OFFICIAL REPORT
AITHISG OIFIGEIL

Finance and Public Administration Committee

Tuesday 7 June 2022

Session 6

The Scottish Parliament
Pàrlamaid na h-Alba

Tuesday 7 June 2022

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FINANCE AND PUBLIC ADMINISTRATION COMMITTEE
18th Meeting 2022, Session 6

CONVENER

*Kenneth Gibson (Cunninghame North) (SNP)

DEPUTY CONVENER

*Daniel Johnson (Edinburgh Southern) (Lab)

COMMITTEE MEMBERS

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

*attended

THE FOLLOWING ALSO PARTICIPATED:

Professor Francis Breedon (Scottish Fiscal Commission)
Kate Forbes (Cabinet Secretary for Finance and the Economy)
Gary Gillespie (Scottish Government)
John Ireland (Scottish Fiscal Commission)
Dame Susan Rice (Scottish Fiscal Commission)
Professor David Ulph (Scottish Fiscal Commission)

CLERK TO THE COMMITTEE

Joanne McNaughton

LOCATION

The Robert Burns Room (CR1)

Scottish Parliament

Finance and Public Administration Committee

Tuesday 7 June 2022

[The Convener opened the meeting in private at 09:45]

10:02

Meeting continued in public.

Economic and Fiscal Forecasts, Resource Spending Review and Medium-term Financial Strategy

The Convener (Kenneth Gibson): Good morning and welcome to the 18th meeting in 2022 of the Finance and Public Administration Committee.

Agenda item 1 is evidence taking from the Scottish Fiscal Commission and then the Cabinet Secretary for Finance and the Economy on "Scotland's Economic and Fiscal Forecasts—May 2022" and the Government's resource spending review and medium-term financial strategy. For our first evidence-taking session, I welcome to the meeting Dame Susan Rice DBE, chair, Professor Francis Breedon, commissioner, Professor David Ulph, commissioner, and John Ireland, chief executive, Scottish Fiscal Commission.

Before we move to questions, I ask Dame Susan Rice to make some opening remarks. Good morning, Susan—over to you.

Dame Susan Rice (Scottish Fiscal Commission): Good morning, convener and, indeed, to all of you. Thank you for inviting us to discuss our most recent forecasts. I am pleased to be joined by my colleagues, who have just been introduced.

First, I will say a few words about the economic context before turning to our tax and social security forecasts and their implications for the Government's funding and spending. The outlook for the Scottish economy is much more uncertain than in our forecasts last December, with the Russian invasion of Ukraine, rising energy prices and further global supply chain disruptions on the back of China's response to Covid leading to a very challenging economic outlook.

The main focus in our economic forecast has been on inflation and the cost of living crisis in many households. We are forecasting inflation to peak at nearly 9 per cent in the last quarter of the year as the October energy price cap increase comes in. We do not expect earnings to keep up with inflation, with a significant fall in real earnings of 2.7 per cent this financial year, before a return to slow growth in future years.

Since December, the position with the funding that the Government receives from income tax has, after the block grant adjustment has been taken into account, worsened, with things worsening this year and next before getting better for the remainder of the spending review. Those later improvements are due to the United Kingdom Government's promise to lower the income tax basic rate from 2024-25, which will not apply in Scotland, alongside our new baseline assumption of a frozen higher-rate threshold in Scotland. I should add that, although the Scottish Government has understood this revised assumption, its income tax policies for next year will not be set until budget time.

It is also worth knowing that the Scottish Government's funding comes under further strain in 2024-25 when it faces a negative income tax reconciliation of over £800 million. That reconciliation is the result of two factors in the budget set in January 2021, when income tax revenues were based on our forecasts, the block grant adjustment for income tax and the Office for Budget Responsibility's forecasts from November 2020.

If members cast their minds back to January 2021, they will remember that there was a lot of uncertainty about the pandemic and the state of the labour market, with many people on furlough. The forecast net position in January 2021 benefited the Scottish Government to the tune of £475 million, but we said then that we thought that that was an artificial effect of forecast timing and uncertainty, which would result in a negative reconciliation later.

Since then, we have revised up our Scottish income tax forecast, but the Office for Budget Responsibility has increased its forecasts on United Kingdom Government revenues even more, and the result is the forecasted large negative reconciliation. When the outturn data are available next summer, in 2023, we will know the exact size of the reconciliation. However, we can be confident that it will be negative, and it is likely to be large.

The tax position is part of the Scottish Government's funding position, and the size of the block grant from the UK Government is, of course, key. Overall, we expect total funding to drop slightly in real terms for the next three years, before increasing slightly.

In that context, the Scottish Government has set its resource spending review. On the spending side, social security will account for an increasing share of the resource budget. This year, social security accounts for about 10 per cent of spending. By 2026-27, we expect the figure to have increased to about 14 per cent. Since December, our forecasts on social security spending for 2026-27 have increased by nearly £1 billion as a result of higher inflation and Scottish Government policy announcements, such as the increase in the Scottish child payment to £25 per week and the plans to replace the devolved payments that are still administered by the Department for Work and Pensions. Spending in future years will be determined by policies that the Scottish Government has already set in place and by the commitments in the social security charter.

When our forecasts on social security spending are added to the Government's plans for health and social care spending, the funding lifts for other portfolios are very constrained. Once adjusted for inflation, funding in those other areas will fall substantially for the first three years of the spending review period. Funding will be 8 per cent below this year's levels by 2025-26, and it is expected to be 5 per cent below current levels, in real terms, in 2026-27.

I will finish with a short personal comment. As the committee knows, this is my last forecast, as I will be standing down from the Fiscal Commission at the end of this month. It has been a genuine privilege to lead the commission for the past eight years. I have to confess that I have both welcomed and enjoyed our regular engagement with this committee and its predecessors, so I just want to say thank you.

We will now take questions.

The Convener: Thank you very much. We will be sorry to see you go. I am sure that you said that just so that we would go easy on you for the next hour, but that is not going to happen—I am sorry. [*Laughter*.]

You touched on key issues that the committee will ask about. The first is inflation. One of the concerns about inflation is that the gross domestic product deflator of about 2.4 per cent is not realistic relative to the retail prices index. I see Professor Breedon nodding.

Understandably, we face a lot of public sector pay demands. There will be a real reduction in disposable incomes—in fact, we should note that there will be a reduction in nominal earnings before we think about taxation and disposable income. The overall figure for the economy is a 2.7 per cent reduction, but is there a difference between the private and public sectors?

Dame Susan Rice: I will turn to Francis Breedon, who was nodding.

Professor Francis Breedon (Scottish Fiscal Commission): I was nodding at the first part of the question. The second part is more difficult, because we do not give a breakdown in relation to the public and private sectors.

However, I agree with your first point. What is the real cost of Government services? That is quite a difficult question to answer. The convention has been to use the GDP deflator, but there have been a number of issues with that recently. At present, there is the particular problem that the GDP deflator does not include import costs, which are at the heart of the cost of living problems. For example, heating and lighting this building is an import cost, but it is not covered in the gross domestic product deflator because that includes only domestic production.

The takeaway is that, in some senses, you may think that the real reductions in Government spending that Dame Susan Rice alluded to are a little bigger, because import costs are going to eat a lot of the funding for Government before we start to think about things such as wage bills and other services. At the moment, looking at real falls in Government expenditure is slightly tricky.

The Convener: If an employer such as the Convention of Scottish Local Authorities were to say to unions that local authorities were happy to provide workers with a 2.4 per cent pay rise—I do not think that it is even offering that—because that equated to the GDP deflator, then straightaway there would be difficult discussions. Is the GDP deflator still an appropriate measure to use for forecasts?

Professor Breedon: It is difficult, because measuring the price of Government services is very challenging. Even the data is challenging—indeed, we have seen that during the pandemic. The Government expenditure deflator is specifically for Government services, and we have seen that yo-yoing around because the pandemic has caused us to ask all sorts of questions, such as, "What is the value of education?" and, "How much in real education services was supplied during the pandemic?" That measurement is really difficult.

The convention of using the GDP deflator, which has come from various fiscal bodies, has been a compromise: there is no good measure, but the GDP deflator is the best of the bad measures. As I said, in the current situation, one of the measure's key weaknesses is that it does not include import price inflation, which is key in the current environment. That is why there is a particular problem with the GDP deflator at the moment.

That does not necessarily mean that the consumer price deflator is a better measure to use, because there are other problems with that—

it is possible that it includes too much in the way of import costs, given what Government services are. The right way to deflate Government expenditure is a very hard judgment call.

Dame Susan Rice: Convener, forgive me for interrupting: I think that Professor Ulph wants to come in.

The Convener: Yes, I can see him champing at the bit.

Professor David Ulph (Scottish Fiscal Commission): I just want to say that there is another dimension, which is the impact on public sector workers for us as private sector workers of an average 2.7 per cent fall in real incomes. That will differ across the income distribution. We know that the extent to which wages and earnings are going up is somewhat lower for people who are lower down the distribution than for people who are higher up the distribution. Also, people who are lower down that scale tend to be more reliant on energy and food in their consumption, so the inflation that is hitting consumers will hit them harder.

In principle, you would want to have a different deflator for people who are at different points on the income distribution scale. The consumer prices index measure of inflation is just an average measure for the average consumer; it does not tell you what is happening to the real incomes of all the different consumers in the economy. You also have to take into account that incomes might be growing at different rates across a sector. It is quite hard to work out how that breaks down across the public sector versus the private sector. We have not gone into that issue in our forecasts.

The Convener: Thank you for that. I think that we all realise how incredibly complex that is. It is a tribute to you that you are able to produce forecasts as accurately as you do, given those issues.

As inflation goes up, even with increased pay rises, we could end up with significant fiscal drag, which is concerning many people. In figure 4 of your report, you talk about the implied income tax net position. What do you believe the impact of fiscal drag will be on disposable income?

Professor Breedon: Not much. Others can give a bit more detail on that. The key thing is that tax money comes from earnings rather than inflation.

The Convener: Yes, inflation and earnings.

10:15

Professor Breedon: It is an important point because that is the other feature of the current scenario—we have a lot of inflation but we do not have much earnings growth. Normally, in the case of old-fashioned inflation, earnings keep track with inflation and there is a lot of fiscal drag, where people are dragged into higher tax bands and a lot of Government revenue results from that. We will see less of that in the current scenario because although inflation is high, earnings growth is not so high. However, there is clearly some fiscal drag and some people will move into higher tax bands as nominal earnings rise. Nevertheless, fiscal drag is not as big a factor as it is in classic, old-fashioned inflation where both inflation and nominal earnings rise.

The Convener: In that regard, the Government is caught in a wee bit of a squeeze, in that fiscal drag is not bringing in as much money as it might have anticipated, because pay is not keeping up. At the same time, the Government is faced with significant pay demands.

Professor Breedon: Exactly. On the other side, benefits and things like that are being uprated by inflation. I am not saying that there is negative fiscal drag, but I am noting that it is not the bonus that it would be in the old-fashioned inflationary scenario.

Dame Susan Rice: I have a thought on the side, which is that we are projecting inflation to be rising steeply by the end of 2022. The number attached to inflation matters less than whether inflation becomes entrenched or rises and then recedes. It is important to keep that in mind.

The Convener: Absolutely. I fully appreciate that. In your report, you talk about how you expect inflation to get back to around 2 per cent. Once oil prices have jumped, and if they do not increase any more, the following year there will be zero inflation in oil prices—there is a platforming effect. I understand that you expect long-running inflation to go back to normal, rather than behave as it did in the 1979-82 phase, when inflation was at 27 to 30 per cent for two or three years.

Let me go back to taxation. In your report, you said:

> "From 2024-25 the UK Government intends to reduce the basic rate of income tax to 19 per cent. The income tax BGA will reduce accordingly, thus supporting net Scottish income tax funding."

The committee has quite a good understanding of that point, but it would be helpful if the commission were to expand on it, for the benefit of the *Official Report*.

Professor Ulph: The block grant adjustment is there to reflect what would have happened to taxation, had Scotland been part of the UK tax system. If the UK Government cuts the basic rate of tax to 19p, then had Scotland been part of the UK tax system, the tax rate would have come down in Scotland, too, so less tax revenue would have been raised. What is happening is that the block grant is not being reduced by as much as it would have been had the UK Government kept the tax rate at 20p. The fact that the block grant is being cut by less means that the net tax position in Scotland is stronger. We are forecasting an improvement in the net tax position in Scotland because of the reduction of the basic rate in the rest of the UK.

Dame Susan Rice: There is another side to that equation. Our base assumption, which we have described, is that, in Scotland, the higher tax rate does not go up each year with inflation and that the threshold stays the same, which means that over time, if that assumption bears out, more people go into that band and the take will also increase.

The Convener: That is a question that we will probably want to put to the cabinet secretary—although I expect that, prior to the budget deliberations, she will want to plead the fifth amendment in that respect.

I have one more question before my colleagues come in. On page 18 of "Scotland's Fiscal Outlook: The Scottish Government's Medium-Term Financial Strategy", it says:

> "The assumption of future Barnett consequentials beyond the core Block Grant is based on analysis of historic data."

The strategy suggests £250 million in assumed future consequentials next year and £400 million after that.

In paragraph 32 of your report summary, you talk about consequentials of £250 million, rising to £591 million in 2026-27. That is £191 million more than the figure in the MTFS. Can you talk about that? Will you also say how the Scottish Government fared in terms of its assumption about the £620 million, which the committee deliberated over considerably, and whether—or how much of—that came forward?

Dame Susan Rice: There is a lot in that question. Has John Ireland located—?

John Ireland (Scottish Fiscal Commission): Not yet; I am still looking.

Dame Susan Rice: Okay.

Professor Ulph: Regarding the second question, we have been tracking that £620 million quite carefully. We know that roughly half of it has come in, through block grant adjustments that have arisen and two fiscal events that have already taken place. We know that ScotWind, which had previously been factored into the £620 million, will no longer be used for that; it will be used for other fiscal issues, so it has come out of the equation.

The issue about reconciliations still remains open; we do not have a final determination on what is happening there. Therefore, the position that we have taken is that, in our judgment, it is broadly reasonable to assume that the remaining part of the £620 million will still come in. There seem to be enough other sources of income out there that could potentially generate the money that has not already come in of the £620 million, but we continue to monitor that.

Professor Breedon: You said reconciliations, but I think that you meant spillovers.

Dame Susan Rice: Yes, there is the spillover dispute, which is on-going, and something is expected from that, and there are consequentials from UK main estimates, so there are elements that are a little different from what made up the £620 million in December, but we still think that there is potentially enough there.

The Convener: Why is your £591 million figure different from the Scottish Government's £400 million figure?

Dame Susan Rice: I am not sure where you are—

The Convener: I am comparing the MTFS with your forecasting document. The £250 million is exactly the same as the figure that the Scottish Government gave, but you have put in £591 million for 2026-27, whereas the Scottish Government has just £400 million in 2024-25.

John Ireland: I think that we are doing it over a longer time period. From my reading of the table, the Government has made different assumptions for each financial year about the Barnett consequentials on top, but I do not have a comparison with the MTFS. Perhaps we could write to you with an explanation.

The Convener: Yes. I am just wondering why the Scottish Government has not included those figures but you have done so. That was all. There is a difference of £191 million.

John Ireland: What we were trying to do, in a sense, was to unpack the Government's assumptions. The Government has compressed a fair amount of detail in that other category and we have tried to expand that and make it consistent with what we produced in the budget documentation. That probably explains why we have a bit more detail, but I can certainly have a look at that, compare it with the MTFS and get back to you.

The Convener: Thank you very much.

Daniel Johnson (Edinburgh Southern) (Lab): Following directly on from the point about future Barnett consequentials, are you confident that the Government's approach is sufficiently robust? It sounds almost as though it is being too granular and that there is therefore quite a large contingency in those forecast consequentials in future years. Is that the position that the commission has taken or the fear that the commission has?

Dame Susan Rice: The position, and possibly the wording that we used, is that we think that the approach that the Government has taken is reasonable. Obviously, we are talking about forecasts and we do not know what those will be, but it is probably wise to have taken a look over the period of the resource spending review, so that there is a kind of baseline that is based on our tax and funding or spending forecasts now. The Government has basically outlined how it would achieve the balanced budget that it is required to have in each of the years of the spending review. If funding changes—as you know, these numbers always change over time—the Government can then make decisions based on that rather more known platform than the one that it is starting out with now. It is hard to say that the number in the consequentials is exactly right and, the further out you go, the harder it is to confirm that.

Professor Ulph: We had extensive discussions with economists in the Scottish Government about the issue, and we probed their assumptions quite forensically. We also did our own independent analysis of potential future consequentials. We have presented some of the Government's findings in a different way that we thought was better, but the numbers were the same. However, our independent analysis also suggested that the Government's assumptions about future consequentials were broadly reasonable and could be backed up.

John Ireland: It is perhaps worth unpacking the issue a little. There are two sets of numbers floating around: there is the Barnett baseline, which is the substantive amount of money of about £39 billion by the end of the period. We are confident about that. The figures for the first couple of years were taken from the UK Government spending review and, for the later years, the Scottish Government took figures from OBR projections of resource expenditure and applied the growth rates from the OBR to the Scottish baseline. Therefore, we are reasonably confident about that very large component of £39 billion; indeed we are more than reasonably confident about it.

The other part, which we talked about earlier, is the Barnett consequentials line underneath, which by the end of the period is about £0.6 billion. That is where David Ulph's and Susan Rice's points—that we have done our own analysis and we are broadly comfortable—apply. It is important to have that distinction between those two different lines in the table.

Daniel Johnson: I understood that, but it is a useful clarification. I guess that the danger is that you fall into the trap of thinking that we have always had the extra consequentials and expecting to have them again in future. I take that point.

On the difference between the OBR growth forecast and the forecast growth in Scotland, I want to unpack what is contained in your forecast. We have had a change. I understand the points about holding the thresholds rather than inflating them, and about the decision at UK level to have a 19p basic rate in future years. However, if we strip those out, it appears that, since December, the commission's forecast for earnings growth in Scotland has deteriorated. Certainly, it is clear that earnings growth in Scotland is slower than that in the rest of the UK. Can you provide any insight into what changes have occurred since December and what the likely consequences are?

Dame Susan Rice: I will answer that on a broad level, and then my colleagues can come in. If we look at GDP since December, we find that the slowing of the oil and gas sector impacts Scotland's GDP. The buoyancy in earnings in the London area this year, particularly in financial services, has been marked compared to the previous few years. That creates a bit of a bifurcation in GDP growth.

Professor Breedon: I am sure that the committee has heard us talk regularly about real-time information. That almost real-time data points exactly to Daniel Johnson's point that Scotland has not kept up with the rest of the UK in that period. That is mainly for the reasons that Susan Rice mentioned.

Looking forward, I think that a big part of the fall in total earnings is relatively slow growth in employment in Scotland versus that in the rest of the UK. There is an element of slower growth in average earnings, but I think that, of the two, the growth in employment is the bigger element of the slowdown in the first two years.

Daniel Johnson: Just to clarify, my assumption was drawn from figure 3.17, where the teal line, which is your latest forecast, is significantly lower between 2021-22 and 2023-24 than the yellow line, which is your December forecast.

10:30

We all understand the underlying issues with oil and gas in the north-east. Your December forecast included quite a detailed regional breakdown that showed that that trend was also apparent in the south-east of Scotland, a place that we might have expected not to be in the same situation and which we might have expected would benefit from some of the same things that have benefited the south-east of England, such as the financial services industry. Has the Fiscal Commission carried out regional analysis and what does it show? Why are all the regions in Scotland suffering that lag, which seems to be more pervasive than in just the north-east?

Professor Breedon: You are right that that is slightly surprising, given that there is finance in both London and south-east Scotland. We are still looking into that, but the nature of the finance industries is different. The large bonuses that are associated with portfolio or hedge fund management drive London earnings, but those are not such a big part of Scottish financial services, which do more work in other areas. That is a tentative explanation. We are stretching the data to its limits when we get down to that level of granularity, but that is our feeling about what has happened. There are particular bonuses in the financial services that are focused on in London rather than in other areas of the UK.

John Ireland: Box 3.2 of the main report repeats that analysis and goes a little bit further by looking at growth in RTI pay since 2016-17 by region and summarising all that with a nice map.

Daniel Johnson: Earnings growth and employment growth are fundamentally underpinned by growth in productivity. Figure 3.13 shows a downward trend in productivity growth since 2010. You state quite starkly in paragraph 3.39 that

"productivity growth has stalled in Scotland since 2015."

I assume that that is largely tied to falling levels of investment in oil and gas. More fundamentally, you seem to imply that there is an inflection point in this financial year when we will start to see productivity growing again in Scotland. What lies behind that assumption? That almost gives us a hockey stick. I am always slightly concerned when I see such things in forecasts rather than in retrospect.

Professor Ulph: Some of the growth in productivity simply comes from people getting back into jobs. There are quite high levels of demand to sustain quite a lot of production.

In the medium term, for the next couple of years, we are worried about the pressures that we are seeing in the labour market. Some sectors are struggling to get hold of workers. We have seen that with airlines and airports in the past few days. There is a sense that, although the total amount of labour is probably okay, it is in the wrong places and in the wrong industries. Until the economy sorts that problem out in the next couple of years, there will be issues about the levels of output and productivity that can be sustained by the workforce. That problem is not peculiar to Scotland. It is a problem in the rest of the UK and in other parts of the world too.

Daniel Johnson: I have one final question, which relates back to a question that the convener asked and to your answer about what is likely to happen with inflation in future years. The convener made a comparison to the late 1970s and early 1980s. Am I right to infer that the fundamental difference is that we have a much more globalised economy, such that the spend on items that are rising in cost is not being cycled back round our economy but is going to other parts of the world, whereas, back then, in a much more isolated economy, it would have fed back round and provided headroom for earnings to grow? Is it the case that those revenues going elsewhere in the world, particularly to China, will dampen inflationary impacts, or am I doing too much amateur economic theorising?

Dame Susan Rice: I will make one point about what we have said about inflation. It has been repeated here that inflation will be very high and that, starting next year, it will begin to come back to the Bank of England's target of 2 per cent. As we were closing out our forecasts, we looked at that very carefully and felt that it was still a proper assumption to be our central assumption in the forecasts. However, we have noted the increasing downside risk that higher inflation could last longer, which I think is what the question is about. That is certainly a risk—we are not saying that that could not happen—but our forecasts now assume that our central assumption will be the case. That does not answer your question directly, but I want to be clear that we did not have blinders on and fail to look at the possibility of worsening inflation.

Professor Ulph: Some of the inflation that we are currently suffering is imported inflation due to issues such as rising energy prices. The gas market that other consumers want to buy into is driving up the price and there are shortages of component parts coming out of China because of the Covid lockdown there. That will also have knock-on effects on inflation. Therefore, it is quite difficult to work out how far our demand is driving up prices elsewhere, and how much demand is driving up domestic prices.

Daniel Johnson: I guess it is a question of whether it is a correction or an on-going cycle.

Professor Ulph: Yes.

Professor Breedon: You are right that this is a different character of inflation. As my colleague Professor Ulph says, we are seeing a trade shock in the price of imports relative to exports, which means that, sadly, we will end up as a poorer country than we were when we entered the situation, because we have to pay more money overseas for the stuff that we require.

It is not the first time that this has happened. In the 1970s and 1980s, we went through exactly the same routine. It is somewhat different now, which is what you are driving at, partly due to globalisation and partly due to very anchored inflation expectations. It does not feel like the beginning of an old-fashioned wage price spiral, which we saw in the previous oil price shocks, partly because the labour forces are global rather than just at country level, and also because we had such a long period of low inflation, it will take us a while to get back into the habit of trying to claw back surprise inflation each time.

However, at the moment, we and all other forecasters are making the assumption that it will be a one-off and will not lead to an attempt to claw back the higher inflation in higher wages. I think that you are probably right to say that the fact that all forecasters have made roughly the same judgment as we have does not necessarily mean that it is the right judgment—it just means that we have made the same judgment.

Michelle Thomson (Falkirk East) (SNP): I was going to raise similar questions and ask how confident you are—accepting what Professor Breedon said about everyone else making the same prediction—that inflation will peak at 8.7 per cent in the last quarter of this year. When you read more detail about some of the uncertainties that you point out on the supply side—which we have much less understanding about—realistically, how confident are you? We know that the prediction will probably be wrong, which I fully accept because all these things can be wrong, and Andrew Bailey recently conceded that the fiscal levers that he has to exert control over CPI inflation are fairly limited. It is always uncertain, but how uncertain is it? If I asked you to place a wager of, say, £500 of your own money, how much of that money would you risk? Perhaps that is a better way of putting it.

Dame Susan Rice: David, how much would you risk?

Professor Ulph: I will get my chequebook out.

The issue is that, as Susan Rice mentioned, we are talking about two components. There is the question of what level inflation could get to and there is the question of how prolonged the period of inflation could be. One problem is that inflation is quite volatile, and it depends whether we are looking at monthly, quarterly or annual inflation rates. We could be out a little bit on that because of a spike in one of the monthly levels of inflation.

We come back to the question of how confident we are that inflation will drop significantly back down towards the 2 per cent level. That is where the greatest uncertainty lies. The question of how embedded inflation gets depends on whether other sources of shortages that we have not been aware of emerge over the next year or so.

I go back to the point that Francis Breedon made. At the moment, it seems to be the case that, because we have had many decades of quite low inflation, inflation expectations are anchored at quite a low level, so there is not the same spirit that there was back in the 1970s and 1980s whereby, as soon as prices started to go up, people immediately thought that they should get higher wages. There is a recognition that wages might not always go up at the rate at which prices go up. That anchoring of inflation expectations could still hold inflation down a little.

There is also the arithmetical point that Susan Rice mentioned. Inflation is about the rate of increase in prices, so even if oil prices stay high, inflation will still go down, because oil prices will not carry on rising. That is one reason for our view that inflation will come down. We do not see obvious forces that will continue to drive up prices. That does not mean that we think that prices will go down—we think that prices will probably stay high and that that will still have impacts on the cost of living—but we do not see forces that will drive them up.

Dame Susan Rice: The other element on the periphery is that, over the spring, the Chancellor of the Exchequer put some money on the table. The most recent packet of money, which he provided in late May, benefits lower-income households in particular. That is a one-off, which should, for this year, keep those households relatively okay as regards the increase in the cost of living. We are very cognisant of the fact that, at the end of the day, we are talking about households, people and communities. If, in general, those households are not suffering from the cost of living crisis because of that one-off grant—some will even be better off as a result of it—that creates less pressure to pump up wages more and more.

Putting all those factors together, that is why we thought that it was at least still reasonable to think that inflation might not last all that long.

Michelle Thomson: Okay. I will collect £500 from all four of you at the end of the session.

I am not clear about how and where you baked the impact of Brexit into all your forecasts. I assume that you have reflected all the way through your forecasts the hangover from the pandemic and the supply issues that we have talked about, which have reverberated around the world, but I was slightly surprised that there was no mention of Brexit in your report, given that we now know that the impacts are only starting to be felt. I appreciate that it is complex to pin Brexit on one thing, because it is a very fragmented picture, but I was surprised that there was no mention of it. How and where have you baked it into all the numbers?

Professor Ulph: The answer is that it is baked in, in the sense that it is now part of the baseline assumption in the economy. For a number of years, we talked explicitly about Brexit and how it was having an impact on our forecasts, but it is now baked into the forecasts on what will happen to the economy. I said that there might be subtleties about how far Brexit is driving some of the inflation stories that we have been talking about, but it is too early to disentangle the effects of that from all the other factors and draw a view on that.

Michelle Thomson: Is that similar to what you have done with the pandemic? Have you taken the same approach?

Professor Ulph: Broadly—that is in there already.

Michelle Thomson: It is there. Okay.

10:45

Professor Breedon: If we begin to observe the Brexit effects being different from what we have baked into the forecast, we will make an adjustment at that point. At the moment, it is too early for us make a judgment on whether our original judgment was incorrect, so we are still running with our original judgment on the effect of Brexit.

John Mason (Glasgow Shettleston) (SNP): I have a few things to ask about. However, first of all, I want to say how much I have appreciated working with Dame Susan Rice over the years. I was on the Finance Committee before the Fiscal Commission was set up and was involved in that process. I have had a long-running relationship with the commission and Dame Susan and I have very much appreciated that.

We have spent quite a lot of time on inflation. On social security, the numbers are going up quite dramatically. It has often been said that if we give more money to people who are less well-off, that will have a secondary effect of boosting the economy, because they will spend the money in local shops on local goods and services. However, when people who are better off have more money, they might spend it abroad or on other things. Does that secondary effect come into the forecasts, or can we not really go that far?

Dame Susan Rice: A lot of the growth in social security benefits relates to how much more the Scottish Government must fund them beyond the amount that comes from Westminster for the original shape of those benefits. That comes with opening up the benefits in various ways in terms of eligibility and length of time on a benefit. One of the things that now kicks in significantly is that a majority of the benefits—not all—increase with inflation. A suite of disability benefits—the adult disability benefit is the big one in number terms—will increase with inflation. Some of the growth is for that reason.

The Government's focus on child poverty has led to the expansion of the age range of children whose families can get the Scottish child payment, and the payment, which increased by £20 a week earlier in the year, is now £25 a week. The growth is not only because of growing inflation but because the benefits are significantly different.

John Mason: Does it make any difference to the economy that the Scottish Government is putting money into social security, which is clearly its focus? That money is going into the pockets of certain groups and on from there. That is in contrast to money that goes to Scottish Enterprise, which might go to international companies.

Professor Breedon: Yes, to a small degree. You are exactly right that, if you give money to people with a high propensity to spend, that money will quickly re-enter the economy and more so than it would if you give it to someone with a very high propensity to save. That effect is there.

We do not track that directly. Overall, the effect is relatively weak. The people who receive benefits will not be paying more income tax; rather, the effect is on the shops where they go to spend their money, which means that the incomes of the people who work in those shops might go up. It is a second-round effect. We have not explicitly modelled that, but my guess is that it would have a relatively small effect.

Professor Ulph: Another point to make is that you are talking about "the" economy, but it is about more than just the aggregate or average economy; it is also about the distribution of wellbeing across individuals. Social security subtly plays a role in giving you a distribution of wellbeing across individuals that is different than would be the case if you did not have those programmes in place.

John Mason: Absolutely. That is a key point.

The reconciliation of £870 million sounds quite scary. However, previously we thought that we had quite a large reconciliation coming along but it turned out not to be quite as bad as that. Should that make me hopeful that, once again, things will improve, or are things very different this time?

Dame Susan Rice: We really do not know because the numbers that will define and make specific that reconciliation are the outturn numbers that will come out in the summer of 2023. We see the income tax numbers 16 months after a budget, so we do not know yet.

John Mason: Am I right in saying that, last time, even at the end of the year in question, we still forecast a more pessimistic position than turned out to be the case? It is hard to know in advance.

Professor Ulph: Yes, it is hard to know.

John Ireland: There are two components to the £870 million reconciliation: pay as you earn and self-assessment. We are talking about tax that is collected in 2021-22. Real-time data comes in every quarter on the pay-as-you-earn element, so we can be reasonably sure about that component as we get towards the end of the 2021-22 financial year and past that point. However, the difficulty is self-assessment, which we just do not know about.

We know some stuff. Pay as you earn is bigger than self-assessment but we do not know the self-assessment stuff, which could move quite a lot. It might be as bad and it might be worse.

John Mason: Is that because the balance between the number of people who are self-employed and those who are employed can change a lot from year to year?

John Ireland: That is part of it for sure but it is also because 2021-22 was the tail end of the pandemic and funny things were going on with self-employment because of furlough. It genuinely is a big question mark.

Professor Ulph: The other thing about self-employment is that, for very high earners, it is often driven by bonuses in the city. Those are inherently hard to forecast. We have had high levels of bonuses this year but that can change from year to year.

We are pretty confident that the reconciliation will be negative. It will not suddenly become positive again, but it is harder to be confident about whether it will be £600 million or £900 million.

Professor Breedon: That is a key point. To go back to your original question, it could be worse so do not think that, because it is uncertain, it could be good news. Sadly, because it is uncertain, it may be even worse news. That is a depressing message to keep in mind.

John Mason: I thought that I was pessimistic but that underlines it more.

There was a suggestion that you were going to investigate further the slower employment growth in Scotland compared to the UK. Will you expand on what you are going to do?

Dame Susan Rice: We continue to consider the matter. Someone referred to figure 3.13. We did not produce that figure for this purpose but it illustrates a demographic point that we have made at the committee over the years, which is that we have a population that is getting older and therefore coming out of employment, but we do not have the replacement population. The 16 to 25-year-olds—the people who might be going into employment—are a smaller group. The issue is not just the upper end of the age range but filling in the workforce from below.

Professor Ulph: The issue is the participation rate among younger workers. It seems to be lower in Scotland and has been for a while. To be honest, we do not know precisely why that is. One reason why we might have lower participation is people going into education and delaying going into the labour market. It might be that, if people perceive greater uncertainty in the future, they feel that they need to get more qualifications.

That could be part of the story but it would not explain why there is a difference between Scotland and the rest of the UK. We will look into that in more detail. It is hard to get all the data that you need to do that.

Professor Breedon: A key question is whether that is a one-off and things will go back to normal in future years or whether it is a secular trend. The difference between those two outcomes is hugely important for the Scottish economy. I am not sure that we will get to the answer to that question but we are trying to dig down to discover whether something is going on that has big implications for the sustainability of Scottish finances in the long term or whether it is a one-off and in a few years' time we will look back and scratch our heads about it when it has already stopped.

John Mason: Would life expectancy be part of that equation, given that it affects things such as the proportion of the population that is working? It seems to be a UK-wide issue.

Professor Breedon: Exactly. Obviously, we can predict the demographics with a relatively high level of confidence. As David Ulph said, we are scratching our heads about that issue of participation among younger people. It is important to get to the bottom of that question.

Douglas Lumsden (North East Scotland) (Con): I, too, want to ask about the £620 million pot. I am quite new to this and am still trying to get my head around it. How much was ScotWind going to contribute to that £620 million, at the start of the year?

John Ireland: That question is probably for the cabinet secretary.

Douglas Lumsden: It is just that I struggle to see the transparency around that £620 million. I do not understand how you can approve it, almost, or say that it is okay, if you do not know what is going to be in it.

John Ireland: We had some conversations with Government officials, but those were in confidence, so the best thing is to ask the cabinet secretary about the components of that £620 million.

Douglas Lumsden: Could that figure have been higher at the start of the year? For example, if I was to say that we should spend another £50 million on child poverty, I would have to say where that money was going to come from. At any time, could I just say that that £620 million could be made into £670 million? Is there a flexibility for that to go up, just like the other forecasts?

John Ireland: From the very early days of the Scottish Government budget, there has always been an additional lump of money, to a degree. There have been various conversations about that in this committee—people have referred to it as money hidden behind sofas. However, over the past three years or so, the Government has been much more transparent about the size of that and what goes into it, and we have certainly been pressing the Government on that quite a lot.

In the current report, again, there is more transparency than previously. For example, we now know that about £660 million of ScotWind money is going to be drawn down in the first two years of the resource spending review period. That commitment is about £670 million; and, if you dig around on the Crown Estate website, you can find a rough indication of how much money it was thinking would come from ScotWind.

It is reasonable to assume that most of that ScotWind money is in the resource spending review for the future. From that, you can infer something about what happened in the past. My going much beyond that is probably not proper. It is a matter for the cabinet secretary.

Douglas Lumsden: But am I right in thinking that it is not easy to work out what constituted that £620 million at the start of the year?

John Ireland: We were given a story about that, which, after some probing, we judged to be reasonable. However, we are trying to work towards much more transparency. You have to credit the Government with moving a massive distance from its position five years ago to where it is now. It goes into the documentation, there is a degree of narrative, and it tells us stuff. This year, that transparency has increased. The Government is moving very much in the right direction to improve transparency.

Douglas Lumsden: I guess so, but it still worries me that, for example, money comes out of that £620 million—the ScotWind money, for example—and, magically, other things appear that make that figure still achievable. That has happened once already, to do with Covid recovery money, and now we have it with ScotWind. I will ask the cabinet secretary about that.

My other question is about non-domestic rates. In the table, the tax take from that goes up from £2.7 billion to £3.3 billion next year. Some of that will be because Covid relief funding came through for retail, hospitality and leisure, but it is still a 20 per cent increase. Was there any narrative on why it would increase by so much? It also increases by 9.8 per cent between 2025-26 and 2026-27. Do you have any detail on that?

Professor Ulph: We have revised down some of our forecast for NDR, because of appeals losses. We had assumed that a certain level of appeals losses would materialise over a period of time. However, we were getting into a position where that level was already being hit, so, we thought that it was reasonable to assume that, in the future, there will be even more appeals losses; we have revised down the monthly NDR that will be collected over the next few years because of those appeals losses.

11:00

Douglas Lumsden: Yes, but the take is going up by 20 per cent.

John Ireland: Figure 4.17 in the report breaks down the change in the forecast between December and May. As you go out, more of that increase is basically due to inflation. There is a total change in 2026-27 of around £132 million since the December forecast, and around £136 million in that equation is because of inflation. Inflation is the main driver of increases towards the end of the forecast.

Douglas Lumsden: It is not really growth, because we can see that the growth is quite flat. Businesses will pay more because of inflation, which affects the forecast.

John Ireland: Yes, and underlying that is an assumption about the poundage. We assume that the poundage will go up with inflation, but if you look at how the poundage has actually moved, it tends to be a little under inflation, so there may be a bit of difference because of that.

Douglas Lumsden: In three years' time, when it goes up by another 10 per cent, will that be around revaluation time, or might there be something else happening?

John Ireland: Revaluation is a factor and there are lots of rumours at the moment, but on balance, we do not think that there is enough information to say where revaluation will go, so we made a pretty neutral assumption about it.

Douglas Lumsden: It is still going up by 9.8 per cent.

John Ireland: Looking at the NDR table, since the December forecast we have made changes for a couple of years' time that are principally due to inflation. I am just trying to do that thing that you have been doing in your head as well. My hunch is that the principal driver of increases in the second half of the forecast is inflation.

Liz Smith (Mid Scotland and Fife) (Con): I will ask specific questions about where you, as forecasters, think there is the best potential for improvement in productivity and economic growth. Obviously, that is the bottom line in trying to improve the Scottish economy for the future.

I know that you cannot set policies and will not comment on that, but how easy is it for you as statisticians and people who are analysing the various trends in the economy to spot where there is the best potential for improving productivity and economic growth in the current set-up?

Professor Ulph: That goes beyond our remit as forecasters. First, you have to realise that there are different definitions of productivity. There is productivity in terms of output per head, but there are much wider definitions of productivity. The answer to your question probably depends on which measure of productivity you are talking about.

A general driver of productivity is when things become very expensive and people find alternative ways of doing them. For example, if there is a shortage of people to pick fruit, that causes a real problem for the fruit industry. There was an article last week about sophisticated automatic fruit pickers that have been developed. If those were developed in Scotland and if Scotland could then sell intellectual property rights around the world and capitalise on that discovery, that would bring a lot of income to Scotland and increase productivity, because you could pick far more fruit than you would do otherwise, given the current workforce.

Those are the normal sources of productivity growth. It comes from technological improvements and innovations that are driven by the need to overcome the problems and shortages that are found in the economy.

Liz Smith: Some of your recent analysis highlighted the fact that there are issues in relation to tax revenues from the north-east and the fact that some parts of the labour market there may change as a result of the just transition and changes in the structure of the economy.

Is it within your ability to set out where you think the greatest impact of the changes to tax revenues might be in the future, or is that something that you would let the Government do? I see tax revenues as absolutely critical. You have said in several consecutive reports that tax revenue is absolutely critical to how well the Scottish economy can perform. I would like to know how easy it is for a Government to set policy on the basis of your interpretation of that.

Professor Breedon: I will add a slightly left-field comment. In some of my research, I look at small economies. Scotland is not one of those, but is close to being one and is particularly close to Iceland, which a country on which I have done a lot of work. One thing that is notable in smaller economies is the importance of softer areas of productivity growth, such as social capital and social cohesion. The economics of a country like Iceland look awful: it is a tiny cold island in the middle of nowhere with about three trees. It really does not have much going for it, but it has been a very successful and productive economy. One of the key reasons for that is that there is a strong identity among the people and strong social cohesion in that country.

Our role as the Scottish Fiscal Commission means that we have a very fiscal and money focus, but productivity growth is not all about money. It is also about the softer ways in which countries develop. I chip that in as a slightly left-field way of thinking about productivity.

Professor Ulph: As forecasters and analysts, we do a more negative thing—unfortunately—which is to identify the reasons why things are not going well. Being able to say how that compares to what is going on in other places might suggest that, if only we could do what they are doing, that would be a way forward. Whether something is a feasible and viable policy for Scotland is a different issue. We do not see it as our role to work out what policies the Scottish Government should have for driving up tax revenue.

Liz Smith: I absolutely understand that, but if we are to set effective policies it is helpful to know not only where the negative concerns are but where the potential for growth is. For several years now, your reports have highlighted tax revenue as being absolutely critical.

You have highlighted this morning, as well as within your report, that there are different factors to inflation. One is the cost push angle. Global prices, particularly in the energy market and in supply chains, are clearly causing very significant cost push. There is also the demand pull side. We are obviously hoping that demand within the economy and an eventual increase in earnings will drive that up. Are there different timescales in which the inflation effect will start to diminish? Is it different for the cost push and the demand pull? What is the likely scenario for when we will start to see inflation tailing off? Will that be largely because of cost push or demand pull?

Professor Ulph: We think that the cost push element will bring inflation down quite rapidly in the next few years. We do not see sources of cost push that would sustain that rate of growth in price increases.

There is still quite high demand. People coming out of the pandemic have accumulated lots of savings. That does not apply to everyone, but certain parts of the population have savings. That money is there to be spent: people have not blown all of that, so there are still potentially quite high levels of demand to be met. If you wanted to see inflation falling away, you would look at the cost push element.

Professor Breedon: That is right. If we go back to the earlier discussion of our fears about prolonged inflation, that comes from the demand side. Anything could still happen, but as we have discussed, the feeling is that this is a one-off and the most likely scenario is that inflation is coming from the cost push side. The question is whether that, in combination with a tight labour market, will then get translated into a longer-term inflation problem. That is where the risk comes from.

Liz Smith: Thank you; that is helpful.

The Convener: Iceland has always been socially cohesive, but it was also historically one of the poorest countries in Europe. Independence in 1944, harnessing geothermal power and victory in the cod wars in the 1970s probably had a significant and positive effect.

Ross Greer (West Scotland) (Green): How do I follow that?

So much has been covered already, so I have only two questions this morning, the first of which goes back to Daniel Johnson's theme of productivity and, specifically, the assumptions that you have made about this year's inflection point, which is in figure 3.13, and the growth in productivity. David Ulph said that the assumption is not about getting more people into jobs, because unemployment is low, but about getting more people into the right jobs.

The highest-profile examples of labour shortages during the past year or so have not been in particularly high wage sectors. Retail and hospitality have been some of the biggest examples. Could you expand on the assumptions that you are making about that rearrangement within the labour market? From what you said previously, I take it that there will be sectoral winners and losers, because it is not about reducing unemployment, which is already quite low, but some sectors will end up with labour shortages as a result of workers moving into the sectors that will result in the kind of productivity growth that you are assuming. Could you expand a little bit on the underlying assumptions there?

Professor Ulph: Labour markets should work in this way: you get adjustments in wages and adjustments in people's expectations about where they are likely to get good employment, and those adjustments end up shifting labour around between sectors, so that you get the right amount of people in the right sector. In the longer run, therefore, we expect markets to work and broadly to sort that problem out.

It is quite hard to say exactly how that will break down, sector by sector. It will depend on what responses there are on wages in different sectors, what type of sector it is and what type of wage negotiation goes on in that sector. There are a lot of factors, therefore, which makes it hard to predict the detail of how it will go, but, broadly speaking, economists take the view that such things do get sorted out. There will be some levels of wages across the different sectors that will get the right people into the right jobs.

All that said, it is still widely predicted that the Covid pandemic will have long-running scarring effects on young people. People who came out of school thinking that they might go into the hospitality sector, develop some skills there and move on to start running their own pub or restaurant at some point, saw all the early stages in their career taken away when the hospitality sector was closed. They are now faced with new school leavers competing for the same jobs, as the hospitality sector opens up again, so their job-market profile is very different from what it would have been had the pandemic not taken place. That could have long-term effects on their salary levels and prospects of promotion.

We certainly expect the pandemic to have long-term effects on workers, and that there will be workers in various sectors and jobs who will not have the same jobs and salaries that they would have expected to get had the pandemic not taken place.

Ross Greer: Taking on board what you have just said about it being difficult to predict what the impact of the pandemic would have been on various sectors, I want to press you on one element of that, but not on a specific sector. Are those assumptions based more on assumed growth in existing high-wage sectors or on an increase in the average wage in low-wage sectors such as retail and hospitality? What is the balance? Are you assuming that there will be an improvement in pay in the low-wage sectors or that people will continue to move out of them into existing high-wage areas?

Professor Ulph: To be honest, we have not broken our analysis down to a level that will enable us to see where some of that matching is worse, where it will go in the future and where wages will go. All of our forecasting is still at a pretty high level and I do not think that we can break it down to quite that level. Francis Breedon might want to come in on that.

11:15

Professor Breedon: That is exactly right. We have not got down to the level of who has got to move where. However, I think that you are right that there is a degree of labour market mismatch at the moment. There are people in the wrong jobs and there are vacancies in some sectors and people still employed in sectors that need to shrink or do things differently.

We have not looked at the detail of those flows. Another reason why analysing the economy is hard right now is that we do not know what the economy will look like when everybody has shifted place and everything is back to normal. We are still in the transition and the mismatch is still being worked out. Therefore, the economy feels tight, but that might just be because the mismatch is still being resolved.

Ross Greer: I will stick with that spirit of high-level assumptions. I have one final high-level question, which is probably just to ask you to pull together various points that have already been made. In its precursor to the spending review, the Institute for Fiscal Studies said that, in essence, the cabinet secretary had the options of “axing, taxing, and hoping”. “Hoping” would involve kicking the can down the road and hoping that more money would somehow appear later. It boils down to the choice between making difficult decisions now or just hoping that things will get easier in the future. On balance, do you think that the spending review was a successful exercise, if the measure was making difficult decisions now, or is a high level of can kicking still going on?

Dame Susan Rice: May I just make a point about the IFS’s view, report and article? It published that article on the Friday before the Tuesday on which the spending review and our forecast were laid before Parliament. Therefore, because of the timing, it did not have the advantage of either our up-to-date numbers or, in particular, the Government’s view on how we would achieve balanced budgets based on those up-to-date numbers. We need to put the comments in that context. However, in principle, the right challenges were being raised: what happens here?

You asked whether the resource spending review was a sensible thing to do. I think that I referred to that previously and that my colleagues would agree that, overall, although some people might say that it was a brave thing to do, it seems that it was right to do it because it gives—“currency” is the wrong word. It provides the concepts that the Government can use as the actual numbers come in and it can see what funding there really is over the next year and the year after and what the costs are—what its spending really is. The Government will have to make adjustments, but its approach is more anchored and more rooted because of the spending review, so I think that it was a good thing to do. Colleagues, do you share that view?

Professor Breedon: Yes, because, by its very nature, that document had to be published with balanced budgets projected into the future. That meant that the question that you asked at the beginning had to be answered. There was no way to dodge it, because there was no alternative. There was nowhere else to put the mismatch—the funding gaps, or whatever you call them. In that sense, it has provided a fair amount of clarity as to how the situation will develop.

Professor Ulph: Another thing is that, within the figures that we published to support the spending review, there are elements of both taxes and cuts in spending. The baseline assumption is that the higher rate tax threshold will be frozen. That will generate more tax revenue, which is reflected in the assumptions, the forecast and the spending review. However, as Susan Rice said in her opening remarks, we have seen significant cuts in real spending in the non-health, non-social security area. Therefore, there has been a combination of taxing and axing.

Ross Greer: Thanks. I can see the cabinet secretary at the door, so I will wind up my questions there, convener.

The Convener: Thanks—I appreciate that. We have many more questions that we could ask, but time is against us and, as Ross Greer has pointed out, the cabinet secretary is waiting to come in. We have another evidence session to begin.

I will wind up the session by formally thanking Dame Susan Rice for all her phenomenal work over the years and her leadership, wisdom and insight, which have proved invaluable to the committee. Like John Mason, I was here at the very birth of the SFC, and it is great to see how it has developed and flourished over the years. I am sure that it will continue to do so.

I will see you tomorrow, Dame Susan, at the Scottish Parliament information centre briefing, which starts at 8 am—with bacon rolls, just for those who are not already sold on the idea of attending. The committee will take a break until 11.25.

11:19

Meeting suspended.

11:25

On resuming—

The Convener: We continue our evidence taking on "Scotland's Economic and Fiscal Forecasts—May 2022" and the Scottish Government's resource spending review and medium-term financial strategy. I welcome to the meeting the Cabinet Secretary for Finance and the Economy, Kate Forbes MSP, who is accompanied by the following Scottish Government officials: Andrew Watson, director for budget and public spending; Gary Gillespie, chief economist; and Andrew Scott, director of tax and revenues.

I invite Ms Forbes to make a short opening statement. Good morning, Kate.

The Cabinet Secretary for Finance and the Economy (Kate Forbes): Thank you very much, convener.

I thank the committee for its input into the resource spending review and the medium-term financial strategy.

Obviously, this is a hugely challenging time to be delivering a spending review. We are recovering from a pandemic as well as experiencing an unprecedented cost of living crisis, and there is quite clearly significant volatility in the funding outlook. Despite that, I think that our partners appreciate their having as much certainty and transparency as possible in our setting out the spending parameters for the next few years.

That is what lies behind the spending review, which commits £180 billion over the next few years. We started the process by focusing on a number of key objectives and priorities. Where you have priorities, you, by extension, focus your attention and funding on them. Those priorities include tackling child poverty, transitioning to net zero, economic recovery, and strengthening the public sector in Scotland. In addition to that, we have added as another priority responding to the cost of living crisis.

We have also set out commitments to drive reform and greater efficiency across the public sector because, notwithstanding the current uncertainties, the funding position is constrained. As far as that position is concerned, the assumptions in the MTFS and the spending review are based principally on the existing block grant settlements as implied in the 2021 UK spending review, the OBR forecasts of future public spending, and updated tax and social security forecasts from the Scottish Fiscal Commission.

When the UK spending review was set last autumn, inflation was about 3.1 per cent. Despite the fact that inflation is now hitting a 40-year high of about 9 per cent, the UK Government has not updated its spending plans. We have far less funding in real terms, and we have had to use the best available assumptions. In addition, there has been a real-terms reduction of 5.2 per cent between last year and this year, and our real-terms funding will grow by only about 2 per cent across the whole four-year period, once we account for the devolution of social security benefits.

As the committee knows, I have highlighted some of these challenges with regard to delivering our priorities, and there are other issues that emerge as a result. That also goes to the heart of a point that the committee has made in the past about the limitations of the current fiscal framework and the lack of economic and fiscal levers available to the Scottish Government to manage the volatility and risk that are inherent in any forward-looking spending review.

Finally, we have also undertaken a targeted capital review to address a lower than expected capital grant allocation provided by the UK Government. As members will recall, we had set out our capital spending review in advance of the UK Government's own spending review to try to provide as much certainty as we could in emerging from the pandemic. That review will invest around £18 billion between April 2023 and 31 March 2026, with over half a billion pounds of additional funding directed at net zero programmes compared with the funding in previously published plans.

As a brief conclusion, the aim of the plans is to provide as much long-term certainty as possible in an extremely volatile economic situation.

The Convener: Thank you very much for that opening statement.

It is significant that you have very little room to manoeuvre. I think that the committee appreciates that fact, but we will ask questions about the Scottish Government's choices and the reasons for making them.

First, some outside organisations have expressed an element of frustration about the detail that has been provided. I know that you will want to make it clear up front that this is not a budget but a resource spending review. However, the concern is that we have received only level 1 and level 2 funding figures, and organisations are obviously wondering where they fit into some of the decision making that is taking place.

11:30

Kate Forbes: That is a fair question, and it was captured in the Fraser of Allander Institute's pre-RSR publication analysis. I think that the Fraser of Allander Institute asked about the level of granularity that could be published and suggested that we publish just a high-level narrative with priorities.

I thought that it was important that we provide as much granularity as possible. That is why it goes to level 2. Due to the level of volatility in the funding—I can unpack a lot of the assumptions that underlie the available funding—it is extremely difficult to be any more granular than level 2. Even providing level 2 detail was challenging.

The reason for that is partly driven by inflation. As I have already said, much of our spending review is based on the UK Government spending review, as members would expect. Inflation was at 3.1 per cent; it is now at 9 per cent, and it is going to rise. We have to make a judgment about the risk. Being too granular carries its own risk in terms of planning things that might not come to pass.

It is not easy and, at the end of the day, this is not a budget. We will set out our tax rates and our public sector pay policy, for example, in advance of each budget.

You are right to comment that it is a judgment call. We have pushed as hard as possible to be as granular as possible in an extremely volatile situation.

The Convener: From my reading of the situation, it appears that you have been very cautious in your spending proposals. I imagine that you hope to be able to add some resources to the figures that are outlined.

To start with the level 1 figures, in your statement to Parliament last week, you said:

"We have prioritised spending on health, social security, education and tackling climate change".—[*Official Report*, 31 May 2022; c 11.]

However, if we look at the education and skills resource, we see that, during the first four years of the spending envelope, from this year onwards, there appears to be virtually no increase—there is just a 1 per cent increase in cash terms over the next three years. It is interesting that there is then—in 2026-27—a huge jump of about 17 per cent. There are a number of other areas in which we see significant changes in that last year. Why is that the case? If the decision is that education is to be prioritised, why has the funding for it been kept very tight over the next few years before there is suddenly a significant jump in 2026-27?

Kate Forbes: Much of that goes back to the core objectives that I set out, such as tackling child poverty. Much of the spend for that is in the social security line, as members will see, but there is also much of it in the education line, which covers, for example, the roll-out of free school meals and early learning and childcare expansion.

We have tried to ensure that the trajectory of spend in each portfolio matches the plans for the roll-out or expansion of particular initiatives. Someone else might want to come in on the breakdown by year, but that has been our starting position. We have tried to match the funding to the commitments that have been made which are specifically tied in with core objectives.

There is another element to that. The trajectory is quite bumpy over the next few years because of the impact of reconciliations that need to be accommodated. For example, there are larger reconciliations in certain years than there are in others, and that eats into spending power, because there is a limit on borrowing of only £300 million to manage some of those reconciliations. You have to use your core spending power to make up the difference, as it were.

We have also tried to smooth the trajectories so that, for example, we do not have a portfolio that has to deal with a rapid and sudden drop in one year, only to have a climb up in the following year, because that involves employees, or workers. You cannot expect a portfolio such as education to see a drop. Therefore, we have tried to smooth the trajectory over the period across portfolios.

I hope that that answers the macro question as well as the particular question. I do not know whether anyone else wants to add anything.

The Convener: It is just that, in real terms, there will be a decline in education over the next three financial years and then, suddenly, there will be quite a dramatic increase, and that is repeated in a number of portfolio areas. Time is against me, so I cannot ask all the questions about that that I want to ask, but I will try to touch on a number of areas. Colleagues can follow up on some of my questions if they so wish.

Another area is local government. Local government is alarmed and, although you have said that it will have a fair settlement over the years ahead, I do not believe that it would agree with that. How does the static budget—or declining budget, when inflation is taken into account—allow flexibility for local government? Local government spends much of its funding on statutory services. It has to provide those services; it does not have a choice. Statutory services already have a higher proportion of spend than perhaps they did five or 10 years ago, because of the relative reduction in local government resource. That is one point in relation to local government.

Also on local government, if there is greater flexibility—for example, I know that you are looking for public sector workers to be more productive, but perhaps over a four-day flexible working week—how will that impact on other areas of the economy, such as transport? There has been a significant reduction in the number of people who are using public transport, not only because of a lack of reliability. For example, in my area, there is a lack of bus drivers; we have also seen rail disputes. There are issues across the UK in that regard. What would be the knock-on effect on the retail sector if lots of public workers were staying at home?

You have talked about the multiyear estates programme. From reading the document, there seems to be an enthusiasm for selling off surplus public buildings if, for example, there are going to be fewer people in the public sector and more people may be working in a hybrid way or from home. The difficulty for local government will be that, in some areas of Scotland, there might not be much demand for those surplus public buildings, whereas in other areas, such as Edinburgh, there might be significant demand. That would mean that some local authorities would be unbalanced in terms of the resource availability.

I know that that is a fairly convoluted question, but it is about how local government will be able to innovate and reform and, at the same time, cope with those huge changes over a relatively short time.

Kate Forbes: I think that I heard three questions in there. I will take them in turn.

The Convener: That was because I am trying to allow other people a chance to come in. Therefore, I do not want to ask about too much.

Kate Forbes: Absolutely. First, you asked about local government. The question is similar to the question that you asked me about education. I think that that will be a recurring theme in the various questions that are asked this morning. I am not in any way denying the extremely challenging outlook that we face right now with the funding that is available to us, and the job that we have had in trying to be as fair as possible across the public sector.

To go off on a brief tangent, we set out three objectives in our budget: tackling child poverty, transitioning to net zero, and economic recovery. We have intentionally added resilient public services to that list because, if we were to base all our decisions on those first three objectives, core public services would find things very challenging. We have therefore tried to protect those core public services.

I am not in any way saying that the outlook is not extremely difficult. There are no two ways about it. That is why public sector reform—including, for example, the estates—is so important. If we can become as efficient as possible, that will allow us to focus our funding on front-line services and, ultimately, to focus on achieving those objectives.

I have two quick points to make on local government. First, in the most challenging circumstances, we have protected the revenue budget in cash terms, with £100 million in the final year, and we have also protected the baseline of £120 million from this year. That means that local government will receive about £42.6 billion over the resource spending review period.

Secondly, because it is level 2, those figures do not include the funding that is normally allocated to local government from other parts of portfolios, such as the transfers from education and social care. You will therefore see a significant uplift in future budgets, because the resource spending review does not provide the granular detail on the funding that is made available through those transfers.

There is also a point about flexibility, which has to go hand in hand with the fiscal framework. Now that we are through the local government elections, that work is being dusted off again. It has not stopped, but it obviously had to be briefly suspended during the local government elections. The fiscal framework has to look at maximising the flexibility and empowerment of local authorities.

On the estates programme, I note more briefly that it is not about focusing all the Scottish Government workforce in, for example, Edinburgh; it is about the fact that we now have hybrid working across Scotland and therefore it does not make financial sense for me to continue to renew leases—it is largely about leases rather than necessarily outright ownership—when buildings are only half or a quarter occupied. It is about how to ensure that we maximise the use of that estate. If we can save money on estates, for example, I can maximise more money for social security to feed hungry kids or to help front-line workers.

The Convener: I completely agree with that. However, it is not about focusing public sector workers in Edinburgh—as you said—but about the distribution of capital receipts. My concern is that you are unable to sell buildings in some parts of the country while there is a higher demand in other areas and a higher price per square foot is received for them. Would the Scottish Government look to balance that?

The funding formulas that we have at the moment are quite rigid and I feel that some of the poorer local authorities might be left behind unless the Scottish Government looks at a way of redistributing, because they will not be able to generate capital receipts. Of course, if you do that, you will have the other problem in that some councils will say, “Well, there’s no incentive for us to sell this building if the money is gonnae go to another council.” There will therefore have to be a way to square that circle. I will leave that hanging. We need to move on, because there is a lot to cover.

The Government has significant climate change ambitions and we have requested further detailed information from the cabinet secretary in recent weeks. However, I still think that there is a frustration that we do not have all the information that we require. Page 22 of the report mentions the decarbonisation of more than 1 million homes and 50,000 non-domestic buildings by 2030. There is also reference to supporting our commitment to cut car kilometres by 20 per cent by 2030 and loads of other commitments. Even if the money is made available for that, one question is where the workforce will come from. I have asked that question directly of the First Minister as well.

If we look at the level 2 detail in relation to training and skills, we see that there seems to be a significant reduction in that area. I am sorry—funding for employability and training is, in fact, going to be stagnating for a year or two, and we then have an 80 per cent increase up to 2027. However, funding for enterprise, tourism and trade—which one would have thought would go hand in hand with that—will have a 9 per cent reduction over the four years, and that is before we even look at inflation. It therefore seems that, although you are trying to encourage enterprise and innovation, the budget is being slashed significantly and training is not really kicking in at this stage, despite those huge ambitions and a skills and labour shortage.

Kate Forbes: On that point in particular, obviously, funding for employability is going up. It is therefore a choice. I am sure that we will come back to this, but employability and skills are probably the two areas that people most frequently raise with me in relation to the pressures right now—particularly with unemployment at 3.2 per cent—and the need to invest. In the finance and economy portfolio, we therefore see an intentional choice of investing more in employability and skills—and the skills line does go up. We cannot mirror that significant increase across the board because, by nature, a budget cannot prioritise everything.

Enterprise and skills link back to the national strategy for economic transformation and the constant refrain from the economy committee and others about decluttering the landscape. We need to be as efficient as possible. That does not compromise our objectives, but we need to ensure that we are reducing duplication across the various public bodies that operate in the enterprise and skills space. To my mind, we have struck the right balance in the finance and economy portfolio, because it reflects the constant refrain that I hear about the need to invest in skills and to ensure that we are as efficient as possible in supporting businesses.

11:45

You asked where the workforce will come from and mentioned the need to invest in training and skills. That is why I have prioritised the budget in the way that I have. That means that the focus will nearly always be on the areas that do not see the more generous uplift; the focus is very seldom on the areas that are seeing an uplift in challenging areas.

On climate change, it is important to say at the outset that, from a capital perspective, we cannot reach net zero without leveraging in private funding; there is no question or dispute about that. The Scottish National Investment Bank has a role to play in leveraging in private investment. We need private investment. We can allocate public funding out of our available capital—bear in mind that that is approximately £5 billion per year, and we have approximately £450 million in borrowing capacity each year—but it will take more than public funding for us to reach net zero, and we should not hide that. I hope that that answers your questions about skills and funding.

The Convener: Yes, but when you talk about private funding, you are not talking about businesses; you are talking about home owners having to invest significantly in transforming their houses.

Kate Forbes: I am actually talking about private investment. At the 26th United Nations climate change conference of the parties—COP26—the Glasgow Financial Alliance for Net Zero told us that there are $130 trillion-worth of assets under management right now that are looking for a home in significant infrastructure projects and other things to help with the transition. I am talking about the substantial sums of private sector funding that are available.

The Convener: Right, but you can deliver only if you have, A, the money and, B, the personnel.

Yesterday, I had a meeting with representatives of Stakis Forestry LLP—it had funded a bridge that I opened in my constituency—and they said that one of the drawbacks, which makes them tear their hair out, is the sclerotic way in which the public sector deals with developments and planning applications and so on.

One example from my constituency is a road junction that was agreed to way back in 2020. For 18 months, I have chased Transport Scotland for a start date on site, or even the date that it will go out to tender, and all I get back is that Government processes and procedures are taking place—it has been 18 months. Transport Scotland does not even tell me what those processes and procedures are, even though I have asked and have raised the issue in the chamber. There is still no start date.

If people are going to invest in Scotland, they need to have a structure in place that not only welcomes investment but processes it. Years ago, I read an article by the former chief executive of West Lothian Council, who went from coffee boy up to chief executive. He was asked how he had turned things round—obviously, proximity to Edinburgh helped—and he said that the council turned all planning applications round within a month indicatively, whether it said yes or no, and then it went into further detail if necessary. That meant that people knew that West Lothian was a place where they could invest.

Clearly, there is a shortage of planners that has to be addressed, but surely, in this day and age, we must be able to approve projects much more expeditiously. I had a project in the zero-carbon area that involved 900 jobs, and the company considered moving to Teesside because the planning committee put back its deliberations for 11 weeks. I contacted the chief executive of the council and he brought the date forward so that that did not happen, but that happens all the time.

I know that this is a long-winded question, but I feel passionate about this issue, as do many people. What are we going to do about that?

Kate Forbes: I feel equally passionate about it, and I appreciate that much is challenging and difficult about the resource spending review, but I do not think that it is unreasonable to set out a programme for improving our outcomes; doing so goes hand in hand with efficiency.

In the examples that you identified, I do not know how many people or teams had to manage that application or what the cost of that additional time and inefficiency was. If we are serious about achieving our objectives, we have to make sure that the processes are there and efficient and that we have the right people and teams to deliver them.

The resource spending review does two things: first, it sets out the challenges of the financial position, which I cannot change, because I can spend only what the SFC forecasts; and, secondly, it sets out the fact that, if we want to improve our ability to meet our objectives, we will have to take a long, hard look at how we achieve that. I have used the example of the enterprise and skills space. I am sure that we all have businesses in our constituencies that go to five, six or seven different public bodies, because five, six or seven public bodies provide grants. That is inefficient. We want to make it easier for businesses to access the help that they need in a one-stop shop.

The Convener: Also, when businesses put an application in and ask when it will be dealt with, it would help if there was a detailed timescale for that, so that the businesses are not just told "mañana".

Scotland and the whole of the UK pay significantly more to procure simple, straightforward things, such as road upgrades, than countries in continental Europe pay. Will that issue be addressed? Are we going to look at the procurement costs here compared to elsewhere? If procurement costs were reduced to continental levels, that would release significant funding to enable us to have more projects. How often have people driven along the road, got stuck at road works for half an hour and then found that nobody was even working there? It does not matter what time of day or night people go past, there never seems to be anybody there—or else one guy is in a digger and 10 folk are looking at the hole that he has dug. I am sure that we have all experienced that. I raised it with Stewart Stevenson 15 years ago. He said that it would be looked at, but I am still waiting. Those are real issues that we have to address. Adversity is the mother of invention, so surely this is the time to really address those issues. What focus will there be on procurement? I do not want to be in a situation in which, three or four years from now, we are still asking the same questions but not seeing significant improvement, other than less money being spent on the ground.

Kate Forbes: That is the necessity of the art of resource spending review. Again, we cannot afford not to make those reforms. The four pillars of the reform agenda in the resource spending review include procurement. The agenda is to encourage public bodies to look at four areas where we might drive efficiencies. The first is on estates, which you have already touched on. The second is on shared services; the third is on procurement, and the fourth is on brand management.

The RSR does not, in one go, give all the answers as to how we are going to achieve that, but it sets out a plan—over the next few years—for driving that reform. The reason why we need a resource spending review to do that is that it is difficult to drive reform within one year and difficult to do it within annual budgets, so we need to have that longer-term perspective of a three or four-year spending review. The changes that we make in year 1 might be expensive, but we will see the benefits in year 4.

The Convener: Colleagues are clearly keen to come in, so I will ask my final question, which is about the social justice, housing and local government portfolio. I noticed that, in that area, 96 per cent of the increase in spend over the next four years will be on social security. Half of that increase is related to further devolved welfare benefits and half is related to choices that are made by the Scottish Government. Given the paucity of resources and the fact that, for example, the police will face a zero budget increase at a time of rising cybercrime, and that various other areas will have to deal with fixed budgets, is it the best use of public money to spend an extra £1.2 billion on benefits? What will be the impact to the wider economy of that spend and of removing people from poverty, which is clearly what that spend is about?

Kate Forbes: Yes, and I would argue that it is important spend. I would argue that £1.8 billion for the Scottish child payment is an important choice that we have made. However, you are right that it is a choice, and where you choose to prioritise one area of spend, you by necessity deprioritise other areas. We have chosen to make tackling child poverty a core objective. We have backed that up with increased spend on social security. We have reformed social security powers over which we have control, and tackling child poverty must be one of this Government's missions.

Interestingly, I think—unless I am told otherwise in the next few minutes—that it is pretty much supported by all parties in the Parliament. Therefore, it is a choice. However, ultimately, if we achieve our objective, those figures should decrease. You should not set out to invest in social security over the extreme long term because, if you manage to tackle child poverty and you meet your child poverty targets, you should see that spending figure coming down, because there will be fewer families in need of that additional support.

The Convener: I asked that very question of the Scottish Fiscal Commission representatives—not today but the last time they were here. Their view was that that would have no impact on spending in fact. However, I would say that the child poverty budget line, as distinct from social security assistance, is projected to increase from £34 million to £97 million, so that is a significant increase, but it is only a fraction of the £2.4 billion increase in social security spend.

Kate Forbes: Yes, it is a choice that we have made. The other difficulty with social security, of course, is that it is demand led. Therefore, the forecasts will inevitably change, because no forecast is 100 per cent aligned with outturn. For that reason, we must ensure that we have the capacity to meet that demand from within our own budget, irrespective of where the demand falls. Therefore, it creates risk and volatility, but it is a choice of this Government, and I think that it is the right choice. With regard to the Scottish child payment, it is not unreasonable to suggest that, if you meet your child poverty targets—the Scottish child payment is one of the levers for doing that—you will see that figure fall.

The Convener: However, at a time of chronic labour shortages and skills shortages, surely trying to get more people into work is the ultimate cure for poverty, because people need a good wage. There is an issue about people who are on the cusp of these benefits—people who are working who earn just over the amount to claim certain benefits and therefore do not receive as many benefits. There is a real issue with regard to the relative tax burden that they face. What we are looking at, from the figure of £1.8 billion, is an extra £500 a year for every taxpayer in Scotland, if you were to even it out. Clearly, people who pay a higher tax rate will bear a higher share of that. That is an issue for some people: some people who are on fairly low pay and have to work long hours will wonder whether that is the right priority.

Kate Forbes: Obviously, many families who will receive the child payment or additional support are already in work, too. You cannot look at, for example, the figure of £1.8 billion for the Scottish child payment in isolation from the employability and training budget line, which is going up by £100 million over the next few years, because those are two sides of the same coin. From a child poverty perspective, Government has a moral obligation to care for children in poverty, because it is not their choice to be in poverty, and those figures need to be grappled with. However, simultaneously, it is about helping parents not just by getting them into work, because many of them are already in work, but by ensuring that they are paid sufficiently, which is where the real living wage comes in, and that their employment is secure.

The child poverty plan captures all of that. The resource spending review comes in behind it and funds it. However, we cannot ignore the issue and we must tackle it. We have made a choice to tackle it through the priorities that we have set out for the resource spending review.

The Convener: Thank you.

John Mason: We spent quite a lot of time with the Scottish Fiscal Commission earlier this morning looking at inflation from different angles. Professor Breedon talked about the previous, old-fashioned spiral in the 1970s and 1980s when wages and costs chased each other up. The Scottish Fiscal Commission representatives seem to think that that will not happen this time. They are predicting a real earnings decrease of 2.7 per cent. What is your angle on that? Will there have to be a reduction in real earnings because wage increases will not be able to match inflation for a period?

12:00

Kate Forbes: We set out public sector pay policy in advance of every budget. I have been clear in this year's budget that I cannot inflation-proof public sector pay policy, because of the high level of inflation and the fact that it is due to rise.

I am conscious of the SFC's forecast on inflation, which it thinks will average 8 per cent across 2022-23 before falling back in line with the Bank of England's 2 per cent forecast from 2024-25. That is in very stark contrast with the inflation assumptions that the UK Government used to underpin its spending review in October 2021. Therefore, the difficulty for me in answering your question when it comes to the years beyond this year and perhaps next year is that the funding pot that is available to me is based on assumptions that were made last autumn and have been completely overridden by the inflationary outlook that is inherent in the SFC's forecast.

I am happy to bring in anyone else who wants to come in; I do not know whether your question has been sufficiently answered.

John Mason: I suspect that there would be no end to our discussion of the subject. Another point that the SFC made was about how long inflation might last—I was surprised that it was not more certain on that point. Inflation might come back down; I presume that it will come down if oil prices come back down. However, if oil prices do not come down, it could carry on rising. Do you agree?

Kate Forbes: Gary Gillespie might want to comment.

Gary Gillespie (Scottish Government): I managed to catch some of the conversation in the previous session about cost-push inflation and demand pull, so I will not go over that. In essence, where we are at the minute is a combination of both, with the supply-side cost pressures really driving inflation.

John Mason asked where we think that inflation will go. The Fiscal Commission, the Bank of England and others believe that the mechanical nature of how inflation is calculated is such that inflation will come back down. Oil prices would need to be rising at the same rate this time next year for the current calculation to continue. That is why the forecast comes back down.

I think that your more general question, which refers to the 1970s, is about the impact of pay growth through labour and wage pressure. In a sense, the Fiscal Commission partly answered that question today, because in its assessment it says that real wages are falling by 2.7 per cent on average this year. The Bank of England forecasts average pay settlements across the economy of around 5 per cent—so there is a squeeze. If that is the squeeze this year and inflation comes back down to circa 3 per cent, as forecast, that should mitigate wage pressure.

To get back to the convener's questions, the challenge is that we have an incredibly tight labour market, with businesses competing for staff. It is about the extent to which we can ease that pressure.

That relates to the cabinet secretary's comments about employability support so that we can get more people into jobs. Jobs are changing in nature, too. That gets us into a broader discussion about productivity, how businesses use labour and the extent to which businesses replace labour through investment and capital.

The short answer to your question is that it is perfectly feasible for inflation to go back down next year and for this to be the type of shock that lasts a year to 18 months. The risks in the longer term are to do with Scotland's demographics and the extent to which we can address them. That issue could continue to put pressure on labour markets.

John Mason: Other members might want to come in on that point, so I will not pursue it.

I asked the Fiscal Commission about the emphasis on social security. Cabinet secretary, you have been asked about that. Social security will be protected—indeed, more money will be invested in the area. Will that have a knock-on effect? The concept is that, if we give people who are less well off a bit more money, they will spend it locally and it will quickly come back into the economy and boost jobs and, eventually, tax revenue. The SFC has said that it has not made that assumption. If we give more money to Scottish Enterprise instead, some of it might leak out to very highly paid people.

Kate Forbes: Others might want to come in on this, but from my perspective, getting social security right has two impacts. I have already touched on the Scottish child payment, and if we manage to meet an objective such as tackling child poverty, that will, in a very obvious way, deliver benefits not just for those families but for the wider economy and, ultimately, for public finances. If people are taken out of poverty and they are in well-paid, secure employment, I do not need to spell out the benefits of that to the taxpayer or in relation to pressures on public services and so on.

The other impact relates to the tight labour market. Again, if we are able to support people into work at a point when unemployment is at 3.2 per cent, we know that the area on which we need to do most work is the economic inactivity figures in order to expand the labour market.

To my mind, there is a moral obligation to ensure that those who are entitled to social security support get access to that support in a dignified way; that is an ideological choice, and I think that it is the right one to make. Equally, if we get this right and support more families out of poverty, inevitably that will deliver benefits elsewhere, reduce pressures on public services and, I hope, boost the labour market.

John Mason: It has been suggested that the headcount in the public sector would reduce to pre-Covid levels—30,000 fewer staff, I believe. Daniel Johnson gave us some figures earlier, and I believe that there has been an increase of 14,000 in the NHS. Can we expect a reduction of 14,000 in the NHS? How does that work out?

Kate Forbes: It is unlikely that we will see that in the NHS. I have intentionally set out a flexible approach because we know that some parts of the public sector have grown and probably will need to grow further. For example, the national care service will need to be able to employ people and expand in some areas flexibly.

Other parts of the public sector will no longer need to maintain the Covid-related expansion of the workforce. Rather than taking a UK Government approach to this, which is to put arbitrary figures on it—I think that its figure for bringing staff numbers down to 2016 levels is 91,000 full-time equivalent—we have said that we will freeze the pay bill. That does not equate to a freeze in pay levels; we want to work with employers and trade unions during the next few months in advance of the budget to understand how we can manage workforce numbers in a flexible way that will allow some parts of the public sector, such as the health service, to continue to grow where it needs to grow, and other areas to decrease their staff figures when they do not need those post-Brexit, post-pandemic levels of staffing.

Liz Smith: Cabinet secretary, I would like to begin by seeking one piece of clarification, if I may. Last week, during your statement in the chamber, and at First Minister's questions, we raised the Scottish Fiscal Commission data that is in figures 4.3 and 4.7, which made a projected estimate for 2026-27 of a £3.5 billion hole in public finances. You seem to be implying that that was not a correct estimate from the Scottish Fiscal Commission data. Why is it not correct?

Kate Forbes: No, that is not my position. Those are forecasts from the SFC. I believe that the £3.5 billion is actually our figure, which was published in December and which was based on a number of assumptions. The point that I was making in my answer to you, and which was made in the First Minister's answer, was that we are now working with a resource spending review that is completely balanced. It is factually inaccurate to suggest that the resource spending review is not balanced, because I must balance it by law.

The gap between spending and funding, based on the RSR framework, which was published in December, has come to the fore again in recent days. That projection was based on, for example, inflation at 3.7 per cent and 2 per cent thereafter, and on social care growth in line with the 2018 medium-term financial strategy. It was based on a whole number of assumptions, and, in a sense, the resource spending review is the answer to a lot of those assumptions, and is based on more accurate information.

I am very clear that the suggestion, based on forecasts in advance of the publication of the resource spending review, that there is a deficit in the resource spending review is inaccurate.

Liz Smith: Right. To be clear, did you use that £3.5 billion figure in your estimates before the financial statement that you made, or were you using a different figure?

Kate Forbes: We do not use figures in that way. The SFC updates its forecasts in the weeks in advance of the resource spending review publication, and then we have to balance our spending commitments. There has been so much change between December and the SFC finalising its forecasts a few weeks ago that it is just inaccurate to suggest that we go back to December figures.

Liz Smith: Sorry, I will press you on this, cabinet secretary, because it is absolutely vital to the policies. It is extremely helpful that we have a statement that looks over a longer period of time—it is the first that we have had since 2011.

You are making choices and setting your policy commitments based, I hope, on what you see as the accurate statistics. Given what you said last week, I want to know what you think we need to take into consideration that changes the statistic that the Scottish Fiscal Commission produced relatively recently.

Kate Forbes: The question is hugely important, because it goes right to the heart of how we build a budget or a resource spending review. The notion that I would base a May publication on December figures, considering all that has changed since then, is flawed.

I will go through the assumptions that underpinned our budget in December and the resource spending review framework in December. They included SFC forecasts for social security in December 2021; assumptions around pay growth; assumptions around health growth and social care growth; and assumptions around inflation. All those forecasts have been updated—not by me, because it is not my job to forecast; it is the SFC's job to forecast. In order to build a budget or a resource spending review, we use the latest figures that the SFC provides me with, which it has now published, and I must balance my budget based on that. Forecasts change constantly.

Liz Smith: I understand that. I am asking you to tell us—because it is important, as you have acknowledged—if, as you rightly point out, those changes have all taken place, what figure are you using for the black hole in the public finances?

Kate Forbes: There is no black hole in public finances.

Liz Smith: Really?

Kate Forbes: There is no black hole. These are the basics of the budget that the Scottish Government sets—

Liz Smith: It is not a budget, cabinet secretary—you said that originally. It is not a budget that you are producing.

Kate Forbes: Indeed—the basics of a budget or a resource spending review. I do not know how else to explain the absolute basics of Scottish Government budgets or resource spending reviews: I must balance; I can only spend to the penny what I am forecast to either raise or receive. In a resource spending review or a budget, I cannot have a position whereby I am overspending. That is why querying the Scottish Fiscal Commission's assumptions is so important. The SFC starts with assumptions, it provides us with forecasts, and I can spend only what it enables me to spend.

Liz Smith: Let me put it another way. What statistics have you used to make the projections and policy choices that you have set out to the committee?

12:15

Kate Forbes: I have used the SFC's forecasts, which are based largely on the UK Government's spending review and on tax and social security forecasts.

Liz Smith: Okay. I will make the same point from a slightly different angle. When you set out the national strategy for economic transformation, universities were said to be

"integral to the realisation of the national economic transformation strategy",

because they play such a vital role when it comes to developing research and development, and innovation. Why are you cutting universities' budgets in real terms, given that they have a considerable influence on economic growth and ensuring that we are developing research and development?

Kate Forbes: There are three reasons why the outlook right now is challenging across the board. First, our budget from last year has been cut by 5.2 per cent, and it is forecast to grow by 2 per cent in real terms, if social security devolution is excluded. The challenge for every part of the public sector is captured in the fact that less money is available. On top of that, inflation is at 9 per cent and is forecast to go to 11 per cent. That reduces our spending power. On top of that, if there is an increase in one budget line, there must be an equal and opposite decrease in another budget line.

My job has been to treat as fairly as possible all parts of the public sector, including universities, because I know how important they are. Again, that demonstrates the point that we have been discussing: I cannot spend a penny more than what I will receive or raise according to the SFC's forecasts.

Liz Smith: However, you have to make choices in relation to where you think the Scottish economy can improve. You have to think about the receipts that you will get from tax revenues and from other areas of expenditure, and about where cutbacks have to be made. You have spelled out some of the cutbacks. What information can you give to the universities sector that proves that it deserves what will probably be an 8 per cent real-terms cut over the period that is covered by the financial strategy?

Kate Forbes: We should bear in mind that, in cash terms, we are trying to protect as much of the public sector as possible, including universities. You have quoted 8 per cent, which is a real-terms figure based on the fact that inflation is at a 40-year high and is eating into our spending power. In the same way as I have given a commitment in relation to the employability and training lines, my commitment to universities is that we will protect them as far as possible. I say "as far as possible" because the overall block grant that I receive will not increase significantly over the next few years, and inflation is currently at 9 per cent. If there is not real-terms growth in the funding that you have available, by necessity, you can go only so far when it comes to allocating funding. Like many other spending lines, universities are hugely important, and we will protect them as far as possible. If you want funding in any part of the public sector to increase, you need to either take it from elsewhere or increase the pot.

Liz Smith: If extra money that you are not currently expecting became available to you, would universities benefit from it?

Kate Forbes: I would hope so, yes.

Liz Smith: We might hold you to that.

You mentioned Covid spending in answer to Mr Mason. Can you or one of your officials confirm that Covid spend from the UK Government was £8.6 billion for 2020-21 and £7.1 billion for 2021-22?

Kate Forbes: I do not know whether we have those figures immediately to hand, because I am giving evidence on the future budget, but we can probably write to you.

Liz Smith: That would be very helpful. Thank you.

Michelle Thomson: Good morning. I am sure that, for people who are watching the committee—I always say that, and everyone laughs and says, "No one ever watches this committee"—the discussion about whether or not there is a black hole is an important, pivotal point, because it is actually predicated on debt. You make the important point that whether or not there is a black hole comes down to actuals, not forecasts. Perhaps the media have tended to use that in a very florid way.

Dr Verne Atrill discovered that

> "there is a precise point, a mathematical singularity, which we can measure as the Ratio of GDP/Total Debt, at which an economy stops expanding and begins to contract instead."

On that point, I simply note that the UK Government is hugely in debt.

That leads me to the fiscal framework, and I want to get some reflections from you. We know that any Government, including the UK Government, will have frequent errors across a wide range of forecasts. The UK Government—unlike the Scottish Government—does not suffer any penalty as such for the forecast that, for example, it will have to repay £817 million in 2024-25. Of course, the UK Government does not then have to repay that in a single year's cycle; it can repay it over several years and—to go back to my earlier point—it can borrow.

I, too, applaud the fact that the resource spending review has been done; it is a worthwhile exercise. However, it really brings into sharp focus the issues with the fiscal framework, utterly and fundamentally, with regard to what you are being expected to do within limitations that other normal Governments would not have. Therefore, perhaps the discussion is really about that. I would like some further reflections from you on that issue before I move on.

Kate Forbes: You make a very good point. As we have just been discussing, forecasts are, by their very nature, uncertain. The SFC—not me—is trying to predict our budget position in three years' time based on tax and on receipts from the UK Government. Inevitably, I am still to see a forecast that is 100 per cent aligned with outturn—they are forecasts, so they are based on assumptions. Over the past three or four months, we have seen how assumptions can wildly fluctuate. For example, who predicted war in eastern Europe back in December? It is inevitable that forecasts change.

What other Governments around the world can do is accept that those forecasts should be managed, nearly always, through resource borrowing, so that you smooth the trajectory and do not require the NHS or education to give up funding in order to manage forecast error. However, that is what we are expected to do if the forecast error is greater than £300 million. That is where it hits next year and in subsequent years, where you see the impact of the pandemic and of—through no fault of their own—two different forecasters working on different assumptions as well as forecasts that did not come to fruition.

The reconciliation that is required in that year significantly exceeds the borrowing capability to meet it. Therefore, about £500 million has to be found from front-line services. All it would take for the UK Government to deal with that would be for it to adapt the fiscal framework in that one area to ensure that there is £500 million more for front-line services.

The other aspect of that, which goes back to my answer to the convener, is about smoothing the trajectory. You cannot expect the public sector to suddenly, in one year, absorb £500 million, when we are talking about a workforce, and then see that climb again the next year. That is why most Governments borrow for that.

The fiscal framework review is on-going. For me, this is one of the most obvious areas where I would like to see progress. One of the arguments that we have made in the past, for example, was for the ability to use one of the borrowing powers for cash management, which we have not used or needed to use, and redeploy that to manage forecast error. That is one of the biggest areas where I would like to see progress. It would make a big difference for resource borrowing for forecast error to be indexed or even aligned to inflation.

Michelle Thomson: Thank you for giving such a clear illustration. I think that you are making the point that nobody would choose to start from where we are, as it is an inefficient way to manage the finances.

That leads me on to another issue that I found interesting when I read the spending review document. We are talking about people's understanding of what is actually going on. I was attracted by the economies of scale that you are looking at getting through, for example, shared services, which to me is an absolutely obvious example of where we could derive value. You mentioned other areas to look at, such as grant management, procurement and the 129 or so public bodies.

That brings me to the point about the public's understanding. I appreciate that it will be useful to have a conversation with councils about whether we might be able to do this, but I foresee difficulties in that people will not necessarily want a shared service, because they will see that as a loss of control. I agree with your approach of having a conversation, but what further challenges do you foresee? In principle, the approach is useful and good but, given the discussion that we have just had, I foresee that it will immediately throw up comments such as, "Oh, you want to get rid of this?", even though we are all aware of the huge fiscal constraints.

Do you have any more thoughts on how you will approach that and the timescales involved? My experience is that, even if you get agreement, it always takes longer than you think, it is always more expensive than you think, and the return on investment is never quite what you think, either.

Kate Forbes: We will certainly engage with public bodies on taking forward that reform. The important point is that the public sector exists for the benefit of citizens. We need to start with citizens, and they will not necessarily be aware of or interested in the backroom shared services. In an age of digitalisation—obviously, digital is one of the key focuses—we need to consider things such as shared cloud services and shared investment in digital capability.

We have talked about estates. Sharing estate will lead to the need to share services as well. Many bodies do very similar things with their finance or human resources capabilities. As I said, I am not sure that citizens are as interested in the backroom capabilities as they are in getting the service that they want. We all need to be aligned on the need to improve outcomes for citizens, whether that is individual businesses, households or anybody else.

We will certainly work with public bodies and look at the art of the possible. I want to ensure that we protect and preserve public bodies' autonomy to deliver services to citizens as they wish, but I also want to work with them where they need, for example, investment in their information technology or digital services and where there is scope for those to be more effective. The Scottish Government has been working on our shared services—even within the Scottish Government, we can ensure that we have one system for all the parts. There is a lot of scope, but we will need to act carefully. Obviously, we will report on the initial conclusions in the upcoming budget.

Douglas Lumsden: Hi, cabinet secretary. It will probably come as no surprise that my first question is on local government finance. There seems to be a real-terms cut of about 7 per cent in the next four years. Is that not passing the buck to local government to bring in huge increases in council tax?

Kate Forbes: No, it is not. However, as I have said, the outlook is very difficult across the public sector. From the local government perspective, we obviously need to do this work hand in hand with the work on the fiscal framework, and we need to recognise that the resource spending review is not a budget. I can well imagine that, in future budgets, local government will, for example, have a significant uplift through the education and social security lines as a bare minimum.

Douglas Lumsden: You have spoken about things such as digitisation and reducing the estate. Do you not accept that many local authorities have been doing that over the past four years? Therefore, for that to be set out as a way for those bodies to save money is actually quite insulting to them, because they have been doing it already.

Kate Forbes: I am not sure that I am advising or advocating that—unless you are quoting something that I said earlier. What we are saying to local government is, "Here are the spending parameters over the next few years". That allows them to plan, but it will not replace annual budgets; it gives them the parameters, but not all the details. Future budgets will need to update the details.

12:30

Incidentally, there is a lot that we can learn from local government, particularly in the way that it works together and the way that COSLA facilitates a lot of sharing of best practice. You are right to say that there is a lot for us to learn. However, to all intents and purposes, local government is fully autonomous. We set the spending parameters, but ultimately, it is for local authorities to determine how they spend that money.

Douglas Lumsden: However, you also set targets, for example in relation to reducing the public sector head count by 30,000 over the next few years. That will feed back to local government, too.

Kate Forbes: Local authorities have to make choices within the spending parameters that they have. I do not dictate to local government how it uses its funding—that is for local government to determine. All I can do through the resource spending review is to set out the parameters; it is for local government to decide what it does with that core budget. Obviously, there is additional funding on top of that for education and social security, which we have more influence over. However, inside the core spending parameters, it is for local government to determine how that money is spent.

Douglas Lumsden: I go back to the reduction in head count. The figure of 30,000 has been mentioned, but 15,000 of the additional 30,000 pre-Covid level relates to the NHS, and as you have already said, that will probably not be affected very much. That means that the reduction will have to come from other places, one of which could well be local government.

Kate Forbes: All decisions around how local government spends its money are for local government to make. As you well know, I do not tell local government how to spend the core budget—that is entirely up to it.

Douglas Lumsden: However, you have been suggesting a head count reduction of 30,000 people.

Kate Forbes: It is across the public sector, and I have not put a figure on it. That is your figure—or other people's. I have suggested that we need to get back to pre-Covid levels.

However, let us take the expansion of early learning and childcare, which is one area of local government. The policy has seen a workforce expansion in local government and that needs to continue. However, in other areas of the public sector—it is for the public sector to answer this question—as a result of Covid, there might have been an increase in head count that they no longer need. There may be other parts of local government, as in other parts of the public sector, that will need to see increases as we come out of the pandemic. That is why we are being very flexible.

In the discussion around public sector efficiency, local government is unique, because ultimately, it is local government that makes the decisions, rather than me. I set the spending parameters; I do not dictate to local government how to spend that money.

Douglas Lumsden: I struggle to see where the head count efficiencies—let us not call them reductions—will come from, given that they are not going to come from the NHS and you have already said that ELC expansion will continue, so there are new nursery teachers that we cannot get rid of suddenly. Where is the axe going to fall, cabinet secretary?

Kate Forbes: We will work with public sector employers. I have been at pains not to set an arbitrary target—although figures have dominated the press coverage—or to dictate to public bodies what they need to do. Over the next few months, in advance of the upcoming budget, we will engage with them and, most importantly, with trade unions, on where the workforce needs to reset. It is based on a freezing of the pay bill that does not equate to a freezing of pay levels. That is what is driving the need for reform.

I hope that Mr Lumsden will accept that there is a fundamental difference in my relationship with, for example, a public body such as Transport Scotland, and my relationship with local government.

Douglas Lumsden: Yes, you are not dictating the figures in terms of head count, but you are holding the purse strings in relation to the amount to be spent on pay. That means that you are really dictating head count in all areas, are you not?

Kate Forbes: I have been quite open and honest about the need to freeze the pay bill, but not pay levels. I do not think that there is anyone who does not accept that there has been a lot of change in the public sector over the past two, difficult, years. Inevitably, some areas have had significant and rapid increases in head count because of Covid that are no longer required. Indeed, there were initial teething challenges around Brexit that resulted in spikes.

It is about having a general reset rather than setting arbitrary targets, which is what the UK Government has done. Your questions stemmed from a local government perspective. I am saying, loudly and clearly, that I do not tell local government what to do, and nor should I, in the way that I can work more effectively with other public sector employers.

Douglas Lumsden: The figures show a 7 per cent reduction in real terms. Are you saying that it will not be as bad as that for local government?

Kate Forbes: I am saying that the resource spending review is not a budget. We have used what the SFC called reasonable assumptions to set our budget. However, we are setting a budget based predominantly on the UK Government spending review of autumn last year, which is completely out of date—it has not been updated to reflect inflation. Therefore, the numbers will fluctuate further.

Douglas Lumsden: So it might not be as bad as local government expects, then.

Kate Forbes: I sincerely hope that our budget will not be as bad as I feared but, ultimately, the only way for that to change is for the UK

Government to increase the funding pot and take into account the huge increases in inflation.

Douglas Lumsden: You said earlier that you are not cutting the budget for enterprise but cutting duplication instead. Will you give us some examples of duplication within the enterprise budget?

Kate Forbes: To clarify, I was saying that, in the finance and economy portfolio, the budget for some areas will go up, but that cannot happen for all areas. For example, the budget for training and employability is going up.

The national strategy for economic transformation calls on all parts of the enterprise and skills landscape to focus on fewer objectives and to do them really well. For example, it calls for a focus on productivity, some of the new markets and entrepreneurship. I like to think that focusing on those key objectives means that enterprise and skills organisations will align all their spend and workforce to achieving them.

Looking across the board, some public bodies will be better at some things than others. For example, the Scottish National Investment Bank has an important role to play in scale-ups and Scottish Enterprise has a great track record when it comes to start-ups. Scottish Enterprise focusing on start-ups, the Scottish National Investment Bank focusing on scale-ups and both of them trying to ensure that they do not just duplicate each other's efforts would be an example of aligning to NSET and to the agencies' track records of success. Scottish Enterprise has generated significant revenues for the public purse as a result of very attractive investments.

A second example is something that I have already talked about, which is a recurring theme when it comes to business grants. Where does a business go first for grant support? Does it go to Business Gateway, SE, Highlands and Islands Enterprise, VisitScotland if it is in the tourism community or the Scottish Government? Right now, it is confusing for businesses but, in each of those organisations, there are teams that do similar things. The question is how, through collaboration and discussion, we make a more effective relationship for business. There is good practice on that already. The enterprise agencies are completely on board and have already started some of that work.

Douglas Lumsden: Do you envisage some of those agencies potentially going, then?

Kate Forbes: No, I do not.

Douglas Lumsden: Just people within them going, I guess.

Kate Forbes: They all have an important role to play, but they need to ensure that they are as efficient as possible and focused on the core objectives that we have set. My impression, based on my extensive conversations with the enterprise agencies and VisitScotland, is that they are all on board with that and get it.

Douglas Lumsden: Are they on board with a reduction in their budget? That would be unusual for any organisation.

Kate Forbes: The fundamental challenge with some of the discussion is that, if we are more effective at serving the citizens, by extension, we will have more efficient public bodies. What is not to appreciate about improving outcomes for citizens and businesses and ensuring that every penny of resource that we spend delivers our objectives?

Douglas Lumsden: That ties into another issue. In the medium-term financial strategy, there is little mention of the national performance framework. Is that truly embedded right through this document?

Kate Forbes: I would say so—yes. Certainly it is embedded in the resource spending review. The medium-term financial strategy focuses a lot more on the funding that we have available, and the resource spending review focuses a lot on how we are going to spend it. That is the distinction between the two documents.

I go back to identifying the four objectives. Tackling child poverty is completely in line with the national performance framework. Transitioning to net zero is completely in line with the national performance framework. Economic recovery and resilient public services are also completely in line with it. I would say that this resource spending review is far more focused on outcomes than perhaps many things are.

Douglas Lumsden: You mentioned tackling child poverty, but what about preventing it? That is difficult when you have cuts to the local government budget, cuts to the universities budget and cuts to the enterprise budget. Surely those are the areas where we should be investing in order to prevent child poverty, as opposed to trying to tackle it.

Kate Forbes: I think that the greatest contributor to child poverty over the past 10 years has been UK Government austerity, and that view has been backed up most recently by a report from the University of Glasgow. We will do all we can to mitigate it, but we are limited in what we can do. We will continue to invest our money through a different approach to social security, but, ultimately, much of what we spend is on mitigation. If you fix that issue at source, we could probably redeploy the funding elsewhere.

Douglas Lumsden: This Government always talks about early intervention and prevention, but a lot of the areas that you are cutting are carrying out early intervention. For example, local government can tackle child poverty at source before it becomes a problem. That is why I am slightly confused by some of what you have said today and some of what I see in this report.

Kate Forbes: Let me just say that we are spending £1.8 billion on the Scottish child payment, which will go up to £25 per week. That will just about mitigate the cut to universal credit of £20 per week.

Douglas Lumsden: But you are making cuts in areas that could prevent child poverty. That is my point.

Lastly, I want to talk about tax. You said that you have gone by the SFC forecast. In that forecast, the higher-rate threshold would remain frozen as part of the forecast's baseline. Is that something that you see as frozen? The forecast says:

> "an individual higher rate taxpayer pays up to an extra £653 in income tax in 2023-24, rising to £1,317 in 2026-27".

Do you think that you will stick to that?

Kate Forbes: We will update all tax policy in advance of every budget. I will not be drawn today on setting tax plans for subsequent budgets.

Obviously, the SFC has to work on the basis of assumptions. The intention here was certainly not to determine tax policy for future years.

Douglas Lumsden: Okay. Thanks, convener.

Daniel Johnson: I want to go back to the public sector head count. The aim is to return it to pre-Covid levels, and I accept and understand that you say that that will be done essentially through capping the total payroll at value, but not in terms of levels.

However, there will be a certain arithmetical outcome from that. As John Mason pointed out, half of the 30,000 staff are in the NHS, but its workforce will not be reduced. Therefore, in the remaining areas, there are two options: reducing people's pay or reducing the head count. If you maintain the NHS head count at what it is, and that is half of the total number, that means that the other areas will need to reduce their head count by double the amount that they have increased it by. I just want to highlight that. From quarter 4 of 2019-20 to quarter 4 of 2020-21, there was an increase of 4,000 posts in the civil service, 7,000 in local government and 5,000 in public corporations. You refuse to be drawn on local government, but you do have control of the civil service head count. Will we see a reduction of 8,000 civil servants in the Scottish Government?

Kate Forbes: Over the next four years—it is important that it is understood that this is over the longer term and not over a one-year period—we will see a reduction in workforce and in head count to pre-pandemic levels.

There are number of ways to do that, including through effective vacancy and recruitment management or redeploying staff. All that has to be done in collaboration and through discussion with trade unions. That is important. We have a policy of no compulsory redundancies, and we will update public sector pay policy in advance of every budget. The key with a resource spending review is that we are not trying to drive reform over the space of 12 months; we are trying to drive reform over the space of four years, so by 2026-27, we want to the total size of the devolved public sector workforce to be at pre-Covid levels.

12:45

In relation to the health workforce, a lot of people already work in care, so we have to take that into account for a national care service, which is an example that I used earlier. It is about effective management across the board, rather than setting arbitrary targets over a very short period of time.

Daniel Johnson: I do not think that I was suggesting arbitrary targets or that the timeframe was 12 months. I appreciate that the timeframe is four to five years. You might not want to put a number on it, but if you are going to maintain the health service head count in broad terms, albeit with some change, and if you have that macro figure but are going to protect the half of the increase that is in the health service, other areas will have to be reduced by more than the figure than they increased by. That is an arithmetic necessity, is it not? You do not necessarily need to put a figure on it, but the head count reduction in the civil service will need to be more than the 3,800 it went up by in the Covid period.

Kate Forbes: Some of that civil service reduction will be in the health service. I am not disputing the sentiment behind your question, which is that I have said that we need to reset the size of the workforce, we will freeze the pay bill and, ultimately, we want to return to pre-Covid levels. The public sector is large; it is approximately 470,000 people in FTE terms, and we need that to return to pre-pandemic levels. That will need to be managed across the board. That is where my concern is with your arbitrary figures, including the 15,000 in the health service. That is putting arbitrary figures on the other side of that argument.

Daniel Johnson: Let me avoid the figures altogether. If the aggregate point is going to come out at 29,500 and some areas are not going to have to return to pre-Covid levels, other areas will have to go further. Is that a statement of fact?

Kate Forbes: That is a statement of fact, yes.

Daniel Johnson: Thank you. One area that you disputed at your statement last week was the overall position on productivity growth and wage growth in Scotland. The Scottish Fiscal Commission is clear; in paragraph 3.39 of its report, it states that

"Productivity growth has stalled in Scotland since 2015."

Likewise, on its projections of income tax receipts, the Scottish Fiscal Commission is clear that wage growth in Scotland is slower than the UK average. That is a trend that goes back to 2016 according to ONS figures; not a single Scottish region outperformed the UK average in that period.

Prior to 2016, Scotland typically outperformed the UK average. I am not talking about the higher performing areas of the UK, but the UK average. Do you accept that that is a fact, and is there sufficient focus on driving up jobs and wages? Ultimately, that is what we need to do to increase the amount of money that we have to spend on public services, and because it is a good in and of itself.

Kate Forbes: There is a more balanced answer to that, and hopefully a more balanced question behind it than I was asked in the chamber. I accepted in the national strategy for economic transformation that increasing productivity is one of the most important objectives that we can have as a Government, a society and an economy. We take it as read that increasing productivity matters, and we need to up our game on that.

You still have to accept that between 2007 and 2019 we saw significant growth in productivity; indeed, productivity in Scotland grew by 10.7 per cent compared with 5.2 per cent in the rest of the UK. Why is that important? It is important, because it brings us back to the question of what we need to stop doing, because it might be dragging down productivity, and what we need to keep doing, because it might be boosting it. That is what the national strategy tries to get underneath.

Our economy is recovering right now, and we have the unique circumstance of a record low unemployment rate of 3.2 per cent. We cannot do much more with regard to the labour force if unemployment is at 3.2 per cent, with the exception of trying, as I said earlier, to work with those who are classified as economically inactive and get them into the labour market. There is work that we can do on migration, too.

I did not catch everything that the SFC witnesses said, but they made it quite clear that Scotland is exposed to an ageing demographic and, as far as earnings are concerned, to the situation with the oil and gas industry. While there has been a significant increase in financial services down south—the figure is about 16 per cent, if I remember correctly, but I would need to double check that—the oil and gas industry in Scotland has had a challenging time, which has had an impact on earnings. You have to distinguish between wages and productivity a little bit; they are linked, but I think that these are two different questions to which there are two different answers.

Daniel Johnson: Wages and productivity are inextricably linked—if you want to drive one, you have to deliver on the other. The demographic is definitely an issue in Scotland, but the fact is that the fiscal framework is, to a degree, indexed, so average earnings growth is the fundamental issue.

I do not disagree with what you have said about productivity, and I think that the NSET does a good job of narrating the issue, but I would still take issue with the view that it focuses sufficiently on solutions. Going back to what Professor Ulph said in the previous evidence session, I think that Scotland has a particular issue with labour market participation. He admitted that it was not clear what the issue was, but, as he put it, the overall labour force is probably the correct size, but it is not necessarily in the right places. That suggests to me that we need interventions that allow us to redeploy and reskill people and ensure that they maximise their wages, which is not just a matter of focusing on people who are out of the labour market altogether—although it is in part.

In that case, I have to wonder about the priorities in the spending review. You have highlighted the employability fund, but that is not the entirety of the skills spend; a significant proportion of the budget of the Scottish Fiscal Commission—I am sorry, I mean the Scottish Funding Council; I am getting my SFCs mixed up—goes to colleges, but that is flat cash through the spending period, with an 8 per cent cut. Likewise, universities make a significant contribution to skills, and Skills Development Scotland's budget falls within the same budget lines. Again, those budgets are flat cash throughout the spending period, with an 8 per cent cut.

Therefore, there are at least four budget lines—four areas of spend—that contribute to skills and ensure that, as Professor Ulph put it, people are in the right places in the labour market. However, only one of them is going up—the other three are being cut. Is that the right priority, cabinet secretary?

Kate Forbes: I actually think that prioritising employability and training in the finance and economy portfolio is the right call. However, if spending in one area goes up, the same increase cannot be maintained across the board.

What we require is a flexible training offer. Universities and colleges have an important role to play in that respect, and they have to adapt and be cognisant of future skills demand. With employability training, which, as I have said, is one of the very few budget lines that is going up significantly, we are endeavouring to provide a more flexible retaining and reskilling offer to individuals who need to retrain and reskill.

That said, I go back to my starting position: the outlook is very difficult, given the funding that we have available. I imagine that around this room and across the chamber there will be different asks in terms of where I should be spending more. Indeed, I have already heard some of them today with regard to local government, universities and employability.

If I could spend significantly more on every budget line, I would—of course, every finance secretary would want to do that—but I cannot as I am constrained by a funding envelope, and I have sought to be fair across the board. It is even more challenging because our spending powers have decreased as a result of inflation, which you cannot get away from. What you are counting as real terms cuts is higher because I have less spending power as a result of inflation. We have tried to protect spend, but if you want any line to go up, I am afraid that on the resource spending review—which is different from a budget—I do not really have anywhere to go.

Daniel Johnson: Even if we consider spend on employability, it is really only in the past year that that has gone up by any significant amount. Therefore, you have four budget lines which—certainly in the early years—will all probably experience significant real terms cuts. Almost certainly, on aggregate across the five years, skills spending will have an aggregate cut. If you want to drive up average earnings, is that not inconsistent?

Kate Forbes: Gary Gillespie might want to come in on earnings more generally, but I will go back to my fundamental point: I cannot overspend by a penny; I can only spend what the SFC thinks it is reasonable for me to receive. Therefore, if you want any part of that resource spending review to increase, that has to come from elsewhere in the pot, because my spending and funding assumptions must be based on as much fact as possible—which they are.

Daniel Johnson: However, if you drive up earnings faster than in the rest of the UK—you cannot do that in the short term, but it is not an unreasonable medium-term ambition—you can increase the amount of money that you have to spend. That can certainly be done within a five-year time period. Is that unreasonable to expect? You certainly cannot do that if you cut skills funding.

Kate Forbes: No, that is a very reasonable assumption to make. My question to you would be: if I had given significant increases on the four lines that you are asking about, would you have been here asking me about four other lines that had been severely cut?

Daniel Johnson: I am merely trying to clarify the choices that you have made, and this is clearly one of them.

Kate Forbes: The choice that I have made is to increase employability and skills funding and to protect other budget lines.

Daniel Johnson: I will leave it there.

Ross Greer: I will return to Daniel Johnson's line of questioning on productivity and wage growth. I asked the SFC, but by that point you were outside the door, so you probably missed that.

The SFC's assumptions about increasing productivity are based on more people getting into the right jobs; in other words, more productive, higher paid jobs. The workforce will not increase, as we have just discussed, which means that either low-wage sectors need to become higher wage—so wages in sectors such as retail, hospitality and tourism need to go up—or there will be a continued exodus from those sectors into higher wage sectors.

In terms of the Government's overall strategic priorities for the economy, what balance of those two trends would you like to see? We already have acute labour shortages in those sectors, which is usually tied to wage issues. Is it more of a priority to grow high wage sectors or try to raise wages in those existing sectors where there are shortages because of those issues?

Kate Forbes: Our immediate priority is to embed fair work. It goes back to questions about poverty and productivity. If you have fair work conditions and people are in secure, well-paid employment and get paid a reasonable wage, that delivers multiple benefits for our economy and the overall cost of the public sector.

Our primary focus right now is to embed fair work principles. Employers also want to focus on that, because, at a time of high demand and more supply, they have to distinguish themselves. Having said that, we are particularly exposed by the fact that a lot of the highest earners are in very few industries. That means that a downturn in oil and gas has a disproportionately large impact on our tax revenues and economic outlook, so there is an argument to make sure that we diversify, while also taking into account the impact that that has.

13:00

Ross Greer: If that is the case, would it be fair to say that the strategic priority for, say, Scottish Enterprise—which is issuing grants from a fixed budget—is far more aligned with targeting grant offers, with attached fair work conditions, at low-wage sectors, than with issuing grants to businesses that are already in a high-wage sector?

Kate Forbes: The way that we are doing the former is through embedding conditionality. Businesses should not, for example, be able to access grant support without signing up to fair work principles. Rather than being a particular focus, it should be the status quo and the norm that businesses can access Government support only if they adhere to fair work principles.

It is not an easy either/or situation, because we also know, from the NSET work that was done, that Scotland has some of the greatest potential in the high-growth sectors—for example, in the areas of technology and renewables. I do not think that we can neglect some of our core industries, although they should expect to receive support only if they meet those conditions. With regard to future growth ambitions, which is where we maybe have a slight difference of opinion—

Ross Greer: The difference of opinion is just on how to define growth; it is not—at all—on the principle of growth.

Kate Forbes: With regard to our growth ambitions, we want to see far greater rates of successful scale-ups, because we know that that is where a lot of jobs are created.

Ross Greer: I have one final question. As you pointed out, the single biggest factor affecting so many of our discussions this morning is the current rate of inflation. What discussions have you had with the Treasury about the impact of inflation on, and the potential to inflation-proof the Scottish budget?

Kate Forbes: We have had discussions, and I will see the Chief Secretary to the Treasury next week, when, I am sure, we will continue those discussions on the fact that our current assumptions around block grants are largely based on an out-of-date spending review that does not take inflation into account.

I will continue to make those points to the Treasury. I certainly would like to see, at the very least, some review of the fiscal framework, taking into account the impact that inflation has, not only on our spending power but on the way that certain elements keep track with inflation.

Those conversations will continue. I am, generally, an optimistic person, but I have been having those conversations for a very long time.

Ross Greer: Thank you very much.

The Convener: I have one final question, which I hope is on an optimistic note. Section 2.4 of the spending review document is titled “A Stronger, Fairer, Greener Economy”, and there are a lot of positives in there. Again, you talk about the national strategy for economic transformation

“stimulating entrepreneurship; building new markets; increasing productivity ... developing ... skills”

and “embedding entrepreneurship”. You also talk about an investor panel, an inward investment plan and an export growth plan, which are all very positive.

What kind of impact do you believe that the strategy will have by the end of the period up to 2026-27, which we have been discussing, in relation to increasing investment, jobs and job retention? Many businesses, when they get to a certain level, move outside Scotland. What impact will that new cultural change have on Scotland and our revenue base?

Kate Forbes: If we get it right, it will have a huge and hugely positive impact. The resource spending review covers the period that is just short of half way to the national strategy for economic transformation outcomes, which we aim to deliver over 10 years. If we get that right and invest our funding in achieving outcomes and objectives, rather than in maintaining the status quo, we can shift the dial on those things. If we just defend the status quo, we will get the same outcomes, but I think that all of us have an aspiration and ambition to actually deliver what the resource spending review sets out in relation to economic growth, resilient public services and tackling child poverty.

The Convener: Cabinet secretary, thank you very much for spending so much of your morning in responding to our questions. That ends today’s deliberations.

Meeting closed at 13:04.

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