent lower in 2022-23 than it was in 2021-22 is perhaps not all that helpful either, because we all hope, at least, that 2022-23 will be a year in which the direct impact of the pandemic on public services will be significantly less than it was in 2021-22.

There are always different comparisons that we can make, but the undeniable point is that, in the context of the priorities and commitments that the Government has set and from the point of view of the legacy of the pandemic for public services, it is a challenging outlook for the budget. In the following two years, when the resource block grant will, in effect, be flat in real terms—relative to the 2022-23 level—that outlook becomes even more challenging.

Of course, there are different numbers in the SFC's document, because, as John Ireland pointed out in the earlier evidence session, the SFC is not looking just at the resource from the UK Government but at various other things. For example, the SFC includes around £400 million of drawdown from the Scotland reserve in 2021-22, which boosted spending in 2021-22. At the moment, there are no plans to draw down in 2022-23, but I suspect that that will change. The SFC also includes the Scottish Government's assumption that additional resources will come from the UK Government in the early part of 2022-23, which will also boost Scottish Government spending in 2022-23. Also material here is the rollback of the non-domestic rates relief in 2022-23, which also contributes to additional spending in 2022-23 relative to 2021-22.

The Convener: David Eiser touched on the Scottish Fiscal Commission assessment, which sits half way between the Scottish Government's and the UK Government's assessment of the figures. In paragraph 9, the Scottish Fiscal Commission says:

> "Overall the Scottish Budget in 2022-23 is 2.6 per cent lower than in 2021-22, after accounting for inflation the reduction is 5.2 per cent."

As David Eiser said, one of the issues is that that includes the drawing down of resources. What are the implications for the long-term sustainability of Scottish finances, given the fiscal framework that we have to work within, which has become increasingly tight through inflation and so on?

Professor Roy: David Eiser has run through the numbers. In every budget cycle, there is a ding-dong about whether the budget has gone up or down and by how much—like Christmas, it happens every year, and then we move on. Whether that means there is a marginal increase or decrease, if we take a step back, we can all agree that the budget settlement is tight.

There are additional pressures and challenges because of inflation. Potentially, inflation will be much higher this year than it has been historically, which puts huge pressure on wages, so that even if there were to be a relatively generous increase in public sector wages, it is likely to be a real-terms cut for most people because of inflation. If we add those challenges relating to inflation and those that we have spoken about already in relation to tax revenues and things like that, and also build in the wider public spending pressures, then if we can agree on one thing it would be that it is a challenging settlement. What the exact number looks like is something that we could debate all day and everyone will stick to their fixed position. However, the general point that you make, convener, is really important.

The Convener: As a committee, we are trying to cut through some of the politics—it is not exactly easy—to try to get as much of a consensual approach as possible. I am keen to get more information from you on the legendary £620 million, which is mentioned in annex A of the budget document. How we get to the figure of £620 million and how likely it is that that money will be delivered is not really spelled out in precise terms. The Scottish Fiscal Commission has said that it thinks that it is reasonable to assume will be delivered, but there is a difference between a reasonable assumption and the money actually arriving. That would have implications. Perhaps Graeme Roy can have first go at that and then David Eiser could come in. Daniel Johnson wants to come in with a related question after that.

Professor Roy: David Eiser might know more about the detail. It jumped out as quite a significant addition to the budget. The Fiscal Commission's report and earlier comments did not go into detail about exactly what makes up that £620 million or its components, although all the explanations make sense. There is the personal allowance resolution that might be due this year or slightly later, which might lead to additional funding flowing to the Scottish Government, if the Scottish Government is successful in its challenge in relation to the fiscal framework and no detriment. There is also the potential for another fiscal event between now and the start of next year. Around March there will be another UK spring budget, which might bring additional Barnett consequentials. The Government is obviously making an assessment of what those might be.

The other point that the Fiscal Commission made quite well is that the nature of the framework and the way in which it works means that the Scottish Government is right to have an overestimate, because any kind of underestimate could lead to challenges about how it manages its budget. Having a relatively generous assessment of that probably makes sense from a technical point of view.

The key point is that, if the money does not flow through, it will create additional pressure and money will have to be found from within portfolios to make up the demand. David Eiser might know a bit more about the breakdown of the £620 million.

David Eiser: I am struggling to find the table, although I know that I have seen it in the documents. We know from previous budgets that it is almost inevitable that there will be some additional resources of at least several hundred million pounds that will flow through because of additional UK Government spending that might come at main estimates or in the March budget. In that context, the Scottish Government has a couple of options: it can assume that that is not going to happen, but when those additional resources are confirmed at a later point, it can then decide what it is going to do with them and announce that as part of the spring budget revisions, or it can make an assumption and factor that into its project plans.

12:00

Given that it seems inevitable that an additional sum of at least several hundred million pounds will be confirmed—that has been our experience in recent years—it is prudent to factor that into the budget. Arguably, that would result in the money being used more strategically and being subject to greater scrutiny than if it were dealt with in the spring budget revisions.

The Convener: It is 2-1 on, rather than 2-1 against, so to speak.

Daniel Johnson: I wanted to follow up on David Eiser's point about whether the budget is seven point something up or seven point something down. I will confound you both by saying that I can recognise both figures and not be rigid about my view on it.

I recognise that, in the total figure, because of Covid there is approximately £5 billion resource funding in the current financial year. However, to my mind, the key point is that throughout the debate around Covid spend, the Government has been pretty clear both publicly and privately that that money cannot be used for non-recurring budget items. We can all accept that Covid has not completely gone away, so the costs that we incur have not disappeared, which is why we end up in that fuzzy middle position. Is there an issue around transparency and about the clarity on how that £5 billion has been allocated, whether it has been allocated, strictly speaking, on non-recurring Covid items, and what in the current budget is Covid related?

This budget is particularly difficult to track. Several items are jumping between budget lines and it is not entirely clear what in the budget is directed at Covid. Is that a fair assessment of why we find ourselves in this position?

David Eiser: I agree that tracking things in budget documents is always challenging. When the 2021-22 budget was set, at that point, the Government did not have £4.9 billion pounds in Covid consequentials—it had significantly less than that—so a large chunk of that money has come during the year and has been allocated in-year. That all adds significantly to the challenges.

As Audit Scotland has flagged up on several occasions, it was always going to be the case that, as we moved away from the pandemic, the distinction between pandemic spending and non-pandemic spending was going to be increasingly blurred. An example of that is health spending and the substantial increase in the core health budget in 2022-23. How do we disentangle the part that is there because of the legacy of the pandemic from the part that relates to the underlying pressures that were there all along? I am not sure how helpful it would be to try to do that. I do not know whether that answers your question.

Daniel Johnson: It does—the example is quite useful in itself. We know that the increase in health spending is about £2 billion, which means that there is about £2 billion to find elsewhere. If the Government is saying—not unreasonably—that there are still on-going costs from Covid across the board, it should be more straightforward to identify that spend in the non-health budget lines. However, it is not entirely clear where that is in the budget, outside health.

David Eiser: Sorry, do you mean that it is not clear where the resource for the £2 billion uplift in the health budget has come from?

Daniel Johnson: I think that that is relatively straightforward. We see the increase and we know what the consequentials are when it comes to health. However, if we are saying that there is, in essence, a 7 per cent cut, and we still have all that Covid cost, which extends beyond health, then there is £1 billion to £2 billion to be found in other budget lines, which is legacy Covid spend, but it is not clear where that is.

David Eiser: I agree that it is very hard to track individual budget lines and the consequences for them of the change in the overall resource settlement. To an extent, that is always the case, but the issue is magnified this year, because if you compare budget to budget you are ignoring the large chunk of the Covid funding that has been allocated in-year this year.

Daniel Johnson: Thank you. I do not know whether Graeme Roy wants to add anything.

Professor Roy: I do not have much to add, other than to say that you are right, in that budget documents and budget information are not really designed to go down to that level, in that way.

You can probably think of areas that are clearly a Covid cost, such as lateral flow tests, boosters and so on. However, the extension of non-domestic rates relief into next year, although it clearly relates to Covid, is not Covid funding but is to do with Barnett consequentials coming through and giving the Scottish Government the opportunity to take that approach. I understand your frustration and I think that there could be greater clarity in some areas, but there will naturally also be grey areas in all this.

Let me make a general point, which builds on your question as well as a question from the convener, about levels of understanding and the ability to scrutinise the budget. The issue is exceptionally complex. We did some research recently about just how difficult it is for people to understand it and work their way through it; the Parliament, Government and others collectively need to get better at this and consider what more we can do to make the information more accessible so that people can understand the differences in budget lines. Everyone is right in what they produce; what is missing is someone who can come along, pull it all together and say, “This is why you are getting different results here and there.”

Daniel Johnson: It is also important so that Government can manage.

The Scottish Fiscal Commission’s document is important in providing a medium-term outlook on fiscal pressures. I think that we were all surprised by the pessimistic outlook on tax and the implications in that regard; there is also the potential growth in social security spending.

I want to test a bit of logic that I put to the SFC. If we take the broad assumptions—and I freely accept that we are talking about forecasts, which are liable to error—about a negative net tax position of around £355 million, coupled with additional social security spend of around £764 million, does that mean that a deficit of about a billion pounds will need to be addressed in the Scottish budget over the next four to five years?

Professor Roy: There is no deficit, in the sense that the Scottish Government does not run a deficit—

Daniel Johnson: A challenge, then.

Professor Roy: “Opportunity cost” is how I would describe it; it is about what else the Government could be doing with that money.

The income tax situation is concerning. That takes me back to my earlier point about the growth in the tax base and Scotland’s economic performance relative to that of the rest of the UK.

The fact is that the UK is growing much faster, but that has always been an issue. Indeed, it was built into the fiscal framework, which is not just about how Scotland is doing but about how the rest of the UK is doing. If London is going flat out, we will struggle to keep up. That is the issue that is leading to the negative tax position.

One of the commissioners made a technical point about the assumptions that they use in respect of future tax policy. Because the UK is freezing its thresholds, you will have to take the specific nature of some of the numbers with a bit of caution. For example, if the Scottish Government chooses to freeze the thresholds, too, that will have implications for those specific numbers. However, the general point is that the net tax position is negative.

As for social security spend, you will see from the breakdown in the report issues about how the block grant adjustment works in that respect, but I would also highlight the quite helpful table that the Fiscal Commission has provided and which decomposes all this into differences by block grant and differences by discretionary choices. It is the discretionary choices that are driving quite a lot of this. That is not to say that they are not the right choices, but with a fixed budget, they bring an opportunity cost that has to be covered from somewhere else.

Daniel Johnson: Do you agree with that, David Eiser? Of course, the other question is whether I am looking at the right numbers here.

David Eiser: I certainly agree. The fact that the Scottish Government is setting a distinctive policy based on its new social security levers—the adult and child disability payments—and is rolling out the Scottish child payment is clearly a great illustration of the benefits of devolution, but such policy choices come with cost implications. On the basis of the forecasts, the implication is that spending on other things will be £700 million or so lower than it would otherwise have been. That is undoubtedly going to add to the medium-term challenges. Again, if we take the current forecasts as given, the tax situation is an additional constraint on the budget.

Daniel Johnson: My final question is about the really interesting points that Graeme Roy made about Scotland's relative economic performance. In a sense, that is what is driving all of this, and according to the oversimplified rules of thumb in my head, I have always assumed that Scotland will do a little bit less well than London and the south-east but better than pretty much the rest of the UK. However, the analysis suggests that that is not correct any more and that we are actually trailing most of the rest of the UK.

I have also always assumed that Scotland is not that different from certain other parts of the UK, whether it be the south-west in some ways and the north-east in others. What is so particular about Scotland with regard to lower participation and slower income-tax growth?

Professor Roy, you also made an interesting point about our companies being less productive, but what is driving that? You suggested that we have not been as good at adopting technology and so on, and I wonder whether you can go into that in a bit more detail, as I find it really interesting.

Professor Roy: You are correct in the framing of your question. When you compare the level of economic performance in Scotland with that in other parts of the UK, you typically find that Scotland is third behind London and the south-east. That position has been sustained over a significant period of time, because of the strengths of our economy such as financial services, a highly skilled workforce and what happens in the North Sea. Moreover, Scotland, like the rest of the UK, was boosted by the inflow of migration from the European Union in the early 2000s, which, in turn, supported the Scottish economy. That is where Scotland would normally sit relative to other parts of the UK and the UK as a whole—pretty much not that far away from the UK average, but third behind London and the south-east, once you have accounted for the huge regional inequalities in the UK. However, since the financial crisis, we have seen that, from that base, the relative growth of the Scottish economy—not only per head, but in total—has been slower than that of the UK as a whole.

12:15

The Fiscal Commission talks about the potential reasons for that, such as issues around demographics and participation, and it is hard to disagree with its view. We are protected from the effects of raw demographics because of the block grant adjustment. However, if participation among older workers is slightly different, there will be an impact.

There is also the north-east. Again, there are some interesting charts in the Fiscal Commission's report to show what has been happening to pay-as-you-earn numbers and average earnings in the north-east. That has been a huge part of Scotland's economy for 50 years—it was our largest industrial sector, in terms of output, for decades. As the sector goes through a transition and enters its twilight time, that situation is unique to the Scottish economy. It is in the UK economy, but it is a fraction of the overall economy. If it is 10 per cent of the Scottish economy, it is 1 per cent of the UK economy. The relative importance of that sector means that there is a much bigger impact on the Scottish economy. Crucially, jobs in the energy sector tend to be more highly paid, so there is an additional issue around income tax, which tends to be paid by higher earners.

On productivity, we could go into those issues all day. Just a few weeks ago, there was an interesting report from the Productivity Institute, which is an initiative looking at productivity across the UK. It is starting to unpick some of the issues, and one thing is quite noticeable. Scotland does well on productivity because of our sectoral mix. We have high-productivity sectors such as financial services and energy, which boost our productivity. However, if we move away from that and look at the core business base across other parts of our economy, we see that average productivity and take-up of innovation and entrepreneurship is lower in Scotland than in the UK. For example, our average spend on research and development is lower than in many other parts of the UK, as is our level of business investment.

From an economic point of view, an interesting point is that we quite often look at the star companies and at what we can do to attract more life sciences or inward investment into the country. However, thinking about what our core business basis is like, if we can shift the dial on things such as the basics of connectivity, access to digital skills, flexible working and good management practices, we can shift a larger business base. We are not talking about radically transforming the business landscape and creating gazelle companies and the next Skyscanner—it is about just gradually shifting the core productive base of the economy.

That is where there is potential, and not just for Scotland. If we compare the UK with other parts of the world, we see that it is an issue for the UK overall.

Daniel Johnson: That is fascinating. I think that we need a committee session on that topic alone.

Does David Eiser have anything to add?

David Eiser: Not really. It is clear that, since income tax devolution started in 2017-18, the rate of earnings growth has been slightly lower than that of the rest of the UK. It was only modestly slower in 2017-18, 2018-19 and 2019-20, but the latest forecasts seem to imply that that divergence is going to increase in 2022-23 and in subsequent years.

If we were to look on the bright side—or trying to find a way to look on the bright side—we might say that part of the reason for the divergence in the forecasts is that the SFC and the Office for Budget Responsibility take a slightly different view from each other about how inflation will feed through into earnings growth.

In reality, the way that inflation feeds through into earnings growth will not be as substantially different between Scotland and the rest of the UK as the forecasts currently imply. It does not really matter whether it turns out that the OBR is currently being a bit optimistic for the UK or the SFC is currently being a bit pessimistic for Scotland—if the forecasts end up being a bit closer, the outlook will not be quite as bad. However, I would not want to alter the conclusion that it is not a particularly great outlook for Scotland. Even if what I am saying comes to fruition, that will not change the fundamental outlook, which is not particularly positive for income tax revenues.

Liz Smith: I will follow on from that point. If we assume that the main challenge is to address the problem of proportionately declining tax revenues, am I right in thinking that you both suggest that the policies that are required to deal with that challenge are not only fairly straightforward fiscal policies, such as increasing tax or changing thresholds, but policies that will address some of the structural problems in the Scottish economy?

David Eiser: The issue can certainly not be rectified by changing income tax policy—it is much more fundamental than that. When it comes to which policies will change the outlook, there is no obvious answer; if there were, we would all be jumping up and down and saying, “Here’s the answer!” It is fundamentally very difficult for any Government to change the outlook for productivity and earnings in the short run. That is at the heart of the matter. It is not straightforward to address the issue through any policy.

Liz Smith: I asked the question largely because one of the difficulties that has been flagged up, in this meeting as well as previously, is that we have an ageing population, so the working population—which obviously pays the tax—is shrinking as a proportion of the overall population.

That cannot be changed overnight, which leads to the question of whether there are other policies that we can put in place to try to compensate for what is predicted. Both of you, as well as the witnesses from the Fiscal Commission, have said that the outlook is not great. Which policies will give us the best chance of addressing our difficulties and potential deficits? That is the main question. I will ask the cabinet secretary that question, too, but I am interested in what you think the evidence shows.

David Eiser: As I said, it is very difficult to give a list of three or four policies that will, inevitably, close the gap. We have been talking about the explanations for why average earnings growth in Scotland has been slower than that in the rest of the UK. That is the key issue—it is the relative performance that matters. Some of those things are clearly linked to developments in the offshore sector, which, as Graeme Roy said, have a more direct impact on the income tax base in Scotland than on the tax base in the rest of the UK. How to undo that in a short space of time is not immediately obvious.

Liz Smith: Professor Roy, you made some extremely interesting points about productivity and said that Scotland does very well in some cases and not very well in others. How does that relate to our concerns about employment trends in the Scottish economy? Do we have to use employment policies more to try to get us around some of the difficult structural issues?

Professor Roy: What would you suggest with regard to employment policies? As David Eiser mentioned, unemployment is less of an issue than it was. There are more subtle questions about underemployment, skills gaps and skills mismatches. Those areas are probably the—

Liz Smith: I am thinking about two things in particular. It is quite clear that there are people who are able to work but are perhaps not able or willing to work in certain jobs. That is why the vacancy rate has stayed higher than we might have expected at a time when unemployment was supposed to rise. There is a skills mismatch, and we might need policies to address that.

Do we also need education policies that allow younger people in particular to get a wider range of skills, so that they are more flexible in the jobs that they can do? We have seen increasing flexibility over the years, but do we have sufficient flexibility to fill some of the gaps?

Professor Roy: That is all really interesting, and it is worth looking at incentives for people to move into work. Paying the living wage, for example, is important in that regard. It is not just an important thing to do; the evidence suggests that it encourages people to move into work and boosts productivity.

There is an interesting wider question about the balance between skills and education for the workforce and the labour market that we know there will be in the future. When my generation was coming through, the idea was that you studied at school and went to university to get your education and skills, and that was it, whereas the labour market is now much more dynamic and flexible.

People will probably have to retrain and reskill much more regularly. Are we set up for that? How easy is it for somebody who is in a job to be retrained and reskilled? How affordable is it? How can people do that along with their existing work and caring commitments? Is it accessible? How do we deal with the skills gaps and mismatches? There are some really interesting things that are worth considering in the context of how we can get the labour market to be much more dynamic.

I will build on the more general point about which policies we can pursue. There is fiscal policy—we have some tax powers. There is a debate about whether increasing or decreasing tax is good or bad, but if tax is increased, there is more to spend on the things that help to boost productivity. It is not as easy as saying that increasing taxes is bad and decreasing taxes is good, because the money can be invested correctly.

The wider point, which we have spoken about, is the huge structural pressures in Scotland's economy around demographics and the transition from oil and gas into new industries. In the past, big structural changes in the economy have created legacy effects. We see that across the UK.

As a word of caution, I note that policy makers can do things that make differences at the margins but, when it comes to big structural changes, it is largely about adapting to them rather than about what can be done to counter them easily.

Liz Smith: Thank you.

John Mason: I have a question for David Eiser that follows on from some of the issues that have already been touched on. I do not know whether you heard the previous session, but I quoted a SPICe report about GDP growth rates in the calendar years that are coming up. The Fraser of Allander Institute's prediction, which I think it made in September, is that growth will be 4.8 per cent, whereas, in December, the Scottish Fiscal Commission predicted growth of 3.8 per cent. Those figures are just within Scotland. The OBR has predicted growth of 6 per cent, which appears to be at the highest end at the UK level. It is higher than the Bank of England's prediction, for example. Do you have any further thoughts on that?

David Eiser: There is, and has been, a lot of uncertainty around the outlook for the economy. That was true even before anyone had heard of omicron. Despite economic performance being much stronger than forecast during 2021, as I mentioned earlier, there are bigger uncertainties for 2022. Those uncertainties relate to the outlook for inflation and how that might impact things, to business investment and to what we have said about the economy being configured slightly differently and how quickly that happens.

All forecasters have been very open in saying that there is greater uncertainty about their forecasts than is usually the case, so there is inevitably some variation among them. The uncertainty has, of course, increased in the past couple of weeks.

John Mason: Earlier, you said that, if the OBR is being a bit optimistic and the SFC is being a bit pessimistic, it will come out in the wash in a few years' time. I get that. That is not exactly what you said, but it was roughly that.

The problem for us is that, in the short term—the next one, two or three years—those forecasts affect our budget, so we could end up making savings that we would not need in the long run because everything would come out in the wash and the economy would, in fact, recover. Is there not a problem if one forecast is cautious and another is optimistic?

12:30

David Eiser: There is a problem if one is cautious and another is optimistic. However, if everything came out in the wash, that would be a much more preferable situation to one in which the forecasters got things right, big structural differences existed in the economy's performance and everything did not come out in the wash. The best outlook at the moment is that everything will come out in the wash.

John Mason: There would be short-term pain for long-term gain.

David Eiser: Yes. If it turns out that, in 2022-23, things have been much better in Scotland, or much worse in the UK, than what was forecast, there would be a positive income tax reconciliation in a future year—there would be a transfer of resources over time. That outcome would be preferable to one in which the current set of forecasts are a good reflection of what actually arises, without a positive reconciliation further down the line.

John Mason: I am interested in what Graeme Roy said about differentiating between what we can and cannot change, and in some of the comments about productivity, which is probably more the work of the Economy and Fair Work Committee—I think that Michelle Thomson also sits on that committee.

I still wonder about productivity. Putting two crew members on a train is less productive than putting one on it, but doing so increases safety, enables the collection of fares and so on, so productivity is not always an issue. Is tourism a sector in which it is harder to have good productivity, because a good hotel has more staff and looks after people better? I am not sure.

Where I am going with this is that we cannot control the population, in one sense, but we could control it with immigration. Out of all that we are talking about—productivity, skills and population—is population the biggest issue? Is that what is holding us back?

Professor Roy: I have not done any modelling on the relative difference between those issues. Population is not a quick fix unless one can get migration, and it is an issue that beds through. Scotland's population challenges are decades old and go way back to population flow differentials between Scotland and the rest of the UK in the mid-20th century. Those differentials are just coming through now—those things are decades in the making rather than short term.

I did not mean to lead us away into a big discussion about productivity. However, you hit the nail on the head about productivity not being everything but being crucial to boosting wages. In the fiscal framework that has been signed up to, what matters—whether one agrees or disagrees with economic growth—is the ability to get earnings and employment growing at essentially the same rate as those of the UK. That point is crucial for this framework, although you might disagree.

Your other really important point is that productivity is not just about volume—doing more stuff—but about doing better-quality stuff. In an economy such as Scotland's, we have the potential to focus on better-quality jobs, products and activities rather than simply on volume. In the past, the conversation sometimes got too lost in productivity technicalities, but the focus could be on working smarter and more efficiently to create better-quality things. That focus is how an economy such as Scotland's has the potential to be at a comparative advantage.

That does not mean that there should not be a wider discussion about whether growth is good or bad, but what matters under the current framework is whether the relative tax revenue is in our favour.

John Mason: I realise that you work at a university and that you said earlier that there was an assumption that, if people went to university, they would get a good job and that would be them for life—that was absolutely the case when I was younger.

Liz Smith: You could end up as a politician.

John Mason: Yes, that is right.

I think that schools still think that way in a sense. Earlier, I made a comparison between my nephews. I do not want to provide too many personal details, but one of my nephews went to university and it will take him some time to earn wages, whereas my other nephew did not and is earning very good wages. In the short term, that helps with tax. Are we emphasising going to university and getting academic qualifications too much, at the expense of practical apprenticeships such as those in engineering and so on?

Professor Roy: I am not an education specialist, so I cannot comment too much on the detail. [*Interruption*.]

It is not necessarily about doing less. We should take a step back and look at the changing nature of our labour market and how we provide the flexibility and access to education and skills that we need for the labour market. That will still involve significant tertiary education, and we need to think about how we make universities and colleges more accessible to older workers, so that we can access expertise. What more can our universities do to support innovation and technological change?

However, you are right that there is a general question about what more we can do to provide support for young people to enter the labour market, which was a point that was made earlier. It is important to think about what we can do to give them skills and experience.

I know that I have not answered your question specifically. You might want to follow up on the issue.

John Mason: We have not said very much in this session about capital expenditure. We seem to be coming to the limit of how much we can borrow for capital expenditure, which is £3 billion. If we have to cut back on capital expenditure, will that result in a hit on growth in the economy?

David Eiser: Clearly, investment in capital spending—not just in the public sector but in the private sector—is an important component of growth in the long run. The story with capital spending is the same as that with resource spending. The capital block grant from the UK Government is the key thing that influences what the Scottish Government can do. We can argue whether the UK Government should be more expansive on capital spending, but the Scottish Government has to play the card that it has been given.

In relation to the picture in the long run, the capital budget over the next few years is relatively high in historical terms, but it is fairly flat over the course of this parliamentary session. The Scottish Government can use its borrowing powers to increase that budget a bit at the margins.

You could probably make a case for the Scottish Government to have greater capital borrowing powers, and you could certainly make the case that the current limits are fixed, in cash terms, at the levels that were agreed in 2016. There is no rational explanation for that. At the very least, there is a good case for the annual borrowing limit and the overall cap to increase in line with some measure of inflation or of the overall budget. The two Governments will negotiate the borrowing limits beyond that in the fiscal framework review next year.

The Convener: Is it not the case that the capital budget is declining quite significantly—by about 9.7 per cent in real terms—in the next financial year?

Is one productivity issue not that much of the Scottish budget is demand led? Given our ageing population, we need more care workers and more people in the national health service, and it is harder to increase productivity in those areas. Much of that work is highly people focused and labour intensive. We cannot just decide to reduce the number of people who are seen by a certain doctor, nurse or carer in a shift. It is much more difficult than increasing productivity through technological change in manufacturing, for instance.

Professor Roy: The short answer is yes. It goes back to my general point that we must be careful about how much we think we can turn the dial on those things. Much of it is about things that are naturally not going to do that. It also comes back to the general point that creating good, secure work in social care is not about boosting productivity or having a better economy; it is about providing good-quality care for people in social care. We should not lose sight of that.

The point that I am making about productivity is that, although there might be things that you can do at the margin, you must view that in the wider context, just as you have said, as regards what the Government can and cannot control and make a difference on.

The Convener: You were going to say something about capital, David.

David Eiser: Yes. My comment on capital spending relates to 2022-23 and the whole parliamentary session: as far as we know, it is fairly flat in real terms, but you are right to say that there is a drop from 2021-22 into 2022-23.

Ross Greer: I will follow up on John Mason’s point and on some of the comments that you have made, Graeme, about the objective of driving up wages and creating a high-wage economy. In the plethora of economic plans, enterprise strategies and innovation documents that exist in the Scottish public sector landscape, is there a clear, overarching sense of which sectors we are discussing and where we think we can create jobs in the high-wage economy that we are talking about? Is there a consistent understanding of what that specifically means beyond a very agreeable high-level objective?

Professor Roy: As you probably know from stuff that I have said in the past when I was at the Fraser of Allander Institute, there is a cluttered landscape and a lack of focus in many ways. We need to be more focused about what we are trying to achieve and, generally, about what sectors we could potentially create value in.

Also, what is our relative scale? We talk about some large-employment sectors such as social care and tourism. On a technical basis, they might show up as having lower productivity than life sciences, for example, yet we employ far fewer people in sectors such as life sciences relative to social care and tourism—and we are never going to employ large numbers of people in life sciences. I take your point about having a laser-like focus on where the relevant sectors and the opportunities to create high-value jobs are.

We have the opportunity to create better-quality, fair work more broadly across the economy. That is not just a way of increasing tax revenue; it feeds through to all the other conversations that we have had about demand and public services.

Ross Greer: On another, wider point, we will be moving pretty quickly in a matter of weeks into discussions around the spending review and its remit. Beyond the obvious overarching question of how to close the gap between the cost of current spending commitments and the resource that will be available, what are the questions that you believe we should be asking? What, specifically, should the remit of the spending review include beyond the obvious question of how we close what is a significant gap?

Professor Roy: I will say three quick things. You are obviously right: first, there is the question about what the immediate priorities are, given the envelope that we have, which you might not be able to shave too much off, as a large amount of it is demand led, as the convener has said. Then, you can consider what the Government identifies as its priorities: cross-Government collaboration, public service reform, better targeting, targeted revenue raising and so on. For me, it is important to separate those out into two elements.

Prevention and public sector reform, which we have spoken about for ages, are very long term. The changes that you make now in the spending review that will take place in the spring will not really change the dial over the next few years. However, greater cross-government collaboration, better targeting and targeted revenue raising are things on which you could make more progress here.

It is a matter of separating things into three areas. What are the very long-term and difficult things that we could have a discussion about? What are the things that could be done now, through more efficient and better working, that could have an impact in the medium term? What should be prioritised for the short term?

12:45

David Eiser: I agree with all that. The Government has set out the principles by which it will undertake the review, which are all sensible. The review will be outcomes focused, evidence based, consultative and so on, which all sounds right.

Clearly, the spending review needs to provide certainty about spending over the two years following the 2022-23 budget. Therefore, I expect the Government to set out very clearly what it thinks its overall budget outlook will be, the allocations that it has made in that regard and how the outcomes-focused and evidence-based approach has informed those allocations.

Douglas Lumsden: I want to ask about the north-east, not just because I represent North East Scotland but because the area is still a significant part of the Scottish economy. I remember the oil price crash in 2014 to 2016, when things were quite grim up in Aberdeen. The oil price has recovered and is in a good place, so why is the North Sea economy still holding the Scottish economy back?

Professor Roy: There are lots of dynamics in the north-east, when we consider what is happening in the oil and gas industry and the changing nature of the workforce and the deployment of oil and gas activities, which are having an impact in the sector. As you know, there is spillover from that into the north-east economy more broadly and core business activity, which is not as strong as it has been in the past.

There has been a lot of churn in the north-east and in oil and gas, but, typically, if we look over the decades, we see that the sector is moving into its mature phase, which is feeding through into the longer-term trends in employment, levels of investment and overall economic activity. In that context, the efforts of the north-east to pivot into other opportunities become crucial. It is about not just other forms of energy—hydrogen, carbon capture and the like—but diversification into other parts of the economy. I am thinking about the stuff that One North East does to support life sciences, get more of a digital economy and boost tourism, with a focus on the quality end of tourism, which will ultimately be crucial to the north-east transitioning away from being the oil and gas capital to being not just an energy capital but a diversified economy. What we are seeing is happening not over years but over decades—a decades-long transition is showing up in the numbers.

Douglas Lumsden: We know that the decline is coming; it is about how fast it is. That is the issue when it comes to policy.

Professor Roy: Yes, and there are big political debates about how the decline is managed, the trade-off between that and climate change objectives and so on. From a purely technical point of view, in the context of the framework, the existence of high-income jobs across the Scottish economy is crucial. In the long term, what matters from a Scottish perspective is getting people who are in high-paid jobs in the north-east that are tied to oil and gas, which might not be there in 10, 20 or 30 years' time, into high-paid jobs in other parts of the economy, whether we are talking about renewable energy, other sources of energy or the wider economy. That is crucial, given how the framework operates.

Douglas Lumsden: Thank you.

You mentioned prevention and collaboration. I do not want to be a spokesperson for local government, but I will say that I fear that prevention will be impacted by the cut of 2.7 per cent to the local government budget that we heard about. Is that a fear that you share?

Professor Roy: In terms of what?

Douglas Lumsden: In terms of the fear that the prevention agenda cannot happen because local government, which is where a lot of the prevention takes place, is having its budget squeezed.

Professor Roy: I probably will not say anything specific about whether local government's budget settlement will make things better or worse for prevention. The premise of your overall question comes back to the first question that the convener asked me, which was about how, with a tight budget settlement, we can make the changes that are required to do prevention. Prevention means shifting money from something in the here and now to something that is potentially speculative and very long term, which is hard to do. Local government is at the front end of that, because a lot of what it does is about prevention.

In the spending review, it would be helpful not to put everything into the pot at once but to try to separate out the changes that we could make now—they might be about providing better service delivery or making efficiencies that will generate relatively quick savings—and then continue to have the thorny and difficult conversations about where we make the changes that relate to prevention, which will take a very long time.

I do not have the answer to that. We have been talking about the issue for more than a decade. About a month or so ago, along with James Mitchell and the Auditor General, I talked to the committee about that, and we have not come up with the solutions in the six weeks since then.

Douglas Lumsden: We could talk about it for a long time and still not find solutions.

The Convener: Let us be a bit more optimistic than that.

Michelle Thomson is next.

Michelle Thomson: If you are looking for optimism, you have possibly come to the wrong place, convener.

We have covered an awful lot of what I wanted to explore. Sometimes, politicians play the game of thinking, "If it were me, what would I do?" I have been thinking about lots of things. For example, we could make all of Scotland a free trade zone but, oh no, we cannot do that. We could attract lots more entrepreneurs into Scotland, to go back to the digital line, but, oh no, we cannot do that. We could pick up on George Osborne's old phrase about the "march of the makers" but, as the convener pointed out, there has been a 9.7 per cent cut in capital expenditure.

Having said that, I accept Graeme Roy's comments about public sector consolidation and focusing on key sectors and the move away from oil and gas. One thing that this session has been very good for is looking at the wider perspective. Graeme Roy talked about structural issues. I do not think that we have talked about those enough in the committee. How are the structural issues in the UK economy holding Scotland back? I fully accept that there are structural issues in the Scottish economy but, looking at the macro picture, how are UK structural issues holding Scotland back?

I am looking at you, Graeme.

Professor Roy: I will say a few things on that. It is important to reflect on your general point about who controls the levers. The framework means that Scotland takes the risk of its income tax performance diverging from that of the UK, but it is not purely the Scottish Government that controls the drivers of income tax. There are structural factors in Scotland, but there are also UK policy choices that impact not just on Scotland but on Scotland relative to the rest of the UK.

It has been nice to be at a committee that has not mentioned Brexit, but that is an example of where decisions that have been taken at UK level will have an impact on Scottish income tax revenues. We do not know whether the impact will be worse or better in Scotland relative to that in the UK, but it is an example of a decision that has been taken outside Scotland that will potentially have an impact. We have to be realistic about what the Parliament can do to control the relative performance there.

Many of the structural issues that we have spoken about from a Scottish perspective exist at the UK level. Some of them are slightly more pronounced in Scotland, and some are potentially less pronounced. The UK has an ageing population; it is just that the population is ageing more rapidly in Scotland. I heard the earlier conversation about different parts of the UK ageing differently. Scotland should be seen in that context.

The productivity puzzle is a UK puzzle. Scotland has actually caught up with the UK on productivity in recent times. The issue is that the UK overall is lagging behind our key competitors.

There are in-built regional inequalities in the UK economy. Whatever "levelling up" means, it is designed to try to address those.

There are wider inequalities, which Parliament can control to an extent. Those inequalities are not only an issue in themselves; there is increasing evidence that they affect issues such as productivity and labour market participation.

Those are the broad UK issues. They are very similar to those in Scotland, but there are nuances as to whether those issues are more or less significant from a Scottish perspective.

Michelle Thomson: A lot of the levers that you might choose to use reside at UK level. Those include macroeconomic policy, a bunch of taxes, borrowing—which Scotland cannot do—and immigration. When you look at the current Scottish budget, is it your assessment that the Scottish Government is doing the best that it can with fairly limited fiscal levers? I do not want to put words in your mouth—I am not trying to do that. You can put your own words to it. I am asking the question because this committee and the Economy and Fair Work Committee have consistently agreed that, post-2008 and post-Covid, radical policy choices are required, yet this meeting has brought out the limitations on the Scottish Government when it comes to macroeconomic policy and levers.

This links back to the idea of asking what I would be doing if this were me. No matter what I thought of, we cannot do it. We cannot do any of the radical things that I thought of. You are both experts and I am merely a committee member. I would appreciate your thoughts.

Professor Roy: I might dodge two parts of your question—the one about what would happen if Scotland controlled more of the levers, because that opens up a whole series of questions about macroeconomics under different constitutional settlements; and the question of whether the Scottish Government is doing the best that it could, as that is ultimately a decision for you to make as you scrutinise the Government.

Under the framework, the Scottish Parliament takes the risk of income tax divergence, but it does not have all the levers. That is a natural feature of devolution and it is the nature of the framework. Decisions that are taken elsewhere will spill over into the relative performance—either good or bad—of the Scottish economy.

You spoke about radical policy choices. There is nothing that constrains the Scottish Government from doing different things within its spending envelope. It is within the Government's gift to do that. If the Government wanted to, it could use the money that it spends at the moment to do completely different things from what the UK Government does on all aspects of skills, education or economic development. In general, in the 20 years of devolution, there has not been radicalism in economic development policy in comparison with other areas. We can think of policies such as the smoking ban or the minimum unit pricing of alcohol and see that quite radical decisions have been taken in other aspects of policy that the Parliament controls, but if we look at the economy, we can see that there are differences at the margin but no real radical differences. That might be because there is a consensus on what constitutes the right policies for economic growth, such as supply-side policies, but there has certainly not been radicalism. I do not think that that is purely because the Parliament is constrained. I think that it is a deliberate choice.

Michelle Thomson: I have one last wee question.

The Convener: We are scrutinising this budget, not the budget that we might like to see.

Michelle Thomson: My last wee question is about behavioural elements. You talk about the Scottish Parliament taking a risk. If I was running a business, there is no way that I would run it in this way. How does that affect behaviour? That is probably my last question before the convener closes me down, and rightly so.

David Eiser: What do you mean by "behaviour"?

Michelle Thomson: Does risk diminish the appetite for change? Does taking a risk with differential tax policies inhibit behaviour?

David Eiser: I thought that you were going to ask about behavioural responses to tax change. Are you asking about political culture and behaviours?

Michelle Thomson: There will be economic outcomes, so the two are linked.

David Eiser: I do not have any immediate thoughts about political cultures and behaviours and how those influence policy.

Professor Roy: On the issue of economic development policy, there is a consensus about what we need to do to create a better economy.

Most people would agree that we need skills and investment and should tackle inequality. There is probably broad consensus across most policy makers and most economists about that. The question is the relative balance—how we weight some things more than others.

It may be that the nature of the framework means that we are always comparing what we are doing here to the rest of the UK. That might constrain behaviours. It might not be about risk; it might be about how much we are spending on economic development or what our poundage on business rates is compared to the UK poundage. The framing of that may constrain people's willingness to be more radical if it is always looked at through that lens. It is an interesting question that I would like to follow up on.

The Convener: I sometimes think that we look too much at what is happening in the UK and that we should look further beyond our borders, where there might be many more ideas for us to look at.

That brings us to the end of our time. I thank our guests, David Eiser and Graeme Roy, for again providing thought-provoking and helpful evidence for our scrutiny.

We will allow our witnesses to leave and then I will take a couple of minutes to update members of the committee on a couple of important matters.

Meeting closed at 13:01.

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