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Finance and Public Administration Committee

Tuesday 14 November 2023

Session 6

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Pàrlamaid na h-Alba

Tuesday 14 November 2023

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FINANCE AND PUBLIC ADMINISTRATION COMMITTEE
29th Meeting 2023, Session 6

CONVENER

*Kenneth Gibson (Cunninghame North) (SNP)

DEPUTY CONVENER

*Michael Marra (North East Scotland) (Lab)

COMMITTEE MEMBERS

*Ross Greer (West Scotland) (Green)
*Jamie Halcro Johnston (Highlands and Islands) (Con)
*John Mason (Glasgow Shettleston) (SNP)
*Liz Smith (Mid Scotland and Fife) (Con)
*Michelle Thomson (Falkirk East) (SNP)

*attended

THE FOLLOWING ALSO PARTICIPATED:

Charlotte Barbour (Chartered Institute of Taxation)
John Ireland (Scottish Fiscal Commission)
David Phillips (Institute for Fiscal Studies)
Professor Mairi Spowage (Fraser of Allander Institute)
Mark Taylor (Audit Scotland)

CLERK TO THE COMMITTEE

Joanne McNaughton

LOCATION

The Robert Burns Room (CR1)

Scottish Parliament

Finance and Public Administration Committee

Tuesday 14 November 2023

[The Convener opened the meeting at 09:45]

Scottish Fiscal Framework: Independent Report and Review

The Convener (Kenneth Gibson): Good morning, and welcome to the 29th meeting in 2023 of the Finance and Public Administration Committee. The first item on our agenda is an evidence session on the Scottish fiscal framework independent report and review. We are joined by David Phillips, who is associate director of the Institute for Fiscal Studies and one of the authors of the independent report, and Professor Mairi Spowage, who is director of the Fraser of Allander Institute. I welcome you both to the meeting.

We have about an hour for this session. Before we move to questions, I will set the scene a wee bit. In November 2021, the then Cabinet Secretary for Finance and the Economy, Kate Forbes MSP, confirmed that the independent report would focus only on block grant adjustments. However, she said that the Chief Secretary to the Treasury had

"agreed this will inform a review that will be wider in scope"

to ensure

"that the current arrangements are thoroughly assessed and options for reform considered, and that input is obtained from a wide range of stakeholders as part of the overall process."

On 2 August 2023, the Deputy First Minister confirmed:

"I have now reached agreement with the Chief Secretary to the Treasury ... on a package of changes to the Scottish Government's Fiscal Framework."

She explained that she had judged it appropriate to concede to a review with a narrower scope than the more fundamental review that was originally envisioned

"in the interest of securing long sought practical borrowing and reserve flexibilities, and to protect those arrangements that we already have in place which work in our favour".

I wanted to note that in order to set the scene for the questions that will follow.

One of the things that the Deputy First Minister secured is the indexed per capita mechanism for calculating block grant adjustments being adopted permanently. What are the benefits of that to Scotland? Further on in the paper, it says that that will be reviewed every 50 years. Is that what they mean by "permanent"? Do you have another view of what "permanent" might mean in this situation?

David Phillips (Institute for Fiscal Studies): The indexed per capita method of adjusting the block grant takes account of two factors that might mean that Scottish revenues do not keep pace in cash terms with those in the rest of the United Kingdom. First, it takes account of the fact that Scotland has, initially, lower tax capacity than the rest of the UK. At the point of devolution, for example, income tax earnings per capita were 79 per cent of those in the rest of the UK. Using a percentage change in tax revenues to calculate block grant adjustments accounts for that because the percentage is based on the Scottish revenues. The other factor is that the per capita element accounts for potential differential population growth between Scotland and the rest of the UK.

The way that the method works is that it takes the block grant adjustment from the previous year and applies the percentage change in revenues per capita in the rest of the UK and the percentage change in Scotland's population. That insulates Scotland from having a different initial level of earnings per capita and from having different population change. In recent years, Scotland's population change has tended to be lower than the change in the rest of the UK—Scotland's population has gone up less quickly.

The fact that the method accounts for that means that the block grant adjustment grows less quickly than it would if it had to keep pace with the overall level of growth in the rest of the UK. We think that, compared with the alternative method, which is called the comparable model, it will reduce the increase in the block grant adjustment by about £50 million a year on average. That means that Scotland benefits by £50 million, then £100 million, then £150 million and then £200 million, compared with what would happen if the comparable method was used.

It is worth pointing out that, of the methods that are on the table, this one probably best addresses what is called the no-detriment principle—the idea that Scotland should not, in expectation, lose out from tax devolution just because it has been devolved, although it can lose out if the economy performs less well or benefit if the economy performs better and, of course, it can benefit or lose from its policy changes. Of the methods that are on the table, the one that has been chosen probably best addresses that, but it addresses less well some of the other principles from the Smith commission.

A key aspect of the report is the fact that there is a fundamental tension between the taxpayer fairness principle, which says that revenue should not be redistributed from the rest of the UK to

Scotland post devolution, and the no-detriment principle, which says that Scotland should not, in expectation, lose out. Those two principles are fundamentally in conflict. The agreement prioritises the no-detriment principle, which benefits Scotland financially compared with the alternative.

The Convener: Mairi, the Deputy First Minister more or less said that the reason why we did not go down the road that we said that we would in November 2021 is that the UK Government said that the model was a kind of take it or leave it. Is that your understanding of the situation? Was the only room for manoeuvre that the Scottish Government had to accept this?

Professor Mairi Spowage (Fraser of Allander Institute): I suppose that it depends what alternatives were on the table. I know that the committee has had concerns in the past about not just the population risk that the Scottish budget is open to in relation to the overall population, which David Phillips explained, but the mix of our population—the extent to which it is ageing more quickly or is made up of people of working age and that sort of thing. However, those different options did not seem to be on the table. Since the fiscal framework was put in place in 2016, both methods have been calculated—the comparable method and the indexed per capita method. It seems likely that the question about the block grant adjustment in the review would be which of those was going to be chosen.

The Deputy First Minister was also looking for further flexibilities, which the Scottish Government did get as part of the agreement. It was not just about the Scottish Government securing its preferred BGA option out of the two, as there are also the further flexibilities on things such as borrowing. It looks as if the Deputy First Minister made the calculation that it was better to have the agreement confirmed after many years of it dragging on and to take the additional flexibilities that were also being offered. Given the choices that the Scottish Government is facing immediately in the current budget round, the fact that there is more flexibility in borrowing will help to some extent this year, when there is a large reconciliation to be made.

David Phillips: I very much agree with that. In our independent report, we looked at some of the alternative options, such as adjustments related to demographics, and there are two points to be made on that. First, it is not clear, at least in the short to medium term, that adjusting for demographics would necessarily benefit Scotland. Although Scotland's population is ageing more rapidly, a lot of the difference is not about the working-age population; it is about the growth in the child population. I have seen some calculations that suggest that, if we adjusted for the demographic mix, Scotland could actually lose out in the short term because pensioners pay tax whereas very few children do. It is not clear that Scotland would necessarily benefit in the short term from adjusting for the age mix, although that might change in the longer term.

The second point is that some tensions in the principles come to the fore here. If we think that the Scottish Government has limited control over long-term demographic trends, we might think that adjusting for the differential demographic mix is consistent with the no-detriment principle because it will prevent Scotland from either gaining or losing from things that it has little control over. However, if we think that these things are to some extent affected by Scottish Government policy—for example, it may be looking to attract workers or businesses to Scotland—it would perhaps be less consistent with what is called the economic responsibility principle, which is that Scotland should bear the costs or the benefits of its fiscal policy.

It is reasonable for Governments, when they make decisions, to trade off those different objectives and also to take account of the objective of simplicity. The more additional bits we put into the fiscal framework, the more complicated it gets. We have also seen from the census just how big changes in the overall population and—even more so—changes in the age distribution and demographics can be. That adds another bit of volatility on a 10-year cycle when the census is updated. Arguments can be made that we should control for additional factors such as demographics or tax-based structures, but there are definitely trade-offs with regard to complexity and the other principles of the fiscal framework.

On the breadth of the agreement, I note that there was quite a strong difference of opinion on what the fiscal framework actually consists of. The view of the Scottish Government and the Scottish Parliament is perhaps that it consists not just of the technical arrangements on borrowing and block grant adjustments, but also of the wider fiscal settlement and what is devolved. I think that the Treasury took the very firm line that that is a separate issue that is to do with the settlement and not the framework. I think that the Scottish Government made a decision that, in order to make progress on the framework, those issues could be put to the side and perhaps handled in a more political manner.

The Convener: It was not a negotiation between equals. Obviously, the Treasury always had the whip hand. We will certainly put the question to the Deputy First Minister, but no doubt she had to accept, more or less, the progress that has been made. Some of that progress is on capital borrowing, which will no longer be fixed at £3 billion in total and £450 million a year for capital expenditure. The limits will now increase in line with inflation. As Mairi Spowage has pointed out, that should really have been the case from the beginning, because the value of those borrowing powers has been eroding significantly over time.

I am interested in how the capital borrowing power inflationary impact has been assessed, because it is based on the gross domestic product deflator. Between 2023-24 and 2027-28, it is predicted to be 5.5 per cent. That is not the figure for this year; it is the total over the next four years. Is that in any way realistic? It would mean that the resource borrowing limit would go from £600 million in the current financial year to £633 million and the capital borrowing limit would go from £450 million to £475 million. How realistic is that, Mairi?

Professor Spowage: The calculations that we did were based on the Office for Budget Responsibility predictions at the time. As we have seen, there are issues around inflation in the wider economy and things have not evolved as lots of people expected. Inflation has certainly has not come down as quickly as we expected. On that stock of borrowing, the increases will now be linked to inflation, as they should always have been. The limits were set in 2016 in a low inflationary environment, but I think that everybody should have looked ahead and considered that they ought to be index linked because their power would erode over time.

Given the quantum of borrowing, it is not going to make a massive difference to the borrowing powers of the Scottish Government. In theory, it will have the same purchasing power in the years ahead, but it will remain tied to the sorts of limits that it has at the moment. We also need to remember that, over the past few years, the Scottish Government has used up a great deal of that borrowing limit, which may well constrain the amount of borrowing that future Administrations can do.

The Convener: In your submission, you say:

> "There is still a question though about whether the limits for forecast error are adequate given the risks the Scottish Government are facing ... Given that forecast error is all that this borrowing mechanism can be used for, it would seem sensible to consider that they should be extended further."

Professor Spowage: Yes. The predicted income tax reconciliation for the current year was £712 million prior to the outturn data coming in. Self-assessment receipts surprised on the upside and the figure ended up being just below £400 million. It has not reached the limit—this is just for income tax—but it could very well have done. Modelling that the Scottish Fiscal Commission has done in the past has suggested that the £600 million limit could be reached perhaps once or twice in a decade, and that is for income tax alone. The borrowing power for forecast error is to be used for all taxes and for social security as well, so there is a question about the extent to which it is still sufficient to manage the risk that exists.

One could argue that there are chances that there will be positive reconciliations in the future and that taxes will surprise on the upside while social security may surprise on the downside, so less will need to be spent than was budgeted for. The Scottish Government also has the facility to save up and put money into the reserve and so on in order to even out some of these things, as well as using borrowing powers. However, given that this borrowing is only for forecast error, the Scottish Government may be managing a large reconciliation, essentially with six months' notice, for the budget year that is coming. There is an argument for the limit to be increased further so that it will cover an income tax reconciliation that may come fairly regularly.

10:00

David Phillips: I echo those points. One can make a case that, because the powers are constrained for use simply for forecast error, they cannot be used for other circumstances, but you could have, potentially, even an unlimited capacity to borrow for those forecast errors. That is conditional on the forecasting being done independently, which it is, by the SFC. I would be much more worried about that if it was done by the Scottish Government. The other thing that one could do if one was concerned about the potential to, in effect, defer the issues indefinitely is to say that borrowing needs to be repaid within a certain time. One could combine increases in the borrowing limit with a restriction on the time period over which those borrowings have to be repaid.

With the devolution of social security benefits, something that may not be appreciated in the short term is the difficulty in predicting what rates of disability benefits people will qualify for and how long they will stay on them. There is quite a lot of uncertainty on the social security side at the moment. Even though the disability benefits are not as demand led as the unemployment benefits, which go up and down with the cycle, there is quite a bit of uncertainty about them at the point of introduction. As the data starts to come through, it might be worth looking at whether there are big forecast errors for social security benefits.

Professor Spowage: I absolutely echo that. With the devolution of income tax, it has been so obvious. We have had a few years of that, with large reconciliations being predicted and in some cases emerging in practice, but it is important to keep an eye on the extent to which we see forecast errors for social security benefits. The Scottish Fiscal Commission does its best to forecast the demand for those benefits. Social Security Scotland wants to take a different approach and the Scottish Fiscal Commission says that that is likely to lead to higher take-up, but there is quite a lot of uncertainty about how much we might end up spending on some of the benefits. As David Phillips said, they are not as demand led as benefits that are tied to the economic cycle, but they are new benefits with new criteria and they are being delivered by a relatively new agency. It is important to keep an eye on the extent to which they generate forecast errors that will need to be covered by the facility.

The Convener: David, you said in the independent report that

"relevant data used to forecast the BGAs and to determine tax and welfare receipts should also be reviewed to ensure it is sufficiently robust and comprehensive for those purposes."

You make a number of other recommendations, one of which is about

"whether the OBR and SFC forecasts could be better tied to minimise this risk."

David Phillips: One of the issues at the moment with the fiscal framework is that the forecast for the block grant adjustment is made by the OBR, which makes sense because the OBR is the forecaster for the tax revenues and social security in the rest of the UK, while, on the other hand, the revenue and spending forecasts for Scotland are done by the SFC, which also makes sense, because it is the official forecaster for Scotland and it can pick out more factors that are Scotland-specific. However, as well as Scotland-specific factors driving the differences between the two forecasts, there can also be differences in their judgments about the overall performance of the economy.

My understanding is that, currently, for the earnings forecasts, it is not the case that the SFC thinks that earnings will grow much more quickly in Scotland than in the rest of the UK, apart from maybe a little bit of a lift in the financial services industry. It is just that the underlying model or framework that the SFC uses on earnings projections and forecasts differs a bit from the OBR's. The OBR's current forecast is that earnings will go down below 2 per cent over three years, but the SFC took the view that that is unlikely to happen, given the situation with wage settlements and the benchmarks that guide wage settlements.

That means that part of the forecast increase in Scotland's tax revenues relative to those in the rest of the UK is driven by differences in judgments about the overall performance of the UK economy, including Scotland, rather than expectations about how Scotland will under or overperform compared to the rest of the UK. It is only the latter part that matters for the actual final ultimate budget impacts for Scotland. What might happen is that either the OBR revises up its forecast to match the SFC forecast, in which case the block grant adjustment is higher, which brings down the budget, or the SFC has to bring down its forecast to match the OBR and the revenues.

That is one of the challenges with a system of having two separate forecasters forecasting separate sides of the equation. It is not super easy to solve that, because you do not want those guys to agree on everything—you want to avoid groupthink. You want to have some challenge and you do not want people to just copy each other. On the extent to which there can be discussions and clarity around the factors that are driving these things—that is, to what extent it is differences in Scotland's earnings versus UK earnings compared to just overall optimism or pessimism—first, the forecasting body should have a good understanding of that so that it can think about what it is doing and, secondly, that needs to be communicated to Parliament and to the Scottish Government so that, when looking at the medium-term financial strategy and the spending review, there is an understanding of what side the risks are on.

As it stands, the risks are perhaps weighted more to the downside, in terms of lower funding, than to the upside, given that part of the growth in tax revenues is the difference in overall optimism rather than the difference in Scotland-specific optimism.

Professor Spowage: I absolutely agree with that. We should not mix up the spring experience with the autumn one—there is a much bigger gap in the spring. Things have settled down a bit and, hopefully, there is a year-round budgeting process that we can rely on to know when things will happen. The spring budget was in early March and the SFC presented its forecasts on 31 May. What I took from the evidence that it gave to the committee is not that the SFC knows what the OBR is going to do but that it expects that the OBR, in its next forecast, will probably significantly revise up its earnings forecast. That is what I took from the evidence that the SFC gave, without it actually saying that. At the end of May, the SFC thought that earnings were in a better place, and that is probably what it expects the OBR to do.

We have a much smaller gap between the forecasts now, at the end of November and in December for the Scottish budget, which are the ones that matter for setting the budget. We have seen issues when the gap has been larger—that happened with the 2020-21 experience, which generated the reconciliation that we have to deal with in the 2024-25 budget. When the gaps are smaller, it is less likely that there will be big divergences in judgment, which are caused by how the economic conditions have changed. That is part of the story about the March and the May earnings outlook, but it is always possible that the two bodies will have differences of opinion on overall economic performance and the overall earnings forecast, which is what really matters for income tax.

As David Phillips said, that is good in some ways, as it avoids groupthink—forecasters should have a healthy debate and should not always agree on things. They may well have different opinions, and they have different roles. The SFC is there to forecast the Scottish revenues and the Scottish economy to the best of its ability; it is not there to take into account how that interacts with the OBR's forecasts for the UK and the BGAs. The SFC does a lot to help scrutiny of those things, but its role is to get the forecasts for Scotland as right as it can. These things will always be in tension.

David Phillips: Mairi Spowage is correct in that it is not the role of the SFC to predict the other side of the equation, but perhaps the Scottish Government's role is to take into account both sets of forecasts and the potential issues of uncertainties and the balance of risk—is it on the upside or the downside?—when it is making budget decisions about the extent to which it should build up or draw down reserves. That is one thing that the Scottish Government can do to take account of the potentially unbalanced risks.

The Convener: Lastly from me before I open it to colleagues, I understand that the figure for fines, forfeitures and fixed penalties is at approximately £30 million at the moment but that there will be a flat deduction of £25 million from the block grant going forward. Is that linked to inflation at all and are those figures accurate? We have two sets of figures—£30 million for this year and £25 million from now on, which seems to be a reduction.

David Phillips: That is a block grant adjustment that is taken off the Scottish Government's funding and Scotland gets to keep the revenues collected from those. Reducing the block grant adjustment means that Scotland gets more than it otherwise would have if the figure had been kept at £30 million. By freezing that in cash terms, which I believe is the agreement, Scotland gets to keep any inflationary increases in those in full. I think that the Scottish Government will be relatively pleased with that part of the deal.

The Convener: That is right—as long as we do not become a more law-abiding society, of course. Thanks very much.

John Mason (Glasgow Shettleston) (SNP): The second of the bullet points on the Smith commission says:

> "The devolved Scottish budget should benefit in full from policy decisions by the Scottish Government".

Is the assumption there that, if Scotland varies from the rest of the UK, that is entirely Scotland's responsibility and it is under our control, for better or for worse?

David Phillips: That is the economic responsibility principle. The way to interpret that is that for taxes or spending that is devolved to the Scottish Government, when it comes to Scottish policies, whether they are related to those specific taxes or spending items or are more general—for example, policies that might boost or harm the economy—Scotland should bear, as far as possible, the full benefits and the full costs of those changes.

It is quite hard to do that in practice. For example, let us say that one of the impacts of a Scottish policy is to attract more high-skilled workers from the rest of the UK into Scotland. As it stands in the block grant adjustment mechanism, Scotland would get to keep the higher revenues generated in Scotland and, because those people are coming from the rest of the UK, that would reduce revenues in the rest of the UK and slow down the increase in the block grant adjustment slightly. Scotland would gain a little bit more from those extra revenues, because it would gain from the higher earnings and a little bit from the impact on the rest of the UK. You can see other instances where those effects might work in opposite directions.

John Mason: That is helpful. I will just say where I am trying to go with this: it is about the impact of London. As I understand it, London is an outlier, certainly in the UK and possibly in Europe. Broadly speaking, in most things, Scotland competes quite well with the rest of England, Wales and Northern Ireland—the rest of the UK, apart from London and the south-east. If London grows faster than the UK average on the economy, tax and all the rest of it, as it has tended to do, we have no control over that, but we are being punished for it.

David Phillips: On that, I would distinguish between the two sides of the fiscal framework. One argument that can be made is that, when we look at the block grant adjustment, we should not look at trends in revenues in the rest of the UK as a whole; we should exclude London, because by adding in London you are making the comparator not fair for Scotland. That is because, although revenues in Scotland might keep pace with revenues in the rest of the UK excluding London, if the rich in London are pulling away from the rest of the UK and from Scotland, Scotland cannot keep up with that. Conversely, if in a downturn there is a huge fall in the top incomes in London and that is dragging down revenues, Scotland is not seeing that, so why should Scotland benefit from the fall in top incomes in London?

You can make that case. However, the other side of the equation is the way that the spending side of the budget works: as that tax from London is spent, either it is spent on things that are subject to the Barnett formula, and hence Scotland gets its share of that revenue via the Barnett formula, or it is spent on things that are UK-wide, such as social security or debt interest, and on average Scotland receives a population share of that spending. If you look at just the revenue side, you can make a case that Scotland is potentially being compared to a baseline that it is hard to keep up with but, if you reflect on the spending side of the budget, you see that the money comes to Scotland through the Barnett formula or through spending on UK-wide things.

10:15

That comes back to the tension between the principle of no detriment from tax devolution and the issue of taxpayer fairness in the redistribution of tax revenues from the rest of the UK. The issue is where you draw the line on those things. The further you draw it towards no detriment, the further you move away from taxpayer fairness, and you need to draw the line somewhere.

Professor Spowage: I absolutely agree with everything that David Phillips said. You cannot divorce the issue from the way that Scotland is funded through the Barnett formula. If you look at spending on services in Scotland compared to spending in other parts of the UK, particularly parts of England, Scotland has higher spending. The fact that revenues generated in London and the south-east will be funding spending in devolved areas in England that generate consequentials or UK-wide spending is important to bear in mind when thinking about the budget overall.

John Mason: As you said, Scotland has above average spending, but the Barnett formula is designed to reduce that gap, as I understand it. On top of that, despite what you have said, it still seems to me that, given that London in recent years has been doing better than the rest of the UK, the fiscal framework is disadvantaging Scotland. I take the point that a collapse of the London economy would benefit us, but that does not seem to be the evidence so far.

Professor Spowage: I will give a quick answer and, if David Phillips wants to talk about Barnett convergence, he can do so. The Barnett formula convergence has not really happened to the extent to which it was expected, for various reasons, including the differences in population movements over the years and the impact of things such as spending cuts during the austerity years and so on, and there is still significantly higher spending in Scotland than in every part of England, and we should bear that in mind.

David Phillips: I agree with Mairi Spowage that the Barnett squeeze has not really happened to date. There are three factors that have been holding it up: population; the cuts in the 2010s; and Scotland benefiting from an error in the way that business rates were accounted for in the Barnett formula in the 2010s, which amounted to about £1 billion by 2015. However, the situation is going to change. We have already seen it start to squeeze down since 2020. In 2019, spending per capita in Scotland for devolved services was about 129 per cent of the average for England, and it is now about 125 per cent. I expect that, by the close of this decade it will be about 122 per cent, and will fall below 120 per cent by the mid-2030s. That squeeze will put pressure on the Scottish Government’s budget in the years ahead.

You are also right that, if it is the case that London and the south-east will pull away from the rest of the UK in the long run and it was not within the capabilities of the Scottish Government to make policy changes with the levers available to it to change that, there could be a potential for divergence and a fallback on the income tax side. I come back to the point about the two principles that were set out by the Smith commission: that, on the one hand, Scotland should not lose out from tax devolution in expectation, effectively; and, on the other hand, post-devolution revenues in the rest of the UK should not be to Scotland from devolved taxes. Those principles are incompatible. Either we need to go back to those principles and revise the position, or we should choose one to prioritise.

In this agreement, the Scottish Government and the UK Government have chosen to largely, but not completely, prioritise the principle of no detriment over that of taxpayer fairness. Hence, there is still some potential for detriment around issues such as the south-east and London pulling away from the rest of the UK and Scotland.

John Mason: You are saying that, having been at 129 per cent, rightly or wrongly, we are on a decline to 120 per cent?

David Phillips: Yes, and, in the longer term, given current population projections, I would expect that to converge to about 115 per cent. Given Scotland’s demographics and socioeconomics, that is probably still a little bit higher than Scotland’s relative needs, but it means that many of the things that Scotland has traditionally benefited from and enjoyed, such as free tuition, free personal care for the elderly, would have to be funded by alternative means, and that the more universal social welfare state in Scotland will be more difficult to fund in the 2030s and 2040s. Even if the UK Government were to match spending needs in the rest of the UK—which is a big "if"—it would still be hard for Scotland to fund that than it has been traditionally in the past, given the Barnett squeeze.

John Mason: But there has not been any assessment of needs for quite a long time I think. If needs includes rural areas, we have got big challenges with that.

Professor Spowage: David Phillips might correct me if I am wrong, but I think the last big assessment of that was done by the Holtham commission for Wales many years ago, which I think was in 2010. That suggested that Scotland had been relatively overfunded by the Barnett formula, by quite a way, and that Wales had been generally underfunded. I think that that was the last big assessment of the situation, and it would certainly be interesting to update that. That took account of things such as the higher cost of living in rural areas and the great cost of providing services in those areas, but it still suggested that Scotland was considerably overfunded compared with the sums that it would get according to a needs-based formula. It would be interesting to redo that exercise and see where we are now, given all the changes that have happened to the health, wealth and outcomes of lots of different people across the whole of the UK.

David Phillips: It would be particularly interesting to look at it given the rise in the elderly population and particularly the concentration of elderly people in more rural areas. The older population is where a large share of spending goes and if they are in the more rural areas where it is harder to deliver services—I think that it has become increasingly more so in rural areas—that could change some of the figures a little bit compared with, say, 2010 when the calculations were last done.

John Mason: At previous meeting, the Deputy First Minister told us that both Governments were having to make compromises. Do you see that the UK has made any compromises in this?

David Phillips: I think that the UK has made compromises. My overall impression is that both Governments are reasonably happy with the agreement because they avoided the big risks that they wanted to avoid.

The UK Government's compromise was on the block grant adjustment indexation where, partly because of individuals involved in the negotiations, there was a particular focus on trying to make sure that Scotland's block grant adjustment mechanism treated population the same way as the Barnett formula does. That is what is called the comparable model. That was brought in in Wales in the fiscal framework. I think that the UK Government compromised on that. It would have wanted to put that in there because several people feel that it is unfair that Scotland is effectively protected from slower population growth on the revenue side but benefits from it on the Barnett formula side, and that there is asymmetry in there. The UK Government compromised on that one, although, as I said, you could argue that, by compromising, it made it more consistent with the no-detriment principle, which is one of the principles of the Smith commission.

The other area where both Governments compromised was on the Crown Estates. The UK Government wanted to index the Crown Estates to revenues in the rest of the UK, largely to account for the fact that, with regard to the offshore wind farm licences, if the arrangement had been fixed in cash terms at its old level, Scotland would have got its offshore wind licences as revenues and then would have got a Barnett share, or another share, of the revenues being spent from the English and Welsh licences. Treasury thought that was unfair and wanted to index it. The Scottish Government argued that its position is different because its Crown Estates are quite different to those in the rest of the UK, as they do not involve places such as part of Regent Street and the central London estates that are racing away in value, so it would not be right to index Scotland to that. In the end, the Scottish Government compromised around the sum of £40 million by 2028, which I think is roughly halfway between full indexation and fixing it in cash terms, so I think that there was some compromise there.

Where the Scottish Government would have felt that it compromised was that, although it got an improvement in its borrowing powers, the arrangement was linked to inflation rather than being indexed to the amount of revenues or spending at risk, which typically grows faster than inflation. I agree that there was a compromise there. Overall, however, the Scottish Government will be pleased it has kept the index per capita and that it has got some increases, and the UK Government will be pleased that it had some increase for the Crown Estates and that it did not have to grant substantially increased borrowing powers.

The impression that I got is that both sides are pretty happy. I think that the Scottish Government won an award for its negotiations at the Chartered Institute of Public Finance and Accountancy event.

John Mason: Professor Spowage, as well as responding to that, could you also comment on where we are now with regard to Scotland-specific shocks?

Professor Spowage: I agree that both Governments will be happy. To be honest, generally it is the teams of officials who will be happy with the outcomes; I imagine that the politicians involved will just be happy that it is done. As the convener touched on, there is a question of what happens now with the agreement and any review of it in the future. I am sure that the committee will be interested in the extent to which there will be any scrutiny of future discussions or agreements on this, given that there was limited scrutiny this time. Obviously, there was a consultation that went out but there was not any discussion or consultation on the agreement, which came out during the recess and caught everyone by surprise. The scrutiny by and involvement of Parliament in what happens next is a wider question.

On the Scotland-specific economic shock, the provision that was put into the original agreement was that borrowing powers would be doubled for forecast error from £300 million to £600 million in the event of a Scotland-specific economic shock, which was defined as Scotland's economic performance seriously underperforming that of the UK and also being very low. That provision has been removed and the borrowing limit was just increased to £600 million all the time, so there is no current provision for additional flexibility of borrowing powers in the event of a downturn that is just in Scotland rather than across the UK. There is no provision there for further borrowing in the event that that happens now.

John Mason: If there was a specific shock to particularly Scottish sectors such as tourism or food and drink, would that cause us a problem?

Professor Spowage: Yes, to the extent to which a sector impacts on the income tax revenue take. For example, if hours or wages were to be constrained in the event of a Scotland-specific economic issue, the extent to which there could be increased social security payments is relevant. As we said earlier, the social security payments that are devolved are not generally linked to the economic cycle as such, but, yes, there could be an impact in that way, and in relation to spending in areas such as crisis funds and other things that local government manages.

If there was a Scotland-specific economic issue—such as the downturn in the oil and gas industry in 2015-16—it is likely that there would be downward pressure on revenues and upward pressure on spending, which could cause issues for the Scottish Government. However, you must remember that the additional borrowing flexibilities in the event of a Scotland-specific economic shock were taken account of in relation to the forecast error borrowing. The borrowing would be additional borrowing for that purpose, not just borrowing to spend more money on whatever the Scottish Government wanted to spend it on on the resource side. I am not sure that there was huge flexibility there anyway to deal with those sorts of things, given the restrictions around that borrowing.

David Phillips: I will add that the borrowing powers are not to address ordinary downturns in revenues; they are to address unexpected downturns in revenues. There could be scope to further enhance the powers of the Scottish Government to borrow. At the moment, for example, if, in advance it is forecast that Scotland's revenues perform less well than those in the rest of the UK, there is no scope to borrow to smooth that, even if that is a temporary dip because of, for example, a downturn in the oil and gas industry that is expected to come or because of issues with tourism or other factors.

I think that there would be issues in giving the Scottish Government discretionary borrowing powers that are very large. I can talk about those if you want, but for a small amount—perhaps, say, 1 per cent to 1.5 per cent of the Scottish Government's resource departmental expenditure limit, which would be £460 million, subject to some caps on the total amount and some caps on how long the borrowing can be for—either there is a case to give the Scottish Government some powers to respond not only to unexpected downturns in revenue or shocks to social security spending but things that are forecast in advance for social security spending or tax revenues, as well as unexpected shocks to public service spending. Something like 1 per cent to 1.5 per cent of the fiscal DEL would not be a threat to fiscal sustainability, and I do not think would be an issue in relation to fairness to the rest of the UK, but would give more flexibility for the Scottish Government to respond to other forms of shocks.

10:30

Michael Marra (North East Scotland) (Lab): In the absence of any real public discussion or parliamentary scrutiny before the agreement and the publication of the report, we are left reading priorities into the text. It seems that the Scottish Government has placed the population dynamics at a higher level of priority than other economic challenges such as low gross value added or longer-term lack of investment in research and development that might be driven by more capital spend. Is it your feeling that it has put the immediacy of those issues ahead of longer-term economic transformation, as it might put it?

David Phillips: I am not sure that I would go quite that far. My understanding is that, on the block grant adjustment, you are right that, focusing on population has tried to address something that would hit the Scottish budget immediately—as I said, that involves around £50 million a year cumulating for each year, and that was not accounted for. On the capital side of things, it is perhaps less the case that the Scottish Government did not want to prioritise than that the UK Government did not want to cede too much ground in that area.

This is a personal opinion—it is not based on inside knowledge or anything—but I think that the UK Government is perhaps concerned that, if it were to grant substantial additional borrowing powers for capital investment, those could be used in the short term to substantially boost spending and could be used in arguments about the constitution. I think that the UK Government would have been much more reluctant to see substantial additional capital borrowing powers, particularly in the context of the current set-up in the rest of the UK, where there are no England-only capital borrowing powers.

You are right that it has ended up prioritising short-term funding issues over long-term potential investment, but I am not sure that that was a thing that was substantially under the Scottish Government's control to vary.

Professor Spowage: The cumulative nature of the population risk compared with the comparable method on the table—if those were the two methods that were on the table—made it, from the Scottish Government's perspective, a no-brainer. That does not mean that it could not also try to push for increased capital borrowing powers and, as I said, the Scottish Government has extensively used those capital borrowing powers since they have been in place—up to 75 per cent of the overall cap in the current year. I guess that the Scottish Government would say that, in the negotiations, it was trying to argue for both. However, from its perspective, it absolutely had to secure the IPC method, because that cumulative erosion of the spending power of the overall budget would be a significant issue permanently embedded in the fiscal framework.

Michael Marra: As much as other members may describe the negotiation as a process in which the UK Government has the whip hand, it involves a two-party signatory agreement where one party can withhold agreement and say that "Until we get more of what we want, we are not going to agree to it". Although, as David Phillips described, one party might, for very sound reasons, be reluctant to go in a particular direction, it is a two-party agreement.

That takes me to the issue about how rushed some of this feels towards the end. It is a long-term process but it seems like we are now locked into what is described as an agreement for more than 50 years on the basis of trying to deal with a short-term issue in terms of borrowing capabilities to deal with a £1 billion black hole of the Scottish Government's own making. Is that not part of the risk in the way that the Scottish Government has dealt with this? It has focused on short-term budget priorities and how it can get through this budget year, and has locked us into a process for 50 years as a result.

Professor Spowage: The fiscal framework provisions make clear that both Governments can suggest changes to the fiscal framework review that would be reviewed by the joint Exchequer committee. I imagine that this committee or future iterations of it in the Scottish Parliament would be interested in how it can make suggestions in that regard, or how its scrutiny can be brought to bear on any discussions on the arrangements. I think that it is unlikely that this agreement will lie untouched for 50 years. There are provisions to suggest changes, but there is not a point at which it would definitely be reviewed, as there was in 2016. The trigger for that was because the two Governments in 2016 could not come to a permanent agreement on the BGA mechanism. Now that they have, it does not mean that other provisions in the framework could not be looked at.

The £1 billion issue that you referred to was set out in the medium-term financial strategy and that was the revenues that the Government thought it would have access to to spend compared with the commitments that it had made. It is obviously up to it to explain which things it is not going to do to meet that challenge, and that is what it will be doing in the budget. I suppose that the increased borrowing powers made the approach to the issue a little bit easier, given that the Scottish Government is able to borrow for the whole of the income tax reconciliation now, whereas it was not able to do that before.

I do not know whether your characterisation is fair, because there will clearly be opportunities to review the arrangement in future years. The Scottish Government and the Treasury can make suggestions and changes and, as I say, I do not think that the fiscal framework will remain as it is for 50 years.

Michael Marra: The Barnett formula was set in similar circumstances. It was thought that it might be revised within a couple of years but it has existed for decades and we are still unpicking the complexities of it. Mairi Spowage might want to come back to me on that one, but I invite David Phillips to share his thoughts first.

David Phillips: It is fair to say that, sometimes, arrangements that are seen as temporary can end up becoming permanent fixtures of the system. It is also fair to say that the Scottish Government would have had a eye on the short-term fiscal position when it comes to trying to reach an agreement for the current financial year. I point out, however, that might have been a typo in some of the notes, because my understanding is that it is not a 50-year review cycle but a five-year review cycle. It is five years, but not more than once in any UK or Scottish electoral cycle.

Michael Marra: Upon which basis decisions are made, I suppose.

The Convener: I am sure that a future UK Government could easily reopen those negotiations if it wanted to be more generous to Scotland.

Liz Smith (Mid Scotland and Fife) (Con): Let me return to the issue of forecasting by the OBR and the SFC. What you have set out for us is extremely important not only for determining some of the issues within fiscal frameworks but in relation to setting budgets. We have had the OBR and the SFC in front of this committee—they were extremely professional in both cases, I have to say. Is there statistical evidence, within recent trends of the forecasting of the OBR and the SFC, or particular data that shows a greater issue of error or volatility, or is it just the overall predictions that provide some problems for us?

David Phillips: I understand that there is a particular difficulty with self-assessment. The initial expectation for the most recent year was about £700 million in reconciliation, and it came in at just under £400 million—a £300 million difference. As a share of overall income tax revenues, that is only about 2 per cent or so, but, as a share of the self-assessment revenues, it is probably more like 10 to 15 per cent. There is quite an issue with self-assessment.

Looking forward, I think that there is also a risk that the Scottish Fiscal Commission has quite a difficult task ahead. Do we baseline the faster growth and assume that it is now at a higher level, or will there be some reversion to the mean—will we grow faster in this year and slower in the subsequent year? There is a particular issue there.

More generally, we have seen a big issue in the economic statistics in the UK recently whereby different earning series are giving a vastly different picture of what is happening to earnings. For example, over the past few years, things such as the labour force survey, the average weekly earnings and the annual survey of hours and earnings—some of the main surveys that we use for earnings—show that earnings have grown much more slowly than HMRC data suggests. However, the HMRC data over the past couple of months has suggested much slower growth than some of those other indices. I know that the SFC can take account of the HMRC data that it gets through as a feed, but we know that that data is not a full sample.

So, there is a particular issue with self-assessment and a fundamental issue that earnings data in the UK seems to have got a lot worse recently, which is causing some issues in the forecasting process.

Liz Smith: When you say that it has got a lot worse, is it that the trends of that forecasting have got worse, or is there just extra volatility in the earnings that is very difficult to predict? I am asking whether there is a problem with the statistics that we are using and, therefore, a difficulty for the OBR and the SFC in interpreting that data or whether something else is causing a problem.

David Phillips: There are definitely issues with labour market statistics currently. There has been a big drop in the response rate to surveys such as the labour force survey and the annual survey of hours and earnings—ASHE—which has made it much harder to know what is generally going on with both employment and earnings, particularly in those areas that are not so well covered by the income tax statistics, such as the self-employed and those at the bottom end of the market.

Liz Smith: The *Financial Times* contained an interesting article about this a couple of weeks ago. The presentation of the data is making life very hard for the OBR and the SFC. That matters to us big time because the data is absolutely crucial not only for informing us what the current economic picture is but for informing the Government when it sets policy. Can we do anything else to help to reduce the forecasting error, which obviously has created difficulties between the OBR and the SFC, certainly over the past few years?

Professor Spowage: I think that it would be difficult to reduce the forecast error much more. There are huge challenges with all the data about earnings and the labour market, which have been well documented in relation to the ONS's difficulties with response rates and the labour force survey, and I am not sure that those challenges will be addressed by the transformations that the ONS is trying to put in place. It is a big challenge. We have seen that even in what the Bank of England thinks about the economy and the decisions that it is making—because it is hearing very different signals about wage growth and the economy.

You must remember that the SFC has extra challenges because it does not have all the data sources for Scotland that the OBR has at the UK level. It does not have the equivalent of the average weekly earnings data to look at, to see whether it is different from the HMRC data. All that it has is the HMRC data, and it is doing its best to forecast using that. Extra data sources could possibly be made available to allow the SFC to do that sort of thing, but there are huge challenges in collecting that data at the UK level at the moment, so it is pretty difficult.

I would always advocate for more access to data for analysts and researchers. HMRC data is a particularly difficult area for academic researchers and researchers outside Government such as David Phillips and me. Access to more data would obviously help, but forecast error will always be a feature of the process. The SFC's forecast error happens because it is forecasting for a smaller economy, so the data and the forecasts are likely to be slightly more volatile. Whatever forecast error the OBR has, the SFC will probably have a slightly bigger one just because Scotland has a smaller economy. Such errors are part of forecasting. The issue is amplified in Scotland because there is the OBR forecast error on top of the SFC forecast error. They could go in the same direction, but they might go in opposite directions; therefore, the issue is amplified for the Scottish budget.

Liz Smith: That hits the nail on the head. In Scotland, forecasting is a difficult job because the SFC is having to deal with two forecasts rather than just one.

If we accept that there will be a degree of forecast error, we have to play that into the system. Do you know whether, when the OBR and the SFC are looking back at the predictions that they made and how things turned out in practice, there is a lot of co-operation between the two in order to assess where some of the forecast error came in? In your opinion, is that well documented?

10:45

Professor Spowage: I understand that they work together fairly closely and will be trying—as fellow analysts and forecasters doing a very difficult job—wherever possible to learn from each other and to improve the situation. Let us not forget that the past five years or so, during which the SFC was set up, has been a mad time economically, with lots of things happening that were not expected. There have been a lot of difficulties that none of us could have predicted. However, I understand that they are working very closely, as fellow analysts, wherever possible, to share information and to understand where their models are maybe looking at things slightly differently, in order to reduce those differences.

David Phillips: The OBR has recently been doing some work to look at its Scottish forecasts. It has focused more on its own forecasts of Scottish revenues—as opposed to its forecasts of rest-of-UK revenues, which go into the block grant adjustment—which is what matters for the Scottish budget. That can be very useful, and both the OBR and the SFC produce forecast evaluation reports, which look at the historic performance of their forecasts and try to learn lessons from those. I am pretty sure that they also look across their two systems.

As there will always be forecast errors, it is worth thinking about not just the increase in limit that we have seen, which will help to address the fact that the forecast errors are now bigger than they were previously, but whether there is a case for going even further and potentially saying that it is important to cover any forecast error but subject to some overall cap and some time limits on repayment. I also go back to the fact that understanding qualitatively, at least, which direction any adjustment may come from is important. Then it is up to the Scottish Government to set its budgets with those risks in mind.

My own view is that, in 2021-22, when we had the reconciliation, it was quite clear that Scottish revenues were not going to outpace those in the UK by £500 million or whatever was said. It would have been possible for the Scottish Government to bank some of that money into reserves, to potentially reduce the amount that would need to be borrowed in the coming year to help to smooth things.

Liz Smith: That is very helpful. I think that the committee would agree with the statement that forecasting is an inexact science. Obviously, we have to accept that. However, is there anything that we can do through budget analysis and fiscal framework analysis to ensure that the forecasting error is minimal?

Professor Spowage: We have talked before about the issue of the RUK forecast, which the block grant adjustment is based on, coming from the differencing-off of the OBR's Scottish forecast from the UK forecast, but its Scottish forecast is done using a different economic model and not Scotland-specific economic determinants. The OBR, in its commentary around its Scottish forecast, does seek to adjust the Scottish share on the basis of Scotland-specific factors, and some of the work that it is doing to look at that may well improve it. However, more work could be done in that area, because the RUK forecast is differencing that off from the UK forecast, and its view of the Scottish economy not being based on a Scotland-specific model is potentially a bit of an issue.

Other approaches to the issue are being taken in other parts of the UK. Wales has made a different decision about the extent to which it wants its own fiscal institution, and it is asking the OBR to take that role—at the moment, at least. It will be interesting to see how the different approaches lead to different outcomes in things like reconciliations, forecast errors and so on.

Liz Smith: Thank you. That is very helpful.

Michelle Thomson (Falkirk East) (SNP): Good morning. I want to go back to a comment that David Phillips made earlier about capex and the accommodation that was made by the UK Government. In some respects, I am surprised. I appreciate why the Scottish Government wanted to fix on the IPC, for all the reasons that we have discussed. However, in relation to the current fiscal challenges, I am surprised that it did not push more around capex thresholds, given that there is a very real need for capital projects and given what those could have brought to the economy in the complete absence of any of the meaningful levers to grow the economy that it might ordinarily expect to have. A lot of what we are discussing is really dancing on the head of a pin in terms of the nature of the fiscal transfer and the way that things are happening in the UK.

Do you agree with my assessment? If you had been doing that, would you also have been pushing hard for increased capital borrowing powers, with the intent of using them because there is a good reason to do so in the current economic climate?

David Phillips: First of all, I do not know what was going on behind the scenes. We wrote the independent report and had some discussions with the two Governments in the context of that, but I do not know what conversations were taking place and how much different aspects were being pushed by both Governments. I could not say whether the Scottish Government should have pushed it more or whether it pushed it as hard as it could and it was a red line for the UK Government. I do not know. My sense is that the UK Government would be more concerned about giving ground on borrowing than it would be about what accumulate to quite large amounts on the BGA side but are, in any one individual year, relatively small amounts. I would not want to comment on whether the Scottish Government should have tried harder, because I do not know how hard it tried.

On the capital borrowing limits, you could argue that, yes, given that we know that inflation for many things on capital is outpacing the GDP deflator at the moment—that was commented on earlier—if you want to maintain the real value of the capital borrowing, linking it to capital inflation as opposed to GDP inflation might have been a start.

When it comes to what the priority is then, in terms of further increases to increase capital investment or to increase resource investment, I think that there is a question about what the Scottish Government's real challenge is. Is the real challenge at the moment in maintaining services and maintaining the resource side of the budget, or is it in maintaining investment in the economy? Also, what is the supply-side capacity for those things? Is there the supply-side capacity to deliver substantially higher investment without driving up costs further?

I do not know the answer to those questions, but I would hope that the Scottish Government is doing some work around those things when thinking about its negotiation strategy—thinking about not just what the numbers are, but where it can get the biggest bang for its buck and where it can avoid, for example, spill-over effects that end up pushing up costs and undoing some of the potential benefits that the higher limits could give you.

Michelle Thomson: That is very helpful. Do you want to come in on that point, Professor Spowage?

Professor Spowage: Yes. I agree. A lot of the challenges for Government capital spending can be about the capacity for delivery. Obviously, through Covid and everything else, there have been lots of challenges in the supply of materials and labour. The Government has to consider those things and the extent to which there is capacity to deliver on the capital spending programme that it is looking to set out. In recent years, there have been significant challenges in doing that in some parts of Scotland, so it is definitely something to consider. Otherwise, as David Phillips says, you might just push up prices further.

David Phillips: I am not sure that it is the same in Scotland, but, in England, capital budgets are consistently underspent because delivery lags behind planning.

Michelle Thomson: Thank you for that helpful clarification.

On the point about the baking in of some of the things that we have been discussing today and the nature of the fiscal transfer system, how does what we have now compare with other fiscal transfer systems elsewhere in the world? We have previously talked about how complex the system is. Are we simply baking in complexities that will need to be managed in future—we talked about some of those earlier—or are we starting to move towards more comparable methods that are used elsewhere? I do not think that that is the case, but you are the experts.

David Phillips: Because the UK started with a highly centralised position and has been devolving things, rather than starting with a decentralised system and centralising certain things, the idea of there being block grant adjustments linked to particular taxes is quite unusual. I think that that reflects the starting point. Given that we are moving from a point where everything was centralised to one where things are decentralised while trying to avoid, where possible, detriment and taxpayer unfairness, it is understandable how we have ended up in that situation. That is quite unusual, and it is quite complex.

Where I think that things are less complex than in many countries is around what happens after the point of devolution. Many countries do not just have a fixed block grant adjustment that goes up in line with what happens in the rest of the country or does not respond to changes in the relative circumstances of the countries involved. They have some kind of on-going insurance or equalisation mechanism. For example, in Germany or in Scandinavia, if the economy of one part grows faster than that of the rest of the country, it gets to keep some of that, but it must hand some of it back to the central Government so that it can be redistributed. Similarly, if one part falls behind, it will get some insurance to stop it falling further behind.

When the Independent Fiscal Commission for Northern Ireland looked at the issue for Northern Ireland, it said that although it agreed, at least in the first instance, with the principles that underlie the Scottish agreement—that there should be economic responsibility and Scotland should gain or lose if its revenues grow faster or slower from devolved revenues so that it has responsibility for its policies—there should be a backstop to that. Because we know that revenue performance is driven partly by Scottish decisions and partly by things outside the Scottish Government's control, there should be a backstop if the revenues fall too low or some kind of mechanism—I am not sure that "backstop" is the right term—to redistribute money to the rest of the UK if its revenues grow particularly fast. That is something that we do not have in the fiscal framework in Scotland. Many other countries do.

I think that, in future arrangements and future reviews, it would be worth looking at whether some form of on-going insurance or cap or ceiling would make sense in the context of the Scottish fiscal framework.

Professor Spowage: Absolutely. The Northern Ireland report goes into that in a lot of detail. The discussion about the extent to which the devolution of taxes adds to accountability and so on is an interesting one. This is something to consider that is not present in the UK system, which is quite unusual. You can totally see how we have got here. As David Phillips said, we have the centralised system, and Barnett had to remain—that was one of the agreements. Therefore, the complex position that we have ended up in is the best way to meet some of the principles that are set out in the Smith commission, albeit that they are in tension. It is completely understandable how we have got here. Some quite significant reforms would be necessary for it to be more like a federal system or a different approach.

Michelle Thomson: I have one last question, which picks up on what John Mason was talking about earlier. To what extent are we baking in recognition of the tremendous pull of London and the south-east, which I think Vince Cable described as the vortex that sucks everything in? Are we not simply recognising that that will continue to be the case—indeed, will always be the case—even allowing for a technical mechanism, which would mean that, if there was a cataclysmic event, regardless of whether we are talking about Scotland or anywhere else, we would have very little capacity to do anything about it under the system that has now been devised?

David Phillips: As I said, the fundamental tension with regard to whether London and the south-east should be excluded from the comparison comes back to the issue of how to prioritise no detriment versus taxpayer fairness. How do you square the revenue side and the spending side of the budget? One way in which you can do that, while keeping a relatively simple mechanism that involves comparison with the whole of the UK, is to have a backstop that says that if there were to be an on-going trend such that Scotland were to fall behind, there would be some sort of reset or insurance mechanism that would prevent that from continuing indefinitely.

Equally, the flipside of that is that if Scotland were to improve relative to the rest of the UK, there would need to be a reciprocal arrangement, but such a mechanism might be a way to address the concerns that John Mason raised while having a main underlying system that is not overly complex and which is still based on revenues in the whole of the UK.

Professor Spowage: At the same time, it should be recognised that spending in Scotland is also supported, through Barnett, by the revenues that are generated in London and the south-east. It is always important to remember that as well.

The Convener: We have covered all the changes that are mentioned in the summary of changes to the fiscal framework, except one. It is a fairly minor one, but it would be remiss of us not to touch on it. What will happen to the coastal communities fund? What will that mean for Scotland? We understand from the agreement that

that fund will be absorbed into Barnett, and that there will be no immediate impact on funding. What are the long-term implications?

11:00

David Phillips: I must own up to not having looked into that in any great detail. I can explain the principle of the change. By rolling the fund into Barnett, that will mean that it will be included in the comparability factors that are allocated to a department in England. If, subsequently, that department gets any increases, Scotland will get a population share of the increase that relates to the part that is the coastal communities fund in the rest of the UK—or in England, I should say. If Scotland were to receive a bigger than population share increase in subsequent funding, it would lose out from the mechanism. If it were to receive a smaller share, it would gain from the mechanism. It depends on its relative use of those.

The Convener: What are the financial parameters that we are talking about?

David Phillips: I am sorry—I have not looked at that.

Professor Spowage: I am not sure either, convener; I am sorry.

The Convener: On that positive note, we will end the session. I thank our witnesses—both of whom will be involved in the next session—very much for their contributions. I will call a wee break until five past 11 so that our new witnesses can be brought in.

11:01

Meeting suspended.

11:07

On resuming—

Scottish Fiscal Framework: Value Added Tax Assignment

The Convener: The next item on our agenda is a round-table discussion on value added tax assignment in Scotland. For this session, I welcome to the meeting Charlotte Barbour, who is deputy president of the Chartered Institute of Taxation; David Phillips, who is associate director of the Institute for Fiscal Studies; John Ireland, who is chief executive of the Scottish Fiscal Commission; Professor Mairi Spowage, who is director of the Fraser of Allander Institute; and Mark Taylor, who is an audit director at Audit Scotland. We have around 75 minutes for this session. I would like it to be a discussion between us all. If witnesses or members would like to be brought into the discussion at any point, they should indicate that to the clerks and I will call them.

Initially, I will ask a question to Charlotte Barbour, and then anyone else who wishes to comment should let me know. The discussion will proceed in that way. It will be somewhat different from the last session.

In your submission on behalf of the Chartered Institute of Taxation, you said that

> "the lack of a suitable model for identifying and assigning VAT revenues raised in Scotland, the lack of policy autonomy that would be afforded to the Scottish Government from a policy of 'assignment', and the introduction of additional risks to the Scottish budget"

mean that, in your view, this would be a highly risky adventure, so to speak. Will you expand on that?

Charlotte Barbour (Chartered Institute of Taxation): Thank you very much for inviting me to speak and to make a submission.

I think that the passage that you read out summarises what our submission says about where we are. We spoke at a previous round-table discussion on VAT assignment, and we had reservations about it at that stage for those three main reasons. There has been some interesting work in the intervening period, but the reservations remain. Broadly speaking, VAT assignment means taking all the VAT in the UK, trying to work out an allocation—a divvying up of the kitty—and giving some to Scotland that is meant to represent Scottish VAT.

I am not convinced that we have an assignment model that makes it clear that any actions that the Scottish Government has taken have a direct influence on the VAT that comes back. It is very difficult to see the connections between the two.

Obviously, in very broad terms, if the economy grows, you would hope to have more VAT, but I do not think that there are close connections. I also think that, because the process involves assigning part of UK VAT in its broadest sense, you will not have a lot of influence on policy over VAT. That, too, is questionable if you are trying to tie tax and policies together.

Last but not least, as was discussed earlier, any modelling will bring in risks, so further risks will be attached. The last time we looked at the models, it was clear that the more you try to pin down where the risks sit and identify them and tighten them, the more complicated you make it, and the more complicated you make it, the less transparency and visibility you have. This discussion is not dissimilar to some of the forecasting discussions that took place earlier.

The Convener: I turn to John Ireland. In its submission, the Scottish Fiscal Commission says:

"we are still in a situation where the estimates of VAT raised in Scotland are too volatile to be suitable for the purposes of VAT assignment."

John Ireland (Scottish Fiscal Commission): Yes. As far as the Fiscal Commission is concerned, we would want to hold back on the political debate about VAT assignment, but for us the practical issue is how we would forecast what is assigned. For us, that is difficult, for a couple of reasons. First, we still do not have absolute clarity on what the VAT assignment model is. The best information on the model that we have is the 2018 paper from the Treasury and HM Revenue and Customs, but that still leaves lots of important details unclear. There is a lack of transparency about what the assignment model is.

Since we last had a round-table discussion, a lot more assignment data has been published by HMRC. That is helpful. That allows us to get a better sense of where our forecasts work or not. However, there are problems there. That data is back revised. As you can see from our submission and the charts and figures in there, the most recent publication had £0.3 billion for each year for most of the back series, and then for the last observation, it had a revision of £1 billion. Again, that level of volatility makes it hard to forecast; it also makes it hard to operate the reconciliation process, so there is an issue there.

The final issue for us is that, because we are forecasting the output of a model that, by definition, includes a lot of random error, we have to forecast not only the real economic VAT—the notional VAT; if our forecasts are going to be accurate, we also have to forecast that forecast error, and that is very difficult, too.

There are a severe number of practical issues around the VAT assignment model that concern us.

The Convener: Before I get trampled by people wanting to come in, because no one has so far, I will add to what you have been saying there. HMRC did a presentation this morning and it said that the changes between each publication in the past year were, indeed, the highest that they had been in the last decade at 9.81 per cent. Mark Taylor, you said:

"The implementation of VAT assignment would further increase the uncertainty, volatility and complexity of the Scottish Budget."

Mark Taylor (Audit Scotland): Absolutely, and we are used to those things now in the fiscal framework. The fact that those things exist, per se, is not problematic. Our entry point is that, for this to work, there needs to be that public confidence in the robustness of how it works and that the benefits that it brings in terms of the aims of the Smith commission around accountability and the like—and we heard discussion about those aims this morning—are evident in the model. More information is needed to understand that.

Stripping back from that, the other thing to flag—I am sure that we will get into more detail about this—is that although in other areas of the fiscal framework there are risks of estimation—there is a small amount, for example, in the Scottish income tax outturn—in terms of scale, this is all estimation. Therefore, it brings in a new and fundamental issue with estimation error, where we will never know how much that error has played out in any of the outturns because the outturns themselves are estimates. That is a new thing to understand and deal with.

11:15

Since we last discussed the issue with the Finance and Constitution Committee in a similar round table, more information has become available from the HMRC, and that helps to give more of a sense of the scale of those risks and the estimation error. However, we are still a long way from understanding how much that plays through.

The final thing is that the resource borrowing powers are not available to give the ability to manage that estimation error. They are available for forecast error, not for estimation error. There will be a lack of clarity about the volatility and how much of that is due to how we have measured this and how much is due to performance of the economy and how it plays through the model. We will never know that and the Government will not be able to use any stabilisation mechanisms or borrowing powers to adjust to that. It adds an extra layer of risk on top of the volatility, complexity and uncertainty risks that already exist in the fiscal framework.

The Convener: I will bring in one of my colleagues in a minute but there are a couple of others who want to speak so I will bring them in first. First of all, David Phillips, to add a wee bit more to the mix here, you said that

“VAT has properties that make it a relatively poor candidate for devolution”,

although we are talking about assignment at the moment. Then you go on to say:

“The administrative difficulties of devolving VAT to Scotland should not be overstated”.

David Phillips: The model of assignment that has been suggested for use if VAT is assigned to Scotland is a statistical model. It is not one where you work out exactly how much VAT was collected in Scotland. You do not assign a tax base to Scotland. You try to estimate a share of the UK tax base that can be reasonably apportioned to Scotland. That comes with a number of issues, as we have just talked about.

There are ways in which you could perhaps now reduce measurement error, particularly on the consumer side. Rather than just relying on the living costs and food survey, for example, there is now scope to use credit card and debit card data and real-time information from banks and so on to improve the modelling of that side of things. That mechanism would always be a statistical mechanism and, as has been pointed out, you never have an outturn; you just have an updated estimate. You have a forecast estimate and then an updated estimate.

I talked about VAT being a relatively difficult candidate for devolution or assignment. The alternative approach would be to split up the UK’s VAT and try to assign the tax base more directly to Scotland, to ask companies to split out their sales and transactions, not just with other companies but for transactions within the same company when items move from, for example, a warehouse in Northumberland to a warehouse in Fife or from a warehouse in Fife to a shop in Northumberland.

If we asked companies to do that, it would allow you to do a full assignment and without those forecast errors, but it would also mean a lot of additional administration and compliance costs for an assignment model. Even for a devolution model. it would only be worth going through that if one would expect there to be notable, significant changes in tax policy rather than just changes around the edges. That was the point I was trying to make.

We should not say that VAT cannot be devolved to Scotland. If Scotland wanted to make substantial policy changes, it is a tax that can be devolved. We see subnational taxes in other countries, although they are generally sales taxes as opposed to VAT. Substantial policy change can rationalise that, but if it was to be devolved or assigned and we made very little change, it would not make sense to go down the route of trying to split the tax base up.

That leaves you with a statistical methodology, which I think can be improved upon, but I still think that it will be in a situation where knowing to what extent changes from year to year occur because of economic fundamentals versus changes in the measurement error, which could be an issue of financial accountability for the Scottish Government under the assignment model. I have spoken about a lot of issues there, but I hope that my points make sense.

Professor Spowage: There are two things about the sense that the idea makes overall and the practical difficulties of doing it. Others have said in their submissions and comments that the extent to which the VAT that is generated is related to the economic activity that the Scottish Government might have control over in terms of generating or supporting in the Scottish economy is questionable. There are also lots of issues around the distributional effects of VAT and the things it is levied on and so on. I question the extent to which it makes sense that this is a tax that would be assigned in order to incentivise support for or growth in the economy and so on. It opens up a large proportion of the budget to significantly expanded risk.

However, the biggest problems are about the practicalities of assignment and the fact that, after almost a decade of work, no model is sufficiently accurate or can estimate these things with a precision that is suitable for this purpose. As David Phillips has pointed out, the ONS is looking into potential improvements to consumption data for issues around estimating and consumption in the national accounts. Those investigations have been going on for some time and there are lots of issues with using scanner data, credit card data and so on because it does not identify individual products and things like that.

That is not without its challenges, but estimation of the household proportion of VAT could improve over time. That is possible because it seems as though there is data that could do that. However, the rest of the model is subject to quite a lot of national accounts data, which is open to revision in perpetuity. Some of the questions I would have about this is not just the extent to which there would be volatility in the estimates but the time that those estimates will be open for revision and reconciliation. The entire series of national accounts is revised quite often, particularly the areas that are using national accounts data for financial services and so on. That is open to revision, methodological changes and so on.

Overall, I do not think that there is a way that this could get to a point where it was suitable for the purpose, so I do not think that it is a good idea.

The Convener: I am not hearing an overwhelming endorsement from people around this—I was going to say round table; it is more of a horseshoe, to be honest. Everyone is all bunched together.

John Mason: I have a couple of questions, and David Phillips may have partly answered the one I was going to ask him, which was what he meant by the phrase

"I think the noise versus signal ratio would adversely affect the financial incentives"

and so on. My other question was to Mark Taylor. You said that you thought that this would be difficult to audit. I wondered what that meant.

Mark Taylor: I will start with that one. The starting point is to recognise that, on the back of what I said about transparency and the importance of that, it is important and valuable for the Parliament to have something that says, "We have looked at this and we think it is right". We have had initial discussions with the Scottish Government and the National Audit Office about the shape of that and what it might look like, and there is a long way to go before we will be able to resolve that question.

The fundamental challenge is that this a statistical estimate and such estimates do not get audited. What happens in income tax and devolved taxes is that the audit process confirms the existence of actual transactions and some estimation and balances. Effectively, actual things that happen are recorded and are capable of being audited. In a statistical estimate, it is not an accounting discipline. There is not that same recording of financial transactions where you would end up with an audit opinion in the way in which we have an audit opinion from the National Audit Office on Scottish income tax and teams within Audit Scotland on Revenue Scotland's taxes, social security expenditure and the like.

That gives a fundamental challenge: what do we mean by audit for this figure? In that initial reflection we recognise that Audit Scotland has to explain all this, to set out the process, to make some comments and to give transparency and assurance that it is well managed. We could do something like that. We also think that we could probably work with colleagues in the National Audit Office to do something that ultimately says that the process works as it was planned to work, the way it is set up is the way in which it has been executed, and possibly even that the numbers that come from these places have been input correctly into and reflected properly in a process. There are different flavours of audit among that.

What we are clear about and have said in our paper is that the opportunity to have a firm audit opinion on a number that we have in other aspects of the fiscal framework seems very unlikely. We need to get into the detail. We need to have much more discussion. We need to have a model that is agreed. We are talking in hypotheticals at the moment because there is still not an agreement, but that is the sense of where we are in and around that at the moment.

Professor Spowage: In statistical models and statistical publications such as this, there is a role for the Office for Statistics Regulation in accrediting that statistics are produced free from political interference, to good standards and they provide public value. I presume therefore that the OSR would have some sort of role in something like this in order to ensure that it was accredited as a national statistics publication, and that certain methods have been used—not quite over-engineered to the extent that the current VAT assignment model is—but to estimate statistics that are accredited, such as "Government Expenditure and Revenue Scotland", and the country and regional public sector finances that the ONS produces.

Those estimates of the VAT that is raised in all the 12 regions and nations of the UK are probably good. They are good enough for statistical publication, but they are not precise enough for budgetary purposes or for a VAT assignment. It is not that the estimates are not good; it is just that they are too imprecise for the purposes of budget setting, in my view.

The Convener: Charlotte Barbour, you have said that

"VAT is the only 'assigned' tax in the package of taxes that fund Scotland",

that the UK Government would retain

"full legislative and administrative responsibility",

and that

"The aim of VAT assignment is to bring greater accountability to decision making in Scotland. However, the Scottish Government will have no direct controls over VAT rates and policy."

That goes back to what you were saying initially.

Charlotte Barbour: It is what I mentioned at the outset. Perhaps I could make two points in response.

If only part of the kitty is divvied out to you, you will obviously have little direct influence over the wider kitty. You will not be able to change the rates, you will not be able to decide what should or should not be taxable or what rates you would charge—and on it goes. I do not think that that is necessarily an attractive way to make a Government accountable for its economic policies. We often talk about how much taxpayers do or do not understand tax—I do not think that such an approach draws those connections any closer. I will just leave it at that, convener.

The other point I wanted to make follows on from what David Phillips said. We have been talking about an assignment model and I would not like to leave what has been said just on the table. You can devolve the tax as you do with income tax—say, on rates—or you could fully devolve it as you can with others that are still in the making. However, I would have grave reservations about suggesting that we go down that route for two reasons. The first is that I think that VAT is designed to go across a bigger single market instead of being chopped up for bits of market, with everybody accounting for different rates or different things in those bits. Our economy is quite highly integrated, and John Mason and I have discussed in the past what you do about products that are at various stages in their production and what happens when you are in and out of this or that rate.

I am not sure our major retailers will want to account for different rates of VAT in different parts of the UK. That would be quite a hurdle to get over—unless, as David Phillips has said, you radically changed what you were doing with your VAT policy. If you did that, you would open up the doors to competition between different regimes. Competition is one side of the equation; the other side is avoidance.

Michael Marra: The practical issues that Charlotte Barbour has set out feel huge to me. I have to say that I was far from privy to any of the discussions in the Smith commission, so we will just have to assume some of the motivations in this respect. Perhaps income tax was not felt to be a sufficient indicator of economic performance and, therefore, the desire was to have a basket of different taxes that would be indicative of how Scotland was performing. I am keen to hear people's views on whether having just the one indicator with regard to income tax performance creates a very limited set of incentives for the Scottish Government and institutions to drive activity in one particular way within our economy and whether that perhaps skews some of the incentives in the way that Government might act.

11:30

David Phillips: I think that you are right that having a broader basket of taxes can give you a broader basket of incentives. I would just highlight, in particular, the personal allowance, which has risen substantially since 2010—although it has been frozen again—and as a result, has taken perhaps around 40 to 45 per cent of adults, particularly those on low incomes, out of income tax altogether. It means that even those above the threshold pay relatively small amounts until they have substantial incomes. Income tax, therefore, means more exposure to higher-income people, while VAT means that more of your tax performance depends on what happens to lower-income people, too. You might think that that is a good thing if you want the Government to consider income inequality as well as growth at the top of the income distribution.

There can be a rationale for using tax assignment. Other countries do use it to give the incentives that we have been talking about, even if there is no power to vary the rate. As a result, I am perhaps not quite as down on tax assignment as a methodology as some people are, but in the current context, the practical issues are difficult to address.

As for the incentives provided by VAT, they would depend very much on how VAT was devolved, if you were to devolve it. Let us say that it were devolved instead of assigned, and devolved in the same way as it is across international borders; the fact is that, with international borders, something that is exported is subject to zero VAT, with the VAT becoming fully charged only when it is imported. If you did that for Scotland, too—that is, if you treated the Scottish-English border as an international border for VAT purposes—there would be an incentive to grow consumption in Scotland, because everything consumed in Scotland would be what drove your tax base.

If, instead of treating the border like an international one, you were to do this so that the amount that people could reclaim in VAT depended on who they were buying from—in other words, an English business buying from Scotland could reclaim the Scottish rate of VAT, while a Scottish business buying from England could reclaim the English rate—the incentives could be quite different. Instead of being an incentive to boost consumption in Scotland, it would be an incentive to grow value added in Scotland. You can therefore design VAT in different ways that, within the UK, either provide an incentive to boost consumption or to effectively boost value-added production. However, as I have said, given the administration and compliance costs involved in companies doing these things not just on their own transactions but on their intra-company transactions, you will be able to do that sort of thing only if there is a substantially changed policy.

I think that you are right, though, that one of the ideas was to give a broader basket of incentives.

However, part of it was, I think, referenced to the question of the share of taxes that would be devolved to Scotland. Some of it was just about saying, “Let’s get a certain share of the budget devolved to Scotland” instead of any full appraisal of the situation.

The Convener: But was it not the case that devolution was not considered, because we were part of the European Union then and it was not permitted to devolve such things to sub-state legislatures?

David Phillips: Yes, exactly.

The Convener: As a result, assignment was the only way in which VAT could be considered.

David Phillips: Yes. Of course, that is one of the things that could change post-Brexit. As I have said, though, the compliance and admin costs are potentially quite large.

The Convener: One of the things that you have suggested in your paper is a sales tax rather than VAT. Can you talk to us about that?

David Phillips: The complexity with devolving VAT is that it is charged not just at the final point of sale, but on each transaction. If company A sells to company B, company A charges VAT and company B reclaims it. Company B charges it, and company C reclaims it. It is only at the final stage—with the consumer—that it cannot be reclaimed. It is what is called a fractional collection system. As a result, it is quite complicated to devolve, because lots of goods are transacted across borders not just from company to company but within companies, and you would need to take that into consideration.

That is not the case with a sales tax, which is just charged on final sales to consumers, hence you only have to think about where something is being sold to a consumer. That is how it works in the United States; you will see very local-level sales taxes, with perhaps individual cities of 5,000 people having a different sales tax from their neighbour.

There are two challenges with a sales tax, however. The main one is that you need to distinguish between consumers, who pay the sales tax, and businesses, which do not. Although such an approach solves the issues with intra-company transactions, the production chain and so on, it opens up a new issue around potential avoidance and evasion, with people claiming that they are a business to avoid having to pay the sales tax when they go to a store.

The other issue is that, instead of being collected as a fraction across the production process, the tax all comes at the final point of sale. As a result, if there is any evasion, you lose all the revenue instead of the revenue from that one transaction in the chain. If you wanted to devolve a tax to Scotland, or even within Scotland to different local authorities—indeed, local sales taxes have been discussed in England and Wales—it would be easier to do so with a sales tax as opposed to VAT. However, it brings challenges around evasion, even if it makes the general administration and compliance burden lower.

The Convener: There is also the issue of cross-border purchases and so on, but there are sales taxes in the United States and Europe. They are quite common around the world, aren’t they?

David Phillips: In the United States, yes. In Europe, there are sometimes particular taxes for particular services—for example, a tax on sales of tourism services. It is really the United States and some countries, traditionally India and Brazil, that we are talking about; some of those large federal countries have sales taxes that vary right down to sometimes local levels.

The Convener: We have four political parties represented around this table as well as five experts on this issue. Who thinks that assignment of VAT is a really great idea at this time? [*Laughter*.] I thought that John Ireland was about to come in there heroically. You should remember that this is like an auction—if anyone twitches, they will be called to speak. David Phillips had his finger on the button of his microphone at one point, but he desisted.

We seem more or less in agreement that this presents considerable difficulties across the board, whether from a forecasting point of view, a practical point of view or an audit perspective. Does anyone see any real benefits to this approach or any way in which we could eventually reach a benefit? Is there any perfect way of getting to that point, or will this always be a bureaucratic and costly distraction that will not add any benefit to Scotland? Does anyone want to contribute for or against that?

Liz Smith: Is it not the case, convener, that previous finance committees have come to exactly the same conclusion that we have, which is that there are strong reasons for this being so complex and difficult and that the practicalities are just too great?

The Convener: The finance committee from 2011 to 2016, of which I was convener, looked at the matter briefly and we took the view that there was not enough on it. The Scottish Fiscal Commission was in an embryonic stage; we were not at the stage that we are at now; and it was hoped that, in future years, we would be able to look at the issue in greater depth. I should say that our predecessor committee in the last session of

Parliament was very sceptical about this as a practical way forward.

However, it remains part of the Smith commission's work. I take the view that the Smith commission is not necessarily set in tablets of stone. It happened some years ago now; I think that we have to evolve beyond it in some areas, and this might be one of those area where we have to say that this approach will not be a runner in the foreseeable future. Scottish Government officials are looking at the matter, yet, given that we can see no practical or pragmatic way forward, one has to wonder whether that is a good use of public resources.

Michael Marra: I believe that the principles that we have talked about in the committee this morning about the devolved institutions in Scotland having economic responsibility to focus more on how we grow the economy and how we get money in people's pockets to generate the taxes to provide the public services that we need are right, but it is fair to say that, over some years, the institutions have had a good shot at trying to develop robust mechanisms to project and deliver some mechanism by which VAT assignment might be achieved. It does not feel to me that that work is bearing fruit.

When we took evidence about this from HMRC in private, I was less than convinced by its ability to produce reliable forecasts on the basis of survey data and some other indicators alone. There is obviously a stream of activity that it is funding and supporting with a view that this is continued Government policy. I think that we could reasonably ask whether that is money that is being well spent.

My general, broader opinion on that is that I agree with David Phillips about the need to ensure that we have a focus on a broad economy that takes a different form. Rather than taking a very narrow view of one part of the tax base, we need to understand the role of people who are not earning high levels of income, whether that be wealth, whether that be people who are living in relative poverty, whether that be pensioners, students or people at the bottom end of the income scale. We do need to think about how the Government incentives are structured properly to do that. It does not feel to me that this is a practical means to do that at the moment.

The Convener: Yes. For example—and, John Ireland, I do not know how you would feel about this—HMRC said that its survey would be 2.3 per cent plus or minus at a 95 per cent confidence interval. It would be looking for just a ballpark prediction, but we have seen the revisions that I mentioned earlier—9.81 per cent out in the current year, which is the highest for over a decade. It almost seems as if volatility has increased rather than decreased as it has progressed with looking at this. How would you feel about that? I know that 2020 was an outlier; I appreciate that.

John Ireland: It is hard to unpack what happened in the pandemic from the more embedded uncertainty. It worries me that there is still a lot of uncertainty in HMRC. The other thing that worries me, to be frank, is the lack of transparency. We have made no real progress at all in understanding what is in that assignment model.

The Convener: That is an issue that Mark Taylor is specifically concerned about as well.

John Ireland: I do not understand why HMRC is being so secretive, but I am sure that it has its reasons.

David Phillips: An issue that one needs to remember here with the confidence intervals is that this is not just a case of trying to estimate the underlying population from a sample of data. There is not just a sampling issue here; there is fundamentally a measurement issue. There are errors around what we are trying to measure. Are the proxies that we are choosing doing a good job of proxying VAT? Working out what the errors are around those is very difficult compared to standard statistical uncertainty.

The Convener: We queried that. I specifically asked about Scotland relative to the other 11 nations and regions of the UK, because our geographic and demographic profile is very different. For example, our rurality is quite different from that of the Midlands, for example.

I will let John Mason in, but we have talked about VAT assignment, and everyone seems to think that it is a dead duck, for the reasons that have already been discussed such as the fact that the Scottish Government would not have any control over it. Do people feel the same about the devolution of VAT at this time or do people have different views on that?

John Mason: I am happy to come in on that subject, actually, because I was just going to make a comment. When VAT assignment was first announced, I thought that it would be a good thing, partly because, as David Phillips explained, there are different models. I assumed that, if we attracted a factory to Scotland, that factory would add value. The whole point of VAT is that it is a tax on added value, so attracting more factories—and we have been quite successful at inward investment—would allow us to build up VAT in that way.

However, as we heard in the briefing this morning, clearly, that is not the model that is being looked at. It is purely about the end point where consumers spend their money. Like everyone else—I agree with what Michael Marra said—I am very sceptical about this going ahead as it is. I am not quite as sceptical as Charlotte Barbour, who said that it would be horrendous to devolve VAT. Clearly, other small countries—not just sub-nations but Norway, Sweden, the Netherlands and Denmark—all operate their own systems, I assume, even though they are in a single market. It should be possible to devolve it and then, as and when we become independent, we will have our own VAT system. That is not unmanageable, but I accept that, at the moment, the costs are probably outweighing the advantages.

The Convener: Are there any further comments from anyone?

11:45

Charlotte Barbour: One of the other interesting things in the talk leading up to Brexit was what people across the UK were looking for once the UK had control of VAT and could do what it wanted with it. Everybody was asking for reliefs; there did not seem to be requests for anything other than reliefs on lots of different things. If you were thinking about whether to devolve and whether it would be worth the bother, and if, as David Phillips said, you needed to do something quite different with it, you would need to think what the difference would be. If you introduced reliefs, you would have less income. Maybe it would generate more businesses coming in. That would then have a flush-through in the Barnett formula, because you would be depriving it from somewhere else, I guess. There are quite a lot of intricacies in there and, if we were going to do something different by charging more, that, too, would be interesting.

The Convener: Is the issue for you that it would perhaps skew economic activity as well? For example, if food is VAT zero rated and in other areas of the economy VAT is 20 per cent, that would perhaps skew Government policy and decision making, if it were devolved, into areas where it was likely to have a VAT return.

Charlotte Barbour: If you were collecting your own VAT, you might be driven in part by the things that attract VAT and take your eye off other things that do not. That would all be part of the mix as to whether you did want to devolve it and then do something radically different.

The other thing that we have learned over the past 10 years is how inextricably interlinked all the taxes are across the UK. There are different taxes across the UK, and it is quite difficult to do something distinctly different with the way the economy is currently structured. I would say that that is one of the lessons learned over the past 10 years.

David Phillips: I will make two separate points. First, on VAT assignment, I am not saying that we should go ahead with it, but it may be worth looking further at how other countries do it—maybe it has been done already, but it is something that I have struggled to do. For example, Belgium, Italy, Portugal, Spain and Germany have VAT assignment. I have tried to find information about exactly how it works there and how they estimate the assigned shares.

Unfortunately, the information that I found was nearly all in the languages of those countries and it is quite hard to translate. I tried to get ChatGPT to do it for me, but it did not quite do it correctly. Maybe this has already been done, but if it has not, it might be worth while looking at exactly how they do it—not the high-level information that you often find on the Organisation for Economic Co-operation and Development website but the exact methodology that they use. In Germany, I think that it is not just down to the regional level but down to the local level. It is quite detailed there. Do they go through the rigmarole of making companies split their tax base up in order to do it? Have they thought that it is worth while in their more decentralised systems to do that, or do they use these statistical approaches?

The second point that I will make is to echo what Charlotte Barbour was saying. What you tend to find is that, post-Brexit, there was a lot of discussion about further tax reliefs. In the context of an independent Scotland, I would imagine that the reference point of what has been happening in the rest of the UK would not be quite such a strong reference point as it is currently. In an independent Scotland, you might not see the same pressures to do things a bit differently from the UK. I agree that it is important to be mindful that there would be risks to the tax base associated with political lobbying. That is something that we see a lot of with VAT.

The Convener: Thanks very much. There will be no fact-finding visits to Italy, Belgium or Germany. I want to make that clear.

Professor Spowage: My understanding is that that is what happened at the start of this process. In particular, it was the Canadian model of tax assignment that was looked at. Canadian statistics are much more bottom up and there is much better data at a local level, but my understanding is that the VAT assignment model is broadly based on what they do in Canada. HMRC and the Scottish Government together have looked at other jurisdictions and this was one of the reasons for looking at doing it this way. They also had the VAT total tax liability in existence already to try to estimate the VAT gap for the UK.

My concern is that it has been eight years. I do not know how much money has been spent on trying to develop this. I would say that it is not an insignificant amount of money, including the boost to the LCFS—that is good for other reasons, but there has been a lot of money spent and the improvements in precision have not come. There have been issues about the 2020 data that are specific to that year. As Michael Marra said, they have given it a good go, but we are at the point where it cannot be done to the precision that is required.

Therefore, everybody should just agree that it should not go ahead. My understanding also was that the reason was partly to do with having half of Scotland’s budget being determined by revenues not that they had control over but which were in the Smith commission and previous devolution settlements. It was about getting to that 50 per cent mark rather than about the taxes themselves being sensible for assignment.

The Convener: Yes, I think that there is an element of that. There was a lot of politics in that. I suppose that the Scottish Government felt under a duty to follow the recommendations of the Smith commission and to look at them in detail. It has done that, but how long can you flog a dead horse? That is probably the issue here. There is no enthusiasm certainly for assignment anyway. I do not think that there are many people who are shouting from the rooftops for devolution of VAT either at the present time, unless I am mistaken. No. Does anyone else want to comment on this? It is a nice, cheery session, isn’t it?

It has been a very constructive session because, as has just been said, we have had eight years talking about this and if we, as a finance committee, with the unanimous support of our witnesses and across the political parties, are saying that assignment should no longer be looked at, that is a very strong message that we are sending to the Scottish Government on this.

Unless anyone has any further points that they want to make, I will wind up this quite short round-table session. I had expected it to go on a wee bit longer but, because of the unanimity of views that have been expressed through very detailed and high-quality submissions, I think that we have come to a very strong and unanimous conclusion. Does anyone else have anything to say? Going once—okay.

Thank you very much to everyone for attending and participating in today’s discussion. It has been very useful.

That concludes the public part of our meeting. We will continue to take evidence on the fiscal framework, and we will certainly convey our views to the Scottish Government regarding VAT assignment. We have the Deputy First Minister in next week and no doubt we will put these issues directly to her.

The next item on our agenda, which is a discussion of our work programme, will be taken in private. We will have a wee five-minute break to enable our witnesses and the official report to depart. Thank you.

11:52

Meeting continued in private until 12:27.

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