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Finance and Public Administration Committee

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BUDGET SCRUTINY 2026-27 (UNITED KINGDOM CONTEXT) 1

FINANCE AND PUBLIC ADMINISTRATION COMMITTEE
35th Meeting 2025, 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:

David Phillips (Institute for Fiscal Studies)

CLERK TO THE COMMITTEE

Joanne McNaughton

LOCATION

The Robert Burns Room (CR1)

Scottish Parliament

Finance and Public Administration Committee

Tuesday 16 December 2025

[The Convener opened the meeting at 09:30]

Budget Scrutiny 2026-27 (United Kingdom Context)

The Convener (Kenneth Gibson): Good morning, and welcome to the 35th meeting in 2025 of the Finance and Public Administration Committee. We have one public item on our agenda today: an evidence session with the Institute for Fiscal Studies on the United Kingdom context for the Scottish budget 2026-27. I welcome David Phillips, associate director at the Institute for Fiscal Studies.

Mr Phillips, I understand that you have an opening statement to make—is that right?

David Phillips (Institute for Fiscal Studies): No.

The Convener: Okay—we will go straight to questions. We do not have a submission from you either, so we will simply ask a series of questions on the budget.

First, I want to ask about the £820 million of additional funding that the Scottish Government is to receive. That comprises £510 million in resource funding and £310 million in capital funding over five years. One issue with that is that it is very much front loaded. Will you talk us through that? I understand that it ultimately leads to a cut in day-to-day spending in 2028-29.

David Phillips: Yes. Overall, I would make two points about that funding. First, it is pretty small beer in the context of the Scottish Government's budget: £510 million of resource spending over three years is less than a third of a per cent of the resource budget. Secondly, it is also in the context of a forecasted increase in inflation, so, in real terms, the funding increase does not make up for the higher level of inflation. In real terms, the budget is lower, even accounting for the fact that the money has been brought forward.

Thirdly, you are right in that, not just with the Scottish budget but more generally, the Chancellor of the Exchequer—in the context of a spending review that was already quite front loaded—brought forward further funding into the next couple of years and reduced budgets in 2029-30 and 2030-31, rather than in 2028-29 as was previously planned.

That means that there is a bit more of a boost in the short term—although it is not really even keeping up with inflation—but that makes the fiscal challenges a bit harder in the longer term. In the English context, those challenges can supposedly be met by delivering efficiency savings on top of the savings that are already planned for. I guess the question for Scotland and Wales is, in the context of their budgets, whether they absorb those cuts in later years—and, if so, how they will address those—or whether they use their devolved powers to change revenues.

The Convener: One of the issues, which has been well trailed, is the freezing of thresholds. Ultimately, by the end of the current session of Parliament, the tax take will be the highest on record in peacetime, as a share of gross domestic product. Is that correct?

David Phillips: Yes. The tax-to-GDP ratio has already risen substantially since before the Covid pandemic and it is set to rise further during the current session of Parliament. The further increases are in part because of the threshold freezes that were put in place by the previous UK Government, which are continuing through to 2028, and the new threshold freezes that were announced in this year's budget, combined with some of the other tax changes that were made in last year's budget, particularly the increase in employee national insurance contributions. As a result, the tax-to-GDP ratio will increase to 38.3 per cent of GDP, which will be the highest level in the UK context outside the second world war.

It is worth noting that that would not leave the UK with a particularly high tax burden in the international—or at least the European—context, but it is historically high for the UK. The reason for that is that spending is historically high in the UK in comparison with levels that we have seen outside the wars. In comparison with the pre-pandemic period, spending as a share of GDP will be up by about 5 or 6 percentage points, with that being driven partly by higher debt interest and partly by higher spending on pensions. It is also driven partly by higher spending on public services, which, unfortunately, across the UK—in England Scotland and Wales—has not delivered the improvements in public services that we would have quite hoped for, given what is a disappointing productivity performance in public services.

The Convener: Yes—I think that a lot of that is underpinned by the fact that the productivity forecasts have had to be downgraded, given that they have been overoptimistic for some time.

One issue with the UK budget that many commentators have picked up is the fact that there are a lot of little tax increases rather than anything particularly significant. I will touch on one or two of those increases where the implications for

Scotland may not have been particularly well highlighted.

The tax on property income and savings income will increase by 2 percentage points at the basic and higher additional rates from April 2027. The UK Government intends to engage with the devolved Governments of Scotland and Wales to provide them with the ability to set property income rates in line with the current income tax powers in the fiscal framework. Will you talk to us about that?

David Phillips: Yes. The UK Government made a number of changes to income tax in the budget. Some of those apply directly in Scotland; some of them do not, and it is up to the Scottish Government to decide whether to follow suit.

Of the ones that directly apply, there is the freeze on the personal allowance, as well as the increases for savings and dividends income, because those have not been devolved. However, with the freezes in the other thresholds, such as the higher-rate threshold, it is up to the Scottish Government to decide whether to follow suit.

Property income is devolved so, by default, the extra tax on property income that the UK Government is imposing will not apply in Scotland. As you say, however, the UK Government is liaising with the Scottish Government on the powers to do that in Scotland, and then it is up to the Scottish Government to decide whether to follow suit.

I make the point here—the chancellor made a lot of this in her budget speech—that the reason for doing that is that unearned income, which includes income from property, savings and dividends, is taxed at a lower marginal rate than labour income, and the measure is designed to bring that into line, or at least a bit more into line. She is right that there is a lower rate on property income and so on, because it is not subject to national insurance contributions. However, we must also consider the tax base. Over time, with property income, we have seen a significant restriction on the deductions that people can make for mortgage interest costs and other things. By increasing the rates without fixing the tax base for things such as property, savings and dividends, you end up discouraging investment more than you need to. That should have been part of a package of reforms that looked at not just the tax rates but the tax base so that there were proper deductions for investment.

In a Scottish context, with the property tax, it is important to see that in the light of a series of other policies that, in effect, penalise the private rented sector. The UK Government has already restricted mortgage interest relief; there is capital gains tax on the UK Government side; and there is land and buildings transaction tax at high rates from the Scottish Government. There is, therefore, a question about looking not just at the marginal rates but at the entire series of taxes on the private rented sector, recognising that the restrictions or higher taxes on the private rented sector affect not just landlords; sometimes they affect tenants, too.

I am not saying that you should not follow suit, but I am saying that you should be careful in thinking about that, given that it interacts with other parts of the tax system and that the private rental sector is taxed far more highly than most other parts of the economy, which can have knock-on effects for tenants as well as for landlords.

The Convener: Yes, because costs ultimately have to be passed on.

With regard to implementing lower business rates for retail, hospitality and leisure properties, a lot of pressure is on the Scottish Government to follow what has happened down south. What would be the implications for the Scottish budget were the Scottish Government to do so?

David Phillips: I will make a couple of points on business, hospitality and so on. First, in comparison with the system now, business rates overall are going up in England. That is because the reliefs for retail, hospitality and leisure are just that—reliefs that are paid for by central Government. Going forward, the UK Government is increasing the tax on higher-value properties in order to have a discount for retail, hospitality and leisure properties. It is moving from a relief that is paid for by central Government to a discount that is funded by higher bills on some large properties. Overall, there will be an increase in business rates in England.

Secondly, the retail, hospitality and leisure reliefs are less generous for most small businesses. Currently, they can get 40 per cent up to a cap of £110,000. The new system across England will be about a 12 or 13 per cent discount, but it will not be capped in the same way. A big business with a lot of properties will get a better deal; a small business will get relief that is much lower than the current 40 per cent. That is the background.

On how that affects the Scottish Government budget, the fact that the measure has shifted from being a rates relief that is funded by central Government to one that is funded by other ratepayers means that business rates will increase in England, resulting in a smaller block grant—that is, less money—for the Scottish Government.

If the Scottish Government wants to follow suit, a lot would depend on how it chose to fund the relief. It could do it via a higher rate on bigger businesses, or it could do it through a funded relief, as has been traditionally done in England. There are different options: you could do what England did, or you could do what Wales did and offer a relief that is just for retailers. Its relief does not cover hospitality and leisure, because the idea is that it is meant to help businesses to deal with online competition, and hotels and hospitality do not face the same online competition as retailers do—the latter has Deliveroo, but that is not quite the same.

Lastly, I would be thinking about what the potential impacts will be on the beneficiaries of the policy. That will depend on how much business property we think is not very responsive to taxation. By that I mean that, if there is a side of the market that is not very responsive to taxation—say, the supply of property—that side of the market will bear the tax. I think that implies that, if the supply of business property is not very responsive to taxes, most of the benefits of a lower tax rate would fall to the landlords. Basically, because business rates would be cheaper, retailers and pubs would be able to pay a bit more in rent. Landlords would capture that—they would gain from that.

Retail, hospitality and leisure would gain a bit, too, because their demand would increase. That would not be the case for banks and others that do not get the relief, as they would still be paying the same business rates but would be competing with, for example, retailers that can pay a little bit more, meaning that their rents will go up, resulting in their being worse off.

On who might gain from the measure, landlords would be the biggest winners, and retail, hospitality and leisure would potentially gain to some extent. The losers could be those other sectors that compete for properties with retail, hospitality and leisure but do not get those reliefs, which might be banks, building societies and other service providers.

The Convener: That might be a further incentive for banks, for example, to leave high streets—not that they seem to need much of an incentive at the moment.

David Phillips: If they were not covered by the relief and rents were to increase, that could be another thing that increases the cost of their presence on the high street. Yes, that could be a further incentive for them to leave.

The Convener: At the start of your response, you said that the UK measure would have an impact on the block grant adjustment. How much of an impact would you estimate that that is likely to have in the forthcoming financial year?

David Phillips: I do not have those figures to hand. I think that the last time that I looked at the cost of the reliefs in England it was about £2 billion. If that is correct, given that the reliefs were not further extended and that they are now being funded by higher rates on bigger properties, the new cost would be about £200 million. I would need to check exactly what the previous cost was. Had the relief been extended, Scotland would have got around 10 per cent of that, but the relief will be funded in a different way so it will not get that amount.

The Convener: There is a £20 million loss to the Scottish budget, potentially.

David Phillips: No—if the figure was £2 billion, the loss would be £200 million.

The Convener: Oh, I thought that you were talking about the £200 million change.

David Phillips: Let me look at the figures.

The Convener: Okay. I think that our having figures would be helpful.

David Phillips: Yes.

Lastly, I would expect there to be different effects depending on the types of properties. What I have said so far applies in a context in which the supply of property is not very responsive to tax. However, in some places, it could be more responsive—in the marginal bits of the high street where the properties could be converted from commercial space into residential space. As a result of that more responsive supply side of the property market, it might be that a bit more of the gains go to the tenants.

In city and town centres where a property is really only useful for retail—it is still much more valuable as retail than as residential—the gains would go mostly to the landlords. In some parts of the town periphery or in small high streets, a bit more might go to protect the tenants.

I expect that increased business rates might do a bit to protect retail, hospitality and leisure in peripheral locations, but it will do more to help the landlords in those central locations where it does not make sense to use the property for other things.

09:45

The Convener: One of the issues that has created a lot of heat but not much light in Scotland is the energy profits levy. The UK Government plans to replace the levy with a permanent oil and gas profits mechanism. How would that work?

David Phillips: I preface this by saying that I am not an expert on energy taxation, so please bear that in mind. The new mechanism will differ from the current one in that there will be a defined set of price points for oil and gas that are higher than the ones that are built into the current mechanism, and the new higher rate will apply only when those price points are passed. It will also differ in the sense that it will be a revenue-based tax rather than a profits-based tax. Therefore, once you reach those price points, the tax rate will apply on revenue above that point, with no allowance for additional costs. It is a bit of a regime change.

Yesterday, I spoke with colleagues about the system in preparation for this meeting. In effect, the IFS thinks that oil and gas taxation is being overcomplicated because it involves location-specific rent, which means that oil and gas can be extracted only in certain locations. That is unlike attracting Nike or Apple to the country with low tax rates, because companies that want to extract oil and gas need to go to a specific location. Therefore, it makes sense to have higher taxes on oil and gas than you would under your standard tax regime or on things that can move around the world in a more footloose manner.

However, rather than having a tax rate and imposing a different tax that applies when prices are higher, then another supplementary regime and so on—that complicates the system and creates lots of issues, which I will come on to in a second—all that you need to do is have a high tax rate that applies to profits above the normal rate of return, which allows deductions for the full cost of investment. That high tax rate applies only to profits above the normal return—that is, profits above the amount that is needed to cover your investment costs—which does exactly what you want it to, because it taxes excess profits at that high rate.

When you have a system in which you apply a standard rate without allowing full deduction of costs but then introduce a special charge at the top that applies only when a certain price point is reached, you need to define that price point, see how it changes over time and clarify how it will evolve. It is also unclear how that will respond to changes in production costs and in prices. That risks overcomplicating things, and we have seen that instability in the oil and gas tax regime sometimes increases uncertainty and potentially puts off investment.

We need to go back to a simpler system. Rather than put in place all these add-ons in order to capture revenue at times of high prices and excess profits, you can just have a system that is designed to cope with those times in the first place by having a high tax rate that is above full deduction for investment costs.

The Convener: It is said that a camel is a horse designed by a committee, which is exactly what that tax system seems to be. It is as if a load of people sat down and all managed to add a wee bit into the mix without making it very clear or straightforward, as you have just said.

The Office for Budget Responsibility forecasts real GDP growth of 1.5 per cent across the UK in 2025, but the economy has shrunk in six of the past seven months, so is that forecast realistic?

David Phillips: I do not want to comment on that. I think that the OBR said that the main reason why it upgraded its forecast for this year was because growth at the end of 2024 and in the first quarter of this year—it was 0.7 per cent—was stronger than expected. Boosting growth early on in the year affected the later months in the year, because the growth came from a higher base, but I would not want to comment about how things will evolve over the next couple of months and how that will feed through.

The Convener: A lot of that was before the increase in employee national insurance contributions. There was a theory that people were spending more before 1 April, which boosted that quarter's figures while having an adverse impact on the following quarter. One would think that, over the year, the OBR would have taken those matters into account. Surely, it must have done.

David Phillips: I do not expect that people would bring forward expenditure for a national insurance increase. With, say, a VAT increase, there would be an incentive to bring forward spending, because then you could avoid that higher cost. There is no direct impact of the increase in NICs on consumers, although it carries pass-through effects in terms of prices.

My understanding is that the upgrade to the forecast was largely because of things happening towards the end of 2024 and the start of 2025, which were enough to boost the overall figure for the year. However, the OBR has downgraded its forecast for growth from 2026 onwards, in part because of that productivity downgrade, although the downgrade in forecast is a bit larger than the productivity downgrade. That could be to respond to the weakness that you pointed out in later months' figures.

Next month, the committee will meet the OBR, which might be better placed to respond to questions about its forecasts.

The Convener: Definitely.

The IFS director, Helen Miller, described the budget as a

> "borrow-to-spend budget in the short term, and a combination of a tax-and-spend and tax-and-bank-it budget in the medium term".

What did she mean by that?

David Phillips: Going into the budget and the set of fiscal forecasts, the expectation was that the big story would be the downgrade in the fiscal forecast because of the productivity downgrade and that the chancellor would need to do a big fiscal repair job and raise taxes to cover a hole that had opened up in the public finances.

In the end, there was a bit of a downgrade in the public finances, but it was not as significant as we expected. Also, on top of the downgraded forecasts, the chancellor did two things. First, she announced boosts to spending in the short term, including by confirming the reversal of the cuts to disability benefits and winter fuel payments, which she officially put in the figures, and by saying that the Government would abolish the two-child limit. Secondly, she brought forward some capital and day-to-day spending, as you mentioned.

Therefore, in the short term, there will be an increase in planned spending on welfare, day-to-day spending and capital spending, which will start to ebb later on. The benefits—that is, the welfare—will continue. However, as the chancellor has brought forward capital and resource spending, those areas of spending will be lower in subsequent years. Then, later on, tax rises will kick in.

Another term that we have used for it is the “spend now, pay later” budget. In the short term, we are, in effect, spending more and borrowing more than we were previously. The biggest tax rises will kick in from 2029-30, when the fiscal rules bind, and that is when we will be borrowing less than we were previously. So, we have raised taxes partly to spend a bit more and partly, in the longer term, to borrow a bit less. That is where one of the risks with the budget strategy sits.

In the short term, it is quite believable that we will see that increase in spending, certainly on the benefits side and with the kind of changes that are being made on public services and investment. The OBR now expects there to be less underspending than there has been previously because it has seen the pressures on the budget.

Although the short-term boost of spending is quite believable, the longer-term restraint as we go into 2028-29 and 2029-30, when tax rises are to come on stream, is a bit more risky, given the political context of it coming just before an election. We will have heroic spending restraint and tax rises kicking in before the election. The risk is that, as we approach that point, the chancellor will go, “Oh, this looks a bit scary. I will need to borrow a bit more,” and, when we get there, we never actually deliver that reduction in borrowing that has been pencilled in, because it is all back loaded.

The Convener: There is quite a cynical comment in the IFS blog that

“One could be forgiven for treating”

a hair-shirt approach just before an election

“with a healthy dose of scepticism.”

David Phillips: If I may be so bold, I was a bit surprised at how sanguine the markets were about that strategy. On paper, the strategy increases the headroom that the chancellor has against her fiscal rules in 2029-30 from £10 billion to £22 billion. That is quite a big increase in headroom, albeit that it is still fairly small in the grand scheme of things overall. It increases the chances of meeting the chancellor’s main rule to borrow only to invest from 53 per cent to 59 per cent. There is still a 40 per cent chance of not meeting that rule.

The bigger risk is that, as we get closer to an election, the spending restraint that is required looks a lot less appealing. Governments now repeatedly pencil in front-loaded spending increases, then pare back spending growth—then, when the election is closer, they top budgets up. That eases the pressure on public services but just means debt and the ratcheting up of the deficit every time we approach that moment of reckoning.

The Convener: Yes, I notice that debt as a share of GDP is still expected to grow from 95 per cent this year to 96 per cent by 2030-31.

When it comes to reform, the IFS has said:

“A range of … tax increases—on pension contributions, unearned income, business investments and capital gains—weaken incentives to save and invest”,

adding that

“The Chancellor continues to show no real appetite for using tax reform to boost growth.”

David Phillips: Yes. A number of the tax changes that have been made—for example, the new rates on property income and savings and investment income, and the changes to pension contributions relief, capital gains and corporation tax—increase the effective tax rate on savings and investment income. The chancellor has pointed to the fact that such income is often taxed at lower marginal rates than earned income, and that is true. However, in many cases, we do not allow full and proper deductions for the costs of investment. I have mentioned buy-to-let properties and the property rental sector. If we do not look at both deductions and allowances—the tax base and the tax rates—at the same time, the increase in tax rates does more harm to incentives to invest than is necessary. However, we should not be too harsh on Ms Reeves, because no chancellor has done that for 40-odd years. The last time that we had a really reforming set of tax proposals was in the 1980s.

More recently, there has been a series of ad hoc measures—sticking plasters, almost, on little bits of the system that do not seem to be working—which have sometimes made it better and sometimes a bit worse. It is therefore fair to say that there has not been an appetite for tax reform and that, because of that, the tax system is doing more harm to growth than it needs to do.

That is true in Scotland as well as the UK as a whole. Property taxes are devolved to the Scottish Government in full, more or less—at least, it has the main ones: LBTT, council tax and business rates. There is a real opportunity to think about how we design property taxes in a way that is more growth friendly and distorts people's behaviour less. That probably involves some form of revaluing reformed council tax, a shift from business rates to land value tax and the abolishing of LBTT—or, at least, reducing it substantially and raising the revenue through other means. The Scottish Government has not touched that either.

Basically, we are in a world in which politicians are scared of creating losers. They do not have a strong narrative about why they are doing certain things—such as we had in the 1980s, perhaps, or as the Scottish Government had on income tax, in which it made changes that created losers but had a strong narrative behind it. Because we have not seen that narrative of reform at a UK or Scottish level, we are not making the changes that could benefit growth either in the UK as a whole or here in Edinburgh.

The Convener: In the IFS blog, you say that, as the medium-term financial strategy and the Scottish Fiscal Commission make clear,

"current forecasts for the contribution of devolved tax revenues to the Scottish Budget are likely optimistic, as they assume earnings grow significantly faster in Scotland than in the rest of the UK from 2026–27 onwards. All else equal, if earnings instead grew at the same rate as in the rest of the UK, the 'funding gap' for day-to-day spending"

in Scotland

"would be closer to £3.5 billion."

10:00

David Phillips: Yes. The fundamental issue is to do with how the fiscal framework works. The forecasts for Scottish revenues are made by the Scottish Fiscal Commission, with those SFC forecasts for Scottish revenues then determining both the outlook for the Scottish budget and what the Scottish Government gets allocated at the start of each year in the form of its forecast devolved tax revenues. On the other hand, the block grant adjustments that are subtracted from the Scottish Government to account for devolution are based on OBR forecasts of revenues for the UK as a whole.

It happens to be the case that, after 2026, the SFC is far more optimistic than the OBR about earnings growth. When I last looked, the SFC was predicting earnings growth of between 3 and 3.5 per cent per year, whereas the OBR had that trending down to between 2 and 2.5 per cent per year. The OBR's view was that that was needed because, for some time, we had seen earnings growing faster than the economy and there would be a bit of reversion to the mean so that earnings would remain the same share of the economy and, for a period, earnings would grow less quickly than the economy and earnings growth would be subdued. The SFC said that it had seen no evidence of that in the past and that it was going to assume that earnings would still grow a bit more strongly. That is not because the SFC thinks that earnings in Scotland will grow more strongly than earnings in the rest of the UK—it is just more optimistic about earnings in general.

In short, the forecast that is being used for revenues is more optimistic than the forecast that is being used for block grant adjustments, which means that the current projection for the gap between revenues and the block grant adjustment has what you might call an optimism bias built into it.

By looking at that and using SFC figures about what each percentage point of earnings growth means for revenues, we estimated that the gap between the earnings forecasts from the SFC and OBR would be equivalent to about £900 million a year by 2029. That, in turn, increased the fiscal gap—which was initially £2.6 billion in the medium-term financial strategy—to £3.5 billion.

The impact of the income tax performance gap, which is the extra revenue you would get if it outpaced growth in earnings in the rest of the UK in line with SFC forecasts, was £900 million. To put that in context, it is about 1.5 to 2 per cent of the Scottish Government's resource budget.

The Convener: We now move on to questions from members.

John Mason (Glasgow Shettleston) (Ind): The convener has asked about a number of things already and I will touch on a few more.

You said that the 38 per cent of GDP that comprises tax is not that high in comparison to other countries. Can you give us examples from some other countries?

David Phillips: I do not have exact figures for other countries to hand, but places in Scandinavia and countries such as France and Belgium have higher taxes. Taxes would be perhaps a little higher in Germany, but not much, and places such as Ireland, Australia, Canada and the US would have lower taxes, as would Japan and Korea.

We are probably still a little bit below the western European average but above the overall average for the Organisation for Economic Co-operation and Development, which is lower in part because America makes up a large share of the OECD economy but has much lower taxes.

John Mason: We often think of somewhere such as Denmark having higher taxes but more public services.

David Phillips: They would have higher taxes and so would France.

John Mason: Are they also tending to increase their taxes?

David Phillips: We have seen a bigger increase than most countries in recent years and you see that with debt as well. Over time, we have moved from being a relatively low-debt, low-tax country to one with relatively high debt and tax. That is a different trend.

Basically, most countries increased their tax as a share of GDP between the 1960s and the 2000s, but we did not really do that. To some extent, we are playing a bit of catch-up. We had a bigger peace dividend than most countries. In the 1950s and 1960s, we spent a lot more on defence than most of the other countries in western Europe. When that spending reduced, that allowed us to spend more on pensions and health without putting up taxes.

That period has ended, and we now see rising costs in terms of health, pensions and interest payments on high levels of debt. That is why our taxes have been going up without us getting more for that money. Basically, for 50 years, we had more butter because we had fewer guns; now, we have to get guns and butter at the same time.

John Mason: Good line.

Like most of the western countries, we have an ageing population. Apart from anything else, that would lead us to expect to see public expenditure to increase over time, would it not?

David Phillips: The ageing population is one aspect of the long-term public finance projections. It pushes up spending on pensions and on health. However, for the health sector, a larger share of the projected increase in spending is not directly because of ageing. Rather, it is due to what economists call Baumol's cost disease, which everyone else calls low productivity growth in labour-intensive services.

Traditionally, things such as health and social care, which are very labour intensive, cannot deliver the same productivity improvements as manufacturing, information technology or other things to which you can apply technological processes. As the rest of the economy grows, productivity increases, wages are pushed up and, because the healthcare sector needs to compete with other sectors in terms of pay, its wage bill increases, too. Historically speaking, one of the bigger factors underlying rising costs for healthcare has not been the ageing population; it has been that the sector needs to keep pace with wages in the wider economy, which have traditionally gone up more than those in healthcare.

Another factor is the emergence of new treatments. In many areas, technology can reduce costs but, in healthcare, it can often increase costs, because you can use it to treat more things with more costly treatments. I mention that because the Scottish Fiscal Commission produced a good paper earlier this year—it has issued a correction to it, but it is still a good paper—that looked at how differences in population health could change things. That is really true.

Just as important—perhaps even more important with regard to the pressures on public finances that come through from the health service—will be public sector productivity and productivity in the health service. Can some of the new technologies that are being developed around diagnostics through the use of AI and so on boost productivity and help doctors do more with their time, so that we do not need to have quite such a large increase in the medical workforce and could, instead, redeploy some of those resources?

It is not just the ageing population that is increasing pressure; the traditionally low productivity growth of labour-intensive services is relevant, too. If we can make those services a bit less labour-intensive through the application of technology, the pressures on the health budget will not be as big.

John Mason: There is a lot in that. Earlier, you sounded a little bit pessimistic and seemed to be saying that, on the whole, it is difficult to improve the productivity of public services. Have other countries cracked that, or is the situation much the same in the health services in Germany and America?

David Phillips: In general—again, this is not my particular area of expertise—my understanding is that the UK health services have been relatively productive compared with those in most other countries. Given the amount of inputs that we put in, we have traditionally had a relatively high volume of outputs. We have fewer nurses, doctors and beds than most countries, yet we have delivered comparatively high levels of output.

What has happened is that the UK health service has suffered a bit more than most from a post-Covid hangover in terms of productivity. In part, that might have been because we saw a bigger reduction in activity during the pandemic. One of the things that we did a lot in the UK during that period was stop a lot of standard activity to ensure that there was spare capacity in case there was a big surge in Covid admissions. You can see why we did that, but it meant that there was quite a big pause in treatments and so on; there was also a change in working practices that has been hard to overcome.

I do not have the latest figures to hand, but, when we looked at this a while ago, we saw that, although staffing resources for the Scottish national health service were up about 10 per cent to 12 per cent, the treatment volumes were no higher than they were before the pandemic. I do not think that, historically, we have been a worse performer on productivity; if anything, we have done a little bit better than average on productivity. However, we did badly during Covid and have struggled more than most have to recover from Covid.

John Mason: Debt was mentioned earlier, as was the fact that it is 96 per cent of GDP. Should that be worrying us?

David Phillips: Yes—that is the short answer. When debt interest rates were much lower, servicing that was not a particularly challenging thing fiscally. However, with debt interest rates as they are now, we are spending something like 3.5 to 4 per cent of national income on debt interest costs. As I mentioned, as they stand, the plans have debt as a share of national income just about falling towards the end of the forecast horizon.

However, the plans are based on fairly heroic assumptions about spending restraint just before the next election. As we get closer to that and the target date for the budget to be in surplus recedes, there will be strong pressure to borrow more—the debt target is not binding in 2029-30 but it is in 2031-32, so we can borrow a bit more in the short term—so there is a risk of borrowing and debt ratcheting up. If we are then faced with another large shock that leads to a big decline in revenues or an increase in spending, we will be starting from a higher level of debt and a higher level of debt servicing costs, which would make it harder to have an effective response.

We should be concerned about the high levels of debt, and we should probably be more ambitious in the medium term about bringing the levels down. That means running a bigger surplus on our current budget than Ms Reeves has pencilled in. Not only would that give her more headroom against her fiscal rules, it would help to bring down debt to a somewhat more manageable level so that we can respond more effectively to shocks. Of course, that requires either more tax rises or more spending cuts, so it is certainly not painless in any sense.

John Mason: That buffer of £22 billion is not all that much, or it is probably not sufficient.

David Phillips: There are two ways to think about the £22 billion buffer. On the extent to which headroom of £22 billion gives confidence that we will meet the rule or run a budget surplus in that year, there is a 59 per cent chance of doing so. That is, there is a 40 per cent chance of not doing that and, in effect, a 60 per cent chance of making it. It is better than the position that we were in before, but it is still not a particularly large bit of headroom. It is 0.6 per cent of GDP, which is smaller than the amount of headroom that most chancellors left for most budgets, up until the Covid pandemic.

The other way to look at it is that, because we have a high level of debt and there is fairly substantial borrowing for capital purposes—we are borrowing quite a bit to invest—our debt to GDP ratio is not coming down much. If you wanted to run a surplus so as to bring down debt more quickly, that is not happening very much. If you wanted to have a genuinely large buffer to cope with bigger shocks, and you wanted to bring down the debt at a more meaningful pace, you would probably look to raise the buffer from £20 billion to £40 billion or £50 billion.

John Mason: That is helpful. On the Scottish figures, you said that you have been looking at the Scottish spending review and that there is a suggestion that there will have to be trade-offs between the four key priorities of the Government: poverty, climate change, economic growth and effective public services. Will you explain why there might need to be a trade-off?

David Phillips: The context of that is the tough fiscal outlook for the Scottish Government, which is in line with the wider UK position. When we looked at that back in May, the overall increases that the Scottish Government could expect in its resource budget over the next four years were, on average, about 1 per cent above inflation. Since then, there have been increases above that for social security benefits, given rising case loads in disability benefits; there were also plans at that stage to mitigate the two-child limit. That meant that the amount that would have been available for public services would have increased by 0.2 or 0.3 per cent a year.

10:15

If we take into account the fact that the health budget needs to be increased by about 2 to 3 per cent every year to meet rising pressures, there would have to be cuts to other areas. In the context of a budget that, almost certainly, on average, requires cuts outside the NHS, you cannot feasibly achieve all those different goals to the full extent that you want to. You need to make trade-offs, not just between your priorities and everything else, but within the priorities. You need to decide what your top priorities are, invest the most in them and be more ruthless about the others.

In the Scottish Government's inner world, it will be having to make cuts to a range of services. I do not know whether we will see that in the spending review that will be published alongside the budget in January. There could be a temptation, so close to the election, to kick the can down the road until afterwards and to produce a set of figures that is a little bit more salami sliced. When real plans are set out, whether before or after the election, that will require ruthless prioritisation, because the Scottish Government will not be able to achieve everything that it wants to on child poverty, net zero, growth and public services.

John Mason: Fair enough. You mentioned that prevention and early intervention are important. Do you see any change or movement in that? Is more being spent in those areas?

David Phillips: It is hard to say at this stage. The MTFS and the fiscal sustainability delivery plan mentioned a shift in resources to prevention. I would expect to see more detail in the spending review. So far, there have been a lot of warm words. The tasting of the pudding will be in the spending review and the proof of it will be in its delivery.

Craig Hoy (South Scotland) (Con): Good morning, Mr Phillips. The chancellor trailed a lot of what she thought would be in the budget, which did not materialise, in some respects. Alarm bells started to ring in Scotland at the suggestion that income tax rates would rise, because that would have been the first time that there was an increase in tax and it suddenly dawned on observers in Scotland that, under the fiscal framework, that would potentially mean a material cut to the block grant. However, that did not happen.

Both Governments are leaning on freezing thresholds as the means by which they will raise tax. In the Scottish tax system, there has been significant behavioural change when the Scottish Government has increased or introduced new tax rates. What happens to behaviour when governments raise tax by simply freezing thresholds?

David Phillips: As with all tax changes, one would expect there to be a behavioural response. We can expect a couple of different responses. Most people are able to precisely tune their income so that it is just below a particular tax threshold. If you are an employee, it is hard to negotiate with your employer to get an exact amount of money or to change your hours a little so that you are just below a higher rate or additional rate threshold. However, some groups of people, such as company owner-managers, can do that more easily with savings and dividends taxation. They tend to budget below the higher rate threshold, particularly below the £100,000 mark, when the personal allowance starts to taper. Many people who own their own businesses arrange to take out just enough income so that they come in just below the threshold; they hold the remaining income in the company and pay it out the following year—again, staying just below the threshold. We see that kind of income smoothing or income optimisation among those who are able to do that, particularly company owner-managers.

More generally, to the extent to which you are increasing average effective tax rates, you might expect there to be some behavioural responses among people who are dragged into personal tax for the first time or who are dragged into the higher rate at the margin. If Scotland were to freeze the higher rate threshold as well, the marginal tax rate would be 50p rather than 29p, I think. Paying 50p, rather than 29p, in the pound in tax for the extra bit of earnings would reduce people's incentive to earn a little bit more.

I would expect there to be a smaller response to the threshold freezes than to changes in the tax rates. I would expect a bigger response to changes in tax rates, particularly at the very top, where people have more margins to respond, because a freeze in the thresholds affects the marginal rate only for those people around the threshold, whereas an increase in the tax rate affects the marginal rate for a much wider group of people.

Craig Hoy: We discussed that with the Auditor General last week. Over the past 10 to 15 years, the freezing of thresholds, particularly in Scotland, where new tax rates have been introduced, means that more and more people are being dragged into the higher rates of tax. The upper rate of tax—rather than the Scottish top rate—used to be in single figures. Between now and the end of the decade, it could be approaching 40-plus per cent. How does where the tax base falls in relation to the different tax rates compare with comparative nations?

David Phillips: I do not have the figures to hand for nations outside of the UK. In general, middle earners face lower taxes in the UK than they do in other countries, not because of income tax but because of social security contributions. In most other countries, social security contributions are quite a bit higher for middle earners than they are here. If you look at someone on earnings between two thirds and twice the average earnings, people in the UK pay less tax than those in most western European countries. That is less true at the very top. Our taxes at the very top are more comparable to taxes at the very top in western European countries. It is middle earners where we are relatively low taxed compared with most countries.

Where we tax more highly than most countries is property tax. We raise more through council tax and business rates than other countries do from equivalent taxes. Scotland differs a bit, because, in Scotland, the tax rates are marginally higher once you get above, I think, £30,000. However, once you get above £43,000, that is when taxes really start kicking up. We looked at tax strategy at the start of this year and found that someone on £125,000 pays about £5,000 more a year in income tax in Scotland, which is about 7 per cent of their net income. At the bottom end, there is a small increase in income in Scotland because of the 19p tax rate. For those on salaries around £45,000 or £50,000, there is a bit of an increase. At the top, there are substantially higher taxes in Scotland.

Craig Hoy: We found out recently from data that, if the Scottish Government were to increase the advanced rate by 1p, it would yield only about £5 million. It would be a very small amount of money relative to what the Government might initially estimate or what we might think. How concerned should we be in Scotland about the profile of our tax base relative to the rest of the UK, when an increase of that level would bring in such a relatively small amount of money?

David Phillips: Compared with most regions in the UK, Scotland does reasonably well when it comes to incomes and hence the tax base. If Scotland were a region of England, it would probably be fourth behind London, the south-east and the east of England when it comes to the strength of the tax base. It is a substantially stronger tax base than those of the midlands or the north of England and is much stronger than that of Wales, my home country.

Of course, if Scotland is fourth and behind London and the south-east, where there is by far the highest concentration of high-income earners, it means that you can raise less from the very top. However, the bigger reason why you can raise less from that very top section is that marginal tax rates are already pretty high for that group, combined with the fact that they are pretty responsive to tax policy, as shown by evidence from the UK and from other countries. You tend to see a greater degree of response from high earners, not necessarily in their labour supply but through a range of factors such as tax avoidance and changing their form of remuneration and how they organise their affairs; therefore, you cannot raise so much from them.

If the Scottish Government wanted to raise a substantial amount through income tax, trying to do so through a large increase on the highest earners could end up being counterproductive. If you want to raise a significant amount from income tax, it needs to be a broader-based tax increase, but that then means that people on more average incomes will pay more tax as well.

Craig Hoy: You highlighted earlier that the way in which the UK Government has structured the budget is probably unrealistic and certainly not electorally sound, given that the greatest spending cuts or tax increases will potentially come in the year before an election. You then alluded to the issue in relation to the spending review in Scotland.

Let us say that the UK Government does not manage to have the spending restraint that it is envisaging, and that then provides the Scottish Government with additional funds towards the end of this UK Parliament. However, both Governments say that they are determined to rein in public expenditure, particularly in relation to administration costs. You mentioned the £1 billion that the Scottish Government has identified. How likely is it that the Scottish and the UK Governments will both be able to rein in expenditure in that area? What impression are you getting of the work that is going on behind the scenes to prevent this from simply being, as you said, a salami-slicing exercise in which productive parts of Government are cut?

David Phillips: Again, I do not really have any particular insight into what is happening in the Scottish Government on that. I hope that the Scottish Government takes a different approach from the UK Government to cutting the administration budgets of its different departments. The UK Government made basically the same cut to the admin budgets of most departments, irrespective of what had been happening to its broader budgets. If you are a department that, in general, is seeing its activities increase, you cannot make such a big cut to your admin budget as another department that is seeing its activities being cut back.

I would like the Scottish Government to take a different approach to administration budgets from the, to some extent, salami-slicing approach taken by the UK Government. Whether we will see that degree of detail in the spending review in Scotland, I am not sure. One thing that you can see in the UK budget documentation is a separate administration budgets set of tables. Traditionally, for the Scottish budget, I do not think that administration budgets are separated out in that way. You have the detailed tables underlying the main departments, but identifying which of those is in the £5 billion figure that the Scottish Government says is for administration and is subject to the £1 billion of cuts has not been clear—at least, not to me.

It should be made clear what is within the scope of the £1 billion cut, where those cuts are falling and how that aligns with your ambition on services in each of those areas. If it is an area that you are really prioritising—for example, tackling child poverty—that is probably not an area where you can make as big a cut to the admin budget as you can in an area that you are deprioritising. I would expect to see that information.

The second thing to say is that we have seen periods in which efficiencies have been generated in the public sector. Public sector productivity did reasonably well during the 2010s compared with historical performance, in part because we were cutting back and had to make do and mend. As we were cutting back, it forced some productivity improvements. In this world of spending restraint, I would expect there to be again some push towards productivity improvements. The question is whether they will be on the scale that the UK Government and, in particular, the Scottish Government are saying that they want to deliver.

The plans that were put in place in the UK spending review were equivalent to a 1 per cent productivity improvement across the board—on both admin and operations—each year. That is even quicker than the productivity improvements that were delivered during the austerity of the 2010s, which I think were about 0.7 or 0.8 per cent a year. What was pencilled in in the spending review was already quite ambitious, but the UK Government is now saying that there will be another £4.5 billion of productivity improvements on top of that by 2030. That is really ambitious.

10:30

We do not yet know how changes in technology will affect what is feasible. What AI and generative AI will mean for productivity is an open question, but there are some real optimists out there. In my role on local government, I speak to people in councils, some of whom have suggested that the use of gen AI could bring huge productivity improvements in certain areas of council operations. I do not know whether that is replicatable or whether it is just for small niche areas.

Based on the historical evidence, the plans for productivity improvements were already very ambitious, and they are set to be even more ambitious. Will things be different this time? Maybe, but, if they are not, it will be a struggle to deliver the savings.

Craig Hoy: I turn briefly to welfare. The UK Government has stepped back from the bold welfare reforms that it initially planned to implement. The Scottish Government did not have such plans, and the two Governments are now proceeding in lockstep in relation to the two-child benefit cap. How concerned should we be about the difficulty of tackling that area of expenditure, which the Government classes as demand led, over the medium to long term? Is there a risk that, if the Government becomes seriously financially constrained, as we can see it becoming by 2030-31, it will start to make cuts in other areas because it simply cannot make cuts in demand-led areas? In fact, the demand could go in the opposite direction, as we see happening with the rise in unemployment.

David Phillips: I will make a couple of different points in answer to that. At a UK level, overall working-age welfare has been pretty stable in recent years. That reflects two things: a fall in the non-disability benefits expenditure and an increase in the disability and incapacity benefits expenditure. Of course, what is devolved to Scotland is the disability benefits expenditure, which is the part that is going up.

Although the UK Government has cancelled its initial set of proposals on reforming the personal independence payment, a review of PIP is due to report, and there are still plans in motion to reform how disability assessments work. There are plans to merge the PIP assessment with what is used for disability for universal credit. That could pose some issues for Scotland, because there is a different disability assessment here, which, in some ways, is a bit less stringent than the UK assessment. We do not yet know whether the UK Government would be happy for that to be used for assessing universal credit, so there is an issue coming down the line there. Although the UK Government has shelved its initial plans to cut PIP, I am not sure that we are at the end of the road on potential reforms to disability benefits at UK level.

When it comes to the current trajectories for disability benefit spending and benefit spending in general, the pressures on the Scottish Government's resource budget are being increased to some extent by rising case loads for disability benefit spending in Scotland. There are then the additional benefits that the Scottish Government has chosen to pay out, such as the Scottish child payment and so on. It has made legitimate decisions to prioritise spending on child poverty and to have a different assessment process for disability benefits, but those come at a fiscal cost.

You are right. The Scottish Government has a decision to take about whether it should address those costs through higher taxation or lower spending elsewhere, or whether, at some stage, it should look at the system and say, "Actually, this is costing more than we thought. Maybe more people than we thought are getting this. Let's look at the assessment process."

There was one line buried in the MTFS or the fiscal sustainability delivery plan—I cannot remember which it was—about the reassessment process for Scottish disability payments. It said that more people were remaining on those benefits than expected and that that would be kept under review, so I think that the Scottish Government is considering the reassessment process for adult disability payment. At one stage, very few people were moving off it when they reached reassessment—far fewer even than in England, where the share of those moving off has been declining quite a bit over time. There might be concerns in the Government about that aspect, and there could be reforms in that policy area in the next couple of years.

Liz Smith (Mid Scotland and Fife) (Con): I will ask a more general question, Mr Phillips. As I said in a recent debate, the Auditor General has told us that the Scottish budget process

"is not sufficiently transparent and the Scottish Government is not sufficiently accountable for the decisions that it makes."—[*Official Report*, 10 December 2025; c 31.]

Do you agree with that?

David Phillips: It depends on what aspect they mean. Compared with where we were a while ago, we are now getting more information from the Scottish Government on its medium-term strategy and the plans that it wants to make to address the fiscal pressures that it faces, although there are still huge amounts of detail to be worked out in the spending review and beyond.

Last year, I was a bit disappointed with the budget documentation. Finally, the Government listened to the committee and the likes of the IFS and included, buried at the back, a table that compared spending plans with the most recent ones for the current year but, when ministers talked about increases in spending on the NHS, they still compared them with the initial plans. There were other tables in the document that did not compare plans like for like.

For the NHS, there was a number of, I think, £1.3 billion at the back of the document. That was the real increase in NHS spending. Ministers were talking about £2 billion, which was comparing it with the initial budget at the start of the previous year. There was a table in the main body of the document that had £2 billion, which was calculated in a different way again. Therefore, there were three numbers floating around for the increase in NHS spending2, and ministers cherry picked the one that gave them the best number to talk about.

I mention that to show that there is still room for improvement in being clear about how spending is changing and how that compares with what we have spent historically so that we get a real sense of whether the money would be sufficient or insufficient for various services.

Did the Auditor General mean something a little bit different?

Liz Smith: You are right. I think that we are getting slightly more information than we had in previous budgets. However, I think that the Auditor General's point is that, when it comes to assessing how effective the tax take is in relation to the Government's priorities, it is not sufficiently transparent to us how that tax take is coming in to ensure that the priorities that the Government puts before the public are implemented. My colleague Mr Mason said that there might be some trade-offs in the four priorities. I think that the Auditor General expects a bit more transparency from the Government about that. Do you accept that?

David Phillips: I might not be interpreting this entirely correctly, because I have not seen the Auditor General's full comments, but I agree with the point that, when you set out a fiscal strategy, as well as setting out your priorities, you need to say how you would respond to changes in circumstances. One thing that is lacking in the information is how the Scottish Government would respond if revenues come in less strongly or more strongly than expected, how we would change what we do to account for changes in circumstances and how what we do at the moment responds to circumstances as they evolve.

The MTFS and the fiscal sustainability delivery plan say that one of the Scottish Government's strategies to help to close the gap is to grow revenues even faster than they are forecast to grow. What is the strategy for doing that and, if it does not happen, how would the Scottish Government respond to it? Would it increase taxes or cut back spending. If the latter, which parts would it cut back on?

To be fair, not many countries or Governments do that; they like to keep their options open to respond to circumstances as they arise. However, we are in the context of a Government that does not have the full set of fiscal flexibilities that the UK Government has. If things go wrong for the UK Government, it can borrow a bit more if it needs to—to some extent. The Scottish Government cannot do that. There is more onus on the Scottish Government to say how it will respond to different contingencies, so that people have a sense not just of its plan A, but of its plan B and plan C.

Liz Smith: I think it is entirely right that the Scottish Government keeps its options open about what it will plan for in the future. There is an issue, however. Which of the policies that have already been put into effect are providing the greatest benefit in determining how effective the policies are in terms of delivery? That is really the point that has been flagged up to us.

David Phillips: In general, Governments are poor at evaluating the effectiveness of their policies. It is hard to consider the effectiveness of policies that all interact with each other. In considering the impact of policies on economic growth, it is hard to disentangle the effect of policy A from policy B or from policy C.

You are right: on its major priority areas, the Government should be doing more to evaluate, and it should be a bit more ruthless in culling policies that do not work. I will stray into a controversial area here—and I am not saying that the Scottish Government should do this—but, when it comes to spending pressures within the Scottish Government's budget, higher education policy is one area that does not particularly align with the set of priorities. Taking an honest, hard look at it, is higher education policy meeting the needs of universities, of students and of the public finances? That is exactly the kind of thing that you would consider if you were doing a zero-based resource kind of spending review. I am not sure that that is happening, because certain things are seen as politically totemic even if they are not in line with priorities and even if we do not think that they are meeting the objectives. You might choose to keep them, but they should be subject to a review, and why you have kept them should be justified.

Liz Smith: I think that that is the overall view of the Auditor General and the Scottish Fiscal Commission. They want to have a little bit more transparency on exactly that point. Thank you for your comments on that.

Ross Greer (West Scotland) (Green): I will follow up on the point about being able to track from the input to the output, disentangling policies and their impact. I was a little bit surprised by the IFS's reaction to one particular policy, on road user charging for electric vehicles. If I recall your comments at the time correctly, you welcomed the chancellor doing something in that space, albeit that it was heavily caveated in that she was probably not doing it in the ideal way.

To me, there is quite a disconnect there. There is an argument for road user charging across the board, but if we single out EVs the UK Government's own projection shows that such an approach will depress EV uptake by about 300,000 or 400,000. That blows a hole in the UK Government's climate targets as well as in the Scottish Government's climate targets, both of which are heavily dependent on reducing the use of combustion-engine cars. The Scottish Government had a 20 per cent car reduction target and has dropped that, but it still has the ambition in that space. The chancellor has taken that measure while still freezing fuel duty, effectively. She will gradually reverse the 5p temporary cut from the Sunak Government but, even after that, fuel duty will still be at 2010 levels.

Is there not quite a disconnect there? Okay—that policy will raise revenue, albeit through an administratively complex mechanism, but it will take the Government backwards in other areas where it has put itself under strict statutory obligations.

David Phillips: There are a couple of points to make here. First, most of the externalities that are associated with driving are not the carbon emissions that cars create. If we were to have a tax just on motor vehicles and just for carbon, it would be set at a lower rate than our current rate of fuel duty. Most of the externalities that are associated with driving are congestion externalities. When lots of cars drive on busy roads, it creates delay that has an impact on other people. They account for the fact that it will take you longer to drive in a traffic jam, but not that you will make the traffic jam worse and have an impact on other people.

10:45

When you bear that in mind, you can see that, of the fuel duty that is already paid for petrol and diesel-driven cars, one part is for their carbon emissions, another part is for their particulate emissions, and another is for their congestion-type emissions. The policy will bring in a charge, which, in the end, works out at about half the average tax that you would get for a petrol car per mile, and more than half of the cost is the congestion cost. The carbon cost is probably 10 per cent to 15 per cent—or even less—of the externality associated with the driving.

My second point is that we have been clear that we think that it is good that the chancellor has taken first steps on the taxation of vehicles as we move from petrol to electric vehicles. The longer we leave it, the harder it is to bring something in and the longer that people have been used to not paying anything. However, the policy is still not really that well targeted at what you are really trying to tax, which is congestion. There are large parts of Scotland, in particular, where there is no one else on the road and drivers are not causing any congestion externalities. Ideally, that would not be taxed. Driving into Edinburgh or Glasgow during rush hour probably causes a cost to other people that is equivalent to £1 or £2 per mile, rather than 3p per mile. However, we are aware that there are not just technological but privacy concerns with dynamic road pricing, which monitors where and when different people are driving.

My last point on that aspect is that that policy change came alongside a set of other changes that are expected to boost take-up of electric vehicles—although not to the same extent that the policy depresses them. One thing that people have not fully borne in mind is that the mandates for vehicle producers will still be in place. The mandates set shares of vehicle sales that have to be sales of electric vehicles. If they are not met, the motor vehicle producers will need to pay fines. So, unless they pay those fines, the policy will, as well as slightly depressing the sales of electric vehicles, depress the sales of petrol vehicles in order for the share of motor vehicles sales that are electric vehicle sales not to reduce. That does not mean that there will be fewer cars but that people will keep their old cars a bit longer and that there could, therefore, be more polluting cars on the road. Usually the issue is not so much to do with carbon emissions as it is to do with particulate emissions. The older cars that stay on the road tend to be worse in terms of particulates.

So, where does that lead us? Yes, the policy will have some potential negative knock-on effects on the environment, probably through keeping older, more polluting diesel and petrol vehicles on the road for slightly longer. However, the reason why we said that the policy was, in net, a step in the right direction was that, for too long, no one has been willing to tackle the issue of how we tax road use after the petrol vehicle era, not just in terms of the externalities but to deal with the revenue we would be losing. The policy was a small step in that direction, but we think that there is a lot more to be done to fix this area of tax.

Ross Greer: What about the question on fuel duty? There will be a gradual reversal of the 5p temporary cut to it, but after that it will still be at 2010 levels.

David Phillips: The main thing I would say on that is that the pantomime of a supposedly temporary freeze—it has been extended for a year every year for 15 years—is sort of ridiculous. It means that you have a picture of public finance picture that is partly built on a house of cards, because it assumes that we will have inflation-linked increases to fuel duty from 2027 when we have not had them for years. The chancellor should either say, “Look, this is frozen indefinitely. That is the plan,” or should have the gumption to at least start increasing fuel duty in line with inflation.

Ross Greer: I will switch to a totally different area: national insurance. Various changes have been made by both the current Labour UK Government and the previous Conservative UK Government in its final couple of years, including tweaks around national insurance. A lot of the chancellor’s changes seem to be driven by the main objective of raising revenue without making the most politically unpalatable income tax changes.

Why do you think that the Government has not touched the upper earnings limit? There could be political pain from any of those options, but revenue could be raised by adjustments to the upper earnings limit. A lot of the other changes that have been made on salary sacrifice will result in a much lower yield for what is probably the same amount of political pain.

David Phillips: There are a couple of reasons for that. The reason that the Government has not wanted to increase the tax rate above the upper earnings limit is because it has been trying to avoid increases in tax rates for VAT, national insurance contributions, income tax and so on. It felt more comfortable making other changes.

For income tax, it has now increased with dividends and so on, but for the rates for main sources of income, the Government can say that it has met its manifesto pledge because that was based on the rates of income tax. For NICs, it had not actually said that it would not increase the rates of NICs; it had said, “We are not increasing NICs.” Any of those changes technically breaks the manifesto pledge not to increase NICs, so I think that the UK Government has made a judgment that actually increasing a rate is more obviously a breach than changing other things that increase the amount that people pay.

Why not increase the threshold of the upper earnings limit? That is because it is aligned with the higher rate threshold in England. It took a long time to align the lower threshold with the personal allowance and the upper threshold with the higher rate.

Ross Greer: The graph gets jagged in the way that it is here.

David Phillips: Yes, and people can make a bigger deal of that than it actually is, but it has been a factor. The Government wants to maintain that neat structure to avoid having a period in which there is a high marginal rate. If you were to increase the threshold, as has been done in Scotland—where the higher tax rate is 42 per cent and the NICs rate is 8 per cent—when England has a 40 per cent higher tax rate and 8 per cent employee NICs, the picture would be different. The Government is trying to avoid having a shape whereby the combined rate goes from 28 per cent to 48 per cent and then back down to 42—or 41—per cent.

Ross Greer: I suppose that goes back to the point you were making to the convener earlier. If the chancellor had just bitten the bullet and made the substantial tax reform that has not been made in 40 years, we would not need to resolve that much bigger question about the interaction of national insurance and income tax.

David Phillips: Exactly. You are right. Chancellors have been shying away from that for years. There are lower rates if you are a company owner-manager than if you are self-employed or than if you are an employee. Pension contributions are treated differently if you are an employer rather than an employee. A whole set of things that have accreted over time do not make sense, but no chancellor has been willing to look at them.

That is a charge that can be levelled at politicians in almost every other country but, within the UK, the devolved Governments have not tackled property taxation, either. They are doing something in Wales, and in Scotland they are consulting on something but ministers keep—

Ross Greer: Not for the first time.

David Phillips: Ministers keep suggesting that they are doing it under something like duress.

Ross Greer: Indeed. Before I start talking about the council tax, I will hand back to you, convener.

The Convener: Thank you, Ross. I appreciate that.

Michael Marra (North East Scotland) (Lab): Can we go back to the Scottish spending review, please, David? What does the Scottish Government need to achieve when it publishes its spending review and how do you think it should go about achieving it?

David Phillips: If there was not an election coming up, I would like to see a full, planned review that takes more than a salami-slice approach. Whether we like or dislike the plans that were set out by Ms Reeves in the summer, the UK Government's spending review gave a clear sense of which services were prioritised and which were being cut back.

If we look at the Scottish spending review of 2022, which is the last time there was a resource spending review, we see that there was some differentiation across services, but there was a fantasy that, at that stage, services such as health, which required substantial increases, could be held more or less constant in real terms so that the cuts to other areas did not have to be quite so big. The hope seemed to be that more funding from the UK Government would come through and that would make that easier. At that stage, more funding did come through.

Looking ahead, however, although I would expect there to be some top-ups in 2028-29 onwards—because I simply cannot see a UK Government going into an election with such tight spending limits—I do not think that the scale of increases that the Scottish Government could expect will be anywhere as substantial as what it received between 2022 and 2025.

I would expect the Scottish Government to be ruthless in its prioritisation from the outset and say, "Here is money for the NHS, here are the areas where we can make cutbacks and here are the kind of programmes that we think have to go." I would expect it to say that, and that it will reassess if more money comes to it down the line, rather than using more money that comes down the line to top up the NHS. I think that it will be about prioritising key priorities at the start and then going back and looking at secondary priorities if more money comes down the line. That is what I would expect in the absence of an election. With an election, however, I am not sure whether it will be credible for the Scottish Government to set out a series of plans that will span into the next Parliament and potentially three years into the next Government, which could be a different Government from it.

In that case, I would want the Government to say something a bit more like, "Here is what we think is needed to achieve what we want to achieve, and meet the pressures, in these different areas, and here is some money that we have left over that we think could be used to achieve different sets of priorities." As a bare minimum, I would want to see a set of projections that show what it thinks needs to be spent in order to maintain services. I would then want to see it set out either a baseline review that achieves that or, if it feels confident in doing so, a full political vision for the next session of Parliament in a spending review, with realistic allocations of the different departments.

Michael Marra: The current Government cannot bind the next one in relation to spending priorities. However, at the start of this spending review cycle—which we are already a fair way into, because it has been pushed back to be published in January—would we not miss the opportunity to set an overall trajectory if the Government did not do that now?

You are talking about prioritisation within different areas, but the Scottish Fiscal Commission has set out the challenge around where we need to reach by 2029-30. Surely, therefore, it has to address that issue in terms of the longer-term trajectory. It cannot simply kick it a further year down the road and say, "We'll wait and see what the next Government is and it'll come up with some answers; that might be us or it might be somebody else."

David Phillips: The Welsh Government is doing a one-year budget. Initially, it published what it called a "neutral budget", which was basically inflation for everything. However, we said that that was not neutral, because many services need more than inflation in order to be business as usual and neutral. It then used that as the basis of an agreement with one of the current Opposition parties.

In essence, I think that it was trying to get the Opposition party to have some skin in the game in relation to some of the difficult choices that are needed in the first year of the next Senedd term, so that all the parties could not simply attack it and say, “This is your budget and it is bad because it cuts this and it cuts that.” At least one of the parties will come into it having been involved in setting that budget in a meaningful way.

I do not know how that works in the context of spending. A budget has to be voted on by the members of the Parliament. Therefore, given the arithmetic, at least some Opposition members will need to vote for it, or abstain, for it to be passed. A spending review, however, is simply a spending review; it does not require that same political backing. Therefore, I think that the Welsh Government knew that it could not go down the route of getting Plaid Cymru to support a three-year spending review, because there was no vote, and Plaid Cymru would still be able to come back and say, “No, this is your plan. We disagree with it.”

To come back to Scotland, I think that it is perfectly possible that the Government could say, “Look, this is a one-year budget. The politics are so uncertain that we don’t feel that we can bind the hands of the next Government, and it’s worse to give departments a false sense of certainty when another Government could come in and rip it all up”. I think that it could do that.

11:00

Given where we are in politics in Scotland, I do not think that I will surprise anyone by saying that the most likely outcome is still a Scottish National Party-led Government. Post-election, the SNP will probably, albeit not certainly, be the party that calls the shots. In that world, it is more the case that it needs to set out its stall in advance. What it should not do is pretend that the next Parliament will be all sunshine and roses, then shock people after the election with the tough choices that it will need to make. However, it will need to leave a little bit of flex because, although it is good for departments to have more time to plan, that is true only if the plans will be largely adhered to. If the plans might change substantially, it is worse to set them out in advance.

Michael Marra: As part of those longer-term plans, we have been told in the Scottish Government’s fiscal sustainability delivery plan that there will be a 0.5 per cent annual reduction in the public sector workforce. Is that figure credible?

David Phillips: Historically, we have delivered cuts to public sector workforce on that scale. During the 2010s, at UK level, cuts in the public sector workforce were, at times, greater than that. There were cuts in the civil service and cuts to local authority staffing.

However, a 0.5 per cent cut does not mean 0.5 per cent across the board. Given that there will almost certainly need to be an increase in staffing in some areas—such as the NHS, which, I think, makes up just under half of Scottish Government employees—bigger cuts will be needed elsewhere.

The Scottish Government has tied its hands over teacher numbers. There have been big declines in pupil numbers in parts of Scotland, yet there is a pledge to maintain teacher numbers; previously, the pledge was to increase them. That is a tying of hands. No one wants teachers to lose their jobs, of course, but, when there is a change in the demographic situation in an area, there is a need to reshape the workforce.

What I am saying is that, in order to achieve that 0.5 per cent overall reduction, cuts of 2, 3 or 4 per cent per year will need to be made to some parts in order to resource the areas in which numbers are going up or for which pledges have been made not to cut numbers.

Michael Marra: So, if we are brought budget figures that say that the Scottish Government will achieve a £200 million reduction in the public sector workforce in the following year, is that a credible position?

I will reference figures that have been published today. The headcount in public corporations is up by 5.8 per cent—500 people. In “Other Public Bodies”, it is up by 0.7 per cent. The devolved civil service headcount is up by 1.5 per cent. That trajectory is going in completely the opposite direction, despite the minister telling us that the Government is getting things under control and that it is heading in the other direction. That is completely untrue.

David Phillips: Historically, there have been periods in which such a reduction has been possible, but it requires the political will to do it. If I were you, the question that I would put to ministers is, are you going to do this? Have you got the political will to achieve it, given that it will be difficult? No one wants people to lose their jobs but, if this is your plan, you need to follow it through. Otherwise, your public finance plans will not add up.

Michael Marra: My last point is about the application of AI. You mentioned how that could, potentially, lead to productivity gains. Two weeks ago, we had evidence from representatives of the Scottish Public Pensions Agency, who talked about AI as a solution to some of their problems. However, they have a huge batch of records that are not digitised. Is a big leap in capital investment in public services not required to get us into a position in which AI could be applied, rather than its being seen as an off-the-shelf solution that could result in better outcomes and better productivity?

David Phillips: Again, I am not an expert on technological solutions or the size of the investment that would be needed for future savings. In some areas, substantial investment will be required up front. I have said previously that, although everyone thinks about capital investment in the context of roads, railways and new buildings, the area in which the UK Government and the UK as a whole has traditionally invested less than other countries when it comes to capital is not infrastructure but equipment and technology.

If I were thinking about pivoting the capital budget—of course, I would like to have new roads, new railways and new technology—I might pivot it more towards the new technology, because if some of those productivity problems can be solved, that might free up some resources so that further down the line more can be done on roads, railways and so on. There is a case for investing more of the capital budget in technology and AI.

Some of the conversations that I have had with councils have suggested that some of the things that they have done with AI have had pretty small up-front investments and pretty big returns quite quickly. It is on a case by case basis—there could be some things for which you can invest over a relatively short period and make large savings, but that will not be the case for every single thing.

When it comes to AI, the big challenge for the public sector is not so much the back-office AI—lots of businesses are innovating on that and people have already accepted it—as it is about what role AI plays in front-line service delivery when it starts to come up against the public's expectations about person-delivered service, and professional standards and the professional standing of teachers, doctors, medical practitioners and so on. If there are ways in which we can apply AI appropriately to those front-line tasks, that could help doctors and teachers do more with the limited time that they have. It could also be an area in which there is lots of resistance from people who could think that their professional standing is under threat.

Michelle Thomson (Falkirk East) (SNP): Good morning. I have a few wee questions to finish off and take us up to the big picture level. We have seen pretty terrible growth figures. How likely is it that the UK could dip into recession? We have heard the two figures. What are your predictions?

David Phillips: I am not going to make a prediction on the economic forecast. I point out that the OBR forecasts now are for growth of about 1.3 to 1.5 per cent a year for the next four years. That is down from its previous forecast of 1.7 to 1.9 per cent and, to a large extent, it has been downgraded a fair chunk because of that productivity downgrade. Those numbers are still, a bit, at the upper end of the forecasts—they are a bit higher than the forecasts from the Bank of England and the International Monetary Fund—but they are less of an outlier than they were before.

As always, there is uncertainty with the economy. Is there a chance of a recession? Yes. Do I think that that is a likely outcome? At this stage, I would be happy to defer to the OBR and say, "These are its central forecasts. Other forecasts say that there will be slightly slower growth, but still growth." Sometimes the OBR does fan diagrams that show the probabilities of different outcomes—perhaps it has done such a projection of the chance of a recession that it might be able to pass on.

Michelle Thomson: The other area where the jungle drums are carrying on and there is at least a possibility of it happening is in relation to a sovereign debt crisis—which continues to remain a possibility, particularly when we look at debt to GDP ratios. What are your latest reflections on that?

David Phillips: Again, we cannot rule out there being a panic about the sustainability of the UK's debt and public finances. The markets' reaction to the budget was reasonably sanguine. They took at face value that, although the chancellor had put in place a plan that spent and borrowed more in the short term, she would then pare back spending, raise taxes and borrow less in the longer term. I was a bit surprised that the markets were quite so sanguine, given that that spending restraint and those tax rises will come just before an election. The tax rises probably would go ahead, but it is a lot less likely that the chancellor will hold down spending quite so much just before an election.

Perhaps one of the reasons why the markets were a bit more relaxed than they might otherwise have been is that the chancellor has clearly taken her fiscal rules seriously. To some extent, she has worked within the letter than the full spirit of them, by borrowing more in the short term and only cutting back borrowing later, but she did respond with a net tax rise in those later years.

Although there is always a chance that the markets could panic if there is a global shock or a shock to the UK, the reason that they have not panicked so far, despite the slightly questionable fiscal tightening that is pencilled in for 2029, is that they feel that she is a chancellor who treats the fiscal rules at least semi-seriously.

Michelle Thomson: A colleague of mine pointed out that the OBR and the Treasury have assumed that Whitehall departments will have zero underspend in 2028-29, which is completely unrealistic. That was generally picked up on across the board, was it not? Do you have any sense of whether that position is just more smoke and mirrors?

David Phillips: Traditionally, the OBR has always assumed in its spending forecast that departments will underspend their budgets. Historically, UK departments have underspent their budgets, on average, but given the range of pressures that are faced by the NHS, asylum accommodation and those providing SEN—special educational needs—provision, the OBR is saying, “We now expect there not to be this underspend. We think that they will actually spend right up to the limit.” In the end, the Government might not spend up to the limit or it might burst the limits to some extent, but it shows that, three years out, the limits that have been set for 2028-29 look really tight.

As we approach the election and as the possibility grows that the pain caused by trying to stick within those limits might mean that the fairly tepid progress that we have seen in the NHS starts to unwind, or that, in order to find the money for special educational needs provision—which central Government in England will take full responsibility for—there will be cutbacks in other areas of school budgets or in other areas of public spending. As those cuts start to bite, those budgets will come under pressure, but come the next spending review in 2027, when the fiscal forecast arrives—the point when the fiscal rules bind will have helpfully been moved forward by a year or two—the chancellor would be able to come back and say, “Oh, look, we are going to top these budgets up somewhat.” That would mean more money not only for UK departments but for the Scottish Government and so on, but it would push up debt and widen the deficit once again. It would just kick the reckoning down the road a little bit.

Michelle Thomson: Thank you very much.

The Convener: You have not really touched on capital. The capital that is available to the Scottish Government will be much the same in 2029-30 as it was in 2023-24. There is a projected 1.6 per cent decline over the next five years. Given that growth is the UK chancellor’s overall priority, are you concerned about the impact of that decline, given the higher level of inflation capital?

The second point that I want you to respond to is about the overall cost of public procurement in the UK compared to, for example, Europe. Compared with other countries in Europe, the cost from the point of hiring consultants to the point of actual construction seems to be incredibly more expensive for projects that are quite similar. From high speed 2 down south to the A9 in Scotland, the costs seem to be colossal. What is the IFS’s view on these two issues: the capital position and the cost of capital procurement in this country?

David Phillips: The first thing to mention on capital is that capital budgets are set to rise overall, but a large share of that at a UK level is going into defence. That goes back to the guns versus butter thing that I mentioned earlier. The increases in defence spending do not eat into our day-to-day spending much at all. The defence day-to-day budget is only going up roughly in line with the average across the UK Government.

However, the defence capital budget is going up by much more than average. In England the only two areas that are able to get an increase in capital budgets are defence—which is UK-wide—and non-HS2 transport, as the HS2 budget starts to come down. Because defence does not generate any Barnett consequentials, the Scottish budget for defence is going up by less than the UK budget overall. As has been mentioned, it basically went up, and it is then going to come down slightly in real terms.

11:15

What would that mean for growth? It is important to say that, in a historical context, capital spending will still be relatively high. It will be much higher than it was during most of the 2000s and 2010s but, because it will be less by the end of the decade than it was in 2025-26 and 2026-27, you can do less than you would otherwise be able to. However, the budgets are relatively substantial in the historical context.

I should probably not say too much on the last question, on public procurement. I have asked myself a similar question. It seems, anecdotally, that the costs for major infrastructure schemes involving transport are higher in the UK. I do not know enough about the detail and comparability of schemes or the underlying factors—such as the extent to which it is a matter of balancing procurement, land, regulation and so on—but that is an important issue to consider.

The National Infrastructure Commission has done some work that it might be work looking into.

The Convener: It has been cheaper per kilometre for the Faroe Islands to build tunnels under the sea than it has been for the UK to build roads on the ground.

David Phillips: To the extent that those comparisons are valid, that is a big difference.

As I was saying, the National Infrastructure Commission has done some work there, and it might be work having a look at the factors involved.

The anecdotal evidence suggests that the issue is a big one. The latest project in London is the lower Thames crossing, which is 11 miles long with a three-mile tunnel, and it will cost £12 billion. That seems like a huge amount to me, although I am not an expert in that area. The National Infrastructure Commission probably has the best expertise on that.

The Convener: One considers whether there are suspicions of a cartel in operation and so on. I am sure that, if this was the economy committee rather than the finance committee, we would consider that if we had the time to do so.

Thank you very much for your contribution today. We have gone over time by more than half an hour, which is because of the interesting responses that you have given to our many questions. I also want to thank you, David, for coming all the way up here in person. It really does make a difference to scrutiny having someone giving evidence in person rather than online. Everyone in the committee feels that: it has made a difference. Thank you very much and all the best for Christmas and the new year to you.

David Phillips: Thank you, and Nadolig llawen.

The Convener: The Gaelic is Nollaig chridheil—but I do not know if I am pronouncing that correctly. Thank you very much.

Just before we wind up the public part of the meeting, I want to put something on record. I am sad to say that this is Ross Greer's last meeting as a member of the Finance and Public Administration Committee. He has been a very valued member of the committee for the past four and a half years. I appreciate that he is the Scottish Green Party's co-leader and that he has a heavy burden, serving on two committees. He has decided to sacrifice his membership of the best committee in the Parliament, i.e. FPAC. You will be missed, Ross. All the best for the new year—with your lighter load.

Ross Greer: Thank you very much.

11:19

Meeting continued in private until 12:43.

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