OFFICIAL REPORT
AITHISG OIFIGEIL

Finance and Public Administration Committee

Tuesday 7 December 2021

Session 6

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FINANCE AND PUBLIC ADMINISTRATION COMMITTEE

13th Meeting 2021, Session 6

CONVENER

*Kenneth Gibson (Cunninghame North) (SNP)

DEPUTY CONVENER

*Daniel Johnson (Edinburgh Southern) (Lab)

COMMITTEE MEMBERS

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

*attended

THE FOLLOWING ALSO PARTICIPATED:

Professor Sir Charlie Bean (Office for Budget Responsibility)
Carl Emmerson (Institute for Fiscal Studies)
Richard Hughes (Office for Budget Responsibility)
Andy King (Office for Budget Responsibility)

CLERK TO THE COMMITTEE

Joanne McNaughton

LOCATION

The Robert Burns Room (CR1)

Scottish Parliament

Finance and Public Administration Committee

Tuesday 7 December 2021

[The Convener opened the meeting at 09:15]

Budget Scrutiny 2022-23

The Convener (Kenneth Gibson): Good morning and welcome to the 13th meeting in 2021 of the Finance and Public Administration Committee.

The first item on our agenda is to take evidence from the Office for Budget Responsibility as part of our budget scrutiny. We are joined by Richard Hughes, director, and Professor Sir Charlie Bean and Andy King, budget responsibility committee members. It is the first time that we have taken evidence from the OBR this session, and I thank Mr Hughes and his colleagues for making the journey to Edinburgh.

We have 75 minutes for discussion and will have to finish promptly just before 10.30 am, in time for our second evidence session.

As we have been given a small but perfectly formed statement by the OBR, I will open up the questions. I do not mind who answers the questions—that is a matter for the witnesses, and one or more can answer.

In the third paragraph of your overview of the October 2021 economic and fiscal outlook, published on 27 October, you stated that there are

"supply constraints in several markets."

You go on to say that

"these supply bottlenecks have been exacerbated by changes in the migration and trading regimes following Brexit",

and you

"expect CPI inflation to reach 4.4 per cent next year".

What is your view on how the consumer prices index will impact the Treasury gross domestic product deflator, which is obviously important for the setting of budgets in Scotland? Is the situation with supply bottlenecks improving, and when do you expect it to return to as near normal as possible?

Richard Hughes (Office for Budget Responsibility): I will start, and then ask my colleague Charlie to supplement my answer.

In our forecast back in March, when we put together our forecast for the October budget, it was the case that the recovery and demand over the course of the first part of the year was stronger than we had anticipated. Therefore, with demand bumping up against supply bottlenecks, it is easier to open up a shop and get customers into it than it is to get goods to fill it and provide the customers with goods and services.

Going into the autumn, we ended up seeing stronger inflation than we had anticipated when we did our previous forecast back in March. We closed our forecast in late September in anticipation of its being published in October. At that point, we were forecasting inflation of above 4 per cent, but by the time we took a read of the latest gas prices and other developments in prices since then, it looked as though inflation was getting closer to 5 per cent. That has an impact on not only CPI but the deflator, which has an impact on the Scottish budget.

From the point of view of the Westminster budget, for the moment, that has some beneficial effects. In the United Kingdom tax system, both personal allowances and thresholds are frozen, which means that more fiscal drag comes out of that higher inflation than if the Government had got ahead with the indexation of the rates and thresholds. It delivers some fiscal benefit to the UK budget, some of which was spent by the Chancellor of the Exchequer in his budget. He took the benefit of the taxes that he had raised and the additional fiscal drag to increase public spending, which has consequences for the block grant for the Scottish budget.

Although there are challenging implications for the macroeconomy, higher inflation delivered some fiscal benefits to the chancellor in the budget, which had knock-on consequences for the Scottish block grant. Charlie might want to say more.

Professor Sir Charlie Bean (Office for Budget Responsibility): It is worth saying that some of the supply bottlenecks are global in origin. For example, with regard to chips for electronic components and cars, during the pandemic, there has been a rotation in consumer electronics demand. That has led to a diversion to electronics of chips that previously would have gone to car manufacturers. The Chinese have been buying up a lot of them. The consequence for car manufacturers is that they have not been able to get enough chips, which is why we have long delivery lag for new cars.

There have been particular issues in the gas market, some of which are, again, global forces that are working through.

Layered on top of those are particular United Kingdom features. It is reasonable to expect businesses to respond to shortages by adjusting their supply sources and the way that they operate and, going back to the car example, changing the mix of what they put in and so forth, but it is reasonable to think that it will take the best part of next year for some of those supply shortages to solve themselves.

It is also worth saying that issues in the UK labour market are relevant. We are seeing shortages of particular sorts of labour. The classic example is heavy goods vehicle drivers, but that is not the sole example. Our forecast assumed that some of those shortages would relax as the furlough scheme closed and that some workers who were on furlough would flow into the labour market, looking for new jobs. However, the data that has come in since we closed that forecast suggests that the consequential rise in unemployment as the furlough scheme ends will be less than we expected. There will be less extra labour supply going in, which leaves the labour market looking relatively tight.

In the past, we have relied a lot on inward migration, particularly from Europe, to ease those sorts of labour shortages. That is less of an option at the moment with the new migration regime and Brexit. One issue will be how those labour market shortages play into wage pressures and inflation in due course.

Our central forecast has inflation easing from about 5 per cent in the spring—that takes account of the recent gas news that Richard Hughes referred to—back towards the Bank of England's 2 per cent inflation target over the course of the next year and a half or so. However, if the supply shortages take longer to ease and, in particular, if there is more domestic wage pressure, we would say that the risks are very much to the upside of that.

The Convener: I will stick with inflation. No one has answered the question about CPI versus the Treasury deflator yet. I was struck by the difference between the OBR's assumed nominal earnings growth in 2022 of around 3.9 per cent and the 1.3 per cent that is in the Bank of England's monetary report. That is a huge differential. Most people would probably think that the OBR is nearer the mark on that. From your perspective, do you think that the Bank of England will look again at that, and will there be implications for interest rates? We know that the bank voted seven to two against changing the interest rate last month. What is your feeling about that, and how will it impact on your forecasts?

Professor Sir Charlie Bean: It is dangerous to compare the Bank of England's wage numbers with ours, because the numbers refer to different measures. The Bank of England's forecasts are about the standard average earnings measure that the Office for National Statistics produces. Because we are interested in producing fiscal forecasts, we use a wage measure constructed from total wages and salaries in the national income accounts divided by the number of people. Those two measures can sometimes move in quite different ways. In this particular example, that is due to the different measure that is being looked at.

Decisions about monetary policy are in the lap of the monetary policy committee, which will meet soon to take its latest decision. I was on that committee for 14 years and I know that that is a difficult task. I am not going to tell the members of that committee what they should be doing. I am sure that they will look closely at the sources of inflationary pressure. They pay attention to measures of inflation expectations in financial markets, for example, and they also look at surveys of businesses for measures of inflation expectations. They will be alive to any sign that inflation expectations are picking up.

I made the point that the labour market looks surprisingly tight. Vacancies are at a historically high level, despite the fact that the economy still has not regained its pre-pandemic level of activity: it is about 1 percentage point below where it was before the pandemic broke out in early 2020. The labour market looks very tight. Some of that is because some people have left the labour force. Some people have retired earlier; some migrants went back home during the pandemic; and some migrants who might have come here did not come. That effective reduction in the labour force led to more signs of tightness in the labour market.

I am sure that the monetary policy committee will be mindful of those issues in deciding whether it is appropriate to tighten policy.

One factor that goes in the other direction is the new omicron variant of Covid. Given that there is still uncertainty about the consequences, the monetary policy committee might want to wait until scientists have a better understanding of the implications.

You asked about the implications for us. One key factor in determining debt interest is the level of interest rates. Debt interest is more sensitive to changes in monetary policy than it was in the past, partly because the stock of debt is bigger but also because of the average maturity of the total liabilities of the public sector, which we get by adding together Bank of England and Government liabilities. The Bank of England has been buying Government debt and issuing reserves to finance it under its quantitative easing programme. Those reserves pay the bank rate, which is the rate that the monetary policy committee sets. When it decides to raise the bank rate, that will have a pretty immediate pass through to debt interest.

The Convener: One issue is that the OBR does not necessarily have access to the data that it requires to look at specifically Scottish circumstances. Are there any data streams that could be added to make forecasting in a Scottish context more accurate?

Richard Hughes: We approach our forecasts for Scottish taxes differently from the way that the Scottish Fiscal Commission does that. There is value in doing the forecasts from different perspectives because they provide checks on each other. We take a top-down approach when we estimate the tax basis for things such as Scottish income tax. We estimate what we think is the Scottish share of the tax base and applying the policy rates on top of that.

Since 2016-17—if memory serves—we have had the benefit of outturn data. That provides a check against our initial estimates—what we thought the tax base was, rather than what it actually was. We have also recently had the benefit of the real-time information data that Her Majesty’s Revenue and Customs has started to produce on how much tax is coming in and the composition of taxpayers. We started getting that data during the pandemic, and it comes in frequently. That has provided us with far more real-time information about who is paying tax and how much on an in-year basis.

I ask Andy King to say whether there is any more information that he wishes he had in putting together those forecasts.

09:30

Andy King (Office for Budget Responsibility): As Richard Hughes said, the volume of data that we can now examine specifically for Scotland is good for the majority of the taxes that we forecast. Now that the property tax and landfill tax systems are fully devolved, the tax data is the best current information that we can have.

We are now more practised in using the real-time information for the pay-as-you-earn part of income tax. That is as good as you will get as a starting point for the forecast. It is better than labour force survey data on the tax base because it is, in effect, a census rather than a survey.

We miss out on the self-assessment population, who are about 10 per cent of the income tax base. The tax system provides information for them only once a year, with a long lag. People pay in January and it takes another month or so for the data to be cleaned up and analysed. Given the way that we produce forecasts, if there are differential trends in self-employment or other parts of the non-saving, non-dividend, non-PAYE tax base, we will not pick them up.

Similarly, the SFC has no crosscheck from the tax system for the bottom-up way in which it produces its forecasts. For both of us, the non-PAYE part of income tax is where the data is least helpful.

In all those cases, we are, in essence, talking about the data that helps us to understand the starting point. Because the income tax system has been devolved on a liabilities basis—not in the way that the cash arrives in HMRC—there is a certain amount of forecasting of what has already happened, because you will not know the outturn for a long time given the self-assessment lags. What is common to both the SFC and us is the forecast challenge. When we forecast the Scottish share of the UK total, we take into account population projections but all the other things that determine the trend in tax per head in Scotland versus the UK are forecast judgments.

The issue is not a lack of data; it is the more standard problem of predicting the future given the information that you have to hand.

The Convener: Over the past few years, how accurate has the Office for Budget Responsibility been, compared with the SFC? There are significant differences in the forecasts for the next five years; the SFC predicts that the tax take in Scotland in five years will be £486 million more than the OBR has predicted. It is interesting that the OBR predicts that £78 million will come in from Scottish landfill tax while the SFC predicts only £18 million because of the impact of policy. That is a £60 million difference, which is quite a huge difference for that tax. To help us to consider how the OBR is doing relative to the SFC, will you say how accurate the two organisations’ predictions have been over the past few years?

Richard Hughes: In the devolved tax and spending forecast document that we produced alongside the budget, we looked back at the accuracy of our forecasts versus outturn. In chart A, you can see that we got it quite wrong at the beginning, but that was because nobody knew what the tax base was.

Until we got outturn data in 2016-17, we were out by about £700 million. Since then, there has been a learning process not only for us but for the Scottish Fiscal Commission. That has helped to reduce the forecast errors, which are now down to within £200 million a year. Most recently, the error in the forecast for Scottish income tax was less than £100 million. That shows that we are learning how the systems operate as we go, and that we are taking advantage of hard data, as it comes out.

For our forecasts, we have started to produce a comparison and, where we can, to reconcile where we have made estimates that are different from those of the SFC on certain taxes, and to explain those differences. The SFC has started to do the same. We produce forecasts at different times, which often explains the differences in the expected yields from taxes.

The past 18 months especially have been a particularly volatile environment in which to try to forecast. We have learned more about the evolution of the pandemic, the effectiveness of vaccines, the prospects for reopening the economy, the pace at which that could be done and the outlook for inflation. All those things have had implications for what the OBR and the SFC have forecast for taxes. In many cases, the explanations for forecast differences come down to the fact that there are a few months between our forecasts; a few months is a long time in forecasting, these days. One hopes that things will settle down economically, because that would mean more consistency between what we say in one month and what the Fiscal Commission says in another.

The Convener: I have a final question on taxation before I turn to colleagues. You state in your submission that the amount of gross domestic product that is raised in tax will be 36.2 per cent by 2026-27, which will be its highest since the early 1950s. You also state that taking his past two budgets together, the Chancellor of the Exchequer has

"raised taxes by more this year than in any single year since Norman Lamont and Ken Clarke's two 1993 Budgets in the aftermath of Black Wednesday."

You wrote the submission on 27 October. What impact do you think that will have on future growth projections, given that you have had six weeks in which to analyse the situation further?

Richard Hughes: In relation to implications, our growth projections are consistent with what was announced on tax policies. One thing to say about the forecasts is that the Government has decided to raise a very large amount in tax over the coming five years from personal taxes and corporate taxes, and we take account of the second-round effects of those taxes on incomes and economic decisions.

That is partly because of the beginning of the UK's demographic transition, in which we have an ageing society and fewer and fewer people in work compared with the number who are in retirement. Many of the tax rises are to fund a larger post-pandemic state. Some people have allied those tax increases with somehow paying for the pandemic and they think that that means that the tax rises are somehow temporary because they deal with a temporary cost. However, over the medium term, the rises are for dealing with net zero, paying for a larger health service and paying for the Government's other public spending plans, all of which contribute to a permanent increase in the size of government.

If the Government wants to meet its fiscal rules based on our forecasts, those rises will be permanent tax rises that need to be delivered if the Government is to meet borrowing targets. They reflect the fact that if the working-age population is shrinking, you have to tax it more because of the population in retirement that is benefiting from welfare provision as well as a health service that provides services that they are looking for.

The Convener: The Institute of Fiscal Studies has said that policies have been led by the OBR. We will ask it about that.

Daniel Johnson (Edinburgh Southern) (Lab): I will follow on from the convener's line of questioning on income tax forecasts.

It is of critical importance that since the introduction of the fiscal framework, income tax is a large component of what we have available to spend in Scotland. I am interested to understand why the OBR projects growth in income tax receipts being slower in Scotland than in the rest of the UK. If that is the case, mitigating that should be a real focus of public policy in Scotland. Can you explain the underlying assumptions behind that forecast?

Andy King: First and foremost, the driver of the relative growth rate is the Office for National Statistics population projections that we take into account, which show slower growth in Scotland than in the UK as a whole in the working-age population and the adult population, which is largely down to differences, I think, in net migration assumptions. However, we feed that relative decline in the share of the population that lives in Scotland proportionally through to the income tax forecast.

As we described, we also use the real-time information from the pay-as-you-earn system to look at how income tax liabilities in Scotland are likely to have changed since the most recent outturn year, which was 18 months ago, now. At the moment, that shows a significant decline in the Scottish share of income tax liabilities. We take into account the combination of those two factors when judging the share of UK-wide income tax liabilities that will be raised in Scotland. That is the sum total of the story.

We also take into account where UK Government policy measures are likely to have different effects in Scotland from those in the UK as a whole, but those effects are much smaller than the top-down adjustments about the population and RTI.

Daniel Johnson: Bearing in mind what Mr Hughes said regarding the attempts of the OBR and the SFC to reconcile their methodologies, I note from your paper that it looks as though there will be a £380 million difference between what you and the SFC forecast for income tax receipts. Will you provide a summary of that difference of opinion? I assume that the SFC is looking at the same demographic figures.

Andy King: As Richard Hughes mentioned, one of the key things is timing. At the moment, there are large movements in tax receipts as the economy has closed and reopened, and there are surprises relative to assumptions about how winding down the furlough scheme will impact. I think that we had two or three months more RTI data when we closed our forecast than the SFC would have had, so we will have factored in a negative—or downside—surprise.

There are also more straightforward differences in forecast judgments around the labour market. Our forecasts for wages and salaries growth are very similar. However, ours is more employment rich, while the SFC's is more average-earnings rich; the latter is more tax rich. The SFC might be right or we might be right—although, more likely than not, we will both be wrong. However, those are more straightforward forecast judgments.

Daniel Johnson: Let us bear those points in mind, with what Sir Charlie Bean said earlier, and step back a little bit. We are in a situation that is not panning out as predicted. We see significant labour market frictions and significant differential frictions between different sectors in the economy. It strikes me that, in that situation, making predictions on future earnings becomes a lot more difficult, because you need to forecast almost on a microeconomic rather than a macroeconomic basis what will happen in each individual sector. Is that a fair summary? What is the OBR doing to look at how we can drill into specific issues in specific sectors and extrapolate for the wider economic outlook?

Richard Hughes: That is exactly how we have had, over the course of the pandemic, to change how we forecast. It has been such a sectorally differentiated shock. Some sectors—hospitality, for example—lost about 90 per cent of their output at the beginning. Other sectors—financial services, for example—in which people could easily work from home or remotely, faced much smaller falls of around 10 per cent maximum in output at the peak of the first lockdown. We have therefore necessarily had to take a more sectorally differentiated approach in order to try to understand the implications of the pandemic for the near-term outlook.

Since the pandemic started, our forecast documents have provided a month-by-month sectoral breakdown of how output evolves, to support our macro judgment of where we think GDP is going. It is very difficult to predict.

09:45

We start by talking to epidemiologists and public health experts about when they expect different parts of the economy to be able to be reopened. When that goes to plan, it tends to support the direction of our forecasts. In areas that have ended up locked down for longer, our forecasts turn out to be wrong.

The other thing that we have to take account of is how consumers and businesses have changed their behaviour over the course of the pandemic. Charlie Bean alluded to the rotation in consumption over the course of the pandemic. Early on, consumption simply fell, but then consumers figured out ways of buying online what they used to buy in shops, and suddenly retail goods consumption popped upwards. However, when the service sector opened up, we saw consumption rotate back towards services and away from goods. Trying to keep up with the changing composition of consumption and how people have adapted to the pandemic has been a challenge for us.

It is fair to say that we have consistently underestimated how adaptable consumers and businesses have proved to be. We are putting out a publication on Thursday looking back at our forecasts for the pandemic period for 2020. We consistently underestimated how much consumption there would be and how much businesses were going to be able to sell people because, as we went through the pandemic, more and more consumers found ways to shop online and businesses found ways either to operate using deliveries or to provide services through other means, which has meant that the economy has become increasingly resilient to pandemic conditions and public health restrictions. That has led to upsides and surprises for our forecasts. However, in some sectors, such as air transport, restrictions still play a significant role in holding back output, which will continue even into next year.

Andy King: Specifically on the income tax forecast, one of the real benefits of the RTI data is that it can be cut for any breakdown that is needed to understand what is happening. The information is very close to real time, so we were able to analyse why the Scottish share had fallen in the outturn period, with the oil and gas sector playing a significant role in that.

Our having a good understanding of where we are is beneficial for forecasting, but there is still huge uncertainty about what assumptions we should make about how permanent or temporary an event is and, if it is temporary, how quickly it will unwind. Even that microforecasting, rather than top-down macroforecasting, involves a series of judgments about what will happen next.

The situation would be the same even if the SFC were to be faced with precisely the same information set. The reason why there are two expert committees is that you will get two views—although perhaps that is the reality rather than the reason.

Daniel Johnson: If you had both come up with exactly the same answer we would be asking much tougher questions.

Liz Smith (Mid Scotland and Fife) (Con): Professor Bean made some interesting comments in reference to the impending meeting with the MPC and what is focusing minds on inflation and, specifically, its causes. How easy is it to use economic data to home in on the cost-push factors in inflation and on demand-led inflation? In previous meetings on the economy, people have spoken to us about cost-push inflation being very strong.

Professor Sir Charlie Bean: The key thing for the MPC to consider when there are supply shocks—or cost pushes, if you want to call them that—is whether they will lead to sustained inflation. The standard mantra of inflation targeting in central banks is that if there is a one-off supply shock, you let it feed through into inflation and do not try to offset it in the short term, but instead accept temporarily higher inflation. The MPC wants to guard against that blip in inflation feeding through and generating an on-going wage-price spiral of the sort that we saw in the 1970s.

That is why central banks and the monetary policy committee pay a lot of attention to inflation expectation indicators. Those tell us when people's inflation psyche has shifted and they will start to mark up prices because they expect their input costs to rise, and when people will look for higher wage increases to compensate them for the inflation that they expect will come down the road. Central banks will always be on the lookout for that. At this juncture, I am certain that the MPC will be looking closely at indicators of inflation expectations.

Liz Smith: Would it be correct to assume, therefore, that, because of some of the blockages in the system that you mentioned earlier—specifically, the tightness in the labour market and employers not being able to fill some of the available jobs—your understanding is that the expectation factor may be increasing?

Professor Sir Charlie Bean: There is a good argument in the case of the shortages in goods markets—the shortage of chips that I talked about earlier or the issues in the gas market. We would expect wholesale gas prices to fall back once the short-term issues ease and it is reasonable to think that those sorts of issues will solve themselves. My concern is more about whether problems will develop in the labour market, because that is tight and there are shortages of some sorts of labour. Those are circumstances in which we might see the supply shock that has happened having so-called second-round effects, with wage inflation starting to pick up and so forth. That will be a key judgment that the MPC has to draw.

Liz Smith: How easy is it to understand whether the labour market problems have been caused by Brexit or by people not being willing—rather than not having the right skills—to take up the available jobs? How easy is it to drill down on that?

Professor Sir Charlie Bean: We would certainly try to get relevant indicators of those sorts of factors. Economists refer to the issue where people have the wrong skills for the job openings that come up as skill mismatch. The potential solution is retraining and, if we drive up the pay in occupations where there is a shortage, that will suck people in and encourage them to get the skills. However, that takes time. We can look at indicators, splitting up vacancies by occupation, region and even sector and comparing that information with the skills of people who are looking for work, where they are and so forth. There is some examination of that in our economic and fiscal outlook, so we can dig into those things.

Your question also raised Brexit. It is difficult to deny that that has a potential role. If we go back to the years immediately before the financial crisis, and to the years after the financial crisis but before the vote to leave, an important safety valve for firms that could not get labour domestically was to look overseas to hire workers. There was a very elastic supply of labour. That labour is no longer so elastically available because of the migration policy regime. The key issue is how that regime operates; it is not necessarily Brexit per se, because we could operate a migration regime that allows relatively free inflows of labour, which is in short supply. Everything hinges on how the Government chooses to operate the migration regime. If it is operated in quite a restrictive way, the bargaining position of labour will strengthen and more of the second-round effects that I talked about will be generated.

Liz Smith: That is very interesting. In Scotland, there has been a significant problem in specific sectors such as hospitality and tourism, so I was interested in how such issues are measured.

My final questions are about the chancellor's budget. He made the decision to be a bit more demand led—in other words, he wanted to ensure that public spending was at a higher level than it might have been—and to increase some taxes. Has the budget led to some increase in the demand side of the economy? Is it having an impact on inflationary pressure?

Professor Sir Charlie Bean: That was certainly our assessment in the economic and fiscal outlook. We provide estimates of the macroeconomic effects of the package, and my recollection is that we estimate that the net demand stimulus will add about 0.5 per cent of GDP, which would add a bit to inflationary pressures through the channels that I have been talking about.

Earlier, Richard Hughes alluded to the recovery having been stronger than we and some other forecasters expected. It is also the case that it seems as though demand has rebounded more rapidly than supply has. Earlier this year, we, the MPC and a lot of other forecasters thought that demand might lag behind supply, so supportive policies would be needed to bump up demand as the economy reopened in order to match supply. What we have seen suggests that demand had enough legs on its own and was running a little ahead of supply. Our forecasts embody that judgment.

John Mason (Glasgow Shettleston) (SNP): We have already covered quite a lot of interesting areas. The point was made—I am not sure whether it was by Mr King—that people have adapted more than was expected through the whole system. Have people learned that they need some savings in case they hit another pandemic or a crisis of some kind? If people were to save more, would that have an impact? Is there any evidence that people are doing that?

Richard Hughes: It is the case that the savings ratio went up a lot during the pandemic, but one has to question the extent to which people decided that they wanted to save more. Some people will have been forced to save more because they could not find ways of spending their money; they could not go to shops or go on holidays, for which people often save money. At the height of the pandemic, the savings ratio hit post-war highs—it was in double digits. Initially, we thought that the ratio might stay high, but we have progressively revised the figure down closer to 5 per cent, which is the historical average, over the medium term.

There are still the savings that people have built up and accumulated over the pandemic, and we expect those savings to be unwound relatively slowly—at the pace of about 5 per cent a year, if my memory serves me correctly. We expect that to happen because all the surveys suggest that people do not spend windfalls all at once; they tend to want to smooth their consumption over time. We have not concluded that there will be a significant increase in the rate of precautionary saving over the medium term.

10:00

People unwind the war chest that they have built up slowly, but what they do not do is permanently save significantly more than we had estimated. Surveys of households suggest that that is not the lesson that they have learned from the pandemic. The vaccine has allowed much of our lives to go back to normal—with important caveats, of course, about the emergence of new variants. Government support such as the furlough scheme was also very generous, which meant that Government borrowing came to people’s rescue rather than the savings that they had made to deal with hits to their income. As a result, the lesson that people might well have learned is that Government is there when they need it to provide support through these kinds of events.

Professor Sir Charlie Bean: It is worth saying that we are talking about pretty large amounts of money. The forced savings on households are of the order of a couple of hundred billion pounds. The big picture of the pandemic, if you like, is that Government policy has pretty much preserved incomes but households have not been able to spend anything, because the economy has been closed.

The money has therefore accumulated. Some of it has probably leaked into the housing market, some of it will have been invested and a lot of it still appears to be held in liquid form in bank accounts and so forth. The key question that forecasters have been grappling with is how quickly those savings might be unwound. As Richard Hughes has said, the standard view is that people do not blow it all at once. After all, there are only so many slap-up meals or exotic holidays you can have. It is more that they will have a higher standard of living for many years into the future. I would say that an unwinding of about 5 per cent a year would be consistent with empirical evidence and the many studies of how consumers behave when they have these sorts of windfalls.

The other thing that I would inject here is the importance of realising the difference in impact across households. Not every household has had this windfall in income. Some often older and higher-income households—people like me, for example—stopped doing lots of spending that they would normally have done, but their incomes were largely preserved. However, there are plenty of households—those with self-employed family members, for example, or workers in more fragile jobs—that, because the Government’s safety net was less effective for them, have not been in the happy position of being able to accumulate savings. In fact, some of them have accumulated significant debts. Such important heterogeneities across the population will also complicate any assessment of what will happen.

John Mason: That was helpful. In that one area of savings, there is, if I am understanding you correctly, going to be a short to medium-term impact but you expect that in the long term things will go back to normal. Is it the same story with regard to scarring in the whole economy? Is it that the pandemic and Brexit will have a scarring effect in the short term but in the long term we will just get back to normal?

Professor Sir Charlie Bean: We assume that the pandemic will have a permanent effect. In other words, if the pandemic had not happened, GDP would be higher than the trajectory that it is now on. The medium to long-term hit is 2 per cent, but there is a lot of uncertainty around that figure and we have always made it very clear that we are very unsure about this territory.

The hit comes through a variety of channels. There is the effect on the labour force, part of which is to do with population, given the significant number of deaths, but the migration effect that we have talked about also plays into this, and the pandemic has potentially affected some of those migratory movements in a permanent way.

It is likely that some older workers have decided to leave the labour force earlier than they would otherwise have done, as a result of the pandemic—in some cases because their job disappeared, and in others because they have become more conscious of their own mortality.

We know that some younger workers stayed on in education; they will come back into the labour force in due course. It is also true that more flexible ways of working, such as the ability to work at home, might enable some people—particularly married women—to participate more easily. There are factors going both ways.

There is an effect that might not be fully permanent but might last quite a long time. We will have to accommodate structural changes in the economy of the sort that we were talking about—people not having the right skills and having to retrain and so forth. That can raise the equilibrium level of unemployment for a while.

A bundle of things affect the effective size of the labour force. Of our 2 percentage point hit, if memory serves me right, that is about 0.8 percentage points. That is an indicative decomposition. Do not take these numbers too literally, though, because, as I have already stressed, there is a lot of uncertainty around them.

John Mason: Sorry—I do not understand that point. Two per cent is the permanent effect, but what is the 0.8 per cent?

Professor Sir Charlie Bean: That is the labour force component of it.

John Mason: Right.

Professor Sir Charlie Bean: I will give you two more bits of it, and all together they will add up to the 2 percentage points.

The second bit is that investment has been depressed during the pandemic. Not surprisingly, businesses have held off investing because of uncertainty and so forth. We have data on that, so we have a pretty good fix on how much investment has not taken place that otherwise probably would have. The output consequence of that can be roughly worked out. That is worth 0.6 percentage points.

The other bucket is the bit that economists really do not understand, but it is the big driver of the improvement in living standards, and that is improvements in knowledge and the way things are done, and new products and stuff that is generated by research and development. Because investment in intangibles and research and development has also been hit in the same way as physical investment, we think that the long-run level hit from that is also 0.6 points.

The hit is coming from lots of different channels. It is not something that you can make up for, particularly as it has been a global pandemic, so lots of countries have gone through the same experience. The world would have been a richer place had we not had the pandemic, and that is completely apart from the health consequences.

Michelle Thomson (Falkirk East) (SNP): Good morning. Following on with regard to the pandemic, I am bit surprised at the reaction to the emergence of omicron. Lots of people suggested that it was highly likely that another variant would go into the population. I am interested in exploring the extent to which you have baked the impact of such waves into your economic modelling, and specifically in your points about separation of sector and so on. I totally appreciate that there is a whole range of variables.

I am interested in understanding the extent to which you have done that, and how that will reframe your modelling. I think that it was you, Sir Charlie, who spoke about quantitative easing and how it is, in effect, here to stay and will have an impact on debt going forward. What are your reflections on what you are doing differently now? What would you absolutely, definitely do differently in the future, and what does that means for Scotland? What are you insights on that, in relation to your modelling?

Richard Hughes: I will start on that, and Charlie can supplement my answer. The risk of a new variant has always been on our radar. During the pandemic, we have always looked not just at a central scenario but at a set of scenarios. We had one scenario in which very effective vaccines were rapidly rolled out, the economy reopened and we quickly got back to a pre-pandemic world. In another scenario, we had new variants against which vaccines were ineffective.

In our central forecast at the end of October, we assumed some rise in cases over the winter. Those were not necessarily cases of a new variant; it was a rise in cases of the old delta variant. That was because, with the colder weather, people will be mixing more in closer quarters, which we know has an impact on transmission. We also know that, regardless of what the Government does with public health policy, when case numbers go up, people tend to rein back on consumption through what is called voluntary social distancing. We have therefore already baked in some slowdown in consumption going into the winter, on the basis of an expected rise in case numbers.

We do not yet know what the public health response will be to the new omicron variant, and we do not know much about the science of it. However, even if it leads to another lockdown of the sort that we have seen previously in response to rising hospitalisations and deaths, we now know that our economy is increasingly adapted to those conditions, and we can try to anticipate that better in our forecasts. The first lockdown lost us about 25 per cent of output; the second lockdown lost us less than half of that. As you would anticipate, we are learning how to live with the virus more effectively, even when we cannot walk into shops and buy things or go to restaurants to eat.

We are trying to get better not just at looking at the possible sectoral impact of different restrictions but at anticipating how well adapted those sectors would be when the restrictions are put in place. Obviously, if there is a need for tighter restrictions, there is also uncertainty about what kind of Government support will be provided to the affected sectors alongside that. If that support is rolled out, we know the effect that it has.

The short answer is that we had taken account of some rising cases and some slowdown in consumption just based on the old variant. We do not yet know how different the impact of the omicron variant will be compared to that of the delta variant. If the impact is similar to that of delta, that will have a relatively modest impact on our forecast. If it requires much tighter restrictions or something closer to lockdown conditions, we would be looking at hits to output of the order of those that we saw back in January.

Professor Sir Charlie Bean: It is pretty clear that there will be some impact, even just through December. There will be less spending in hospitality and on travel, I presume, so there is bound to be some negative impact on consumer spending. As Richard Hughes says, there might be an issue that carries through into next year, if more substantial health measures are needed for longer.

It is worth saying that the impact on GDP can sometimes turn out to be not what we would expect. It is easy to pick out what is happening to consumption but, of course, the consequence of omicron is that the Government is stepping up vaccinations, and that boosts GDP. That is because of the way in which GDP is measured—it treats that as output of the health sector, as indeed it should. The GDP numbers may or may not reveal something but, as far as consumption is concerned, we will see some slowing over the Christmas period.

Michelle Thomson: Another area that we have not touched on is the similar question of how you are specifically baking in an assumption on climate change expenditure off the back of the 26th United Nations climate change conference of the parties—COP26. That has not come up today. What is the thinking in your modelling in relation to baking in up-front costs that will filter all the way through, and in relation to longer-term far-side implications? Anyone can answer that.

Andy King: Our forecasts always take the UK Government spending plans as a starting point. The spending review in October presented about £25 billion-worth of net zero capital spending over four years, including the current one. In reading our forecasts, the most important thing to understand is that that spend was the allocation of sums from a total that had already been set. It was not additional capital spending on top of the capital plans that were in our March forecast—it was the bottom-up allocation of the capital that was already there.

10:15

In the summer, we did a lot of work on scenarios for net zero capital spending. The first four years of our scenario are remarkably similar to what has transpired as Government policy in the spending review. Thereafter, in our scenario, the amount of net zero capital spending continued to increase, and it peaked around the end of the decade. Obviously, that is hugely uncertain—it was a “What if?” consideration for us.

The biggest uncertainty in there by far is what happens with people’s homes, with regard to domestic heating and insulation. Fortunately, I am a mere forecaster and analyst, so I have only to look at the numbers rather than think about what it feels like to make decisions on disrupting 25 million homes with building work. That area is the biggest cost, and it looks like the most difficult one to deal with by using tax as an incentive.

The revealed preference across other sectors has been that regulation to ban things is the preferred policy lever, at least once a process is under way. With housing, the fiscal impact might be larger for existing homes, whereas the regulatory lever is much easier to pull for new builds, as the builders can be told what they have to do.

The flipside of all that is what happens on the tax side. There is one very large existing carbon tax—it is known not as a carbon tax, but as fuel duty—which the Government has frozen for 10 years now. As electric vehicles take over and petrol vehicles are banned, that tax, which is worth approximately 1.5 per cent of GDP, simply goes away. There are other environmental taxes that are labelled as such—most obviously the emissions trading scheme. The Westminster Government can make choices about how many sectors that scheme covers and how far it is used as an incentive to get carbon out of the system. That is clearly a big policy uncertainty for the future in our forecasts.

The one thing that I learned from our work over the summer was just how successful the carbon price floor has been as a tax incentive in wiping out coal from the energy mix. In that regard, the UK provides a good example of a carbon tax doing what it is intended to do, and raising some money along the way. Ultimately, however, the revenues go away, because the policy is successful in reducing carbon.

Douglas Lumsden (North East Scotland) (Con): My question follows on pretty well from what Michelle Thomson said. It is good to hear that the net zero capital spending plans are in the forecast. However, I have a concern about oil and gas, and the capital plans that are under pressure not to be spent as we move forward. If those investments did not happen, what would that do to the forecast? I presume that that would have a greater impact on the Scottish economy than it would in the rest of the UK, and there would then be greater divergence between the Scottish tax intake and the intake in the rest of the UK. Has any modelling been done on what would happen if some of those new investments, especially in the North Sea, did not take place?

Richard Hughes: We have not done any modelling on that but, as you have already seen from the data, there is—as a result of the pandemic rather than any action on net zero and climate change—a differential impact on the Scottish economy in comparison with the rest of the UK. The income tax take has been a bit lower in Scotland because the oil and gas sector has not done well during the pandemic. In addition, Scotland’s exports have been much more affected than the rest of the UK’s exports by the pandemic, because there is a stronger oil and gas component to our exports.

We have seen that a little already in the forecasts that we have produced, but I confess that we have not done any detailed analysis of what the sectoral impact would be if particular projects went ahead or not, as that is at a level of disaggregation below what we would do for our own forecasting purposes. However, we have seen that show up in the macro data on tax take as well as on exports.

Douglas Lumsden: So the forecasts that you are presenting assume that many of the investments in the North Sea will take place. If they did not happen, the forecasts would have to be revised, and there would probably be a negative impact on the Scottish economy.

Richard Hughes: They are based on work plans that we get from the firms themselves and the taxes that would come from them. I could not speak to what specific projects are in those plans, because we do not provide them at that level of disaggregation.

Andy King: We used the Oil and Gas Authority’s survey as the basis for our forecasts for the revenue from the North Sea, or the offshore corporation tax. That is a project-by-project and field-by-field survey. We do not look at that detail because the OGA has access to commercially sensitive information. It packages that for us.

The key thing to say at this stage is that investment today rarely yields tax revenues within a five-year forecast horizon, so those are longer-term issues. That is purely the North Sea revenues. Obviously, investment is an economic activity that will support income tax revenues, so there are two different ways of looking at the matter.

Ross Greer (West Scotland) (Green): I am interested in the issue of stranded assets but, given the time, there is one other area that I would like to touch on. Charlie Bean in particular has mentioned a few times the impact of upward pressure on wages. I am interested in the knock-on effect that that would have on the relative value of different sectors to the overall tax base. For example, if the hospitality and road haulage sectors recover from the pandemic as smaller but higher-wage sectors, that will have a differential impact on income tax versus corporation tax versus fuel duty, and so on. How soon do you expect to have a strong indication of the direction of travel in respect of sector-specific differences in recovery?

Professor Sir Charlie Bean: As far as the tax point is concerned—Andy King will be able to expand on this—one of the great virtues of having access to real-time information is that we get it quite quickly. Of course, when the numbers are coming in, we will ask why they are stronger or weaker than we expected. Those sorts of sectoral issues might well be the hypothesis for why the figures come out in a particular way. Ahead of that, we will certainly look at sectoral pressures in labour markets and, to the extent that we can get information on mismatch by skills or by occupation, we will do that in coming forecast rounds.

I am about to leave the budget responsibility committee, but my replacement—David Miles, who is another former MPC member—has just been announced. I am sure that he will want to go over that territory. He will be used to looking at those sorts of numbers in his time at the Bank of England.

Ross Greer: Do you know off hand what the early indications are for hospitality? I am thinking specifically about the questions that Liz Smith asked. Any changes that affect the hospitality sector's contribution to the tax base will have a disproportionate effect on Scotland in the same way that, say, changes to agriculture's contribution would.

Professor Sir Charlie Bean: One of the surprising things about hospitality is that a lot of people who were on furlough came from the hospitality sector and we know that there are a lot of vacancies in hospitality, so one would think that they would be able to match up. However, the hospitality sector relies quite heavily on migrant labour, and it is clear that net inward migration has fallen during the pandemic. There is some uncertainty about the numbers because the international passenger survey, which is the main source of information, was suspended during the pandemic. The Office for National Statistics has therefore tried to make indirect inferences about the figures.

Our experience of the hotel that we stayed in overnight indicates that there are significant labour shortages in the hospitality sector.

Ross Greer: Thank you. I am conscious of the time, so I am happy to leave it there.

The Convener: We shall end this evidence session on that very positive note. I will not ask for the name of the hotel.

I thank Mr Hughes and his colleagues for taking the time and trouble to come all the way to Edinburgh. That is really appreciated in the current circumstances, and it definitely gives you lots of brownie points from the committee. We much prefer to take evidence face to face, if we possibly can.

I also thank you for all your evidence. We could have asked a lot more questions if we had the time, but we have a full agenda today. Thank you for coming to see us, and we hope to see you again before too long.

Our next witness will be Carl Emmerson from the Institute for Fiscal Studies, who will join us remotely. I suspend the meeting to allow final connection checks to take place. We will be back at 10.29 for a 10.30 start.

10:26

Meeting suspended.

10:30

On resuming—

The Convener: For our second budget scrutiny evidence-taking session, we are joined remotely by Carl Emmerson, the deputy director of the Institute for Fiscal Studies. Mr Emmerson is standing in for the director of the IFS, Paul Johnson, who is unwell—we wish him a swift recovery. I thank Mr Emmerson for making himself available to give evidence at short notice and welcome him to the meeting.

I remind members that our broadcasting team will operate their microphones, so they should not touch them. We have an hour for this evidence-taking session, so it would be helpful if members could keep their questions concise.

I invite Mr Emmerson to make a short opening statement.

Carl Emmerson (Institute for Fiscal Studies): Thank you very much and thank you for the best wishes for Paul. He is sorry that he was unable to make the meeting.

I highlight the fact that, in terms of Westminster budgets, there were three substantial fiscal events in the current calendar year. The first was the budget in March, when the OBR provided of a set of forecasts under the assumption that the pandemic and the economic response to it would permanently damage the economy by about 3 per cent in the medium run. That led to the chancellor deciding that he wanted to try to put borrowing in the medium term back on track. He trimmed the spending plans a bit, but he also announced substantial tax rises through freezes in the personal allowance for the higher rate of income tax and a big increase in the rate of corporation tax.

In September, the Prime Minister announced the manifesto-busting national insurance rise, to be followed by the new health and social care levy, to enable more to be spent on the national health service over the next couple of years and to provide some money for social care.

When we got to October, the OBR decided that, because the economy had performed more strongly than it had expected this year and unemployment was not as bad as many people had feared, it was reasonable to lower the assumption of scarring in the medium term. Therefore, it presented the chancellor with a better set of economic forecasts. It is interesting that, in response to that, the chancellor decided to top up his spending plans and not row back on any of the tax rises that had been set out so far this year.

That got us back to a position in which there is more money for the NHS over the next couple of years in particular, spending elsewhere looks like it is in line with what was expected prior to the pandemic and most areas of spending will now avoid cuts, but there are big tax rises coming through that were justified in part by the big damage to the economy that was expected in March and therefore, if the latest forecasts are right, would not now be needed. Therefore, in some senses, the chancellor has decided to go for higher taxes and higher spending. That is probably in part because of pressures that are not to do with the pandemic. There is a reasonable case for saying that, if the pandemic had never happened, there might well have been tax rises to enable the Government to spend more on the NHS and social care anyway.

The Convener: On 27 October, Paul Johnson said that the budget was "very disappointing" and that it showed that household income would be "pretty stagnant" at around 0.8 per cent growth this year. He went on to say,

> "This is actually awful,"

pointing to

> "High inflation, rising taxes, poor growth keeping living standards virtually stagnant for another half a decade."

In his speech that day, he went on to say:

> "Average gross earnings could have been some 40% higher had pre crisis trends continued."

How does that compare to other western countries?

Carl Emmerson: The period since 2010 has been one of terrible productivity growth, which has been associated with terrible earnings growth in the UK. Those are the figures that Paul Johnson set out.

Other economies have experienced pretty terrible economic performance over that period, too. It is fair to say that the UK was harder hit by the financial crisis because it had a bigger financial sector to start with, so the legacy of the crisis is bigger. Part of the effect is due to the economic consequences of Brexit, which are felt largely by the UK economy and not others.

There is also the assumed scarring effect of the pandemic—although it is too early to tell whether in five or six years' time the UK will end up being hit harder than other economies. So far, the UK economy has been pretty hard hit by the pandemic relative to other economies.

The Convener: Paul Johnson said that the decisions taken by the chancellor were

> "almost entirely a set of policy choices unrelated to the pandemic."

He went on:

> "High inflation, rising taxes, and poor growth, still undermined more by Brexit than by the pandemic, will see real living standards barely rising and, for many, falling over the next year."

Is that something that we are seeing elsewhere, or is the UK unique in being in this situation? If the UK is not unique and other countries are battling the same issues as the UK—Brexit excluded—and doing just as badly, we cannot criticise the UK Government. Is the UK doing specifically poorly on these issues?

Carl Emmerson: There are different factors causing this. Next April, there will be a rise in national insurance contributions, which is intended to pay for more spending on the NHS and social care. That will reduce take-home money, predominantly for people of working age. That is an active policy decision in order to deliver better public services. I would argue that there is a strong case that that kind of measure would not have been such a surprise even if the pandemic had not happened. That was an explicit choice to take money out of people's pockets in order to spend more on public services.

There is also a freeze in income tax thresholds, which was announced last March and will come in next April. It is now the case that higher inflation, which other economies are experiencing too, means that the freeze will bite harder than it would have done had inflation matched what we were expecting last March. Indeed, over the four-year period that the freeze is expected to remain in place, we now expect that the Government will raise taxes by about £11 billion, rather than by £7 billion. It makes a huge difference.

However, the particular squeeze comes next April. It is an explicit choice by the chancellor to put up taxes to try to deal with the damage to public finances that has been caused by the pandemic. Other countries may well have to introduce measures at some point and they will have choices about those and whether they want to cut spending on public services or to put up taxes. They will also have choices about how soon they move. My suspicion is that the UK is moving relatively soon. Other countries might be avoiding the pain next April, but it is pain delayed, rather than pain that they will never go through.

As you just heard, we are also experiencing rising inflation, which is happening in many other countries, too, which eats into take-home pay for workers and the incomes of those who rely on interest income. For those who are reliant on benefit income, next April, their benefits will go up by the inflation rate from September, but given that inflation has been accelerating since September, their living standards will be squeezed for a few months, too. They will catch up in a couple of years' time, when their benefits are uprated by inflation.

However, I would stress that the next few months are going to be very difficult, particularly for out-of-work households on benefits. That is because of the price rises in energy—we know that low-income households spend a relatively high share of their budgets on that. Out-of-work households have recently been benefiting from the £20 uplift in universal credit, which ran out relatively recently, and they do not gain directly from either the increase in the national living wage or the increase in universal credit that was announced in the budget.

The Convener: Paul Johnson says that the

"primacy of asset accumulation, and the importance of asset holdings"

has been prioritised over improving living standards through earnings, which will impact on low-income households in particular. Is it fair to say that?

Carl Emmerson: The fact that people with assets have done relatively well over the past 18 months is because of reductions in interest rates. If someone has an asset that bears a set amount of income, and interest rates are lower, that asset increases in value. We can see that in the housing market and in the gilt market, too. That kind of effect can benefit those with assets.

One lesson from the legacy of the financial crisis is that, when making fiscal policy decisions, the chancellor should pay a lot of attention to the distributional consequences of what is happening to interest rates, and in particular, long-run interest rates. If interest rates are going to stay low for a long while, that will reward people who went into the most recent crisis with assets, which is a consideration that needs to be reflected in any fiscal policy choices that the chancellor makes. With hindsight, maybe the decisions that were made in the early 2010s did not take enough account of the fact that, for example, those who had already got on the housing ladder did relatively well over that period.

The Convener: Is it not the case that, if people are incentivised to invest in assets, they are less likely to invest in the productive elements of the economy that are high risk, which impacts on productivity and growth?

Carl Emmerson: There are good reasons to think that lots of accumulated savings over the past 18 months will not be spent in consumer spending very quickly. Therefore, the question is how they get invested. Maybe they will get invested in productive elements across the economy—I am sure that the savings will be partly used in such a way—but maybe they will be ploughed into areas such as residential housing. If lots of that money goes into residential housing rather than other productive uses, there is a risk that the UK economy might not be as strong as it could have been.

The Convener: Inflation is leading to fiscal drag, which is a windfall for the chancellor. What is the impact on middle-income earners in particular?

Carl Emmerson: Fiscal drag is particularly important due to the freeze in income tax personal allowance and the higher-rate threshold that was announced in the March budget. That freeze means that, as incomes rise in cash terms, more and more people are brought into the scope of income tax and higher-rate tax. With the higher inflation that we are now experiencing, those measures will bite harder than was previously expected. We are seeing quite a shift in the nature of our income tax system, particularly with the numbers brought into higher-rate tax.

As I said earlier, if you had asked me in March, I would have pointed out that the four-year freeze was expected to raise about £7 billion a year by the end of the fourth year. Based on current inflation forecasts, we now think that it will raise more like £11 billion a year. As a result of inflation being higher, there will be a substantially bigger tax rise, and therefore a substantially bigger squeeze on household incomes.

The Convener: I have one more question before I open it out to colleagues. In his speech, Paul Johnson said that, over the period since 2010,

"health spending will have increased by over 40%, education spending by less than 3%."

That relates to south of the border, and implies a remarkable lack of priority afforded to the education system, with

"spending per student in FE and sixth form colleges" remaining

“well below 2010 levels.”

He goes on to say:

“This is not a set of priorities which looks consistent with a long term growth strategy.”

What has been the impact on growth of those education policies over the past decade or so?

Carl Emmerson: The key point is that we know that spending on schools, if spent well, will have effects on future productivity. That is certainly one of the motivations for the spending. Although spending on health is a nice to have, and there are clearly good welfare reasons for it, much of the spending will not lead to higher GDP in five or 10 years, simply because much of it is going on people who, sadly, are in the last few months and years of their lives. Therefore, it is spending for a good purpose and with good reason, but it is not about future growth. In particular, over the past decade, the NHS in England has not had large increases by historical standards, and it has been under pressure due to an ageing population putting demands on its budget.

Due to cost pressures, it is difficult for the health system to be made more efficient and for its efficiency to keep up with the economy more widely. That has led to budget decisions to increase its budget pretty substantially—something like 40 per cent over a decade. The schools budget has not been prioritised anything like that much. In fact, in the chancellor’s budget speech, he made a big feature of the fact that, over the next few years, we will get schools spending per pupil in England back to the level that it was in 2010, thereby undoing the austerity that has been experienced over the past 10 years. However, to me, that is not something to brag about—we will be spending the same per pupil in real terms in about 2024 as we were in 2010. That is a remarkable period in which to have no real increase in spending per pupil. If we had kept spending at that level, and it had been done well, you would think that it would have had some positive effect on future productivity, although I am afraid that there are no estimates of how much of an effect it would have had.

10:45

Daniel Johnson: What is the view of the IFS of the comprehensive spending review in relation to Scotland? My understanding is that we will see a 7.7 per cent increase in real terms, but that is front-loaded in the first year, and there are actually small real-terms decreases. That increase of 7.7 per cent is a historically high increase in the block grant. However, I think that that profile leads to some challenges in terms of what it means over those three years. Is that a fair characterisation? Does the IFS have any insights in terms of the decisions that the Scottish Government must make?

Carl Emmerson: The spending review, overall, is clearly more generous than the chancellor indicated that it would be in September, because of his decision to top-up the spending plans for the Westminster budget—as you say, that has knock-on effects for Scotland’s block grant. There is some front-loading. For example, the chancellor has a reserve in the near term that is bigger than usual. That is sensible, given the uncertainty around the pandemic. However, money for local government in England and Wales is noticeably front-loaded, too. That will mean that, for those local authorities, the first year might be okay but, after that, they might find that they are quite reliant on council tax rises, which will clearly have consequences. One issue concerns whether they will want to raise council tax, and another concerns the fact that, if they decide to do so, the areas that get the money from an increase in council tax might not be the areas where the spending needs and pressures are.

The capital spending is also relatively front-loaded, although I have stressed that the Government is essentially locking in spending in areas in which there have already been pretty big increases in capital spending. The Government is looking to hold capital spending at a pretty high share of GDP across the UK, by historical standards.

Overall, the spending plans look like they do not imply cuts for most Government departments. They are much more generous than we expected them to be in September and they will imply bigger increases in the block grant than we expected.

In the run-up to the Scottish elections, we commented on the parties’ manifestos. We highlighted that the Scottish National Party’s manifesto included several increases in spending, such as extensions of universal provision, and we questioned whether they would be deliverable, given the UK Government’s relatively tight spending plans. As it has turned out, the UK has decided to make its spending plans more generous and it may be that the SNP can afford more, if not all, of the promises that were made in that manifesto.

I do not pretend that there will not be some pressures up ahead, not least because there being no further austerity for English departments does not mean that the austerity of the past is being undone in those budgets, and there will be some areas where spending will remain below the 2010 level for some time. Yes, we are returning to 2010 levels in relation to schools, but we are not doing so in further education colleges and certainly not in areas such as the Ministry of

Justice and the Home Office, where spending has been cut substantially. There are still some pretty big challenges for many spending departments, although the budget increases will mean that their budgets will not be anything like as challenging as they have been used to over the past 10 years.

Daniel Johnson: If I remember the election period correctly, the IFS was very fair in that it was equally withering about all the manifestos, which was good of you.

In the previous evidence session, we were looking specifically at the nature of the rise in income tax receipts, noting that Scotland was not seeing such big increases and that we were seeing big differentials between sectors, which brings challenges. Is there sufficient public policy focus on how we plug gaps in particular labour markets or address those differentials? That seems to be a new challenge, and one that is more challenging because of Brexit, but it does not seem to be getting the focus in terms of public policy that it deserves, north or south of the border.

Carl Emmerson: Brexit is clearly a big change to the structure of the UK economy. You can imagine some sectors doing well out of it and some sectors struggling. Clearly, if you are reliant on exporting to the European Union, it will be a much harder time for you than if you were in a sector that was competing with EU companies. You can imagine that the pandemic also brings with it challenges that will differ greatly across sectors. Obviously, if people's working and shopping patterns change, some sectors will be well placed to take advantage of that and some will take some time to adjust. The UK economy faces a big challenge as it goes through these big changes. The shift to net zero is another area where some sectors will gain and some lose, and the transition might well create some pain and friction. Those are all areas that need a lot of attention from policy makers.

As far as the devolution settlement is concerned, the shock of Covid and the economic lockdowns was shared right across the UK. The shock did not really hit Scotland or England alone, which is fortunate, given the current fiscal arrangements. The lesson that we should learn is that we need to carefully think through what would happen if we had another big negative shock, particularly if it was concentrated on Scotland. Would our fiscal arrangements prove to be robust in that case? I suspect that the answer is no. "Lucky" is probably not the right word to use, but it was fortunate that Covid was not disproportionately harmful to Scotland compared with England, given the arrangements in place.

Daniel Johnson: In the interests of time, I will hand over the questioning, but I hope that one of my colleagues will pick up on that interesting insight.

The Convener: We will soon see.

John Mason: In that case, I will change my plan and follow that up. In the fiscal framework review, should we seek changes to the present system?

Carl Emmerson: UK-wide, we should be thinking through the risks that are—[*Inaudible*.]—framework and reviewing it in the light of the big negative shocks that come along. We saw such shocks after the financial crisis and Covid, and we must hope that the next negative shock will be nowhere near as harmful as them.

That said, we need to remember that the next recession is never like the one before. As I said, the shock of Covid has been felt UK wide, broadly speaking, and we need to think about negative shocks that might be concentrated on one part of the UK. It strikes me that the framework that we have is not well placed to deal with a very bad negative shock that hits Scotland but not England and is not well designed for a shock that hits England but not Scotland. We need such stress testing.

If the question is whether the UK would be better served by having something more robust to deal with localised shocks, the answer is yes. We should not be complacent in thinking that the next shock will prove to be as general as the shock that we have just been through.

John Mason: Would part of the answer be to give the Scottish Government or Parliament more borrowing powers? Is that how you would deal with a more geographically specific shock?

Carl Emmerson: You could give more borrowing powers up front or have the flexibility to announce extra borrowing powers quickly if a negative shock materialised. That applies not just to Scotland but to English local authorities, which were subjected to uneven shocks—that depended on their income streams and spending needs. In England, the Government decided to compensate local authorities with broad-brush compensation that looked reasonably generous across the board, given the pressures that they were facing, but we can still imagine some local authorities not getting enough. It is very hard—[*Inaudible*.]—compensation packages that suit that, and the obvious solution is to put in place emergency borrowing powers or to set up in advance how such powers might work. You certainly want them in your toolkit.

John Mason: Thank you—that was helpful. On a different point, I asked the OBR about long-term scarring effects, but we really got only as far as the pandemic. Do you agree with its assessment that the hit in that respect will be 2 per cent, which is a permanent effect from which we will never recover, compared with the position that we would have been in had the pandemic not happened?

My other question is about the long-term effect of Brexit. Is that a permanent effect, too, or will it be overcome in due course?

Carl Emmerson: Economists pretty much agree, as much as they ever agree, that as a result of Brexit the economy will be permanently smaller than it would have been. There are also good reasons to think that the economy will be permanently smaller as a result of the pandemic, relative to what it would have been.

On the pandemic, it is pretty clear that, although unemployment has—fortunately—not been anything near as bad as we feared, some people have lost good jobs and may never get back to as good a job as they would have had, if the pandemic had not happened. It is also pretty clear that, although bankruptcies have been running at a pretty low level, some businesses that would have been viable have had a bad shock and have been knocked out of business as a result of the pandemic. Some investments in the UK are probably not located in the best places, given shocks to working patterns, for example.

We have also had a huge shock in our education system, whereby face-to-face schooling and exam grading have been messed up. It would be remarkable if that did not have negative consequences.

There are good reasons for the negative effects; where we do not agree is on a number. I do not have a number for the 2 per cent; the IFS has not produced one. However, I stress that it is very uncertain. Back in March, the OBR thought that it would be 3 per cent; now, the OBR thinks that it is 2 per cent.

There is good reason to think that there will be a number—it will not be zero; there will be a negative hit. We must hope that the next movement goes lower than 2 per cent, but what moves in one direction can easily move the other way. The chancellor does not have a lot of wiggle room relative to the amount of uncertainty that is in the economy.

John Mason: You and others have mentioned the concept of a skills mismatch—we have vacancies in some sectors, yet some people who are looking for jobs perhaps do not have the right skills, and that might have been exacerbated by Brexit and the pandemic. Will that sort itself over time or should we be seriously concerned about it?

Carl Emmerson: I suspect that the issue will in large part be sorted over time. When parts of the economy are shut down and then reopened, it is natural to have very high vacancy levels. When the economy changes its structure, it is natural for people to take time to adjust and for investments to take time to move.

Where we need to be particularly worried is for groups that we know find it harder to make such adjustments. Earlier in the pandemic, I would have highlighted not just older workers but younger workers and ethnic minorities who were being thrown out of work. They were disproportionately on furlough and disproportionately losing their jobs. Now, the evidence is that younger people and ethnic minorities have bounced back remarkably strongly, and that is a big part of the good news story on unemployment. Maybe they have found that they are more able to move to a different sector or to a different employer.

However, the story on older workers has not got a lot better. It is true that their unemployment rate has not shot up, but many of them have moved into economic inactivity. The worry is that they have moved into biding their time before they reach state pension age. Some of them may be lucky enough to have decent private pension arrangements; others may not be in that position. The worry is that they have prematurely moved out of the labour market in a way that will prove to be permanent. Relative to what I thought earlier in the pandemic, policy makers need to be a little less worried about ethnic minorities and the young and a lot more worried about older workers.

The other group that I would always be concerned about in recessions is people who have low levels of formal education but who are working in jobs that look pretty skilled and have quite a decent wage. In particular, quite a lot of men are working in—[*Inaudible*.]—productivity manufacturing that is geographically located. Brexit is a risk to such industries, and we know from the past that such workers find it hard to get jobs that pay as well as the ones that they have had.

Ross Greer: To stick with the point on skills shortages and mismatches, will you expand a little on the sectors that are experiencing a skills shortage, as opposed to a labour shortage for other reasons such as wage pressure and migration issues?

Carl Emmerson: It is hard to disentangle the two aspects. The work that we did looked at the sectors that people are in and at those that they tend to move to. Lots of people stay in the same sector, so the vacancy rate in their sector is important. However, people in some sectors move to other sectors, so the vacancy rate in other sectors also matters. For the kind of person who works in a sector from which they might tend to move into nursing or social care, the vacancy rate is pretty high.

It is pretty clear that health and social care will be a growing part of our economy for some time. It is also clear that the well-publicised shortages of lorry drivers, for example, are caused partly by the pandemic and partly by Brexit issues.

From the work that we have done, it is hard to identify how much is a skills shortage and how much is other frictions that have come into the system. In the long run, even if the friction that has come in is short term, domestic workers may need to retrain to get skills to move to another sector. An outcome that we may well see over the next few years, for example, is that more people who are British citizens will end up doing the lorry driving around Britain.

11:00

Ross Greer: I will move on to a different area. You mentioned in your initial remarks that most areas of UK Government spending will avoid cuts over the next few years and will be at the level that was expected pre-pandemic. I am interested in how you account for the specific effects of Covid.

If we leave aside the capital issues for projects such as high speed 2, real-terms spending on transport will be relatively steady over the next few years. However, patronage of buses and trains is way down and operators still require significant subsidies. If the budget is frozen in real terms and there are no cuts, a substantial chunk of that money will go into operator subsidies that were not accounted for pre-pandemic. Will that result in a kind of displaced austerity? Will there be cuts not to the overall budget but to areas of UK departmental budgets to cover for the effect of Covid?

Carl Emmerson: That is a good point. We have done work to estimate how big the effects of Covid will be on budget needs in the health service over the next couple of years. There is a lot of uncertainty but, broadly speaking, we think that the Government has found enough money to cover the normal increases that we would expect in NHS spending without a pandemic, plus the additional spending that we think as a central best estimate will be needed because of the pandemic for the next couple of years. There are question marks over whether there is enough money for year 3. It would not surprise me if the NHS ended up getting a top-up towards the back end of this session of the UK Parliament.

You are right to highlight budget increases in transport. If passenger numbers remain very low, there will certainly be challenges to rail and bus budgets. I recommend that the chancellor should stay alive to that, as he might have to allocate some of the big reserve that he has set himself. If train passenger numbers do not come back as strongly as he expects, transport may be the kind of area where we would expect him to use the £10 billion or so that he has squirreled away. There are budget increases, but I agree that pandemic pressures could be substantial and could persist for longer than we expect.

Another area where people highlight pandemic pressures is in the courts, but much smaller sums of money are involved. There are logistical issues about getting through the backlog, but money is not the reason why the courts will struggle over the next few years.

Ross Greer: Thanks—I will leave it there.

Michelle Thomson: You mentioned that various groupings—ethnic minorities, the young, the old and so on—have been affected in certain ways, but you did not mention women. Given the flexibility that women often look for in various roles and given their predominance in care and hospitality jobs, what are your thoughts about them as a vital grouping and about how the public spending outlook might impact them?

Carl Emmerson: In the raw employment numbers, the story is not as bad as we feared earlier in the pandemic. So far, women have not suffered disproportionately from losing paid work following the Covid pandemic. In part, that is because a disproportionate number of women work in the public sector, which has not shed as many jobs as some parts of the private sector have.

There are big uncertainties about how things will play out. We know that much of the burden of the increase in caring responsibilities during the pandemic was borne by women rather than men. Men did more caring than normal, but women took on more still. We do not know how widespread continued working from home will play out—whether fathers will continue to participate in more domestic chores as they did during the pandemic or whether a prolonged period of people working from home will mean that it is increasingly women who try to juggle doing two tasks at once, such as paid work alongside caring for children.

Before the pandemic, periods of part-time work led to graduate women falling behind graduate men. That is a big driver of the gender wage gap. Women with degrees do okay relative to men with degrees until they have their first child; then they move to part-time work and fall increasingly behind in hourly pay—as well as weekly pay, because they are working fewer hours. I do not know how that will play out. In environments with more flexible working, will that lead to more women working part time? If so, will that lead to a more favourable situation for mothers who work part time? Will women do more part-time work from home and will women working from home become more common? There are reasons why people could be optimistic or pessimistic on that.

Michelle Thomson: It is certainly interesting to think about. We have not touched much on structural issues in the economy that have been highlighted as a result of Covid. You talked about assets. It is commonly believed that asset values across the UK are overinflated and that that has been perpetuated for a long time because it is in a lot of people's interests. I would appreciate hearing your current thinking about that. Do you agree with that view? What do you see happening in the future? You might well want to bring up other structural issues.

Carl Emmerson: If someone has an asset such as a house and the interest rate falls, the asset's value will grow. That does not make the asset undervalued in a financial sense. A £200,000 house will be worth a lot more if interest rates are 1 per cent than if they are 2 per cent, because the people who the owner tries to sell it to might be able to finance their mortgage more cheaply.

I hesitate to use the term "overvalued". However, I might not have been clear that if we are seeing another prolonged drop in interest rates—the markets are indicating that interest rates will not just stay very low, as they have since the financial crisis, but edge down even further, if anything—that will have consequences. It means that people who have assets will do well and people who do not have such assets will do badly. People who have just bought their house will do very well, because they will have made a geared purchase—they will own a small fraction of the asset, while the whole asset is increasing in value.

Fiscal policy decisions need to take that into account. The concern is that, through the 2010s, there was maybe not enough attention on who was winning because of the asset effects and what that meant for the tax and benefit reforms that we want to do. For example, what role do we want for the taxation of capital income or the taxation of inheritances versus the taxation of earnings?

The health and social care levy will be levied on dividend income but also on the earnings of those who are in paid work. It will not be levied on those who get rental income from a property or on those who have private pension income, whose investments have shot up in value.

The health and social care levy is therefore a missed opportunity. I understand that it is hard politically to introduce a tax on pension income, but the moment to do it might be when the tax is being increased on everybody, so workers will be paying in, too, and when the money is pretty clearly going to the national health service and to social care, which will benefit everybody. In particular, the levy will benefit those who are of pension age and those for whom health and social care use might be on the immediate horizon.

That missed opportunity means that it will be quite hard for a subsequent Government to say that it will include pension income in the health and social care levy, because that would look like a targeted tax rise on a particular group, rather than including pension income at the outset, when the levy is being applied on earners, too. Policy makers need to think through such decisions in the light of what is happening to asset values and who is gaining or not gaining from those changes in our economy, regardless of whether we think that those assets are overvalued.

Liz Smith: I have just one question. Quite a few of the witnesses who have appeared before this committee have indicated that they think that consumer behaviour has changed quite markedly under Covid. Do you have any way of estimating whether that change is likely to be permanent?

Carl Emmerson: It is pretty hard to say. There have been lots of changes, essentially by design, because the recession was actively caused by Government policy. The "stay at home" message was an instruction not to spend in the economy, and lots of spending opportunities were shut. As we heard in the earlier evidence session, that led to the Government stepping in with lots of financial support, Government borrowing rose and household saving went up by very large amounts. Not everybody was able to save but, in particular, many middle and high income households did. That has a number of consequences. If consumer spending bounces back to where it would have been without the pandemic, that would be a huge increase in consumer spending in the economy, even if no one runs down the savings that they have accumulated.

I guess that your question was more focused on spending patterns. It would be quite surprising if at least some of the change in behaviour did not prove to be permanent. For example, it would be surprising if people do not spend more online—such as on streaming opportunities or online shopping—and perhaps a bit less on other entertainment and social spending. At the margins, it will be surprising if there is not a bit more working from home, which will change the location of where people are spending. Perhaps they will go less often to cafes for lunch and, if they do go to cafes, they might go to them a lot less often in city centres and a bit more often in other parts of the economy.

We have also seen evidence of an early indicator, which I thought was quite striking, of a permanent change: the number of people applying for places in primary schools in London fell. That looks to me like a large number of people are making a pretty permanent decision that they will live further away from the centre of London than they would previously have done.

There are good reasons to think that there will be permanent changes, but not all of the changes that we have seen will be permanent and it is hard to know which ones will be. For example, I am now working in the office in London three days a week. Pre-pandemic, I was doing that four days a week and, during the pandemic, I was in London zero days a week. There will be a large adjustment back to where we were, but it will not go all the way back to where we were. Where we are on that scale is hard to judge and there will be big distributional consequences between industries, parts of the economy at a very local level and different types of households.

Liz Smith: Are there implications for savings patterns as well?

Carl Emmerson: Yes, particularly because of the observation that it was middle and high-income households that were able to increase their savings. That was mainly because many of those people were lucky enough to be able to work from home, so they did not suffer any drop in their income; they just received their wage as usual and lots of their spending opportunities were shut down. They had a painful pandemic for many reasons; economically, they were not able to do the spending that they would have liked to do, so their welfare was hurt in that sense, but their bank balance really was not hurt. Also, if they had investments, such as owner-occupied housing or a private pension in a defined contribution pension, those might have shot up in value, too.

The Convener: The Institute for Fiscal Studies has been quite excoriating in its critique of the UK budget, and I noticed that one of the comments was that

“A crucial ingredient in this year’s policy decisions has been the way in which OBR forecasts appear to have driven policy.”

You touched on that a wee bit in response to Michelle Thomson’s questions, but what can and should the UK and Scottish Governments do differently in terms of fiscal policy? There has been a lot of critique—given your role, I understand that—but do you have more positive suggestions for how we can make things better?

11:15

Carl Emmerson: The critique comes mainly from the fact that, as recently as September, the chancellor was asserting that he was going to keep to spending plans that involved spending less, not more, than was planned pre-pandemic. That looked pretty implausible, and the Government is now not planning to do that.

The determination of policy decisions according to the timing of OBR events comes from what happened in March and October. In March, when the OBR thought that long-run scarring might be 3 per cent, the chancellor responded with big tax rises. In October, when it thought that scarring might be only 2 per cent, the chancellor responded by topping up spending plans but not reining back on the tax rises. The response looks asymmetric. It is an interesting thought experiment to consider where we would be now had the OBR forecast 2 per cent scarring in March and then not changed its mind in October. Would the chancellor still have had such big tax rises, or would we now be looking at smaller tax increases and much tighter spending plans? Those are the sorts of questions that we are asking.

What do policy makers need to learn from this? As ever, there is a huge focus on the central forecast. What will growth be over the next two years? What will that mean for revenues? Do we think that there will be 3 per cent scarring? I realise that it is hard for policy makers, but there is not enough of a focus on, say, what happens if things turn out to be 25 per cent better, or 25 per cent worse. How do we give spending departments the certainty that taxpayers want while ensuring that they remain appropriately nimble in responding to changing environments by borrowing more when we need to, borrowing less when appropriate, tweaking policy as we go and being clear that that is what we are going to do?

The on-going challenge is to move away from focusing on a central set of numbers—I see why they need to be produced—to more of an understanding of the alternative scenarios that the OBR is producing and of that hope for the best, prepare for the worst type of environment. Politically, that is very difficult to do, but that is what we need to hear more of. What will the UK chancellor and policy makers do if the omicron variant turns out to be much worse than hoped? What will be the response and what credible plan is in place? What happens if, as we must all hope, scarring turns out to be only 1 per cent? Will the chancellor’s priority be to cut taxes or to spend more in priority areas? If we had more clarity about how policy makers will respond to a changing environment, that would be a big step forward.

The Convener: No matter whether we move away from or keep focusing on the numbers, the IFS has still talked a lot about fairness, stagnating incomes and lack of growth and productivity. What could or should the chancellor have done differently in October, and what lessons are there for Scotland, given that our budget process begins on Thursday?

Carl Emmerson: The only thing that the chancellor did that was clearly right was to set out a four-year spending plan for spending departments. For several years in a row now, we have had one-year spending plans, for understandable reasons such as uncertainty around Brexit and in the earlier waves of the pandemic. The decision to have one-year plans was defensible and, indeed, something that we called for at one point.

That said, on the public service side, the chancellor has done the right thing by setting out priority four-year spending plans while keeping a big reserve in his back pocket that might be needed to top things up. In that respect, I go back to the transport budget that we talked about earlier. He has got that broadly right; in fact, we think that he has done well there.

What we have not seen from the chancellor is his strategy for tax reform or any long-run planning, both of which can help with fairness and growth. He produced a very good set of alcohol tax reforms in the budget. That was the sort of thing that we could not do before and was facilitated by Brexit. Alcohol taxation will look a lot better than it did when we were members of the EU and the chancellor should be applauded for that.

However, there are many other areas of Government where we have not seen coherent thinking. We have not really seen a coherent plan for the long-run future of business rates; there was some pretty small tinkering around air passenger duty; and we heard about yet another freeze in fuel duty without any plan of how we will replace that revenue when pretty much everyone will be driving around in electric cars and there will be little fuel duty or vehicle excise duty revenue. There are lots of areas where there is a lack of thinking.

Moreover, the new health and social care levy is progressive and broad-based and there are lots of things about it to make you think that it is a good tax rise. However, would it not have been better to expand the tax base a little bit more? Would that have been a bit more efficient or a bit fairer? Although there have been tax changes, I question whether they have gone as far as they could have gone.

The Convener: What about Scotland? What kind of lessons can we learn for our budget from what the UK has done? We have had six weeks to reflect on what has happened, and the Scottish ministers will be setting out their proposals from Thursday. What pitfalls should they avoid and what kinds of things can they do in a positive sense, given the policy restrictions, of course?

Carl Emmerson: You are not suddenly going to implement tax reform across the board, so my advice would be to pick a subset of taxes that are a priority, where you think that you have got the support, plus the wins from making the changes.

You do not want to be rushing into things. You want to consult widely and set up the appropriate processes to get the reforms right. You can pick any area—council tax, business rates, air passenger duty or whatever—because however good any tax is at the moment, it can be made better. You can do that in a way that raises revenue, even though it would obviously create losers, or you can do it in a way that amounts to a giveaway, but you should pick your priority and be clear about your broad objectives. There are plenty of experts who, given those broad objectives, can help you to get the reform right.

Tax reform will not be easy to sell and it will not be completely plain sailing. The worse the tax, the more arbitrary its effects are, in that there will be groups who are winning for bad reasons and who will certainly not appreciate the reform of that tax. However, the wins of a fairer and more efficient tax system are there. That matters more now, because we are going to have a high tax burden in the UK, by historical standards. There is no right answer to the question of how high our tax burden should be, but I can guarantee that the higher the tax burden is, the more costly it will be if the tax system is not well designed.

The Convener: What should Scotland's spending priorities be, given what Daniel Johnson said about there being a jump in resources this year, but a real-terms decline in the following two years? Sustainability of the public finances is, obviously, a major issue for us in Scotland.

Carl Emmerson: Indeed. I guess that, just as in England, the main determinant of how much money Government departments get will be how much money the health service needs. That is a large part of public service spending, and you can see it driving budget decisions and fiscal policy across the board. When you are dividing up the cake across public services, the share that you determine is the right allocation for the NHS will be a huge determinant of what is left over for everyone else. Balancing the needs of the NHS versus those of everyone else will be crucial.

Clearly, there is a big decision to be made about the social care budget, with big reforms taking place in England to make the system more generous. To what extent does Scotland also want to make its system more generous? Does it need to spend that money on social care or would it rather spend the money elsewhere?

The education budget is a priority. We spoke earlier about that not really having been prioritised over the past 10 years. I add to that that there is a generation that has had a bad experience as they have moved through the education system over the past couple of years. However, with regard to those who will be in the education system for a while—those in primary school, for example—there is time to make up for the losses that they have experienced. Clearly, it is harder for those who are older or who have left education but, for those who are still well within the system, we have a chance to make investments to make up for the lost in-person teaching time, which risks harming them for some time to come.

Daniel Johnson: I have a final question, following on from our discussion about labour markets, but taking a longer view.

The last two years have been a brutal shock, exposing our reliance on imported labour to make up gaps and, indeed, do certain tasks that the UK population does not want to do—essentially, low-wage, low-skill jobs.

In the longer run, global population growth, which was around 2 per cent in the 1970s and has fallen to about 1 per cent now, is projected to fall further to about 0.5 per cent in the middle of this century and come to some sort of equilibrium by the end of the century. It strikes me that any sort of model that relies on us continuing to import labour is flawed, regardless of the other things that have happened. Do you share that assumption? If so, does there need to be more focus on increasing the productive capacity of the existing population, because the economy will require working-age people to be more productive, whether by means of skills or automation? Does public policy need to be more focused on that issue?

Carl Emmerson: As those global population growth figures work through the system, there will be an ageing of the population, which is a different issue from increases in longevity, because increases in longevity can involve people living longer in a healthier state and not putting demands on the NHS. Changes in birth rates will not benefit the NHS; they will just mean that there are more people at older ages relative to the numbers at younger ages. The consequence of that is that a higher proportion of people will have to work in health and social care and those types of services, which raises a challenge for productivity performance, given that those areas of the economy that are very labour intensive are ones in which, historically, we have found it difficult to deliver productivity gains.

The UK is a high wage economy relative to most of the world, and we are a small part of the world, which means that, if we want to, we will be able to attract people from overseas. That will always be an option for the UK and any small economy that has high wages relative to most of the world. If we do not go down that route, the consequences for different industries will depend, as you say, on the willingness of the domestic population to work in those sectors, which might require moving location or taking up a different kind of work. It will also depend on the ability of those sectors to increase wages in order to attract people.

We will always need people to drive lorries in England, and it seems to me plausible that wages in that part of the economy could rise without having that great an effect on the prices in shops. However, there are some sectors in which increasing prices is not a plausible strategy. Perhaps it is a sector that is competing against other parts of the economy; perhaps it is the hospitality sector in a remote part of the country and big price rises will mean that people will not want to go there. Perhaps it is agriculture, where price rises for those goods will mean that people will just buy something else, or import something.

In the long run, we will move away from those sectors and there will need to be an adjustment. In that regard, your suggestion about there being a focus on skills, training and what people will need to be doing is a good idea. In particular, there should be a focus on further education, which has often been ignored in the UK. Around half of young people go to university, so it is important, but my guess is that higher education gets more than 50 per cent of the policy attention.

The Convener: The issue of productivity is crucial because the sectors in which more and more people are needed, such as social care, are the ones where it is hardest to deliver the productivity gains that are require.

A shortage of skilled labour for the high-tech and more productive jobs that we need to keep the economy going and create the additional resources that we want to invest in health and social care and so on will force up wages in the short, medium and long terms. How will that impact on our international competitiveness as a global trading economy?

Carl Emmerson: Many of the forces that we are seeing are global. If we need higher skilled people who are highly productive and they are getting paid more for it, they will be producing more, so I do not think that that will be a particular problem.

The bigger challenge will be the adjustments that firms must make in relation to the markets that they are accessing. I would highlight that, between the Brexit referendum and the date of Brexit, exporters had a relatively good time, because they were still members of the single market and they had a depreciated currency, which meant that they were able to compete more easily than they would have been able to do if the referendum had not happened or if the result had gone the other way.

We know that countries typically trade with the countries that they are used to trading with, and opening up new options is always harder than protecting an existing market or expanding your market in a country that you already trade with. That is where the adjustments will be harder. I see companies' ability to adapt to those new trading arrangements as being a bigger challenge than the one around labour markets.

The Convener: Thank you. We allowed 60 minutes for this session, and we have taken just 15 seconds more than that. I thank Mr Emmerson for his short, sharp, direct and stimulating answers to our questions.

11:30

Meeting continued in private until 11:37.

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