OFFICIAL REPORT
AITHISG OIFIGEIL

Finance and Public Administration Committee

Tuesday 26 November 2024

The Scottish Parliament
Pàrlamaid na h-Alba

Session 6

Tuesday 26 November 2024

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FINANCE AND PUBLIC ADMINISTRATION COMMITTEE
33rd Meeting 2024, Session 6

CONVENER

*Kenneth Gibson (Cunninghame North) (SNP)

DEPUTY CONVENER

*Michael Marra (North East Scotland) (Lab)

COMMITTEE MEMBERS

*Ross Greer (West Scotland) (Green)
*Craig Hoy (South Scotland) (Con)
*John Mason (Glasgow Shettleston) (Ind)
*Liz Smith (Mid Scotland and Fife) (Con)
*Michelle Thomson (Falkirk East) (SNP)

*attended

THE FOLLOWING ALSO PARTICIPATED:

Richard Hughes (Office for Budget Responsibility)
Tom Josephs (Office for Budget Responsibility)
Professor David Miles CBE (Office for Budget Responsibility)

CLERK TO THE COMMITTEE

Joanne McNaughton

LOCATION

The Robert Burns Room (CR1)

Scottish Parliament

Finance and Public Administration Committee

Tuesday 26 November 2024

[The Convener opened the meeting at 09:30]

Budget Scrutiny 2025-26 (United Kingdom Context)

The Convener (Kenneth Gibson): Good morning, and welcome to the 33rd meeting in 2024 of the Finance and Public Administration Committee. The first item on our agenda is an evidence session with representatives from the Office for Budget Responsibility on the UK "Economic and fiscal outlook", which will inform our scrutiny of the 2025-26 Scottish budget. I am delighted that we are joined in person by Richard Hughes, who is the chair of the OBR, and by Professor David Miles CBE and Tom Josephs, who are both members of the OBR's budget responsibility committee. I thank you all for taking the time and the trouble to come all the way up here—it is very much appreciated—and I welcome you all to the meeting.

I invite Mr Hughes to make a short opening statement.

Richard Hughes (Office for Budget Responsibility): Thank you for the invitation to come before the committee.

Our forecast was made, before the measures in the UK budget were announced, against the backdrop of a largely unchanged macroeconomic and fiscal position compared with the forecast that we made back in March. There was a rare period of stability over the six months between our forecasts.

However, the budget was full of very significant policy changes compared with the picture that we painted when we produced "Economic and fiscal outlook" back in March. The budget included a very substantial increase in public spending of about 2 per cent of gross domestic product, or about £70 billion, in each year of the five-year forecast period. About two thirds of that extra public spending will be on current spending, and about one third will be on extra capital spending.

The budget will take the size of the UK state to 44 per cent of GDP by the end of the decade, which will be about 5 percentage points higher than it was before the pandemic. About half of the 2 per cent of GDP increase in spending will be funded by an increase in taxes, which will raise about £35 billion per year over the next five years. About half of that will come from the rise in employer national insurance contributions, and the other half will come from a range of other taxes. By the end of the decade, the tax burden in the UK will be up to 38 per cent of GDP—the highest level on record.

The other half of the increase in spending will be funded by about £35 billion a year, or 1 per cent of GDP, of extra borrowing, which will, in effect, slow the pace of fiscal consolidation compared with the previous Government's plans. That means that it will take longer to get borrowing back to what would be seen to be a debt-stabilising level.

In relation to macroeconomic effects, we think that the net fiscal loosening in the budget, with spending rising by more than taxation, will provide a temporary boost to output this year and next year, but we think that that will fade over the rest of the forecast period, leaving the level of GDP more or less unchanged, compared with our March forecast, by the end of the decade.

The budget also includes a new set of fiscal rules for the UK Government. The first one is about balancing the current budget, so day-to-day spending should be balanced against revenue spending by the end of the decade. The Chancellor of the Exchequer meets that requirement with about £10 billion of headroom left to spare.

The second one is a new fiscal rule that is something of a novelty in fiscal policy making, both in the UK and in the rest of the world, which is that the Government's financial balance sheet, or what are known as net financial liabilities, should fall as a share of GDP by the end of the decade. That rule is met by a margin of about £16 billion. However, both of those numbers are small fractions of the potential risks to and pressures on the fiscal outlook, so the chancellor has continued the practice of previous chancellors by setting aside relatively small amounts of headroom against her fiscal targets, given the risks that she might face over the coming five years.

The Convener: Thank you very much for that. In time-honoured fashion, I will start with some questions, then pass over to colleagues around the table.

In your "Devolved tax and spending forecasts" document, which you produced to go with your magnificent 207-page tome on the budget, an element of frustration seems to come through. You say:

> "we lack sufficiently detailed or timely data that is required to produce forecasts for Scotland",

so the OBR needs to do a lot of extrapolation. What additional data could be provided to help you to make your forecasts more accurate? I am well aware that we have the Scottish Fiscal Commission, and I will ask a question about it in a minute or two.

Tom Josephs (Office for Budget Responsibility): I would not say that we feel "frustration". In the document, we describe the different methodology that we use to produce Scottish tax forecasts compared with what we use for UK-wide forecasts. We do not produce a macroeconomic forecast for Scotland, so we use our UK-wide macroeconomic forecast and, in essence, estimate to produce a UK-wide forecast for the relevant parts of income tax and the other devolved taxes, then use outturn information to estimate the Scottish share of those receipts.

We now have good outturn data for the property taxes and landfill taxes that are fully devolved, but we face some challenges with income tax, because income tax is measured on a liabilities basis and there is quite a long lag before we get income tax outturn data on that basis. That requires us to do quite a lot of extrapolation from outturn data when producing our income tax forecast.

For our most recent forecast, we were able to use 2022-23 outturn data for liabilities, so the data was from a few years ago. We can build on that with more recent outturn data on income tax in particular, using more recent data sources from His Majesty's Revenue and Customs, but that does not provide a complete picture of the entire non-savings, non-dividend income that is devolved to Scotland.

We are trying to develop our approach. We work very closely with the Scottish Fiscal Commission, HMRC and the Scottish Government to continually develop our forecasting methodologies, and we have done more in-depth analysis of the drivers, particularly in relation to the income tax forecast, to allow us to do that. Last year, we produced quite a lengthy paper that looked at some of those drivers.

I would not say that we feel too frustrated. As I said, we have to take a different approach for Scotland. We have a lot of good data that we can use to produce our forecasts, and we work with our stakeholders to develop our approach over time.

The Convener: On the issue of outturn data for income tax, which is mentioned in your report, if there was an improvement in the data, would you like the timescale to be somewhat truncated, or is that unlikely due to the way in which the system is set up?

Tom Josephs: The natural lags in the payment of self-assessment tax mean that it is not possible to get more up-to-date outturn information on non-savings, non-dividend income tax on a liabilities basis. However, as I said, we can develop the other sources of outturn data that we use to build the picture on top of the lagged outturn. We have been using more up-to-date HMRC real-time information—which covers pay-as-you-earn data, for example—to develop our forecasts. There is more that we can do on that side to supplement our forecasts.

The Convener: Interestingly, your forecasts appear to be more optimistic than those of the SFC. Historically, how accurate have your predictions been, compared with those of the SFC? Are yours more accurate or less accurate, or are they more or less on the nose, give or take?

Tom Josephs: I will say a couple of things on that. The SFC's latest forecasts were produced some time ago, so it is difficult to compare our current forecasts with its previous ones. As you know, the SFC will be updating its forecasts very soon. We have also faced a lot of volatility in the economy and in public finances over the past few years, so the natural gap in timing between forecasts—

The Convener: You are wasted in this job: you should be in diplomacy. Somehow, I had the feeling that you would talk about the timing of the forecasts. Anyway, it was worth a try, wasn't it?

Tom Josephs: There has been some analysis of forecast errors or differences, but there have not been huge average forecast differences between the OBR and the SFC over time.

The Convener: In your Scottish report, you touch on a couple of issues—air passenger duty, and the final timing for that, and VAT assignment. To this committee, the latter is a dog that just will not die. The committee has made it clear to the Scottish Government that, although it might have been in the Smith commission report, we do not see any advantage whatsoever to assignment of VAT. We could argue about whether or not it should be devolved. In section 8 of the report, you say:

> "The formal methodology for VAT assignment is being developed by HMRC, the Treasury and the Scottish Government."

Is there any point in progressing any further with that? The committee does not see that there is.

Tom Josephs: We do not have a role in policy decisions on devolved tax.

The Convener: Indeed—I appreciate that.

Tom Josephs: We are not involved in that, and I am afraid that I am not able to comment on it. As you can see, we prepare forecasts so that, if agreement is reached on that, we would be able to produce a forecast. However, as I say, we are not involved in the policy discussions on it.

The Convener: Mr Hughes, I am going to quote a lot from your report—everything that I am going to say, more or less, is a quotation from your report. Right at the start, on page 7 of your report, you say that, from the recent budget,

"Budget policies leave the level of output broadly unchanged at the forecast horizon."

You go on to say that

"Real household disposable income ... per person, a measure of living standards, grows by an average of just over ½ a per cent a year over the forecast"

and that

"Compared to our March forecast, the level ... per person is just over 2 per cent higher at the start of the forecast due to data revisions, but 1¼ per cent lower by the start of 2029. The bulk of this difference (around 85 per cent) is explained by policies announced in this Budget."

Is it your view that Scotland will follow the same trajectory? Why do you feel that a lot of the budget detail that you have analysed seems to be on the same theme, with a lot of it being front loaded and with a reduction in growth and investment over the piece? Will you talk us through that particular issue in terms of disposable income?

Richard Hughes: Sure. David Miles will almost certainly want to come in on the precise mechanics of that. We will be interested to see what the SFC has in its forecast, but our expectation is that the forces that will weigh on real earnings growth in England will do the same in Scotland, because much of the slowdown in real earnings growth and in household disposable income over the next two years will be driven by the fact that the bulk of the incidence of employer national insurance contribution rises will fall, ultimately, on the real wages of employees. A big part of what will weigh on real earnings growth in 2025 and 2026 is the passing on of the increase in payroll costs from the employer in the form of lower real wage growth for the employee. Perhaps David would like to say a bit more about how that works.

Professor David Miles CBE (Office for Budget Responsibility): There is a big increase in taxes in the budget, and, in the short run, the biggest effect will be on corporate wage bills and profits, because it is very difficult for companies that have to pay national insurance at the higher rate to pass that on to the workforce. They cannot just announce that they will cut wages—there are contracts, so they cannot do that.

Over the longer term, it seems to be quite plausible to say that much of the effect of that tax will get passed back on to the workforce in the form of slightly lower wage settlements than otherwise would have happened. We estimate that, ultimately, in the longer term, something like three quarters of the substantial increase in taxes will be paid by the workforce and the other quarter will impinge a bit on corporate profits. The numbers are sufficiently big that it is one of the factors why, although there will be a bit of a boost to household disposable income in the short term, a lot of that will get eroded by the time we reach the end of the forecast horizon, because somebody has to pay the tax and there is quite a lot of evidence that most of it will fall back on the workforce.

Therefore, in the short term, there will be a bit of a boost, partly because the increase in Government spending is a bit front loaded, so we just get what we might call a positive effect from the increase in demand in the economy. Over time, that will be offset a bit, partly as a result of the tax increase.

We also think that, as a result of the budget, interest rates will be a bit higher over the next two years than they would otherwise have been. The combination of those factors means that you end up with not very strong real income growth for the workforce and for households, by the end of the forecast period.

09:45

Having said that—this is partly related to your previous question about the OBR having been a bit optimistic in the past about the growth of the economy in general and household real income growth—we are still probably on the optimistic side, compared with most people, with regard to the rate of productivity growth in the UK, which is ultimately the driver of real income growth. Over the past few years, we have been a bit more optimistic than most: we have erred on the side of being too optimistic.

However, we have taken the view that the most likely outcome for the next five years, for Britain as a whole and for Scotland, is that outcomes will not be as bad as they have been during the truly dismal past 15 years. Since the financial crisis—I am going back to 2009, so, yes, that is pretty much 15 years—productivity growth in the UK has been barely 0.5 per cent. In the 30, 40 and 50 years before the financial crisis, it was 2.5 per cent. Therefore, the level of GDP is probably 30 per cent lower than people would have expected if you had asked them in 2009 where the UK would be and where average earnings and total GDP would be 15 years down the road, in 2024. We have lost 2 per cent growth a year for 15 years.

The view that we take at the OBR is that, although it might happen, we would be very unfortunate if the next five or 10 years were as bad as the pretty catastrophic 15 years that we have had in terms of overall growth of GDP. That is why our forecasts are a little more optimistic than most other forecasts, which take the view that, having had 15 years of low growth, that is the new normal for the UK. A lot of people think that the OBR is always pessimistic, but we have actually been on the slightly optimistic side, compared with many forecasters.

The Convener: I have to say that your outlook report does not read in a particularly optimistic way where you say, on page 53, that

"This results in an average annual tax increase in excess of £800 per employee"

and, on page 35, that

"Real private consumption is forecast to fall 0.4 percentage points as a share of GDP from 2023 to 2029. In our pre-measures forecast, we expected this share to rise by 0.4 percentage point but this is more than offset by policy measures in the Budget."

Professor Miles: Relative to the previous Government's plans, which were to see public spending fall fairly steadily and significantly as a percentage of GDP over the next five years, the budget that we saw a couple of weeks back is one in which, as Richard Hughes said, public spending actually rises fairly substantially, relative to the previous plans, by about £70 billion, which is 2 per cent of GDP a year for the foreseeable future—certainly, for the next five years or so. A good chunk of that is to be financed through higher taxes, so there is a switch in resources, away from private consumption towards Government spending, which is what holds back what would otherwise have been stronger growth in household disposable incomes. It is pretty much impossible to raise taxes very substantially without that all ultimately flowing back to there being less disposable income for households. That is really the story of the budget.

The Convener: In your "Economic and fiscal outlook" report, you say:

"The outlook for productivity growth remains our most important and uncertain forecast judgement."

You go on to say:

"The effects of subdued investment, the energy price shock, and Brexit compound the ongoing weakness seen since the financial crisis."

Productivity growth is of great concern to the committee; we have raised it on numerous occasions in numerous fora with different people. How can we break the productivity bottleneck? You have also raised concerns about the number of people who are economically inactive. As a percentage of the population, there are now more people who are economically inactive in Scotland than there are in the UK.

Do you see the way to break the productivity problem being through technology and migration? What impact is demography—the ageing of the indigenous population, if you want to put it that way, or the people who live here already—having on productivity? One would think that migration and technological advances would improve productivity, but an ageing population is creating a drag on it.

Professor Miles: I think that you are right that those are the two big offsetting factors. In the long run, the story of why we are so much better off materially than people were 100, 200 or 300 years ago is because of technological progress. People discover better ways of doing things, which you can see by just looking around. That is a big positive driver over the long run. It seems to have stalled over the past decade or so, not just in the UK but probably in most advanced, rich economies in the world. Productivity growth has been pretty disappointing, but perhaps a bit more disappointing in the UK than in most places.

It would be pessimistic to think that we have run out of ideas. New technology comes along—things that you cannot predict but that nonetheless improve the standard of living. The latest of those are the amazing developments in artificial intelligence, which are perhaps yet to roll out and affect how businesses work and public sector services are provided, but there is scope for some optimism about that. That is partly why we take a view that the past 15 years might turn out, in the long run, to be an unusually bad period of productivity growth that does not continue into the future.

You are also right that when it comes to generating total income for the economy, or GDP, offsetting that are demographic trends and the ageing of the population, which, in the absence of large-scale net immigration, would now mean, and would continue to mean, that the overall labour force and employment would probably be declining. That has been offset in recent years by high net immigration into the UK, so much so that total employment has not fallen and has actually tended to increase a bit in recent years, even though the purely demographic structure of the domestic population that is already here would be pushing in the other direction.

Quite how this will play out over the next five years and beyond depends pretty sensitively on what happens to net immigration. We have taken the central projection of the Office for National Statistics, which is that the level of net immigration into the UK is very high in the historical sense but is lower than it has been in the last couple of years, when it has been 600,000 or 700,000. That falls back to a bit above 300,000, which we take as our central projection. We have no great confidence in that, but we have to make some assumption about what happens to net immigration.

That is a pretty large number of people arriving in the UK every year. It means that total employment does not decline, which it probably would in the absence of such large-scale immigration, because of the demographics of the domestic population—the people who are here already.

The Convener: You have said:

"In 2026 and 2027, we expect households to run down their rate of saving significantly as they try to maintain consumption growth in the face of stagnant real wages."

You talk about a "direct behavioural response" to taxation, in that it will increase

"the incentive for more tax-motivated incorporations".

You estimate that those will

"increase by a cumulative 17,000 by 2029-30"

as a result of the budget, and you say that

"These combined effects reduce the yield by"

£700 million by 2029-30. How do you come to that estimation of tax-motivated incorporations? That is also an issue of great concern in Scotland due to the different tax rates that we have here.

Tom Josephs: That estimate relates to the increase in employer national insurance contributions that was announced at the budget. We estimate with HMRC that the increase in those costs will increase the incentive for some people to switch from employment to incorporation. It is a relatively small effect compared with some other tax changes that we have seen in the past.

The impact is not as large as it might have been if we had just had the increase in the rate and the reduction of threshold, because the Government also increased the employment allowance—which is a reduction in national insurance liabilities that firms pay for the first £10,500-worth of their liabilities—which, for smaller businesses, offsets quite a bit of the increase in the rate. It is in those smaller businesses that more of the incentive to incorporate might take place, and that allowance has offset some of that effect, because it has actually reduced that incentive.

The Convener: You have said that a quarter of a million employers gain from the budget, 940,000 employers lose out and 820,000 employers see no change.

Tom Josephs: Yes, that is right. A large number of very small firms will essentially benefit from that increase in the employment allowance. That number comprises the firms that either see roughly no change or actually benefit from the overall package.

The Convener: Scotland, obviously, has a disproportionate number of jobs in the North Sea, with the oil and gas industry. On page 67 of your report, you talk about the energy profits levy. You say:

"Overall, on average, we assume that over the forecast period capital expenditure is 26 per cent lower, oil production 6.3 per cent lower, and gas production 9.2 per cent lower compared to our March forecast",

which are quite significant changes. What will the impact from those changes be on employment in that sector?

Tom Josephs: We have not made an estimate of the impact on employment.

The Convener: That is why I am asking you—I couldnae find it in the document.

Tom Josephs: We have not made that estimate. For our analysis of the tax raised through the energy profits levy and through North Sea oil production more generally, we do not need to do that calculation, so we have not done it.

That reduction in both investment and production is based on analysis of the impact of the new announcements that the Government made in the budget around increasing and extending the rate in relation to the energy profits levies.

The Convener: Yes, I appreciate that it is over and above things such as, for example, transition.

Tom Josephs: Well, it is also based on the fact that there has clearly been a change in the outlook in relation to the regulation of the sector—you will be aware of the legal cases. All that together was the basis for our assumption of the quite significant fall in investment and production compared to last time.

In our baseline forecast, the sector was already on a declining path—as you know, it has been for some time. Those new policy announcements, and the new policy framework generally, have added to that.

The Convener: Okay. You have said:

"In nominal terms, debt interest spending falls to £104.9 billion this year but then increases year-on-year to £122.2 billion in 2029-30"

which is a £12.6 billion revision since March. Can you talk us through that?

Richard Hughes: It does do that. I think that this is the first forecast that we have ever done where debt interest costs remain above £100 billion every year of the forecast. That reflects two factors: the first is that the Government is borrowing significantly more every year over the next five years, and the second is that it has increased spending by more than it has increased taxation.

The Government's fiscal rules allow it to borrow so long as it is investing in financial assets. Unlike under the previous Chancellor, the Government is no longer committed to reducing the stock of debt as a share of GDP at any point in the forecast on the definition that the previous Government used, which excluded the Bank of England. On that measure, debt excluding the Bank of England rises as a share of GDP throughout the forecast, up to the mid-90 per cents. The figure is a combination of a rising debt stock as a share of the economy, plus interest rates being a bit higher. That was in our pre-measures forecast. As David Miles mentioned, we thought that there would be a further rise in interest rates as a result of the Government's policy measures. Indeed, we saw that market response shortly after the budget announcement. Because of that fiscal loosening, a bigger volume of gilt issuance was expected and that pushed up the yield on Government debt and raised expectations for the level of bank rates going forward—a shallower decline compared to what markets were expecting before. It is both the increase in the volume of debt as well as the increase in the interest costs of servicing that debt that pushes the figure up.

10:00

The Convener: You have said that the probability of the target for the updated fiscal mandate being met is 54 per cent, which is a bit worrying, is it not?

Richard Hughes: It is just the right side of the line. As I said, it continues a practice that we have seen from successive chancellors in recent years, which is to run the fiscal rules very hot and very close to the wire, against the backdrop of what we have observed to be a continually very volatile macroeconomic environment, both in the UK and around the world. It would take just a further 0.3 percentage point increase in interest costs to wipe out the headroom on the current balance, which is more or less what we have seen since March. It does not take very much to wipe out that headroom altogether.

That is particularly binding on this chancellor and this set of fiscal rules, because unlike the previous set of rules, which rolled forward every year, this chancellor is committed to bringing that deadline forward to three years ahead, so she has two years where the rule is not rolling forward a year and she is buying herself a bit more breathing space by having an extra year to get there. She has two years where she has that target moving towards her. It then becomes a rolling three-year target once 2029-30 becomes three years ahead, but for the next two years she is stuck with that as the deadline for getting the current budget into balance.

The Convener: So, there is 0.3 per cent wriggle room. You say on page 158:

> "The net impact of the policies announced at this Budget is to reduce real business investment in the near term by 1.8 per cent, or a cumulative £25 billion by the forecast horizon."

You go on to say:

> "If the tax-to-GDP ratio were to remain at its 2024-25 level, tax revenues would be £62.2 billion lower in 2029-30"

than you currently predict.

Richard Hughes: The reduction in business investment is an artefact of the two points that David Miles mentioned. One is that we think that it will be difficult, at least in the near term, for businesses to pass on the increase in employer national insurance contributions to lower real wages. We are not expecting significant real wage cuts but, over time, you will get less real wage growth.

In the near term, businesses have to find a 2 per cent increase in payroll costs starting on 1 April. Some of that comes out of profits and planned business investments in the near term. Over the medium term, we think that, because there is a significant fiscal loosening in this budget, that crowds out some business investment through pushing up financing costs for businesses and increasing their cost of capital. There is then lower business investment, both because businesses need to find cash in the near term to meet the national insurance contributions cost and because, over the medium term, they have higher financing costs, which also crowds out some business investment.

The Convener: I am keen to ask more questions, but I have colleagues who are all champing at the bit to come in, so I shall desist.

Craig Hoy (South Scotland) (Con): Just for some context, you are projecting that public spending as a percentage of GDP will rise over the period, as will the tax take as a percentage of GDP. How does that compare to equivalent western economies at the moment?

Richard Hughes: It brings us closer to continental-type economies in terms of the tax take as well as the size of the state. The US and Canada are below us, as are Australia and New Zealand; they are lower-tax, smaller-state economies. At 44 per cent for the level of public spending and 38 per cent for taxation, we are still below countries such as France, where the tax burden is more than 50 per cent of GDP these days, but it brings us closer to our continental cousins and, I would say, further away from North American and Antipodean countries in terms of the amount of income being taken out of people's pockets and the amount of money being spent on public services and welfare.

Craig Hoy: Earlier, you discussed demographic trends in relation to the UK workforce. We have been dependent on net inward migration for employment. Is there a risk that, as we close that gap, the UK will be seen as a less attractive place to come and live and work, bearing in mind that, despite the net inward migration into the UK, Scotland is not realising its fair share, which is leading to imbalances in the labour and employment market here? Is there a risk that our dependence on net inward migration could be undermined by the closure in the gap?

Richard Hughes: It might be. At the moment, Government policy is to reduce net migration, so it might see it as a facilitator rather than a problem from a net migration point of view.

Your expected level of disposable income is one of the reasons why you might move from one country to another, if you are moving somewhere to work. In the pattern of net migration recently, we have seen that more of it has been coming from emerging-market countries rather than developed economies, which is partly reflected in the change in migration regime and other things. About half of our net migration used to come from European Union countries; nowadays, nearly all of our net migration comes not from Europe but from the rest of the world, such as countries in south Asia, Latin America and Africa. That probably reflects the fact that the income differential you can get from coming to the UK to work is significantly higher if you are coming from those countries than from countries in Europe. It probably also reflects other factors that feed into people's employment decisions.

Tom Josephs: For a couple of tax policy measures in the budget, we made a specific assessment of whether they would have an impact on migration. The measures were those on non-domiciled taxpayers and on carried interest, which is the tax paid by some fund management executives. We made a specific assessment because those groups of taxpayers—high-net-income individuals—tend to be very mobile. Many of them are actually foreign nationals. We made an assumption that the non-domiciled changes would increase migration within that group by around 10 to 20 per cent. We also made an assumption that there would be some migration among carried interest taxpayers. Those are relatively small population groups, so we do not assume that that has a wider macroeconomic impact on the UK economy.

Craig Hoy: How concerned should we be about the level of inactivity in the labour market across the whole of the UK, and specifically in Scotland, where it is higher as a percentage of the population?

Richard Hughes: I think that we should be very concerned. One of the most striking features of the post-pandemic economy has been the fall in the employment rate and the rise in the number of people who are classed as inactive. There is an important debate going on about the shortcomings in the labour market data that is currently being produced, and there has been some interesting work about the possibility of arriving at different estimates by using different methods to measure the number of people who consider themselves to be inactive.

There is no doubt that the number of people who are on sickness-related benefits is rising significantly, and awards to those people are rising significantly. Even if the labour market data is possibly giving us a misleading signal, the data coming out of the welfare system is giving a pretty clear indication that the case numbers are rising and awards are rising. That is sufficient reason for alarm, for fiscal reasons, even if you think that the numbers in the labour market might be different.

If the trends carry on, they become very significant. If somebody falls out of the labour force, particularly for health reasons, which seems to be one of the biggest recent drivers, you have to worry about it from a fiscal point of view for three reasons: you lose the tax revenue that you would have had from them if they were working; oftentimes, they are on inactive benefits, so they are a cost to the welfare system; and if they need long-term healthcare from the health service, that is a further pressure on public services. Therefore, there are huge fiscal dividends from keeping people healthy and in employment so that they are earning money and paying tax, not increasing welfare costs and not putting pressures on the health service.

We did some work over the summer for our "Fiscal risks and sustainability" report, looking at the potential fiscal dividends if you can get on to a better health trajectory. Over the long term, the pay-offs are huge. Probably one of the biggest differences that you can make to the long-term trajectory of UK debt is if you can keep more people healthy and in employment for longer. That can reduce the rise in debt that you would otherwise see by up to 40 per cent of GDP by the end of a 50-year period. It is one of the single biggest things that you can do to shift the dial on fiscal sustainability.

Craig Hoy: We have heard today about the UK Government's perspective on welfare and unemployment. How concerned should we be about the fact that Scotland has a higher percentage of people who are claiming long-term disability benefits and that the trend seems to be that the percentage of people claiming those benefits is rising faster than it is elsewhere, which should presumably be a concern for any Government.

Richard Hughes: It is a problem, and it is a concern on both sides of the border. It seems to be a nationwide issue—it is not confined to a particular region of the country. Some bits of the country have it worse than others, but it seems to be a common pattern across the regions and nations of the UK.

Craig Hoy: With regard to the active labour market, post-pandemic, there is a sense that people are retiring earlier. Sometimes, that relates to pensions legislation; other people are perhaps just not working quite as hard as they did pre-pandemic. In public policy terms, how do you seek to reverse that trend?

Professor Miles: That is difficult. To the extent that the national insurance measure in the budget will ultimately largely get passed back to the workforce, it pushes slightly in the wrong direction because it is, in effect, a tax on labour supply. That does not help the trends that you mention, and it comes on top of what we were talking about a moment ago, which is the very substantial rise in the proportion of people who are inactive due to long-term sickness.

It is very difficult to work out the extent to which the rise in long-term sickness is a reflection of a real deterioration in the health of the UK population and to what extent something else is going on. There is now a really significant difference between unemployment benefit and the level of benefit that you receive if you are judged to be so unwell as to be unable to look for work. The highest level of benefit is now very large, relative to unemployment benefit, and the conditionality in relation to sickness benefit is much lower than the conditionality in relation to unemployment benefit. Unemployment benefit requires you to show that you are more or less looking for work full time, and if you cannot do that, your benefits will be cut. However, there is not the same level of on-going scrutiny or conditionality for people who are on sickness benefits.

How much of the big rise in the number of people who are inactive due to long-term sickness is due to a real deterioration in health and how much is due to the incentives that the welfare system provides is formidably difficult to work out. If you could change the trajectory of inactivity, which Richard Hughes spoke about, that could potentially have a big impact, because it is a big driver of the big increase in the welfare bill.

Craig Hoy: Is this a UK and Scottish problem, or are there similar trends in equivalent economies?

Richard Hughes: The trend is most pronounced in the UK, which is one of the reasons why some people have started to look harder at the data. It is a trend that we see in some other countries, but we seem to have it the worst of the Organisation for Economic Co-operation and Development countries.

Tom Josephs: One interesting thing to note is that, in the 2010s, the UK actually performed very well on inactivity compared to other countries, and we saw falling rates of inactivity compared to many other advanced economies. There was an increase in inactivity in the UK that was particularly due to health-related reasons during the pandemic. We saw that in a lot of other countries, too, for obvious reasons. However, although that seemed to reverse very quickly after Covid in other countries, the trend has been maintained in the UK, and it has actually increased. Why that has happened in the UK but not in other countries is a bit of a puzzle.

We published a study in September that covered many of the issues that David Miles was talking about. The study looked at trends in incapacity benefits over the past 40 years and it showed that, at different times, there seem to be different drivers of those trends. The underlying health of the population is one driver; the performance of the economy and the labour market in particular is another driver; and there are factors around the structure of the benefits system, which David was talking about. It is difficult to disentangle which of those drivers is having the biggest effect at any one time, but it is certainly a very important issue, where more research would be extremely useful so that we can get to the bottom of it.

10:15

Craig Hoy: I laboured the point in my questions because it is a concern of the committee; it lies at the heart of the problem that we have with the Scottish budget.

I refer to the measures introduced by the UK Government to target the overspend, including the potential savings that were put in place in July, with

> "departments absorbing at least £3.2 billion of the public sector pay pressure ... immediate action to stop all non-essential government consultancy spend"

and

> "a 2% saving against government administration budgets".

The UK Government has said that that process is on-going. How confident are you that it can realise that set of potential savings? Are you seeing anything like the equivalent determination in the Scottish Government to implement those kinds of efficiency savings in expenditure?

Richard Hughes: The Government announced savings and it remains to be seen whether they get delivered over the rest of the year. They have been overridden by the fact that the Government has just announced more than £20 billion more for all Government departments. To some extent, the financial pressure on departments to deliver those savings as a way to meet their budget totals has been substantially alleviated for a lot of them. They are relatively modest measures compared with the increases that departments are getting. For a lot of departments, the financial pressure to deliver those savings as a way to stick within their budget, rather than getting a rap on the knuckles from the Public Accounts Committee at the end of the year, is significantly alleviated.

The budgets of a lot departments are a kind of mass of spending, so it can be difficult to identify exactly how many savings are realised within one proportion. Ultimately, departments have a single budget and they prioritise within it. Most of those budgets are going up very significantly this year: they are growing by more than 4 per cent in real terms, which represents growth rates in public services spending that we have not seen in English departments for a number of years.

Craig Hoy: Does that not go to the heart of the problem? Living standards are going up by 0.5 per cent a year on average and taxes are rising, yet some of the granular work that could be done by Government to reduce its expenditure just gets washed out when a great splurge of cash comes in, which is largely funded by borrowing and tax.

Richard Hughes: The big, real increases are happening this year and next. Departmental spending is growing by 4.8 per cent this year and 3.1 per cent in real terms next year, but it then slows significantly over the remainder of the Parliament, down to 1.3 per cent in real terms per year. Delivering that kind of tight spending envelope, to which the Government and the Chancellor of the Exchequer have said they are now committed, will require some pretty tough prioritisation. Significant savings will almost certainly need to be found somewhere within the mass of departmental spending if that slowdown in spending growth is to be stuck to, given what we know about spending pressures in some particular services. We know that there are lots of pressures in the health service, and we know that there are pressures to increase defence spending. What that means for other services is probably some tough spending settlements, which will demand substantial efficiencies and savings in any kind of new activity involving those services in the second half of the Parliament.

Craig Hoy: Presumably that work should begin now; the UK Government should not be negligent. It should act with gusto and determination.

Richard Hughes: You would hope that that would be an important part of the current multiyear spending round conversations that are going on within Governments, which are expected to come to a conclusion in spring next year.

Craig Hoy: The impact of the national insurance increase on the public sector is topical in Scotland at the moment, as there appears to be a potential dispute between the UK Government and the Scottish Government in relation to the Barnett consequentials that are coming forward. The Scottish Government says that it requires £500 million, but the UK Government is presently giving £300 million. How accurate or robust is either of those figures? How easy is it to project what the figure for Scotland would be on the back of the national insurance increase, specifically in relation to public sector jobs?

Richard Hughes: Those numbers come from the Westminster Government and the Scottish Government, so we do not doubt the validity of their claims. As we understand it, the £300 million that is being provided to Scotland is just the Barnett consequentials on the compensation that is being provided to public servants in England. Even in England and Wales, that is not being provided to all people on the public payroll; it is just going to people who are classed within the public sector as employees.

Craig Hoy: In relation to your assessment of the UK tax take and so on, the convener identified that you have some issues about making projections. In Scotland, there has more recently been a principle of Scottish exceptionalism—we do things differently, and we create new bodies to do things differently. Would there be a case for the Scottish Fiscal Commission being brought into the Office for Budget Responsibility so that you could work seamlessly together to get a more accurate picture of the state of Scotland’s finances?

Richard Hughes: It is good to have competition and contestability in forecasting. We are not the only macroeconomic forecaster in the UK. We often look at the Bank of England’s forecasts and at those that institutes such as the National Institute of Economic and Social Research produce. We have very good and lively discussions with the SFC about our forecast methodologies. When it comes to methodology, we basically have nearly everything that we do in common.

As Tom Josephs mentioned, the biggest difference between our forecasts and those of the

SFC usually comes down to timing. The Scottish budget happens at a different time from budgeting in Westminster, and it makes sense to have the most up-to-date outlook.

Also, this committee and the Scottish Government have different interests and they want to know different things about public spending. The SFC focuses a lot more on what happens in public services spending than we have traditionally done in Westminster. We focus more on tax and welfare. It is good to get the service that you want from the SFC in Scotland. We have very good and on-going discussions with it about methodologies. Where we differ, we do our best to explain why. As I said, it is mostly down to what data is available to different forecasts at different points.

Craig Hoy: Last year, one of the problems that we had with the Scottish budget was the inability to project public sector pay, which led the Scottish Fiscal Commission to come up with one figure that, in the end, was not reflective of the higher figure that fed through. Public sector pay levels are a matter for the Government and the trade unions, but what more should we in Scotland be doing to ensure that we properly project public sector pay, so that our forecasts are robust and we do not end up with very large in-year revisions?

Richard Hughes: We have also not been satisfied with the information on public sector pay that we got out of the Westminster Government. Prior to this EFO—it has changed in this EFO—we did not have a separate published projection for the pay bill within departmental spending. We just assumed that, somehow, the Government's pay policies, whatever they were, would get absorbed within the overall envelope for departmental spending.

As part of a recommendation of our review of our forecasting methodology for departmental spending, we have insisted that the UK Government provide us with a projection for the total public sector pay bill. Within that, there is, obviously, an assumption about numbers of people and an assumption about pay growth.

I think that it is still the case in both Westminster and Holyrood that there is a certain amount of vagueness that you have to cope with around what public sector pay policy is, sometimes within the current year and almost certainly beyond the current year. As forecasters, we would like more information about what assumptions Government is making about public sector pay growth in order to assess the sustainability and realism of those forecasts.

At the very least, we now have some articulation of what the total pay bill looks like as an assumption within total departmental spending, so we can see whether it is squeezing out other elements of departmental expenditure. However, we have not managed to get the Westminster Government to give us a multiyear pay strategy underpinned by pay growth assumptions and numbers. At the moment, it would argue that it has not carried out a spending review, so it could not tell us how many doctors, nurses and teachers there will be within that, but that information is needed as a starting point before the Government can then think about how much it would pay them. Once there is such a plan, we will ask some more questions about how much each group is likely to be paid.

The Convener: I am sure that the SFC will be relieved that there will be no hostile takeover from the OBR. [*Laughter*.]

John Mason (Glasgow Shettleston) (Ind): I return to some of the issues that have already been mentioned, especially the national insurance increase. As I understand it, you have placed quite a big emphasis on profits being squeezed and wages and jobs perhaps being reduced in future years, but you do not seem to put so much emphasis on the idea that prices might increase. If I was running a restaurant and charging £17 for a main course, why would I not just add £0.50 or £1 on to that? Some restaurant people have told me that that is what they do.

Professor Miles: It is tricky to work out how much might come through as a result of employers granting lower wage settlements than they would otherwise and how much comes through prices. In one sense, what matters is not how the pain is felt by households but the real purchasing power of people's wages. There might be lower wages but less inflation, or there might be higher wages that are eroded by higher prices, but, in some sense, there would be the same impact on people's real disposable income and their incentives to work, because what matters is the real wage per hour.

We have skewed things a bit towards companies getting the money back, in a sense, by giving people wage settlements of, say, 2.5 per cent instead of 3 per cent or 3.5 per cent. If that happens for a couple of years, most of the tax will be shifted on to the workforce. You are right that the effect could come through more in higher prices than in lower wages. In a way, that could happen more quickly, because an employer could not say to their workforce that they were getting a 2.5 per cent wage cut from Monday.

John Mason: They could put prices up on the Monday.

Professor Miles: Absolutely. They could put prices up by 2.5 per cent on the Monday. Most of the workers who spent most of their money on things that were not sold in the shop, the restaurant or wherever would say, “Okay, that’s no skin off my nose.” However, if everyone did that, the general level of prices would go up, so workers would not avoid the situation that way.

You are right that the effect could be more price increases, which might come through a bit more quickly. If that happens, our inflation forecast will be a bit on the optimistic side, as might be our forecast on the interest rate that the Bank of England sets, because it will not sit and watch UK inflation go up to 3.5 per cent or 4 per cent and say, “That will blow over.” It cannot afford to do that, in part, because of what happened a couple of years ago, when UK inflation got up to 10 per cent or so. The Bank of England is probably now unusually sensitive to inflation overshoots, whereas it might have been more willing to wait and see had inflation not been at 10 per cent not much more than a year ago.

You are right that there is a risk that there could be more of an inflation impact, and that is how it would come through.

John Mason: That is helpful. On a different subject, I am still trying to get my head around the letters, so could you explain PSNFL—public sector net financial liabilities—to me? I get that, if I was borrowing through a mortgage, you would look at my asset—my house—and the two would go together. In a sense, it makes sense to include financial assets, but physical assets are not included. I would have thought that borrowing money to build a road, a house or a school would be slightly different from borrowing to pay for teachers and nurses or other resource spending. Will you explain the logic of why that measure is used?

Richard Hughes: It is probably more for the Government to explain the logic of its fiscal targets, but we can certainly talk about the features, properties and risks. Traditionally, under fiscal rules, what we have targeted as the stock variable has been public sector net debt. The “net” was included for a reason, but the only things that were netted off were the Government’s cash holdings, which were, in essence, its foreign exchange reserves. The principle was that, if the Government experienced acute financial problems, the cash that it had in hand would probably be available to pay down some of its debt or meet some of its financial obligations. Therefore, if the Government found itself experiencing some kind of acute liquidity shock, net debt was a reasonable measure of its ability to cope with that, because it would have some cash in hand and it would have some debt to service on the other side of the balance sheet.

Public sector net financial liabilities broaden the definition of assets and liabilities that are captured and netted off against one another. On the liabilities side, there is not just debt but the liabilities of funded pension schemes—other things that look more like direct financial obligations not just to creditors but to local government employees who have funded pension rights. On the asset side, the system takes account of the fact that the Government has financial assets that earn it a financial return, which could help to meet the cost of liabilities over the longer term. Therefore, the measure is less about liquidity and more about financial solvency.

On the asset side of its balance sheet, the Government has a small number of loans and equity holdings. The single largest element of the asset side of the portfolio is the student loan book. Students who take out loans to go to university pay those back with interest, and that generates a financial return for the Government, which it can use to meet its financial liabilities in the form of gilts and other financial obligations.

10:30

However, as you said, the definition does not further expand to include physical assets on the asset side. To explain why not, you could argue that those assets do not generate a direct financial return to the Government. You might think that, in the long run, they would deliver an economic return, which would generate some potential output then some tax revenues. However, unlike a loan—which has to be paid back—it does not help me directly to extend that to you. Borrowing for that kind of investment is therefore a more risky proposition, because its financial return is less certain than that of a loan, which has a principal amount, an interest rate and a maturity date.

John Mason: That is helpful. The approach means that we treat borrowing in the same way whether it is for a physical asset, such as a new bridge, or just day-to-day expenditure.

Richard Hughes: Yes—that is right.

John Mason: From your point of view, it makes a difference, obviously, because one of those items will create more of a return in the longer term, even though—I agree—it is not a definite, fixed economic return. Should we be thinking of those two kinds of debt separately?

Richard Hughes: In our economic forecast, we make a distinction between public investment and public sector current spending. David Miles might want to say a bit about that, because it made a material difference to our fiscal forecast this time around. From the point of view of making an economy forecast, it makes a difference to our view on the UK’s potential output. We published a paper over the summer about the methodology of that, then we applied it in practice because, in this budget, there was a big increase in public investment. David, will you say a bit about how that works?

Professor Miles: If we take a long horizon—longer than the five years to which the Government looks for its fiscal targets—we get the benefit of capital investment in things such as a new road, fixing potholes or building a bridge, because we allow for that to increase the UK economy's productive potential. It creates a bit more GDP; you get the tax on that extra GDP; and in principle it could pay for itself. However, most infrastructure spending is unlikely to pay for itself over a five-year horizon. Building a new motorway or a bridge could easily take three or four years to complete. It then has its positive impact on GDP over maybe the next 40 or 50 years. You only get a bit of that back over a five-year horizon, so it does not help the fiscal outlook too much.

As John Mason said, it does not matter very much whether you are borrowing to pay the salaries of public sector workers, provide public services or build a bridge when you are looking at just five years—which will drop to three, in some sense, when the Westminster Government's fiscal target starts to look at where things are three years down the road.

In this budget analysis, we looked at the positive impacts of bigger capital spending—not just at the end of five years, at which point it is meaningful but not particularly large, but at a sustained level—and provided some estimates of how much extra it would boost the level of GDP to sustain the higher public sector capital spending that we have over the next few years. That builds up and does not reach its long-run, extra, positive impact until maybe 20 or 25 years down the road. That is partly because it takes a long time to build stuff. You announce that you are going to spend the money now, but you do not actually start spending it for two years, and you do not finish the job until three years after that.

There is a broader question about whether some elements of public sector spending are not as productive, if you will, as building a road—the physical infrastructure bit. It could be argued—depending on how effectively the money is spent—that spending on education and health boosts the UK economy's productive potential every bit as much as building a road or a power station does. That gets very difficult to measure. A Government could argue, "Well, pretty much everything that we do is like that, so isn't everything that we do investment?" If you took that line—if you said that it was okay for the Government to borrow for investment—there would be no restriction whatsoever on borrowing.

John Mason: I appreciate it that you have unpacked that for me. You mentioned three years and five years. I wonder whether you have an opinion on that. We are to have a spending review, which is for three years, as I understand it, although there is also the five-year forecast period. Is there a right length of time for those things? Three years is quite short. Should the spending review be for longer?

Richard Hughes: Our understanding is that, by the time the spending review is completed, the end point of its set of plans will match the end point of the fiscal target. That is a pretty good principle in fiscal policy making—that plans should extend as far as targets extend. One pretty unsatisfactory situation in the UK for a number of years has been that Governments have been setting fiscal targets for 2029 but, until a few months ago, their spending plans ran out this year. Therefore, an awful lot of those targets were being met by aspirations or stated assumptions about the path of public spending, and they were unsupported by any kind of detailed plan about what that meant for health, education, transport, defence and all the other areas in which the Government had stated—and very expensive—priorities.

Maintaining coherence between the overall financial objective for the public finances and the detailed plans for public spending and tax is a good principle. At the moment, we will get there once the Government finishes its next multiyear spending round.

The Government has also made a legal commitment to running spending reviews more frequently, so big gaps will not emerge—gaps of one or two years may emerge, but nothing like the four-year gap, in the recent past, between when a spending review period ends and when the fiscal target is supposed to fall due.

John Mason: On another subject, the Government has talked about compensation for people who had infected blood and people who were affected by the Post Office scandal. Two quite chunky numbers are involved in that. However, you have made the point that defence and overseas aid aims are unfunded—there is nothing for what is coming along on that. I presume that, if there were changes to defence or overseas aid—areas that struck me were possible expenditure on rebuilding Ukraine or Gaza—that would be a one-off that would just hit us. None of that is really taken account of, is it?

Richard Hughes: It is not. For the moment, beyond the next financial year, the Government has set only an envelope for the spending review. It has not spelled out the details for departmental spending plans, which it will do in the next spending review. We can only guess at how all the aspirations will be met.

We said in the EFO that, if those things end up being funded on top of the overall envelope rather than being accommodated in it, they will pose between £10 billion and £15 billion-worth of extra spending pressure. That would be needed to meet the Government's stated aspiration of raising the level of defence spending, at some point in the future, to 2.5 per cent of GDP, compared with the roughly 2.3 per cent at which it stands, and restoring overseas aid to 0.7 per cent of GDP, which it has not been for a while, since it was cut. Both those commitments have always been subject to resources being available—which, up to now, they have not been. The Government has said that it will spell out in more detail what the deadlines for those targets are, as part of the next spending round, but we wait to see. They are expensive commitments.

Liz Smith (Mid Scotland and Fife) (Con): Behavioural change, which was mentioned earlier, is a key element in deciding on policy. I know that you cannot comment at all on the policy debate but, when you examine tax, do you feel that we are getting better able to understand behavioural change?

Tom Josephs: We, HMRC and the SFC have certainly done a lot of work to develop our methodologies for assessing behavioural change, but it remains an area over which there is significant uncertainty in the estimates. For this budget, we assessed that there would be big behavioural changes in response to the increases that were announced in capital taxes such as capital gains tax, the rate on carried interest and the changes to inheritance tax. Those changes could come through a number of channels. People could delay or even bring forward asset disposal in response to rate changes. They could shift their holdings between different types of asset. They could use tax planning and tax avoidance approaches to reduce their liabilities. In the extreme, as I mentioned, people might even choose to leave the country in response to changes. There are—potentially—a lot of different channels. As I said, estimating how much individual taxpayers will use those channels is uncertain.

We tend to base our estimates on analysis of the impact of similar changes that have been made previously. We can draw on quite a long history of policy changes in those areas, as well as on research from the impact of changes in other countries.

Some of the effects are pretty large. For the changes to inheritance tax and capital gains tax, and certainly for the carried interest change, anywhere from around 50 per cent to almost 90 per cent of the potential yield could be lost because of behavioural changes.

Liz Smith: Are you saying that it is a little easier to estimate what the behavioural change might be for some taxes? Economists often tell us that it is incredibly difficult to measure behavioural change—I understand why—but are there taxes where it is a little bit easier to measure that?

Tom Josephs: Yes. The tax changes that I mentioned fall on a relatively small group of taxpayers, who are typically higher-income earners, who are maybe more mobile and who have more channels available to them to respond to the changes. That is why we estimate a larger response but, as I said, that is uncertain.

For the increase in employer NICs, which is a much broader-based tax increase, we would assume less of a direct behavioural response and have a bit more certainty about the direct costing of that. As David Miles mentioned, the wider impacts on the macroeconomy are complex, and there is quite a lot of uncertainty about the assumptions that we made there, but the direct impact of that tax change is easier to estimate.

Liz Smith: You were hinting earlier that changes in the marginal propensity to save and consume might result from that.

In the work that you undertake with HMRC and the Scottish Fiscal Commission, do you notice any different behavioural patterns across different parts of the UK in relation to specific taxes, such as income tax?

Tom Josephs: When we were looking at the tax changes that the Westminster Government introduced, we did not assess behavioural response on a regional basis. We look more at taxpayer characteristics, such as their net wealth, whether they are overseas and the type of assets that they hold. That varies across regions, but we do not particularly look at the regional impact of that.

When it comes to the Scottish Government's policy changes on income tax, we look specifically at the impact on Scottish taxpayers. Both the OBR and the SFC made a similar estimate of the behavioural response to the increase in the higher rates of income tax, which reduced the yield by around 50 to 60 per cent. That was based on people generally choosing to alter the number of hours that they work in response to the higher rates or potentially switching their income out of employment and into other forms of income.

We also looked at whether there might be an intra-UK migration impact, but the evidence on that is not very clear. Some studies suggest that there might be a bit of an impact on migration, but others found no evidence of an impact. In our costing, we did not assume that there would be any significant or material impact on intra-UK migration as a result.

10:45

Liz Smith: I think that most businesses would agree that the question is difficult. There is no trustworthy evidence that people are moving away. Where there is maybe a little extra evidence is in relation to some businesses in Scotland finding it more difficult to attract people to come here—that is, recruitment is becoming increasingly difficult.

As a committee, we are interested in behavioural change that can impact on people's decisions about how they spend their money. We are also interested in the labour market issues that we have. We have been talking a lot about economic inactivity and whether tax has an effect on it. To make a good judgment on that, it is essential that we have as much data as we possibly can. That always underlies this committee's work, so thank you very much for your reflections on that.

Ross Greer (West Scotland) (Green): Good morning.

I return to the issue of national insurance contributions and your projections of around 50,000 lost hours in the labour market. To what extent do you take into account potential secondary effects? For example, there is acute concern about the effect on the social care sector. If social care employers struggle to pay those costs, it will result in a reduction in the number of staff in a sector that already struggles to attract enough staff, which will also result in other individuals having to withdraw from the labour market to become unpaid carers to family members. Are those second-order effects taken into account? To what extent are you able to project such issues?

Richard Hughes: When we did the assessment of the labour market impact of the tax rise, we were cognisant of the fact that a number of different changes were being introduced for employers at the same time, one of which was the rise in the national living wage and another of which was the rise in national insurance costs.

As soon as we looked at the distribution of that impact across different types of employers, it was evident that employers with a large number of relatively low-paid staff were going to have difficulty doing what would be the conventional response, which would be to reduce real wage growth, because they had to protect or, in some cases, raise wages to reflect the rise in the national living wage. The only way that those employers could afford the national insurance rise would therefore be to reduce employment numbers to reduce their payrolls, rather than simply having lower growth in their payrolls over the medium term.

For that reason—as has been borne out by announcements that we have heard since the budget—some of the hardest-hit sectors are those with large numbers of relatively low-paid people, either at or close to the national living wage, such as retail and hospitality. Social care is quite possibly another industry in that area.

However, we did not then assume an offset in public or public services spending because, alongside that, we saw a very large increase in public spending on health and a whole load of other areas, in this year and the next, as a decision of the Westminster Government. Although some of that was nominally badged as covering the cost of national insurance, we also expected it to increase the amount of resources that are available for the provision of those services in general. It was therefore hard to know exactly what the one-to-one relationship would be between the increase in payroll costs and the increase in spending that was going to come their way via the additions to the departmental expenditure envelope.

Ross Greer: Sticking with national insurance contributions, and accepting that the primary goal was to raise revenue, if the UK Government had taken a different approach, would it have had the same kind of consequences? For example, it could have lifted the 2 per cent cap on earnings above £50,000, albeit that that would have raised perhaps not quite half of what the employer national insurance contribution increase does. The primary impact will be on sectors with large numbers of people on lower incomes of far less than £50,000.

Richard Hughes: It is not something that we have looked at.

Professor Miles: You are right. The distributional impact, and which sectors of the economy that it would have had most impact on, would clearly have been different. Sectors of the economy in which average wages are much higher are hardly affected by the national minimum wage and are less affected by the NICs measure. It would certainly have had a different impact.

Ross Greer: I will switch to a different area entirely. I am flying somewhat blind, because I have tried to open so many of your reports of 200-ish pages from the previous few years that my laptop is really struggling to cope.

On land and buildings transaction tax, your projections have generally been relatively bullish, yet it still seems to be increasing and overperforming year on year—pretty consistently to the tune of about a billion pounds. If I look at the 2022 LBTT projections versus the projections in the most recent report, there is a fairly consistent gap of about a billion pounds, which is replicated if you go back through previous reports. What work have you done to look at the LBTT projections and the methodology behind them, because, although it is positive that it is overperforming, there is a relatively consistent overperformance?

Tom Josephs: As I said earlier, to produce that forecast, we base it on our UK-wide forecast of the property market and then look at how much of the revenue raised is raised in Scotland. Since 2022, we have been consistently surprised by the resilience and strength in the property market, so we have successively had to raise our forecast and have seen outturn come in more strongly than expected.

Part of the reason why we were expecting a less strong property market was the rise in interest rates and the impact that that would have on housing transactions; however, the market seems to have been more resilient than we and, I think, most other forecasters expected. For example, this year, we were expecting prices and transactions to fall, but, so far, prices have increased a bit and transactions have been stronger than expected. That is basically the driver of that trend.

Ross Greer: Sorry, I said a minute ago that there was a gap of about a billion pounds, but the gap for Scotland is pretty consistently about £100 million.

I return to Craig Hoy's point around public sector pay. One of the challenges for both Governments is that any figure that is put into a budget to account for public sector pay will immediately be taken by trade union negotiators as a floor rather than a ceiling. Therefore, there is a tension between Governments being able to put enough money aside to have genuine negotiation versus the transparency that everybody else requires out of a budget process. Do you have any advice for either Government in that regard?

Richard Hughes: The bit of progress that we have made in this forecast has been to at least get a decent assumption for the pay bill over the next five years. Within that, the Government must make decisions about headcount versus pay. It at least shows you that, if the Government plans to crowd out loads of other things that it wants to do with the payroll, you can see that, and, if the Government wants to maintain some control over that so that it can do other things, such as investing or procuring, it can. That is progress. You can then fill in more of the details once you know more about the Government's plans for spending on the health service and education, which translates more readily into assumptions about numbers of doctors, nurses and teachers. Just getting that breakdown of spending by its main economic categories—the pay bill, procurement, investment, interest costs and welfare—is progress in understanding the economic composition of public spending.

I can sympathise with Governments not wanting to telegraph their pay negotiating strategy five years ahead, but, when we forecast tax revenues, we have to make assumptions about pay growth in both the public and the private sector, because it drives tax liabilities. It would be better to base that on a plan for Government rather than have to make it up ourselves.

The Convener: You are basically saying that the UK Government will have an envelope for pay, and it will say that it can be met either by increased pay, which might mean a reduction in numbers, or with lower pay but maintaining the numbers.

Richard Hughes: The Government would describe it as an assumption rather than a plan, but at least there is an assumption.

The Convener: Whereas, traditionally, the Scottish Government will increase numbers and pay beyond that envelope.

Michael Marra (North East Scotland) (Lab): My first question is another on the issue of the pay policy. For clarity, for your forecast this year, the UK Government provided you with a projection on pay for this year within the budget.

Richard Hughes: It had made a set of announcements that it had accepted the pay review body recommendations, so that was what was implied in our forecast. Then, it gave us an overall envelope assumption for the pay bill for the years beyond this year, although it had not got a set of recommendations from the pay review bodies on that.

Michael Marra: For context, you might be aware that the Scottish Government has a commitment to provide a pay policy to the Scottish Fiscal Commission but has failed to do so for the past two years in a row. That is part of the reason why there is quite a lot of interest in the issue from the committee.

On page 45 of the budget, the Treasury published a graph on the budget's distribution effect, which showed that

> "Overall, on average, all but the richest 10% of households will benefit as a percentage of income from policy decisions in 2025-26."

Does the distributional effect of this budget show a significant departure from previous recent budgets?

Richard Hughes: It is hard to say, because the Treasury changed its methodology for distribution analysis quite a lot. Traditionally, it has just done tax and benefit changes, which is a close proxy for the disposable income measure—the financial resources available to an individual household—that we would use to measure households. What it has added into this distribution analysis is an assumption about the benefit in kind that households would get from public services, with the assumption that poorer households get much more of that benefit than richer households.

That might be a reasonable assumption, but it is a step away from just a disposable income calculation—the old Treasury methodology—which is more useful for the economic forecasting of things such as consumption spending and VAT revenues. It is no doubt good and reassuring to know that people are more likely to be able to access a national health service appointment in a reasonable period of time, but that does not affect most people's disposable income very much in a given year.

Michael Marra: Is it credible to want to realise those benefits—to produce the additional resource that will go to the public services—without raising taxes?

Richard Hughes: If you do not want to see your debts rise for ever, it is not. Governments cannot provide and pay for more and more public services as a share of the economy without seeing their debts reach an unsustainable level.

Michael Marra: You have also said in various parts of the commentary that those investment returns have to be strong in the first couple of years if we are to get into growth figures and get the longer-term benefits from changes. In your September report, you referenced, in particular, issues around changes in health situations and how they can impact long-term economic performance. Is the additional money enough, or do we need policy change as well in order to realise those kinds of outcomes?

Richard Hughes: That probably gets into areas that we are not particularly expert in. When we do our own analysis of the economic and fiscal impact of spending on things such as health—education, too, but I will take health as an example because it concerns a lot of us at the moment due to the long waiting lists for the NHS and the big concerns around health-related inactivity—we realise that the biggest long-term economic and fiscal benefits are not from treating people who are already sick, because they are oftentimes older, sometimes in the workforce or already retired and out of the workforce, but from keeping people healthier for longer so that they do not fall ill too early in life and end up falling out of the labour force and not coming back.

You get significant benefits from keeping the population healthier and from an investment in keeping somebody who is 20 now still in the workforce when they are 65, rather than treating somebody who is 65 and already ill. Although you definitely need to treat that person because you want them to be healthy, it will probably not make a big difference to their labour force decisions—they are either in or out of work at 65 anyway, and the kind of healthcare that you are providing at that stage will probably not make a dramatic difference to their employability.

Michael Marra: So, it is about a shift to preventative intervention.

Richard Hughes: Yes, and it is about extending healthy working lives.

Professor Miles: The pay-off on that is very long-term, whereas getting more people to wait two months instead of nine months to have hip replacements has a much more short-term, immediate effect. That might have an enormous impact on life satisfaction and wellbeing in the population but do nothing for GDP, because those people tend to be elderly. They will not get back into the workforce; however, they will suffer less pain.

11:00

Michelle Thomson (Falkirk East) (SNP): I thank the witnesses for joining us—it has been a very worthwhile session. I want to finish off by getting your reflection on Brexit, which, incredibly, we have barely discussed. You comment that

"Weak growth in imports and exports over the medium term partly reflect the continuing impact of Brexit".

You then refer to a decrease in trade intensity, which I think that I asked about this time last year.

My question is about the impact on potential productivity in the light of the budget being projected as a growth budget. I know that you commented on that in March earlier this year, but it would be useful to get your latest reflections on the specific impact of Brexit on productivity. Obviously, we have the nearside issues, but I am asking about the longer term—I think that you used a 15-year projection.

Richard Hughes: Our assessment remains more or less unchanged from the one that we made at the time of the referendum. It is that, in the long run, Brexit is likely to reduce the trade intensity of UK output over 15 years, as you said, by around 15 per cent, compared with if we had remained in the European Union. The long-run impact of that on the level of potential output of the UK economy is about 4 per cent once you translate that into what it means for our productive potential. In essence, it makes us a less open economy, and we are slightly less productive as a consequence.

What we have seen in the data since 2016 is more or less in line with that assumption, with some important caveats. One is that, basically, our goods trade seems to be doing worse than we anticipated but our services trade seems to be doing better. The frictions at the border are making it more difficult to import and export for those who are manufacturing or in any kind of trade in goods or commodities, whereas we have seen quite significant service export growth—it is among the best service export growth in the advanced economies.

Services industries seem to be finding ways of exporting to the rest of the world, especially in areas such as professional services, accounting, finance and consulting, some of which are important contributors to gross domestic product in Scotland. Those sectors seem to be finding ways of getting around trade barriers. To an extent, being in or out of the EU mattered less for them anyway, because the border for a services industry is a slightly nebulous concept in any case.

That said, there are clearly now risks hanging over the global trade outlook in the aftermath of the US presidential election, and those could have consequences for our ability to trade, not necessarily with Europe but with the US and the rest of the world.

Michelle Thomson: You have just made the point that I was going to come on to. We face the geopolitics: we are out of the EU, we have the diminishing trade intensity and we have activity in the rest of the world. We have President Trump and there are geopolitics going on, so we could end up being in a very isolated place when it comes to replacing some of that trade, notwithstanding the point that you make about services.

Richard Hughes: That is a significant downside risk in our forecast, which we completed on 30 October, before we knew the outcome of the US election. We do not know what the policies of the new US Administration will be yet—everyone reads every headline every morning, but we will have to wait to see what is announced. As a bit of contingency planning, back in the summer of 2022, we considered a global trade war scenario and what a worldwide rise in tariff levels would imply for the UK economy. That implication is negative, and of a similar order of magnitude to those that we looked at in the post-Brexit referendum work.

I should say that there is quite a big difference between the introduction of unilateral tariffs by one country on the rest of the world and an outright tariff war in which everybody's tariffs go up by 10, 15 or 20 per cent, which has a very big effect on the volume of world trade. The US is a big economy, but it is only around 12 per cent of global trade and, if it acts unilaterally, that principally affects its individual trading partners. Countries can find ways around such unilateral actions. However, if the situation starts to make trading around the world more expensive for everybody, that can have very significant effects on output for any open economy, including one such as the UK's.

Michelle Thomson: I want to return to the subject of growth and the link with capital. I think that it was David Miles who reminded us that, on capital, we have a short-term bounce of about 2.5 per cent. There was a lot of sleight of hand in the budget in relation to the short-term nearside position but, in the longer term, capital investment will continue to be very low. How on earth will we be able in any way to mitigate—if we can mitigate it at all—the damage of Brexit over the longer term, given that, as we have discussed throughout this meeting, we have had only marginal nearside increases?

Professor Miles: I think that you are right: it will be difficult to offset, solely through higher public sector capital spending, the pretty substantial hit from Brexit that we include in our forecast, at any time over the next five or even 10 years. For that to be the answer, public sector capital spending would probably have to be a lot higher than the level that was announced in the budget. It is costly, and the Government has to pay for it somehow. Taxes in the UK are the highest they have been in 70-odd years. We are starting from a position in which the debt to GDP ratio is close to 100 per cent, and the headroom that the Government has against its own targets is wafer thin. It is the old story of, "You wouldn't want to start from here."

However, that is where we are. As Richard Hughes said, there could be a trade war across the world that would make things worse. I suppose that there are some kinds of trade war that could be neutral or even mildly positive for the UK. If it turns out—who knows whether this will happen?—that we get a severe bilateral trade war between the US and China, which does not directly affect Europe or the UK, it is not inconceivable that that will be neutral or even mildly positive, in the sense that the US will not import as much from China but will have to import stuff from somewhere. The UK produces some things—cars are an example. Those British cars could be substitutes for what would be very expensive imports to the US from China if a 60 to 70 per cent tariff were imposed on them. The Chinese, who sell a lot of stuff to the US, would then be looking for markets where they could sell stuff. That might mean that imported Chinese goods would be slightly cheaper, which, in itself, would not be bad for consumers, at least, in the UK.

Although most of the scenarios for a trade war and all the scenarios for a global war involving every country are almost certainly bad-news stories, a particular kind of trade war that involved only two big countries fighting each other—the US and China—might be neutral or even mildly positive for the UK. That might be too optimistic a note to end on.

Michelle Thomson: I was about to say, “Always look on the bright side,” but the outlook does not seem to be terribly bright.

Professor Miles: Somewhere, there is a bright side.

The Convener: I almost want to start singing that line from the wonderful Monty Python film.

This morning, the embryonic Trump regime said that Mexico, Canada and China will be the target of its tariffs.

To round off our discussion, I have a couple of questions, one of which is about economic inactivity, on which you had an interesting dialogue with Craig Hoy. The rate of economic activity is 26.3 per cent in Scotland and 25.2 per cent in the UK as a whole, so there is a 1.1 per cent difference. Have you looked to see where that difference arises?

The SFC has mentioned the fact that people forget that students are included in the economic activity rates. In Scotland, people do a four-year university degree, whereas, in England, they do a three-year university degree. If 40-odd per cent of Scottish young people go to university and their working life is reduced from, say, 45 years to 44 years, that is included in the economic inactivity rates when, in fact, one could argue that those university students are training for economic activity. Have you broken that down? The big issue that everyone is concerned about is people who are on long-term sickness and incapacity. Do you have a breakdown of the figures in relation to where the balance lies?

Richard Hughes: For the UK as a whole, we have broken down the rise in inactivity into different groups. Early on, there was some optimism that the post-pandemic rise was due just to the delay of people coming into university, as a lot of net migration into the UK as a whole was of students. That was a temporary wave and, in net flow terms, those people then entered the workforce or left the country to work somewhere else, and the number in the residual group of people who seemed to be inactive for health reasons remained high.

In the very initial post-pandemic surge, a big part of the rise in inactivity was students. By this point, after the bow wave of students have gone into and come out of university, it looks as though we are left with inactivity for health reasons being the number 1 cause of the higher numbers since 2019.

In Scotland, you are a perhaps a bit more student-heavy than the UK as a whole, which might explain some of the difference in levels of inactivity here. However, it is also the case that in Scotland, the way in which disability benefits are administered has an impact on people’s financial access to inactivity benefits, which we think—as David Miles was saying—has been an incentive for people to be and remain inactive in the rest of the UK. The fact that the administration of the benefits system here in Scotland is different from that in the rest of the UK probably also makes up some of the difference.

The Convener: In table 2.1 on page 19, you say that from 2019 up to 2028, GDP is expected to rise by a cumulative 4.3 per cent, which puts the 4 per cent impact of Brexit into some context. Just over 4 per cent in nine years is kind of pitiful, really. The UK economy appears to be somewhat atherosclerotic, because in table A.1 on page 168, you say that the

“World GDP at purchasing power parity”

is expected to grow between 3.1 per cent and 3.3 per cent from 2023 onwards, which is more than six times that of the UK. What is your perspective on that, and how can we break that cycle of stagnation?

Richard Hughes: As I said, the budget, in net terms in the near term, is probably neutral for growth, because it is putting a new burden on employers, but is also doing more public investment. Over a five-year horizon, that is probably a wash. As David Miles said, if you take a longer-term perspective and look 10 or 20 years ahead, the fact that the Government is maintaining public investment at 2.5 per cent of GDP rather than cutting it back to 1.7 per cent, which was the previous Government’s plan, is probably net positive for the growth potential of the UK. We certainly assume that that is the case in our projections.

Looking forward, the Government must make another set of choices about its growth-enhancing policies. It has a fiscal framework that allows it to do some borrowing for some types of investment in a rules-neutral way, then it will make another set of regulatory decisions, some of which—such as on planning reform—might be positive for growth. Others might weigh in the other direction. We have yet to see the detail of what the Government calls its “Make work pay” proposals, which are its plans for increasing employer regulation, which might be another burden on employers in terms of their making hiring decisions. There are probably risks on either side of our growth forecast, depending on the policy choices that are available to the Government.

There is also a big question about what the global environment will look like for international trade in the light of the decisions that will be made in America.

The Convener: On page 83, you say:

> "In the downside scenario, public and private capital are substitutes so every additional £1 of public investment reduces business investment by £0.50."

You go on to say that

> "the increase in public investment leaves GDP only 0.6 per cent higher in 50 years".

Richard Hughes: That is right, although that was an assumption in this forecast. We play different tunes on that assumption, depending on exactly where the public investment goes and its relationship to private capital. David, do you want to say a bit about what difference that makes?

Professor Miles: We do not have many details about where higher public sector capital spending will happen. One can think of some public sector capital spending that clearly advantages and helps private sector businesses. If you improve the road network, the rail network and the ability for those who invest in wind farms to link into the national grid, and you do all that with extra public sector spending, that is pretty clearly a positive for the business sector. On the other hand, some bits of public sector investment might be straight competitors with things that the business sector is producing and so, in a sense, could crowd out a bit of activity.

Because we have a spending review covering only next year, we do not really know where the extra public sector capital spending will go for most of the five-year period that we cover in our analysis. Even then, it will not be exactly clear what it will have been spent on. It is not just about what it is spent on: it is also about the time lags. There are some bits of public sector capital spending that have a positive impact within 48 hours—for example, fixing some terrible potholes in a road.

The Convener: They used to call it "shovel ready".

Professor Miles: There are plenty of potholes where I live—I wish there were shovels turning up. If they were fixed, we could actually drive down the road.

On the other hand, building a power station can take 20 years. Until we know exactly what projects are going to be done, what the Government will spend the money on and what the time lags will be, it is a bit difficult to feel very confident about when we will start to see the benefits.

The Convener: Thank you for your evidence today. It is very much appreciated. Before we wind up, are there any further points that the OBR would like to make to the committee?

Richard Hughes: I will just thank you for the opportunity to be here this morning. I look forward to doing so again in the future.

The Convener: It is greatly appreciated that you have come here in person. It makes a big difference to our scrutiny. Thank you very much.

That finishes the public part of our meeting. I will call a five-minute break to enable our witnesses, broadcasting staff and official report staff to leave.

11:16

Meeting continued in private until 12:14.

This is the final edition of the *Official Report* of this meeting. It is part of the Scottish Parliament *Official Report* archive and has been sent for legal deposit.

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