OFFICIAL REPORT
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Finance and Public Administration Committee

Tuesday 20 December 2022

Session 6

The Scottish Parliament
Pàrlamaid na h-Alba

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CONTENTS

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FINANCE AND PUBLIC ADMINISTRATION COMMITTEE
34th 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)
Dr Mike Brewer (Resolution Foundation)
John Ireland (Scottish Fiscal Commission)
Professor Sir Anton Muscatelli (University of Glasgow)
Professor Graeme Roy (Scottish Fiscal Commission)
Professor Frances Ruane (Economic and Social Research Institute)

CLERK TO THE COMMITTEE

Joanne McNaughton

LOCATION

The Robert Burns Room (CR1)

Scottish Parliament

Finance and Public Administration Committee

Tuesday 20 December 2022

[The Convener opened the meeting at 09:32]

Budget Scrutiny 2023-24

The Convener (Kenneth Gibson): Good morning, and welcome to the 34th meeting in 2022 of the Finance and Public Administration Committee. We have received apologies from Douglas Lumsden, who is attending a funeral today.

The first item on our agenda is an evidence session with the Scottish Government's expert panel on the Scottish budget for 2023-24. We are joined remotely by Professor Sir Anton Muscatelli, principal and vice-chancellor of the University of Glasgow; Professor Frances Ruane, chair of the national competitiveness and productivity council and research affiliate at the Economic and Social Research Institute; and Dr Mike Brewer, chief economist and deputy chief executive at the Resolution Foundation. I welcome you all to the meeting.

I intend to allow up to 75 minutes for the session. We will move straight to questions. Our questions do not have to be answered by everybody. I will put my questions to Professor Muscatelli, who can decide which of his colleagues should answer. Although more than one person can answer, that does not need to happen.

The "Expert Panel Interim Commentary on the Implications of the UK Government Fiscal Statements for the Scottish Government Budget" sets out the panel's thinking

"on how the Scottish Government could respond to the challenges it is facing through the tax system and the wider implications for public services and the economy."

It suggests that the Scottish Government will need to find a balance between

"providing short-term support to vulnerable households and businesses; and ... investing to grow and improve the productivity and resilience of the economy in the medium to longer term."

Has it done so?

Professor Sir Anton Muscatelli (University of Glasgow): It has done that as best it can, given the rather difficult situation that we are in with regard to the public finances of the United Kingdom and, therefore, the devolved Administrations.

As members of the expert panel, we are not here to comment on the budget, because decisions involving spending and tax are political ones. However, the Scottish Government has tried to protect certain heads of spending. Health and social care spending and welfare payments have been protected. By increasing taxes, the Government has been able to reduce the real-terms impact on the Scottish budget, but it has not been able to offset completely the reduction in real spending that has resulted from inflation eroding the total finances that are available to the Government.

The Scottish Government has chosen to prioritise certain heads of spending. That is the best way that I can summarise the budget without commenting on the political choices that the Government has made.

I will pass over to my colleagues, who can give their takes on the question.

Dr Mike Brewer (Resolution Foundation): Thank you and good morning, committee. The context for the budget was incredibly difficult, with the rising cost of living putting huge pressure on household and Government budgets. The Scottish Government is in a more difficult position than the UK Government because it lacks the ability to borrow to smooth out the fluctuations. The context is that the energy price shock has made the country poorer and, all across the UK, we are seeing a process of negotiation, bargaining and political manoeuvring as we work out exactly who is going to bear the cost and suffer the most.

In the Scottish budget, I can see decisions to increase tax take towards the top of the distribution and use that to put more money into welfare benefits and to try to ease the pain that is coming to some Government departments, because they are facing increased cost pressures.

The Convener: I realise that you do not want to stray into political areas if you can avoid it, and that is not going to be easy but, when I asked about improving the productivity and resilience of the economy in the medium to long term, you said that the Scottish Government has done the best that it can given the constraints that you have mentioned. Is there anything that it can do differently to achieve those objectives?

Professor Muscatelli: One of the things that we have said in our final report that is very important is that, to some extent, this year, the Scottish Government has been able to attenuate the impact of inflation through tax increases in its budget. However, there are more difficult times ahead and, as we say in our final report, from the UK Government's announcement, we expect further constraints on fiscal policy over the next couple of years.

We do not know what will happen after the UK election; things might or might not get tighter but, on current projections, spend at the UK level will tighten. This is therefore an important time for the Scottish Parliament to think seriously about how it engages in public service reform to get the most efficient outcomes from total public spending, simply because there will be pressures on public service salaries and hard choices might need to be made. Some of the runway has been taken up already in terms of additional taxation, and we might come to that in a discussion about the extent to which taxes in Scotland can diverge from those in the rest of the UK.

This year has been a kind of protection operation, if you like, to protect certain public services and welfare payments, so serious thought needs to be given to ensuring that growth can continue into the future, which will allow the tax take to increase.

One other point to make is that the Scottish Fiscal Commission's report says that part of the additional room for manoeuvre for the Scottish Government has come from some of the revisions that the commission has made to forecast tax take for the next three years. Those might or might not be realised, but for them to be realised the Scottish economy will require to grow, so I urge the Scottish Parliament to think seriously about how spending this year and during the next two years will be allocated to ensuring that that growth continues.

Frances, do you want to come in on that point?

Professor Frances Ruane (Economic and Social Research Institute): I do—thank you very much.

I am very pleased to be here. I was asked to come before the committee very much as an outsider, so I am not on top of the detail of the budget of the Scottish Government. However, like a lot of economists outside of the UK—and, indeed, I suspect in the UK—we watched what happened earlier this autumn with some surprise. Everybody realises that increasing productivity and getting more growth is a good thing, but you want to do that in such a way that the process is smooth and works in the right direction.

The effect that I saw when I was asked to join this group was that massive uncertainty had been created across the whole of the UK as a consequence of what happened. Even though subsequent changes have made that better, it is still the case that there is massive uncertainty. One of the roles of Government in a time of uncertainty is to give as much certainty as it possibly can. Crucial to that is that short-term decisions with regard to a budget such as this year's are properly aligned with the medium view of two to three years out. The importance of ensuring that the level of uncertainty is kept to a minimum is one of the points that we made in the reports.

At the moment, crucial to that is helping households and businesses that have suffered this huge price shock and allowing them to deal with that in the right kind of way without inflation becoming embedded, which is a situation that I am old enough to remember. The big challenge in dealing with inflation for Governments everywhere at the moment is to make sure that welfare issues are well handled but that inflation does not become embedded in the economy. Crucial to that is making sure that the economy grows at the same time. The crucial issue for a Parliament is therefore to make sure that what is being done in the short term will align well with the Scottish economy growing in the medium term in a fair and sustainable way. Of course, we are all much more conscious of the importance of sustainability in all its dimensions, and not just in energy, than we were a couple of years ago.

The Convener: You said:

> "it is important to achieve the right type of growth: growth that is sustainable and in line with other wider policy objectives, such as reducing inequality and the transition to net zero".

Clearly, you will not be recommending the building of a giant coal mine, which they are suggesting will go ahead in Cumbria. Will you give us some examples of sustainable growth that is of the right type to reduce inequality and support the transition to net zero?

Professor Ruane: Do you want me to come in on that, Anton, or do you want to go ahead?

The Convener: I am sorry—I try and put the questions to Professor Muscatelli so that he can decide who answers.

Professor Muscatelli: Why don't you come in, Frances, and then Mike Brewer, if he wants to?

Professor Ruane: The issue in relation to sustainability is in ensuring what people in Europe, or rather the European Union, discuss as the dual transition. It is about optimising the use of digital technologies to be efficient in the delivery of public services, for example, and making sure that the public sector is as efficient as it can be, as Professor Muscatelli mentioned earlier. It is also about issues relating climate and effectively getting investment to take place that helps the climate agenda and assists companies and enterprises in getting to a stage where they are well set up to sell into international markets in a way that will work five, 10 or 15 years out, and not only in relation to what is required at the moment.

The Convener: Professor Muscatelli talked about the importance of the public sector reform programme, which your report says "remains key". You add that

> "there has never been a more important time to consider prioritisation in public services and productivity-enhancing reforms in the public sector".

The Scottish Government resource spending review published in May suggested that the public service reform programme would be undertaken over the remainder of this session of Parliament with additional outcomes to be reported in the 2023-24 Scottish budget, but there is no mention of it in the Scottish budget. Is that an issue of concern to the panel?

Professor Muscatelli: It is something that the Scottish Government and Scottish Parliament really need to have in sight into over the next year or so. The pressures on spending at UK level will increase in the next couple of years, which will have consequences through the Barnett formula allocations. It is therefore an important consideration.

I do not know whether Mike wants to come in on the overall UK picture.

Dr Brewer: I have nothing to add, thank you.

09:45

The Convener: You have also said that the UK Government has announced two new fiscal targets, which

> "gives the UK Government more scope to cut capital spending to achieve its deficit rule by treating current and investment spending equally."

However, you add that that is

> "potentially hampering productivity and economic activity in the long run and reducing tax revenues."

We have seen that there is a £185 million reduction in the Scottish Government's capital budget for the next financial year. How concerned are you about that?

Professor Muscatelli: Mike, I will turn to you to answer that one, because again it is about the overall budgetary position in the UK.

Dr Brewer: Yes, we flagged that in our earlier reports. In the UK Government's budget, Jeremy Hunt pencilled in a reduction in capital spending from the generous plans that were previously announced by the then chancellor, Rishi Sunak. Of course, that impacts on consequentials for the Scottish Government. We encouraged Mr Swinney as the Scottish Government finance minister to do what he could to offset that, because it did not seem to us that cutting capital spending at this time was a sensible action.

It has been very welcome that, through the summer and the autumn, we have noticed an increased focus from all politicians on the UK's fairly dismal growth record over the past 15 years. Low investment is a significant cause of that. It is chiefly in the private sector where the UK is lagging behind other countries, but Government investment can help enormously by acting as a catalyst in certain areas.

We have been urging the UK Government not to make cuts to its capital spending plans and, in our report, we encourage the Scottish Government to do what it can to offset those cuts. However, as I said earlier, the Scottish Government is limited in how much it can offset. It is essentially already taking full advantage of its ability to borrow to offset the cuts coming to the capital budget.

The Convener: You have said that the UK Government's decision not to enhance capital funding given the high levels of inflation

> "will lead to a steep decline in the purchasing power of Scottish Government investments ... this may hamper the Scottish Government's ability to meet its net zero targets and damage the economic recovery".

Dr Brewer: Yes, absolutely. I completely stand by that point. We are pointing the finger of blame principally at the UK Government and then, as there are financial consequentials for the Scottish Government, we made recommendations and suggestions to it. However, as I say, the Scottish Government is quite heavily constrained in how much it can offset the cuts in capital spending that are coming its way because of the position in Westminster.

The Convener: Thank you. I have just one final question before I open out the session to colleagues round the table. It is a question about taxation. We see that fiscal drag will increase income taxes quite considerably over the next few years, and you have said that the Scottish Government should continue to consider

> "ways that the tax system could be made fairer and better aligned to improving productivity and wellbeing, either through reforms to existing taxes or through the introduction of new taxes".

By 2027-28, what share of gross domestic product will be taken up by taxes compared with now? Also, you say that the system could be made fairer, but fairer to whom?

We have an anomaly in Scotland whereby people who are earning £45,000 a year, for example, on marginal tax, will pay in the next financial year 42 per cent in income tax and 12 per cent in national insurance, giving a marginal rate of 54 per cent; on the remainder, they will have to pay excise duty, VAT and all the rest of it, depending on their lifestyle. However, for people earning over £50,000, their national insurance level falls to 2 per cent, so their marginal rate is significantly less. How can the tax system be made fairer, given those anomalies?

Professor Muscatelli: I will address the second part of your question, and my colleagues might want to respond to the first part, with Mike Brewer, in particular, addressing the issue of the overall tax take as a share of GDP at UK level.

It is quite difficult, because Scotland does not control all of the tax levers with regard to income tax. Indeed, convener, you have just highlighted the interactions between income tax and national insurance, which means that, with earnings, you can have marginal tax rates that vary quite a lot over the range. Indeed, that is one of the issues that the UK is facing at the moment. Moreover, the phasing of the personal allowance means that you get tax anomalies even further up the tax distribution.

This is a personal view—my colleagues might differ on this—but our thinking with regard to the other taxes that might be thought about in the devolved context focused largely on property taxes. If we are talking about trying to make the tax system fairer, I would just point out that the income tax system in Scotland is actually more progressive than it is elsewhere in the UK, because it puts greater burden on those with higher incomes. The one area that is probably less progressive is property tax. The council tax is essentially still rooted in a system that has not changed very much and which has not kept pace with property prices or property price differentials and, therefore, with wealth differentials across the country. As a result, if you were going to do anything, it would probably be in that area. Moreover, as any new taxes or tax changes that Scotland might want to introduce have to be approved by the UK Government, that is probably the area where we would have most freedom to act.

That was what was in my mind when we wrote that, but Mike Brewer might want to say something about the tax burden issue and Frances Ruane might say something about progressivity, too.

Dr Brewer: I apologise, convener, but I do not have the figures to hand to answer your precise question. I know that you will be speaking to the Scottish Fiscal Commission later this morning and I hope that it will be more helpful than I can be.

Stepping back and looking at all of this from London, I see the situation that you have described as what happens when the Scottish Government is in control of some, but not all, personal tax rates. Indeed, I was going to make a similar point with regard to the withdrawal of child benefit, which affects families with children in which the main earner has an income between £50,000 and £60,000; their marginal rate goes up by 13 per cent if they have one child and a further 8 per cent if they have two or more children. Of course, that is a UK-wide policy that the Scottish Government has no control over but which should be thought about when we think about the marginal rates.

Problems arise when different bits of Government control different bits of the personal tax system, because they can interact in the way that you have described. At the moment, that particular income band is fairly small, but the Scottish Government must be aware of the parts of the tax system that it does not control when it makes decisions about the parts of the taxes that it does control. It must take account of those interactions and be mindful of the situations that you have described.

Professor Ruane: I had not realised the full complexity of the operation of the Scottish income tax system, with the Government being in control of some levers and not others and changes to other levers effectively impacting on what is already being done. That is a difficult and challenging situation.

The issue of the scale of tax revenues is one that a lot of countries, including Ireland, are looking at. We have just had a commission on taxation and welfare, a key part of which was a recognition of not just the greater complexity in our economy since the previous commission on tax but—and this is very important for Parliament—the sustainability of the income tax system and, indeed, the whole tax system. You need to ensure that your sources of taxation, including taxation on wealth, are much less volatile in response to the sort of changes in the economy that we have had.

Therefore, it would be appropriate for the Scottish Parliament to think about the sustainability of the tax system in the face of volatility and whether, in fact, the system contains the right elements and then to remove as many anomalies as possible in relation to the interaction between what Westminster does and what you do at Holyrood. It would be important to get that sort of thing in play.

The Convener: Thank you very much for that. I now open up the session to colleagues.

Michelle Thomson (Falkirk East) (SNP): Good morning, panel. It is nice to see you all. We are dancing around a lot of similar areas; such is the advantage of the convener that he often asks questions that I might have liked to ask. I will follow on.

We have already heard a lot about limitations in terms of lack of borrowing powers, capital reduction and so on. I find myself thinking that, in terms of both the areas that we have talked about so far—a public sector reform programme and how to drive up productivity—surely, in behavioural terms, the fixed budget, limited borrowing powers and limited fiscal levers must influence the behavioural ambition of the Scottish Government for making a change. Such is the complexity of unintended consequences. That is the case for any Government, but surely it must be so much more of a factor for the Scottish Government. Perhaps Professor Muscatelli could give us some thoughts on that first.

Professor Muscatelli: I have no doubt that the lack of borrowing powers, particularly around capital, must limit the scope of action of any Government. I think that this is one of those areas where the current devolved settlement is what it is; but if you look around at other federal tax systems, you see that a number of other jurisdictions have the ability to borrow more for capital spending. I wonder whether that ability might help in the reform of public services, because some of that reform might be in areas such as automation or where a greater capital intensity, or capital deepening, will improve productivity. You are right—that is one area where those constraints will certainly limit the scope of action.

Michelle Thomson: Following on from that, it is obvious that a reform programme can bring efficiencies, but there is a cost to those efficiencies. Where there is a fixed budget, that cost is not so much in costs as in a reduction in spend in other areas that leads into this cycle. I would like to hear your reflections on how a fixed budget makes for real limitations in any public sector reform programme.

Professor Muscatelli: There is no doubt that, given a fixed budget and rising salary costs, you will have to make difficult choices about what services you can and cannot provide. That is an issue that Scotland will face and that the UK will face as a whole, and therefore the issue is what are the most immediate priorities. When we talk about doing more with less, usually that means doing some things that generally improve productivity. As you say, though, there will be other things that you will not be able to do, and so you have to prioritise. There are some really difficult choices to be made, without a doubt.

I come back to a point that Mike Brewer made earlier. We are all poorer as a result of the particular stagflationary shock that the UK and Scotland have faced, and that means that we will not be able to do as much, unless it is decided to spend and tax more. Essentially it is about where the burden falls. You are absolutely right if the implication of your question is that this is about not just gaining productivity but the diminution of services in some cases. There are hard choices to be made—that is absolutely right.

Michelle Thomson: To finish off this point, I have a question for all the witnesses. Within the limitations of the Scottish Government's powers, where do you see the biggest bang for buck in terms of increasing productivity? Professor Ruane, you have conceded that you are not as across all the limitations, so perhaps Dr Brewer or Professor Muscatelli can take that question.

Professor Muscatelli: Mike, do you want to kick off on that?

Dr Brewer: Yes, although probably with a non-answer. I do not think that I have enough knowledge of what the Scottish Government is up to to answer that question. We said earlier that one of the most important things that any Government could do right now is be clear on its strategy, to make businesses feel able to invest in themselves—it is about business confidence in the Government, stability and having a clear strategy, and I see some of that in the budget that the Deputy First Minister announced. I also note that some decisions have been put off, probably quite rightly, because of the severe challenge that has been caused by the cost of living crisis.

10:00

Professor Muscatelli: It is not all to do with spend and therefore not all to do with the Scottish budget. One of the things that the Scottish Government and Parliament need to reflect on in the next couple of years goes back to the point that Mike Brewer just made—how do we ensure that business investment grows, because it is very low in the UK as a whole? Some of that might not be to do with spend, but to do with areas such as regulation and how to drive innovation or co-investment between public spending and private sector innovation and investment.

In our first report on the national strategy for economic transformation, we said that that must be pursued with vigour because it is aimed at genuinely lifting business investment and productivity. If I were in Parliament, I would be asking for evidence of how that is driven and what co-investment is being done between the private and public sector in those areas of activity.

Ross Greer (West Scotland) (Green): I return to the point about capital powers and your recommendation for the Scottish Government to maintain capital spend. Professor Muscatelli acknowledges the Government's limitations when it comes to capital borrowing, so I want to understand a little bit better how you think that the Government can maintain capital spend when the capital budget is largely set for it through the settlement from the UK Government. You might think that the limited capital borrowing powers are not being used well enough or that we could increase taxation further to increase the capital budget, or it could be a question of reallocation within capital because there is a belief that some capital spend is not efficient enough and we could get more bang for our buck through reallocation. Could you expand a little bit on how you think the Scottish Government could achieve what you recommended, given the limitations that you have acknowledged?

Professor Muscatelli: I am happy to kick off on this, but Frances Ruane and Mike Brewer might also want to come in. There are limited levers here. One possibility is to seek areas of co-investment as per my previous answer. One of the other possibilities will be to see whether there is any room for moving from revenue to capital, but that would put even more pressure on public services. Those will need to be considered if the trade-off is creating more fiscal space in future to then grow the economy more and have more resource at your disposal in due course.

I do not pretend that that will generate hundreds of millions of pounds. We are talking here about actions at the margin, as you suggest. As the budget clearly sets out, a lot of pre-commitment of capital spend is in areas such as the drive to net zero, which is clearly hugely important to sustainable growth.

Professor Ruane: It might be obvious but, at a time of global uncertainty, you want Government to play the role of giving as much certainty as possible. Clearly, Westminster did the opposite earlier in the autumn.

The Scottish Government is trying to be consistent and have what we call boring budgets that are not full of exciting surprises but are standard and steady in going forward. The important thing is to make sure that the capital spend is not ignored and reduced as a way of dealing with current problems. It is really important that the capital spend is done in tandem with the revenue spend.

I chair our competitiveness and productivity council, and it is very clear from the evidence that we have from looking at what companies are doing that they depend very much on having a level of certainty given by the markets and Governments. They want to know that, if a scheme is in place this year, it is not going to disappear or be changed around in next year's budget. That kind of volatility does not help investment, which is exactly what you need for productivity growth.

The other issue with regard to productivity is making sure that Government spend on things such as skills generation makes sense in the context of the way in which the Scottish economy develops as it modernises and goes through different phases. There is a lot of work to be done to ask questions on whether certain elements of capital and revenue expenditure are in tandem and make sense and reinforce each other, because productivity is a long game, not a short game.

Ross Greer: My next question might be best directed at Professor Muscatelli, as our domestic expert. Do you have any views on whether the Government is using its existing capital borrowing powers effectively enough? I acknowledge that they are extremely limited. Have you looked at whether they could be better used?

Professor Muscatelli: We have not looked in detail at particular projects, if that is the question. We have been looking more at the overview and at whether the projects are fully met and expended. I have not looked at the detail of individual projects, so I cannot comment on that.

Ross Greer: I will switch to the issue of tax and your recommendation on continuing to make the tax system more progressive. Do you have any views on the papers that were recently published by the Scottish Trades Union Congress and the Institute for Public Policy Research, which largely focus on the introduction of new tax powers? Both papers included proposals on changes to income tax, non-domestic rates and so on, but they focus primarily on creating new powers, particularly around property taxation, which you mentioned, Professor Muscatelli.

I am conscious of the time, so I will roll in a second question specifically on the higher tax band. Is the range in the higher tax band now too large? For example, should we tax people who earn between £45,000 and £60,000 at the same rate for that portion of their income as we tax that portion of income for those who earn between £100,000 and £125,000?

Professor Muscatelli: On the first point, the easiest way to introduce any additional taxation that targets higher incomes or higher wealth in Scotland is through property. It is the only feasible thing to do, because any new taxes ultimately have to be approved by the UK Government. I cannot see any attempts to tax financial wealth differently in Scotland. First, it would not be approved, and secondly, it would be too easily eluded, given the mobility of that wealth. Ultimately, land and property are the only things that you can tax if you want to make the system more progressive by targeting wealth as well as income.

With regard to what has been published by the STUC and others, we referred to one of the Institute for Fiscal Studies papers for the Deaton review, which shows that if you target particular different types of income, including from land and property, you can gain some of the effects that you would from a wealth tax but without directly targeting wealth, which you could not do with the current devolved powers.

On the range of taxation, it is difficult for me to comment on the exact tax bands, and nor would it be fair for me to do so, because I would be straying into political terrain. However, clearly, there are all sorts of possibilities. One thing that you have to bear in mind is that, the higher you go in the income range, the more mobile that labour is. Who would the incidence fall on? That is a very important question. If you start taxing higher incomes at a much higher rate, sometimes the burden will fall on the individual but sometimes the burden will fall on businesses or, indeed, even public services organisations that are paying higher salaries, because in order to attract people or encourage them to stay in Scotland, they pay higher gross salaries. Therefore, there are also trade-offs that one has to bear in mind. However, I do not think that I would want to go into the detail of how I would design a tax schedule, because that is really a matter for ministers.

Ross Greer: Unless any of the other witnesses wants to pitch in on that, I have finished my questions, convener.

Daniel Johnson: Professor Muscatelli, I have a follow-up question to the answer that you just gave and your previous answer about property tax. You have twice said that that would require Westminster approval. I assume that you are talking about reform of council tax and non-domestic rates, and I think that a property tax or a land tax is a very good candidate for replacing one or both of those. Why do you say that that would require Westminster approval? The power is fully devolved if we use it as a replacement for those sources of local taxation. Will you clarify why you say that?

Professor Muscatelli: I was saying that in relation to any new taxes and not the reform of existing taxation, of which—[*Inaudible*.]

Daniel Johnson: You went quiet there, but that is fine. I will ask a further question.

We recently had an interesting—it was certainly interesting for us—conference on taxation, which was held at the Royal Society of Edinburgh. If we are going to reform council tax and non-domestic rates, I would want them to be reformed hand in hand. They are both property-based taxes, but they have diverged significantly and council tax was only ever a temporary fix. Would you want to reform them hand in hand? Would they both need to be based on the same underlying principles—that is, if you went for a land value tax for one, you would do the same for the other—or could you have a property-based tax for residential taxation and a land value tax for commercial? Does it need to be done in the round and do we need a consistent approach to commercial and residential taxation?

Professor Muscatelli: It would make sense to do it consistently across the piece and, at the same time, consider the progressivity of the tax and where the incidence ultimately lies. If I remember the RSE discussion about that correctly, that is one of the issues. I absolutely agree that you have to look at them in the round.

Daniel Johnson: You also stated that the budget was about dealing with the short-term shocks that we have had and, potentially, their medium and long-term consequences. Do the witnesses consider that there is sufficient focus on those? There has clearly been a real focus on trying to create the envelope for pay awards, but we are also dealing with labour market shocks and utility price shocks.

If we look at the budget, we see reference to the warmer homes Scotland scheme. That is one of the budget lines that was cut in the September emergency budget review. Likewise, on pay and the consequences in the health service, we know that delayed discharge is one of the key issues and there was a 3.8 per cent increase in the minimum pay. It is fair to say that the focus has been on creating the envelope for pay increases, but is there sufficient focus on getting people off gas or to be less reliant on it, dealing with labour market shocks and dealing with the short-term issues that we face in our most fundamental public services, such as the health service?

Professor Muscatelli: I will say a word or two and then pass on to Mike Brewer, because some of those policies have been enacted at a UK level, so he might want to relate his answer to that.

I do not want to stray into political terrain and discuss the detail of what choices I would have made or recommended. However, there is no doubt that anything that you would do to try to cushion the impact of energy prices is hugely expensive. If the focus had been less on protecting the public service budgets from the inflationary salary increases and more on other initiatives, it would really have put a strain on public service budgets. The arithmetic of it would tell you that that is expensive. It would also be an issue of the interaction between anything that is done in devolved Administrations and what is done at a UK level, which is significant anyway on the energy price guarantee.

10:15

Dr Brewer: I would describe the budget as being predominantly focused on dealing with the short-term challenges that are posed by the rising cost of energy and food. Therefore, understandably, it does not give as much attention as the Deputy First Minister might have wanted to give to all the long-term challenges. That is, in part, because the fiscal situation does not allow the Scottish Government to make as much investment and do as much forward planning as it wants, and because there are real challenges this year.

In its budget, the Scottish Government has chosen to prioritise additional welfare payments for the least well-off through the Scottish child payment, and to provide extra resources for the public services that are under the most pressure at the moment. That is a reasonable response to the great challenge that we all find ourselves facing.

Daniel Johnson: You say that, but the Scottish child payment is flat from last year. It is not being increased—in fact, there will be a real-terms decrease, will there not?

Dr Brewer: The increase to £25—

Daniel Johnson: That was last year.

Dr Brewer: Okay, but that will be making a substantial difference. The payment represents a major difference between the Scottish Government's approach and the approach that is taken in the rest of the UK, and it will definitely help to protect low-income families in Scotland.

Daniel Johnson: I have a final question. One of the things that might make a significant difference to this year's budget and to budgets in future years is the spending on the creation of a national care service. However, none of us can identify whether such spending is included in this budget. There is a broad statement and narrative about support being provided. Should the Government provide that clarity?

Does that not also highlight a broader issue relating to transparency? Do the witnesses agree with the Scottish Fiscal Commission that the budget should be stated according to classification of the functions of government—COFOG—principles? Audit Scotland has also made the point that policy commitments should be made much clearer in the budget. What are the witnesses' reactions to those observations?

Professor Muscatelli: I am happy to have a quick go at answering those questions, but Mike Brewer or Frances Ruane might want to come in afterwards.

There is no doubt that there needs to be transparency around major commitments such as those relating to social care. I do not wish to second guess what Audit Scotland and the Scottish Fiscal Commission have said, but if there are any new policy announcements on that issue—or, for that matter, on any other issue—it is important that the Scottish Parliament understands exactly what the implications will be on existing budgetary pressures.

The Convener: I think that it is a bit of a stretch to suggest that the Scottish child payment going from £10 in April this year to £25 next year somehow represents a real-terms cut.

Daniel Johnson: My point was that the £25 has been carried over, so I was looking for clarity on what changes could have been made in this budget.

The Convener: Okay. I will not get into that argument at this point.

John Mason (Glasgow Shettleston) (SNP): The interim commentary report talks about public sector reform, the public sector becoming more productive and, in particular, digital technology. Can you say any more about what we should be focusing on or changing in the public sector?

Professor Muscatelli: I will hand over to Frances Ruane, who might be able to talk about the Irish perspective and the lessons from elsewhere, and then Mike Brewer might want to add to that.

Professor Ruane: Public sector reform is a bit like motherhood and apple pie; everybody always sees it as good. However, it takes a long time, and it requires the Government to be consistent.

In Ireland, not having a sum of money available over the years to invest in digital services has slowed things down. During Covid, as was the case in many countries, it was possible to do an awful lot more, in different ways, than had been done previously. There was a realisation of the enormous potential in that regard.

The use of digital in healthcare, in particular, is really important in relation to making things cost effective and minimising burdens on patients and professions. Digital is not the answer to everything, but given the scale of the change that can be achieved, there must be capital money to allow it to happen. It is the major driver, and it points to a difference between public and private services, if we are talking about very large-scale bodies.

A comment that I would make in response to something that Professor Muscatelli said earlier is that, in our first report, we referred to the need to realise what the shock has been. This is a terms-of-trade shock that has left us all worse off, and it is important for that to be recognised in parliamentary discussions. Where we were a year ago, things were not great, but where we are now, Parliaments, in particular, face an even bigger challenge in making really difficult decisions. Recognising that and having an open discussion about it is in everybody's interests, including all the members of the population of Scotland.

John Mason: Thank you—that was very helpful.

On the issue of where the UK is raising money from, you mention in your report that new energy levies are a part of that. There has been some debate about whether such levies discourage investment or, because they are just one-offs, they do not really have an impact. What are your thoughts on that?

Professor Muscatelli: [*Inaudible*.]—since you have an overall UK perspective.

John Mason: Yes, I am asking for a UK perspective, because that is where the levies are happening.

Dr Brewer: Shall I start? I am sorry—I did not hear whether you had addressed the question to anyone in particular.

My view is this: if now is not the right time for a windfall tax, which is what such levies are, in effect, when is the right time? After all, the profits that are being made by oil and gas companies and electricity generators are entirely due to events outside of their control, so this would seem to me to be the ideal time for a windfall tax. It is very clear from the way in which the UK Government has announced them that it sees them as temporary, and the way in which they are operating should mean that investment is not lower than what it would have been, had there been no energy price shock.

John Mason: As I understand it, you are more concerned about what is going to happen in two years' time than, perhaps, what is going to happen immediately. You say in your report:

> "Adding future fiscal commitments or pressures at this time given the spending outlook is unwise and would require a larger subsequent adjustment."

Do you think that such things are happening? Are "future fiscal commitments" being made that should not be made, or are you just giving a general warning that we should not be making any major new commitments at this time, given Professor Ruane's comment that the whole country is becoming poorer?

Professor Muscatelli: It is the latter interpretation. We are not suggesting that any unwarranted commitments are being made now—as we have said, the budget is constrained anyway—but, as far as total fiscal spending is concerned, harder times might well be upon us, depending on what happens in the next few UK budgets.

Perhaps I can illustrate what is an important point. What the UK budget did to try to stabilise the sustainability of the public finances and the debt to GDP ratio was, to some extent, pain postponed, with spending controls coming in later on, lower spending as a proportion of GDP and capital spending reductions. Essentially, we are warning in the report that we have to prepare for those things.

I know that you will be speaking to the Scottish Fiscal Commission after us, but it has improved its forecasts on Scotland's tax take. My reading of its report suggests that that is largely to do with a more favourable interpretation of employment levels and income tax take; that might turn out to be correct, but that is part of the riskiness of Scotland relying on its income tax base. If the forecast is incorrect, it will put further pressure on the budget.

I have no reason to disagree with the SFC's forecast, but it presents another element of risk on top of the potential reductions in spending that might come at the UK level. For both those reasons, some caution is warranted on what might be possible in future.

John Mason: You also used the word "caution" in the introduction. You are not arguing against measures such as increasing the child payment or putting more into the health service. You are not talking about that kind of fiscal commitment, are you?

Professor Muscatelli: No.

John Mason: That is fair enough.

Your report quoted Andy Haldane saying that the situation around health is acting as a "brake on economic growth". Will you expand on that? Do you think that Covid, long Covid and waiting times in hospitals are having an impact on the economy?

Professor Muscatelli: Mike, do you want to say something about that? Again, there is UK-wide concern about participation rates in the labour force, et cetera.

Dr Brewer: Yes, of course. That was an excellent question. Although the evidence is not clear, there is an emerging story that rising levels of ill health are beginning to hold back the economy—well, I guess that they have always held back the economy. The fact that the health of the UK population is declining means that the nation is less productive than it would otherwise be. The Office for Budget Responsibility pointed that out for the UK as a whole, and the Scottish Fiscal Commission commented on that position as it relates to Scotland.

I do not think we know how much of that issue is due to Covid. Some of our work has shown that the increase in worklessness is partly due to mental health problems as well as physical health problems. I do not think that Covid is exclusively the cause, but it is definitely the case that the UK is getting sicker. We can see that in labour force surveys in which people report that they are inactive because of their health, and we can see it in the number of people who are claiming disability benefits.

I noticed that, at UK level, the OBR has written in a sharp increase in disability benefit claims over the next few years. In more recent months, people have made links between national health service waiting times and some of that inactivity. Certainly, NHS waiting times in England are much worse than they were during the previous decade.

The evidence is building, and we need to be concerned about how the health of our nation is feeding back into the economy. Of course, there is a vicious circle, because the less productive the economy is and the fewer people who are in work, the less tax revenues we get to pay for the health service. All Governments need to be very wary of that.

John Mason: That was very helpful.

My final question is perhaps also for Dr Brewer, to start with. In the report, you mentioned that

> "Although it is normal for debt to increase during a recession, the UK has failed to address the accumulation of debt following the financial crisis and the pandemic."

Should we be worried about the level of UK debt?

Dr Brewer: It is very hard to answer that question. There is no magic threshold above which the country is in deep trouble and below which everything is fine. Ultimately, it is up to banks and overseas organisations whether they want to lend to the UK Government and at what price. At the moment, apart from after the brief kerfuffle in September and October, they seem willing to lend to the UK Government at a reasonable rate of interest, but we cannot take that for granted. It would be a problem if the UK's finances were to look as though they were on a track of debt rising unsustainably, as interest rates on Government debt would rise and we would be in danger of a dangerous spiral.

It is very unfortunate that the UK has been hit by two crises in quick succession—the Covid crisis and now the cost of living crisis—and that it did not have time to improve its finances in between the two. It is also the case that we still have much higher levels of debt than we did about 20 years ago, when debt was around 40 to 50 per cent of GDP.

In the long run, which means beyond the five years for which the UK Government and the Scottish Government plan, it would be ideal if the UK could bring down its debt level in order to create the fiscal headroom to put us in a better position to cope with the next crisis that comes. That is undoubtedly the case.

John Mason: Undoubtedly, there will be another crisis somewhere along the line.

10:30

Liz Smith (Mid Scotland and Fife) (Con): I return to the question of improving productivity and wellbeing, which is one of the central themes of your research. Earlier, my colleague Michelle Thomson asked you about where we can get the biggest bangs for the buck when it comes to improving productivity, and you provided a couple of examples.

I wish to develop the point a little further. We are in a very difficult situation across the UK, including Scotland, because a sizeable number of people, particularly those in their 50s and 60s, are coming out of the labour market. That will obviously have significant implications and give rise to difficulties further down the line with regard to productivity and tax take. I think that Professor Muscatelli talked earlier about skills and labour market flexibilities. What, in your opinion, do we have to do to drive greater flexibility in the labour market, while ensuring that we retain more people in the market than might be the case now?

Professor Muscatelli: [*Inaudible*.]—skills formation, whether we are producing the right skills and ensuring that we continue to invest in them. That will be an important consideration for the Scottish Government in future.

You have probably heard me say this before but, at a UK level, we need to consider how we use immigration to address some aspects of the overall skills issue. One of Brexit's damaging elements has been our inability to attract as many skilled Europeans to the UK as easily as before. Some of that has been obscured by Covid, but I have no doubt that, over the next three or four years, it will become an important consideration. How do we plug those gaps?

Mike Brewer has already talked about issues of health and people's decisions to retire early. It will be interesting to see how that dynamic works out. More research should be done on the data to find out what exactly has caused this great resignation or early retirement by a lot of people, although we know that a lot of people are dropping out of the workforce for mental and physical health reasons.

This is a complex problem, but we need to plug those key skills gaps. That means that the question of what investment we put into the skills base will be important. We need to consider what we can do at a UK level to bring in the skills that we need but which we cannot generate ourselves in short order, so that we are not held back over the next few years.

Liz Smith: I accept that point.

Professor, I want to ask you about something that is obviously close to your heart—the universities sector, and its role in developing innovation and digital technologies and helping to upskill people. What else does the universities sector have to do to improve the future skills of the graduates coming out of the sector?

Professor Muscatelli: That is a really interesting question. I think that a greater challenge facing the whole tertiary education system—both further and higher education—is upskilling, whether through courses funded by the Scottish Funding Council and through our basic undergraduate and postgraduate provision, and targeting the areas of the economy where there are bottlenecks. Increasingly, we as a sector need to capture the clear signals coming from the labour market when it comes to what we provide in such courses.

The kinds of measures that the UK Government has brought in such as the graduate visa route are really important, because they allow talented students to come and study in the UK and then perhaps to stay on, particularly in key areas such as health and digital technologies. We need to sustain such measures at a UK level, given that that is where immigration policy is set.

I do not know whether Frances Ruane or Mike Brewer wishes to come in on that.

Professor Ruane: Giving graduates the prospect of employment is a fundamental issue. For a start, it changes their attitude and the way in which they behave when they are students, and they also interact with other students in a particular—and positive—way.

I want to go back to an earlier point. This morning, I was looking at a chart produced by the Organisation for Economic Co-operation and Development on changes in activity levels in the UK versus a whole load of other OECD countries, and the UK is up there as having one of the highest increases in inactivity levels. It would be useful for Scotland to look at its position in relation to that and try to understand it. For once, Ireland is at the opposite end of the scale; we are doing particularly well, seemingly because women are going back into the workforce, which might, in turn, be the result of policies that have been put in place to increase the amount of childcare and after-school care.

It is interesting to look at that chart, because it shows a percentage change of plus 3 for you and minus 4 for us with regard to inactivity rates. Scotland might not be in the same position as the rest of the UK, so it would be useful for you to take a look at that and not just think that everything is happening the same way. The reasons for such changes are a lot more heterogeneous and they merit attention.

Liz Smith: That is helpful. I am sure that we will have a look at that evidence.

A lot of economic commentators have said that Scotland needs more higher-paid jobs to help with labour market flexibility, to improve productivity and to ensure that we get a better tax take. The committee is interested in finding ways in which Scotland can make best use of all its talents and ensure that more people go into the sort of higher-paid work that would benefit the economy hugely. It would be helpful to hear the panel's reflections on that.

Professor Muscatelli: A lot of that has to be driven by the demand side as well as the supply side. That is why I referred to the national strategy for economic transformation, which contained a number of actions. Of course, these actions must be evidenced and real investment will need to be put behind them over the next couple of years, which again is why you need fiscal space. If we focus on ensuring that the industries of the future—biotech, quantum technologies, advanced engineering and so on—come to and stay in Scotland and that that investment comes here, that sort of demand will drive its supply. Sectors such as the tertiary sector will respond, and more people will come to live in Scotland. As has been said, what happens to our tax base over the next three to five years will be absolutely crucial, but a lot of that will be driven by the demand for skills. The supply side will, no doubt, follow.

Liz Smith: I assume, therefore, that you would like the funding to follow that priority area, because it would be helpful to spend more money on innovation and the university sector, for example, and on ensuring that we drive towards those kinds of productive industries of the future.

Professor Muscatelli: Indeed. To be honest, though, I am not just talking about the university sector; I am trying to leverage business investment in this area, too. We have seen the kinds of measures that have been taken for the tech scalers, for instance, and we need to look at whether similar measures should apply to other sectors of innovation. Some of this will involve co-investment from universities, but some of it will essentially be about catalysing business investment.

Liz Smith: Finally, it is generally agreed that the national performance framework is a good thing to have, but how easy is it to measure what the best outcomes are in it, and how much is that allied to Scottish Government policy?

Professor Muscatelli: That is an interesting question. Economists have for many years tried to focus on the economics of wellbeing and, if you like, how we balance the scorecard. The NPF is a good guide in understanding that this is about not just economic performance but performance more widely, including other sectors.

Of course, it is difficult to use the NPF as a short-term guide on where to allocate spending, for the reasons that we have discussed. What we have to do is trade off the difference that an extra pound of spending on health will make to every indicator in the national performance framework versus the difference that an extra pound of spending on economic development will make. Of course, that is not the way in which the framework has been designed; it has been designed more as a retrospective tool to look at how well all our policies have done and to give us a balanced scorecard that allows us to make an assessment. Both perspectives on where each pound of investment should be put must be based on much more granular considerations. Again, I am interested to hear whether Mike Brewer or Frances Ruane have a view on this.

Professor Ruane: We all want metrics so that we can see how we are doing and make sure that what we do gives us a higher return or allows us to get out of doing the things that do not. Everything to do with productivity is medium to long term. The most extraordinary thing about the September fracas at Westminster was that it was about achieving productivity growth by Christmas—which, short of it being done by Santa Claus, was quite an amazing concept. Increasing productivity is a long game and what Professor Muscatelli has said is absolutely right.

It is all about identifying the weakest links in the chain. If the weak link is, say, underinvestment by Scottish enterprises, you need to look at that; if it is about people not having the right skill sets and a shortage of talent in areas where you want to grow jobs, you need to look at that, too. Looking at where the constraints on and barriers to productivity growth lie is an approach that every country could consider, because it can be quite revealing. Sometimes the constraints are not where they have been in the past, but in some cases, people or policies deal with them as if they were in the past rather than where they are now.

Liz Smith: Thank you.

The Convener: That commentary was fascinating. I note that the budget's three priorities are tackling child poverty, having sustainable public services and moving towards net zero. I have always assumed that people who work in the North Sea are paid very well and that people who work in the net zero industries not quite so well, but the average income is almost exactly the same, at just over £38,000 a year. Given that, and given what the Government has prioritised, how can we accelerate the move to net zero to ensure that it is faster than the decline in employment and the decrease in tax revenues in the north-east?

Professor Muscatelli: That is an interesting question. I am not a specialist on energy economics, but I will try to answer, and my colleagues might want to come in, too.

I go back to the point about properly funding innovation and co-investment in the research sector, which encourages companies to locate here. Ultimately, highly paid jobs are driven by having a large segment of the value chain here.

The drive to net zero can happen in two ways, the first of which is to simply import technologies and deploy them in Scotland. Although that will create jobs, it will not create well-paid jobs across the whole value chain.

The second way is to make sure that, in addition to bringing in some manufacturing, we also bring in highly skilled innovation jobs. The national strategy for economic transformation looks across the whole value chain not only at particular sectors but at technologies and how Scotland can play a role in some of those platform technologies. We have some of the best universities in the world, so we should exploit that research base as per Liz Smith's earlier question. We should also make sure that we are not just talking about manufacturing devices such as batteries or other things that will help the drive to net zero but that we drive some of the other parts of the value chain, too.

Frances, did you want to come in on this?

Professor Ruane: No, it is not my area at all.

The Convener: I thank Professor Muscatelli and his colleagues for their evidence this morning. We will have a five-minute break before we hear from the next panel.

10:44

Meeting suspended.

10:50

On resuming—

The Convener: [*Inaudible*.]—on the Scottish budget 2023-24. I warmly welcome to the meeting, in person, Professor Graeme Roy, who is chair of the Scottish Fiscal Commission; Professor Francis Breedon, who is a commissioner on the Scottish Fiscal Commission; and John Ireland, who is the Scottish Fiscal Commission's chief executive.

Professor Roy, I understand that you wish to make a short opening statement.

Professor Graeme Roy (Scottish Fiscal Commission): Thank you very much for the opportunity to come along and talk you through our forecasts, which we published last Thursday. Our report comes at a time when, over the past year, the near-term outlook for the Scottish and UK economies has weakened significantly. We estimate that the purchasing power of household incomes is anticipated to fall by the largest amount since Scottish records began in 1998. Inflation is on track to peak at around 11 per cent by the end of the year, which will outstrip earnings growth across our economy.

Inflation is expected to drop sharply over the next year, and household incomes should start to recover in 2024-25. Crucially, however, the price level will remain higher than would otherwise have been the case without the cost of living shock. Therefore, living standards will take time to return to their pre-crisis levels. The economy will adjust slowly to the two global shocks of Covid and the conflict in Ukraine.

Despite that challenging backdrop, the net contribution of income tax to the Scottish Government's 2023-24 budget has improved by £582 million since last year's projections. That is due in part to last week's Scottish Government policy changes, but also to other reasons including the revised data in the most recent figures from His Majesty's Revenue and Customs, which pointed to a relatively better tax position for Scotland and projected rising earnings.

The positive income tax net position over the next five years marks a change in the funding position of the Government relative to what we previously forecast. However, we deliberately took some time in our report to set out the caveats inherent in its assessment, and the potential for change. Should either we or the OBR alter our assessment, projections of the net position will change, too.

We are now six years into the operation of the fiscal framework, and we have a much better appreciation that things can change—and change a lot. The Scottish Government will need to take that into account when setting its medium-term financial strategy next May.

As always, our report contains an account of our costings of the tax and social security policy changes made in the budget. We estimate that the changes to income tax will raise an additional £129 million in 2023-24, that the changes to the additional dwelling supplement to the land and buildings transaction tax will add £34 million and that £356 million less will be raised from non-domestic rates.

Finally, turning to social security, as we highlighted last December, the gap between our forecast social security spending and the funding received from the UK Government is projected to widen. That reflects the extra costs of delivering some payments such as adult disability payment, which we forecast to run ahead of the block grant adjustment, and distinct payments such as the Scottish child payment, which have to be funded from within Scottish Government budget resources. We estimate that that gap will be £776 million next financial year, growing to £1.4 billion by 2027-28.

As you know, convener, I wrote to update you on our social security data needs. We are more than happy to answer any questions that you have.

The Convener: As we did not touch on social security at all in the previous evidence session, I will start with that. As you pointed out, by 2027-28, the social security budget will be £1.4 billion higher than it would be if the payments were maintained at the UK level.

The Scottish Government has three priorities: the move to net zero, tackling child poverty and sustainable public services. What impact do you feel that the £1.4 billion will have on public services?

Just before you respond, you are probably aware that the Institute for Fiscal Studies said:

> "The main reason why more services are facing cuts than elsewhere in the UK is that the Scottish Fiscal Commission expects Scotland's growing range of devolved benefits to eat into a bigger share of its budget. Extra spending on benefits will help tackle child poverty and support more disabled people but will mean less for public services."

Professor Roy: There are a few things going on in there.

Our forecast of the £1.4 billion funding gap is made up of two components. One is that there will be a gap of about £780 million in the net position between the social security benefits that are being transferred and the equivalent BGAs. There are a number of reasons why we think that that gap will emerge. The key driver is the different approach that the Scottish Government is taking to delivering social security benefits compared with what has been inherited from Westminster. It has a particularly big impact on adult disability payments, because quite a different approach is being taken to the systems through which payments of that type are delivered.

The caveat is that there is uncertainty around that for several different reasons. One is uncertainty around the take-up of those benefits, and another is how successful the Government will be in delivering that different approach to social security. However, if all of those things come to pass, that would lead to a gap of about £780 million.

Crucially, there is an additional element for the social security benefits that do not have an equivalent block grant adjustment. Those are new, additional decisions by the Scottish Government to implement additional social security payments that will help it to deliver its broader outcomes such as tackling child poverty and reducing inequality. We think that they will add a gap of about £600 million by the end of our forecast period. That is where the amount of £1.4 billion comes from.

What then matters is how that is funded, if that number comes to pass. The Government has two broad choices. One is to use its tax powers to try to raise additional net income. The tables in the SFC's forecasts show the net tax position and how it has evolved. The other thing that it could do is to reprioritise its devolved budgets into that area. There is a trade-off; it is the classic, opportunity-cost scenario in which, if there are priorities in some areas, the Government will have to deprioritise or shift the relative prioritisation from somewhere else. If the Government is going to fund more social security, that will either have to come from increased tax revenues or from existing devolved public spending priorities.

The broad point that the IFS made on that narrative was that, if the Government is going to spend more on social security, then with a relatively fixed budget it can add to that with net taxes. However, it will then have to find other ways to fund it, which would come from the general block of Scottish Government spending.

The Convener: I am going to ask you a follow-up question, but I should have said that I and my colleagues will direct all our questions to Professor Roy, who can decide which of his colleagues should come in on specific questions.

One of the things about the public sector is that 60 to 70 per cent of the money that goes into it is for salaries. So, obviously, if there is £1.4 billion less because that money is, for example, going to additional social security payments, that means that there is less money to pay wages, which will mean a reduced head count. In its overall calculations, has the Scottish Fiscal Commission looked at the taxes that are paid? I would think that the difference between social security payments and wages is that some of the wages will come back to the Scottish Government through income tax, whereas that is much less likely to happen with benefit payments.

Professor Roy: When we do our forecasts for income tax, for example, we will have forecasts for which public sector earnings will be part of those forecasts, so changes will feed through to our forecasts for income tax. We expect earnings to increase significantly over the next couple of years. That is the key driver of what is happening to nominal earnings and therefore it is the key driver of what is happening to income tax, so the calculations are done on the tax side of things.

You are right that the social security side is quite a different flow of income. Those payments go to people with particular special needs, in the case of the adult special needs payment, and the Scottish child payments are additional payments for children. How those payments feed through to nominal earnings is quite different. It is accounted for in our forecasts, but the two payments are quite different in how they feed through.

The Convener: One of the issues is that benefits are going to be uprated in April to the consumer prices index rate, which was 10.1 per cent in September, whereas the GDP deflator is only 3.2 per cent. Of course, that is ridiculously low given current circumstances. Will that increase the gap even further?

11:00

Professor Roy: Because the benefits with the block grant adjustment are being uprated at the UK level, by the CPI amount, the block grant adjustment will also be uprated by the same amount. Yes, the Scottish payments are going up by the higher rate of inflation, but so is the block grant adjustment. There are some marginal differences in there about payments that do not have a block grant adjustment, where the uprating of those may go up.

The Convener: Yes. I apologise—I should have been clearer about that.

Professor Roy: If you are uprating anything that does not have a block grant adjustment, that will have a net impact on the funding. We talk a bit in the report about the different effects of inflation on things that do not have an equivalent BGA, and the additional elements involved in that. Francis Breedon or someone else might want to come in on that point.

However, your broader point about the differences between CPI and the GDP deflator is really important, particularly when we are talking about wages. In particular portfolios, wages account for a significant amount of the total spend. Therefore, if you increase those wages in a way that is trying to compensate for the very high increase in CPI inflation—which it will not keep up with; it is way above the GDP deflator—a significant proportion of your budget will go up by more than the totality of the budget will go up. That means that the remaining part of your budget, which is day-to-day service and all that, has to go down in response. That is one of the really difficult issues with inflation and, in this context, with high inflation. It has a legacy debilitating effect on the spending power of Government, just as it does on us as individuals and households.

Professor Francis Breedon (Scottish Fiscal Commission): One of my pet subjects is the gross domestic product deflator. In a sense, the earnings side is a somewhat second-round effect, because eventually higher earnings will create domestic inflation and GDP inflation.

The really tricky thing about the GDP deflator is that it does not include import costs. That means that things such as lighting and energy in public buildings are excluded and will not appear, so there is a problem with using the measurement for that purpose. I think that, back in the mists of time, a decision was made that public expenditure should be deflated by the GDP deflator, but at times like this everybody scratches their heads and asks why on earth we are using that measure of inflation. Only when import inflation is driving everything is it really shown what a poor measure it is.

The Convener: Hospitals and schools still have to keep the lights on, and ambulances still need to be fuelled, so the GDP deflator underestimates the real costs that impact on the Scottish and UK budgets.

One aspect of the increase in the higher rates of taxation and so on is the impact on behaviour. When I was convener of the equivalent of this committee 10 years ago, Professor David Bell talked about that and the research that had been done on it. What research has been done on behaviour and on where the tipping point is whereby increased revenue is offset by behavioural change? For example, when do people who can do so register in England instead of Scotland for income tax purposes? When does that happen with incorporation, or even with people who class themselves as self-employed? I imagine that such behaviour would have an impact at this time. Where are we with that?

Professor Roy: Back in March 2018, the commission published quite a detailed paper that set out what we call the tax elasticities that are used to capture behavioural effects. It tried, where possible, to draw on international evidence about how people respond to changes in taxation.

I should say that there is quite a high level of uncertainty around tax elasticities. In some ways, elasticities are increased in the devolution context. Usually, when we talk about tax elasticities it is in respect of one fiscal system. Here, there is the potential for additional elasticities because people could change their tax affairs according to whether they are in Scotland or elsewhere in the UK. There is uncertainty around that.

However, the commission's paper says quite a lot about the different types of behavioural responses that people could make to changes in taxation. There is what might be called the marginal response—that is, people changing how much they work at a particular point of time in response to a change in tax—or people could, as you have said, change their tax affairs by becoming incorporated, by relocating their domicile and so on. That is probably the more important issue at the top end of the income distribution, because people at that end tend to have the greatest flexibility to adjust their tax affairs. It is not a matter of tax evasion or doing something illegal; they just have greater flexibility to take some of their income as an incorporated entity, to adjust their hours or whatever.

The evidence is that such tax elasticities tend to be quite high—or, at least, high at the top end in relation to other parts of the income distribution—and that is why our estimates with regard to the changes to the additional rate suggest that we do not expect them to raise that much revenue, compared with the freezing of the intermediate and basic rates. First of all, there are more people in the latter group, and they do not have the same ability to change their tax affairs, because most of them are salaried and are subject to the pay-as-you-earn system.

We monitor those elasticities all the time. A recent study by His Majesty's Revenue and Customs—it was published in the summer, I think—took a first look at the Scottish context and examined some of the elasticities, and we will continue to monitor them to see whether we need to change them. The caveat, though, is that the Government has to be careful when it thinks about how much additional revenue might come in, just because of people's potential behavioural responses.

The Convener: That is an issue that the committee will need to look at more. We all want more revenue, but we do not want to kill the goose that lays the golden eggs either. There is always a balance to be struck.

You have given us some very healthy-looking projected income tax net positions as a result of fiscal drag—which, as much as anything else, is about the reduction in disposable income for people—but what will be the difference in Scotland between the percentage of GDP coming from the tax that is being taken now and that which will be taken in 2027-28? Where do you see that shift as a result of what I guess are generally called increased tax burdens? I should say that John Mason would not call them that.

Professor Roy: We have not calculated the total tax take as a share of GDP in that context. Of course, things are slightly complicated in the

Scottish context because of reserved taxes, which could have an impact on that. You could make some calculations based on the numbers in the “Government Expenditure and Revenue Scotland” document—or GERS—with all the caveats that go along with them, but it would give you relative estimates. However, I do not think that we have ever produced something that we would call the definitive devolved tax burden—caveated as that phrase has been—as a share of GDP. I have to say, though, that I am not entirely sure how useful that would be.

The Convener: Given that the Scottish Government is, apart from the higher rates, more or less mirroring the UK’s thresholds, can you tell us what the UK level will be by 2027-28?

Professor Roy: I do not know that number, but we can get it for you. However, we know that it is going up; across the UK, the relative share of tax as a share of GDP is increasing for a variety of reasons, and it is probably likely to increase in the future more generally, as the costs of delivering the same level of public services get higher.

As for the relative position in Scotland, the devolved context, as I have said, slightly complicates things, because there are all the other elements of taxation that are not included. Therefore, we would be careful about coming up with a number for the proportion of tax as a share of GDP in the devolved context, because there would be no equivalent UK comparator. That said, we can think about the issue and potentially look at it for future reports.

The Convener: In your report, you say:

> “High inflation means that, over this year and next, Scottish households are expected to see the biggest fall in their real disposable income since records began in 1998. Even once inflation returns to lower levels, and real household incomes start to grow again in 2024-25, living standards will take time to recover to the pre-crisis 2021-22 level. Our forecast suggests that, by 2025-26, real disposable income per person will be no higher than its level a decade earlier.”

That is grim news, indeed, but how will that impact the different income distribution quintiles? Have you done any work on who will be affected most adversely, and where the balance lies?

Professor Roy: No—largely because we focus on the overall macro picture, which is our key task in getting to the overall projection for the economy and how that feeds through to taxes and so on.

However, in the report, we talk about the evidence that shows that people in different parts of the income distribution face different rates of inflation. That comes largely from what is in the basket of goods that people consume. People on lower incomes tend to spend a higher proportion of their income on things such as energy and food. As Francis Breedon said, those are things that, typically, we import, so those people are affected. People at the lower end of the income distribution face a higher rate of inflation than people at the upper end and, therefore, a greater drop in their living standards.

In addition, people on lower incomes have less of what is called discretionary spend; they have less ability to cope with the additionality that might be coming through from pressures on energy costs or food costs. They have less savings, less fixability and less discretionary spend that can be adjusted in order to cope—all of which means that the lower end of the income distribution is disproportionately hit.

The Convener: That is interesting and is what one would anticipate.

You have said that the underlying structure of the Scottish economy is undergoing profound shifts. You talked about the impact of the pandemic. More people work from home, and some people suffer from prolonged health effects. Have you looked at that? In recent weeks, we have taken evidence from various panels to the effect that, across the UK, around 600,000 people have left the workforce; the corollary is that the number in Scotland is about 60,000. Do you look on that as a long-term consideration or as a one-year or two-year blip, when it comes to your projections of future economic growth and so on?

Professor Roy: Does Francis Breedon want to come in?

Professor Breedon: You are right that that is a key question. We are beginning to look at that but, in a sense, we are like everybody else: we are observing it as it unfolds in front of us. It is a relatively new phenomenon, so we are all trying to understand just what that participation effect really means.

The data in Scotland slightly limit the extent to which we can identify where all that comes from, but obviously there is, in the background, a mixture of ill health and changing attitudes to work and participation. I am afraid that we will have to wait to see whether that is a permanent or, indeed, a growing feature of labour market participation.

The Convener: There is frequent use of the word “uncertain” in your report, I have to say. [*Laughter*.]

Professor Roy: Yes, but that is important. One aspect is the uncertainty in the economic climate. As we mention in the report, who would have thought that there would be Brexit, a global pandemic, a war in Europe and a cost of living crisis—

The Convener: —and then Liz Truss? [*Laughter*.]

Professor Roy: Yes—there were all those things in a relatively short period of time. We are in a period of particular uncertainty.

However, there is also a really important point to make about understanding the uncertainty that is in the fiscal framework and how we manage that, and how movements in our forecast and the OBR's forecast feed through to significant changes in the budget. That is an additional layer of uncertainty, but we are getting a better handle on the scale of that in Scotland. How we manage it has implications for the review of the fiscal framework, but also for how the Government plans its future budgets in a world in which we know that those forecasts could change.

The Convener: The review of the fiscal framework seems continually to get kicked into touch. There has been delay on delay.

More positive, perhaps, is that Scottish households tend to have smaller mortgage debt than those in other parts of the UK, which means that they will be less affected by rising interest rates—which will support economic activity in Scotland. I would hope that that would mean less fluctuation in house prices, apart from anything else—less decline, then less bounce back, so more stability in house prices. Has that helped economic activity in Scotland in any way? How much of a difference will it make?

Professor Roy: In our forecasts, we talk a bit about how we think the recession will go in Scotland, compared with the rest of the UK. Broadly speaking—again, this is a judgment call—we think that the recession will be slightly shallower in Scotland, compared with the rest of the UK. We highlight a number of reasons for that. It feeds through to our income tax forecast, as well.

11:15

You are right that some of that is about the level of mortgage debt, relative to the UK as a whole, which means that, if interest rates go up—all else remaining equal—Scottish households will be less exposed to that potential increase in mortgage payments.

In the report, we talk a bit about one of the key drivers that we have seen recently of the disconnect between Scotland and the rest of the UK—that is, financial services, and the significant growth in city earnings. Again, in the fiscal framework it is not just about how Scotland does; it is also about how the rest of the UK does. In a world in which interest rates are going up and, potentially, profits are being squeezed, the investment banking arm in the rest of the UK might not make the same amount of profit, which might help Scotland.

The third element that we talk about is the north-east and the North Sea. In recent reports, the commission has spoken about how, potentially, Scotland's earnings would lag behind because of the challenges of a squeeze on earnings growth in the north-east and the North Sea. However, given the energy-price spike, the engagement that we have had with stakeholders suggests that potentially earnings in the north-east are doing slightly better, and that there is greater demand there—which, again, in that context, might help Scottish incomes.

Broadly speaking, we see Scotland as being pretty similar to the rest of the UK over the next couple of years, in that challenging environment.

Professor Breedon: On your specific point about house prices, historically—and almost mechanically—because the average house price in Scotland is slightly lower, an individual gains or loses less money when house prices move around. The house-prices effect is smaller in Scotland mechanically, because the average house price is lower. That is an important factor.

The Convener: In London, for example, a higher proportion of income goes on mortgages than is the case here, so interest rates are much more damaging there, when they go up.

When it comes to capital funding, you have talked about the 2023-24 budget reflecting a real-terms cut of £185 million using the GDP deflator rate. However, you have also said that the UK Government has announced a freeze on capital budgets in cash terms from 2026-27 onwards. What impact will that have on growth and productivity?

Professor Roy: Capital budgets are important in the long run for economic growth and productivity, and for how those feed through.

Figure 2.11 in our report talks about that trend in the capital budget, and the UK Government's announcement is largely flat in cash terms. That is an area in which the deflator really matters. Anyone who has tried recently to do home improvements will have seen a huge increase in costs. That is important in this context. The outlook projection in real terms for capital is likely to be even more challenging than what we have set out, because the level of prices in there—

The Convener: [*Inaudible*.]—3.2 per cent, but the price of materials has gone up by 17 per cent. That is not even in the ball park, is it?

Professor Roy: No, exactly. Again, we do that because that is the process, but it is important to highlight that that is going to be a significant challenge. Obviously, the Government has capital borrowing powers, which can offset some of that. On page 35 of the report, we talk through the potential options for capital. Of course, the more that is borrowed on capital, the more quickly the fiscal framework limit is reached, and the more borrowing costs are embedded into the future. There is a trade-off in offsetting pressures in the capital budget through higher borrowing, which might have implications down the line.

The Convener: Thank you. I have just one more question before I open things up to colleagues around the table. Last Thursday, you sent me a letter, which said that non-domestic rates will be levied on a revalued roll. You said that

"significant uncertainties remained throughout the forecasting process."

Obviously, that is of concern to the Scottish Fiscal Commission. Will you expand on that a wee bit, for the record?

Professor Roy: A revaluation is going on. In order to forecast non-domestic rates, we look at the valuation roll and we project it. However, in going through a revaluation there is clearly additional uncertainty about what the new valuation roll could look like.

The full new valuation roll was not available to us when we made our forecast. Essentially, we had to develop an imputed valuation roll. We took the data that we had from the new valuation roll and used that to project the remaining elements of the roll that we did not have. That is what we based our forecasts on. Because of that imputing process, we did not use the actual valuation roll. That beds an additional layer of uncertainty into the forecast.

We would have liked to have had the full valuation roll. We have spoken with the Government throughout the process and have had really constructive engagement with it in coming up with that method. One of the lessons is that the next time we have a revaluation—their frequency is increasing—we will need to have the full valuation roll earlier in the process, to remove that additional uncertainty and allow us to do our forecasts.

The Convener: Thank you for that helpful clarification. The first member round the table to ask questions will be the deputy convener, Daniel Johnson.

Daniel Johnson: I want to follow up on the convener's question about the interaction between public sector pay policy and social security. The point around pay was clear.

To what degree do you model the long-term economic impacts of social security spend? That is not pure cost; it can stimulate demand. Indeed, unemployment benefits are referred to as stabilisers. We need to look at the increased proportion of spend on social security. To what degree is that—I apologise if I am getting my economics terminology wrong—wider or external economic impact modelled in your work?

Professor Roy: That is a really good point, which I will ask Francis to come in on in a second.

You are right. In the short term, the macro impact of putting more into social security versus putting less into public services basically washes out, because the net effect is still the same. You are just changing the type of spend; the totality of the spend is still the same. That pretty much drives our forecast in the short run.

If you look into it, there is an interesting debate around the multiplier effect, which is essentially about whether taking tax from a higher earner and potentially distributing that via the social security system will lead to a higher multiplier effect than would have been the case if the higher earner had kept that income. Again, most of that washes out when it comes to the short-term forecast.

The more interesting piece relates to the long-term changes. My reading of the Scottish Government's strategy is that tackling child poverty is not just a policy objective in its own right; it is about building a more resilient and prosperous economy in the medium to long term. We do not capture that in the report because we do short-term five-year forecasts. However, it is the sort of thing that we will look at when we come to our fiscal sustainability report. In our March report, we will look at population for the first time, but we have said that we need to think about and look at other issues, such as tackling poverty and inequality. Those aspects will probably require a lot of careful thought and new evidence gathering about how such spending could have a long-term impact on the economy.

Do you want to come in, Francis?

Professor Breedon: In a sense, the demand side is the easy bit, because that it is almost like arithmetic—it is about the amount of money that is spent and where it goes. As Graeme said, the longer-term issue of whether the spend improves the growth potential of the economy in the long run is the more difficult question.

We know from some sides of economics that things such as better health outcomes improve long-term growth in the economy. The question of how big that effect is—social security is a slightly indirect way of improving outcomes compared with direct health spending—is quite a complicated question to answer.

Daniel Johnson: That takes us into the overall points about transparency. It strikes me that, having highlighted the £1.5 billion medium-term shortfall, the key question is what the overall balance of spend should be. Over the medium term, we are talking about a reduction in the share that local government gets and an increase in the share for health. Where in that blend does social security fit in? Should the Government be looking explicitly at that balance and stating clearly what it is? To what degree should that feed into the budget process?

Professor Roy: There is a slight issue about how far we stray from our remit, which is about forecasting the totality. How Government allocates priorities within the portfolios is really up to the Government and the scrutiny process for those allocations. In some ways, the reason for our looking at what the Government is spending on social security is that that is new and, because we have the block grant adjustments, we can calculate the funding gap. We have everything else that was part of old-school devolved spending, and we compare the two.

When most Governments are setting a budget, they simply look at the totality of it and say what the balance is between how much they are spending on social security and how much they are spending on public services. One of the unique elements of the framework is that we can see the net funding position, which lets us say, “Well, actually, we’re potentially reducing spending on public services.”

I would say that the conversation has to be much broader so that it covers the totality of the spend on social security and public services, and whether that spend is meeting the outcomes that the Government wants to achieve in the long run in relation to net zero, child poverty and growing the economy.

Daniel Johnson: I take the point about your remit.

You said clearly in your May forecast that the Government should be stating its budget on COFOG principles. To what extent has it taken steps towards doing that? To what extent would having such clarity help with the issues that we are talking about?

I have one additional question. Audit Scotland has stated that the Government needs to set out clearly in its budget the contribution that that budget makes towards specific policy commitments. Would you add that to your point around COFOG?

Professor Roy: COFOG is helpful, because it is consistent over time and it does what it says on the tin in terms of the spending element. In that respect, COFOG is really helpful and important for our long-term fiscal sustainability work, in which we look at what we are trying to spend on health, not just in the next two to three years but in the very long term. Anything that adds to transparency and understanding on that is really helpful, so COFOG is important.

On the question about specific policy commitments, how the Government presents its budget and articulates its key policy priorities in it probably strays outside our remit. Where we stray into talking about that area is where there are potential policy commitments that we think are feeding through to sustainability. That includes commitments on areas such as social security. We also make a comment about Scotland allocations, because the Government has articulated how it will use those to allay some funding pressures. We highlight those sorts of things, but we tend not to go too much into the specifics of a particular policy being directed at a particular priority.

Daniel Johnson: I will round off my questions by asking about income tax calculations. I wonder how variable they are likely to be. I noted that the IPPR suggested that an additional 1 percentage point on the top rate of income tax would raise £50 million. Given that your forecasters are suggesting that the totality raised by the 1p increase on the upper and top rates will be £129 million, you are much more pessimistic. Does that reflect a genuine degree of variability and, if so, should we be keeping a very close eye on what we actually get in compared with what has been forecast, or is there a bigger difference of opinion in relation to how you calculate it and how the IPPR calculates it?

Professor Roy: I will make a couple of points. The uncertainty element—the potential move-around—is important. I do not know the specifics of the IPPR calculation, but if you look at the penny on the additional rate, we think that the static costing would raise about £30 million next year.

However, that is without behavioural change. When you add in the behavioural change, we think that the totality of that is only £3 million. The key is what you are doing about the behavioural change and how big you think that elasticity will be—how much you think that people will respond and adjust their tax affairs—in order for that to feed through to the final element that you get. That might explain some of what people are saying about the static effect versus the position once you account for the behavioural effects.

11:30

Daniel Johnson: We have discussed a number of times Scotland’s relative position on per capita income tax receipts, which is the fundamental driver of the fiscal framework. In your report, you suggest that that position is improving. To what extent is that because employment and earnings growth are improving relative to the UK average and to what extent is it because of the difference in the policy decisions that are being made on fiscal drag and the additional pennies on the upper and top rates of income tax? It would be useful to clarify the balance of what is contributing towards that.

Professor Roy: I will have the first go, and then Francis can come in.

The key chart to look at is figure 4.5 in the report, in which we talk about the net income tax projections. We estimate that the cumulative effect of the divergence between the policy choices of the Scottish Government and those of the UK Government over the past few years comes in at about £1 billion.

There is a really helpful chart in our August report—I think that it is figure 4.2—in which we decompose how the net tax position can evolve. It can evolve from four things: Scottish Government policy choices, UK Government choices, the performance of earnings and the performance of the economy. The £1 billion is the policy divergence that we think will come through in 2023-24. In essence, it is Scottish taxpayers paying more tax in Scotland relative to the rest of the UK.

The other crucial bit is what happens to the economy, people's earnings and their employment. That is where we get the net tax position, which we think will be around £325 million next year. That gap is the difference between the tax that you are trying to raise and the ultimate final net tax position, which comes through the relative performance of the economy since we have had tax devolution. The combination of those elements is crucial.

Why do we think that the position is more positive than it has been? That is partly to do with the Government's income tax increases, which we think will raise about £129 million, and partly to do with the fact that we got new data from HMRC in the summer, which showed that Scotland's relative position was improved because the outturn for the UK was weaker than the OBR had thought and that lifted up the net tax position.

The remainder comes through the difference between our forecast for the economy and the OBR's forecast. Some of that comes through in what we think might happen in earnings and the catch-up. We talked about the North Sea and the divergence not being as significant as expected. However, it also comes from the fact that we have a slightly more optimistic forecast for the Scottish economy than the OBR does. If either of us changes that, the net tax position will change. If the OBR becomes more optimistic or we become more pessimistic, the net tax position will narrow. That uncertainty is embedded in the framework.

Professor Breedon: There are even more elements going on in the background. As we have talked about, there is the mortgage debt issue. In addition, we have slightly adjusted our participation assumptions for the over-60s. We have raised participation as the state pension age rises. We tend to observe that people participate more as the pension age rises, so we have added that into our forecast.

A large number of things have contributed to the change, so I would not put it down to the one or two elements that you mentioned, Mr Johnson.

Michelle Thomson: Good morning, everybody, and thank you for coming along. I return to questions on modelling behaviours and elasticity, which we have talked about in relation to income tax.

I would like to get your sense of how that has been factored in with regard to ADS, which I think you said in your opening remarks is increasing from 4 to 6 per cent and is estimated to give £34 million extra. Arguably, this is even more complex because of the reasons that you set out before, and it is a newer tax as well.

What level of confidence do you have in that £34 million figure, given the range of factors, which you should feel free to outline? I have merely given my view.

Professor Roy: It is a really good question. We have a policy costing, for which we draw on past experience of what happened with the additional dwelling supplement when it was added, so that is factored in. We have some evidence about how much was raised, which we can use to inform our policy costing going forward.

One wrinkle with the additional dwelling supplement is that if you increase the rate, you might have fewer people buying an additional dwelling, but that opens up the rest of the housing market to people to buy properties there. Therefore, the position is slightly different from that on income tax, in relation to which someone might change their behaviour and that is it—-they are the only person involved. If someone changes their behaviour and does not buy a second home, that could open up the opportunity for someone else to buy it. There is potentially less of a loss in that context.

In recent years, with land and buildings transaction tax, there has been quite a lot of volatility at the top end of prices for houses that are being sold. That is one of the reasons why our forecasts have been out in the past couple of years—there has been quite a lot of movement. A lot of the income has been coming through at that top end, so it will be interesting to keep an eye on what happens if prices fall, whether it is the top end of the market that becomes softer and what implications that might have. There is also the question of the impact of the additional dwelling supplement and whether that is capturing those houses or is having an effect somewhere else in the house price distribution. It is important to keep an eye on that.

Professor Breedon: On your other point, there is more of a forecasting challenge with new taxes and new benefits than there is when you are just changing existing policy. If you look at our forecast evaluation report, you will see—particularly when new benefits are introduced—that we usually make our biggest error in the first year, because there are so many uncertainties when something new comes in, as opposed to a change being made to an existing policy.

Michelle Thomson: I accept what you are saying because it might well mean that more housing is available at the bottom of the ladder. However, that is only if people can get the funding for it, which links into the wider economic environment.

A lot of stuff that I was going to ask about has been covered, so I will turn to the letter that you sent to the convener, Professor Roy. My question concerns sex and gender data for child disability payments. It would be useful to refresh our memory. My recollection—you can tell me if I am wrong—is that the data that is now being collected as part of the equality monitoring form is on gender, and that the equality monitoring form could be filled in by somebody else because it is being filled in on behalf of a child. Is that right?

Professor Roy: John Ireland might want to comment on the technical aspects. For the equality monitoring, the data is gender. I would be happy to give an update more broadly on where we are with social security data and the assessment of it. The point that you are making is that we do not have the information on sex and gender for child disability payments yet, which is a challenge for our forecasting.

Michelle Thomson: When I read the letter, I saw that your title says “Sex/Gender Data”, and then you point out that

“Social Security Scotland have indicated that they would be able to provide the application form they collected on the sex, covering up to October 2022, in February 2023.”

I am trying to understand about accuracy in data terms. I am aware that we do not want to go into other big debates; that is not my intention here. The reason why I am asking is that we know that boys are statistically more likely to have learning disabilities, particularly with regard to neurodivergence. Therefore, getting the data collection correct, and linking it to biological sex. must surely be vital.

I have read your letter. You use the terms “sex” and “gender” interchangeably, and you refer to Social Security Scotland. Setting aside any other debate, the data that is collected will ultimately be used to project costs. We know that a range of factors could lead to social security payments going up, so it would be useful if you could set out what you think is happening and what will happen in future. What are your data needs? This is a question about data.

Professor Roy: I will make a general point and get John Ireland to come in on the specifics.

When we updated the committee in September, we spoke about the importance of access to data. We have had really good conversations with Social Security Scotland about getting the data. We do not have it yet. If you look at our forecasts on child and adult disability payments, we still do not have the core information that we need. For example, we do not have the average payment going to a child on disability benefit; we do not have the number of inflows relative to what has been there.

As you say, it is crucial to understand the data about sex, which has a potential impact on our take-up forecasts. We need that information to inform our forecasts.

John Ireland can give an update on where we are with our conversations. We would also be happy to write to the committee to provide more clarity.

John Ireland: To some extent, the questions asked in the application form and the equality monitoring form are issues for Social Security Scotland. Our concern is to get some sort of data on those issues. What particularly concerns us is that, if the data comes from an application form, every applicant—or every person applying on behalf of a child—needs to complete that form, whereas completing an equality monitoring form is more voluntary, so there is a break in the quality of the data.

The overriding issues for us are what the break in the quality of the data looks like, as well as getting that data. At the moment, we have a commitment from Social Security Scotland to give us the application-form data, which is processed by about February. We are not sure whether we will get published statistics or management information. We lack any clarity from Social Security Scotland about when it will give us the data obtained from equality monitoring forms.

After we get that data, there is that break and we have to wait. Social Security Scotland has plans to put the two pieces of data together to see what the differences are, but it cannot give us a timescale for that piece of work, either. In a sense, we are flying blind, which is a really big concern.

Regarding the payment data that is generated, things look more optimistic than they did a couple of months ago. We have a commitment from Social Security Scotland to give us that data in February or March, so that we can incorporate it into our May forecast. Things are moving forward with payment, but things are still very vague with the application and equality monitoring forms. We need further clarity there.

Michelle Thomson: How did we get to a position in which a fundamental item of data ceased to become important? That strikes me as utterly fundamental, both for assessing current spend and for future forecasting. For example, we might come across a disease that we do not yet know about and that has a proclivity for one sex or the other. We have to be able to project. How did we arrive at this position?

John Ireland: I think it came about because Social Security Scotland was very focused on making the application process as tight as possible, and as unburdensome as possible.

Michelle Thomson: It is not exactly burdensome to learn someone's sex.

John Ireland: Social Security Scotland made the decision and we found out about it later. When we originally wrote to you, we were also concerned about the consultation process. We are very pleased that the chief statistician has made a commitment to improve consultation on how Social Security Scotland collects data. In the future, those who use the data, including us, will have the opportunity to comment on those things before they take place. Unfortunately, this time, the decision was made, and we found out about it after the event when nothing could be done.

Michelle Thomson: I remember that you called it out.

Professor Breedon, you keep raising your eyebrow, so you look as though you want to come in with a last comment.

11:45

Professor Breedon: I think that I just have an expressive face. [*Laughter.*]

In its defence, Social Security Scotland focuses on delivery. It has had a challenging time during the transfer. We can sympathise with the agency saying that its number 1 focus is delivery and that, although management information is, obviously, hugely important, it comes second to delivery.

Michelle Thomson: Okay—thank you very much.

Ross Greer: I will return to the additional dwelling supplement. If you were to assume no behaviour change because of the rise from 4 per cent to 6 per cent, what would the additional revenue have been from that?

John Ireland: It would have been £55 million.

Ross Greer: Therefore, there is a roughly £20 million projected loss because of behaviour change.

John Ireland: Yes.

Ross Greer: Given that that change takes place immediately, to avoid a very obvious bit of avoidance that would otherwise have taken place, do you have a projection for what the additional income will now be in quarter 4 of this financial year?

Professor Roy: Yes. Table 4.21 is about the policy costing from the change in residential LBTT, including ADS, and the projection is £12 million for 2022-23.

Ross Greer: That is fantastic. We have not quite figured out how to fill the gap in the remaining quarter of this year, so every little helps in that regard.

On the question of behaviour change, do you have an estimate of what the tipping point would be at which ADS would become net negative in revenue terms? It is an interesting tax, in that it has two objectives—one is to raise revenue for public services, but the second is that it can result in what many of us would see as a desirable policy change around freeing up more housing for owner occupiers rather than for second or holiday homes. What is the tipping point at which it becomes such a strong disincentive that we have a net loss of revenue?

Professor Roy: I am not entirely sure that I follow the question. We would not calculate a tipping point in that regard. The stock of housing is relatively fixed, so people might not be buying second homes, but you would potentially open things up for other people to buy homes. It is difficult to say what would be the tipping point at which the tax did not raise any revenue.

Ross Greer: I am sorry, Graeme. I probably phrased that wrong. You are assuming that the additional change to the rate will result in behaviour change that would be worth around £20 million, but at what point would it have resulted in a change that would be equivalent to the amount that it would otherwise raise if there was no behaviour change? At what point would we raise it by so much that the amount of money that is coming in would be no more than it was in the previous year at a lower rate? I presume that, if we were to raise it to 20 per cent, we would take in a lot less money than we did from ADS specifically last year. I take your point that we would probably bring in more LBTT, but the amount coming in from ADS would be a lot less.

Professor Roy: I do not think that we have done that calculation.

John Ireland: I do not think that we are allowed to do that sort of stuff. If you remember, the Scottish Fiscal Commission Act 2016 says that we cannot speculate like that. I am sorry to be boring.

Ross Greer: No—boring is important in that regard. You saved me from getting into trouble there, so I thank you for that.

I will ask a similar question, which might result in a similar answer, on income tax. I will take us back to Daniel Johnson's point about the difference between what you are projecting from raising the top rate, versus IPPR's projections. If you are assuming that putting the top rate up by 1p will bring in only a net £3 million, I presume that, if we had increased it by 2p rather than 1p, we would have ended up bringing in less.

Professor Breedon: I think that, normally, that effect would be linear. The take would go up by the same amount, so it would roughly double the revenue. The behavioural effect gets stronger, but the revenue that you raise also increases so, generally speaking, we do not have those non-linear effects. Obviously, there are cases where we do but, in this case—if I recall correctly—there is a linear effect.

Ross Greer: I have a final question, which is just to jog my memory. How did the eventual outcome to the 2018 changes to income tax across the board compare to the behaviour change assumptions that were made at the time?

Professor Roy: It is very difficult to make that comparison. Which year did the HMRC do a study for? It is very difficult to back out because we do not get individual taxpayers' data. Instead, we get the totality of how much income tax is—

Ross Greer: [*Inaudible*.]—from wider economic changes.

Professor Roy: Exactly. What we get from HMRC is the overall tax take, which we then decompose to different points in the income distribution. We can see that income tax revenues have gone up, but we do not know whether that is because of behavioural change, because the economy did really well, because there was a change in earnings, or because of something else.

HMRC is collecting data, which in time could let us do some longitudinal analysis, through which we could perhaps identify taxpayers who have similar characteristics to taxpayers across the rest of the UK, and start to do some modelling to see whether, all else remaining equal, people have changed their behaviour in the context of taxes having changed in Scotland.

We are still in the very early stages of that framework process—people might change their behaviour instantaneously or it might take them a couple of years to do so, so there will always be a lot of uncertainty around modelling that. When the Government sets out policies and thinks about how much it will raise, it can be really optimistic and take the static costs, or it can be cautious and think about behavioural changes, which we factor in.

Professor Breedon: What we have already done, and will continue to do for a long time, is lean heavily on international comparisons. Even if you have long time-series data in Scotland, it is just one border and the data will just be around that, whereas if you look at the millionaire's tax in America or the regional taxes in Spain—where people are crossing many borders—you get a much better reach and data set to see what is going on with the haven effects of regional tax changes. We will have to rely heavily on that evidence for quite a while.

Ross Greer: Thank you very much. That is all from me, convener.

The Convener: I will follow up before I let Liz Smith in. I am struck by something that you said, Professor Breedon. You said that you assume that the 1p increase in the top rate will increase taxes by only £3 million rather than £30 million because of behavioural changes, but that if we put the rate up by 2p, that amount would double to £6 million. Surely you get to a point where the effect of behavioural change exceeds the additional income level. If the volatility is such that a 1p increase will take 90 per cent off the revenue, surely 2p in the pound—I am quite astonished at that high level of elasticity—would tip it over the edge and you could end up with negative revenue.

Professor Breedon: It depends. If the cost of getting out of paying the taxes is £1,000, clearly nobody will react initially—they will react when they reach that £1,000. There is that type of relationship. On migration—although people can obviously adjust revenue in other ways—we found at the international level that it is mostly paper migration. For example, somebody who has a second home south of the border might re-register, which is an almost costless transfer—they have already done it for 1p; if it goes up to 2p, they have already re-registered. Another group of people might make a physical move. You just catch more and more people, but the residual is still rising.

The Convener: I would have thought that some people would just not bother about a 1p increase; some might not bother with 2p or 3p, but the higher the increase, the more you will see behavioural change.

Professor Breedon: Yes. However, in the case of paper migration, re-registering a permanent residence as whatever—some people can do that—is a two-minute job.

Liz Smith: I want to pursue this question, which the convener is right to ask, about behavioural changes. There is almost a Laffer curve of the likely trends. I go back to the additional dwelling supplement and the £34 million. I understand how you have used your arithmetic to calculate that. There was a lot of comment at the weekend about shortages in the rental markets, because the increase from 4 per cent to 6 per cent might mean that some people do not go into the market at all: that behaviour would take some people out of the market. Would that have an impact on the £34 million that is expected?

Professor Roy: Whether we have specifically assessed that is another issue that we can look at and come back to the committee on. Typically, when we consider such behavioural responses, it is very much at the aggregate or macro level. We have evidence about what has happened with the additional dwelling supplement in the past and, therefore, the totality of change in overall housing market transactions. That is typically how we would do that forecast. I am not entirely sure whether there are specific things in individual markets that we might pick up on.

John Ireland: It is worth clarifying that the costing was calculated using the OBR elasticities—the behavioural effects that the OBR uses—which I think were set up a couple of years ago before the changes on rent control took place. I therefore do not think that the elasticities formally include those changes.

Liz Smith: I absolutely understand the arithmetic to which you are referring. My point is that the knock-on effect might be that some people are deterred from going into the market. Therefore, the estimated £34 million of tax revenue perhaps does not have such certainty over the period, because the situation might put people off coming into the market.

Professor Roy: It might do that. We can have a think about that and write to you with a bit more detail on how we calculate the behavioural response and what goes into that component. The only caveat that I would add is that we are dealing with revenue next year of about £557 million, so an extra £5 million or £10 million here or there in our forecast will not really change the totality of that budget. We can certainly have a look at that. I can understand the policy implications and the broader implications for the housing market, but for our overall forecasting, when we are forecasting £0.5 billion, a few million pounds on either side is relatively small, in that context.

Liz Smith: I understand that. It is always difficult to measure expectations and what people are going to do.

I turn to inflation, which is obviously one of the most important things to try to address. Professor Breedon rightly said that high inflation is due to cost factors, and that that particularly affects people on lower incomes. I want to relate that to Professor Roy's point in his introduction that the expectation is that next year inflation will fall "sharply"—I think that that is the word that he used. What is the reason for thinking that it will fall sharply, given that the cost factors will continue, particularly if the war in Ukraine continues and the supply chains still have very high prices? What certainty do we have that inflation will fall sharply, rather than just coming down, given that the cost factor is still very strong?

Professor Roy: I will ask Francis Breedon to come in on that. One of the key things is the difference between inflation and price levels. Inflation will come down, but that does not mean that energy and food prices, which have gone up over the past year, will come down. They are now at a permanently higher level; it is just that the rate of growth will not keep on increasing. That is the legacy effect, and it is the real challenge with the spike in inflation. With inflation at 11 per cent, we would need negative inflation at 11 per cent next year to get the price level back down to where we were. Therefore, we are all going to be paying more for food and energy in the future—that is the debilitating effect of this inflation shock. That is the distinction between inflation and price level.

I ask Francis to comment on why we think inflation will come down.

Professor Breedon: The key point is exactly that: the price level is higher, so it is not as if inflation falling back down means that the issue is over—it is now bedded in. However, energy prices have actually come down from their peak and so they are creating a somewhat negative effect. Energy prices are still higher than they were before the crisis, but they are lower than they were in August and September. Potentially, if they stay low—although they might have gone up while I am speaking—that will have a slight negative impact on inflation for the coming year.

12:00

Liz Smith: I understand that it is the rate of increase that matters. It is just that international events are incredibly uncertain at the moment and there is always the possibility of exogenous shocks and so on. I hope that we will not have that.

I will come back to productivity, which is critical to the future success of the economy. It strikes me, and I think I would be backed up by a lot of economist groups, that Scotland is in desperate need of more higher-paid jobs, particularly jobs that could see people transition from currently fairly highly paid jobs in the energy sector, for example, to other highly paid jobs. In your analysis, do you predict that we are on the right path to getting more higher-paid jobs, thereby addressing the productivity issue?

Professor Roy: I have a couple of things to say about that. We do not comment on policy and whether it is feeding through. However, you are entirely right to say that how the fiscal framework and income tax work means that a disproportionate amount of tax revenue comes from higher earners. Therefore, if you want more income tax, it is not just about growing the total number of people—it is also about growing the number of high-earning jobs, because that is where you take the higher taxes. That comes down to having a highly productive economy that is creating lots of those jobs.

There are a couple of interesting things in the report. Figures 3.6 and 3.12 decompose our projections for the economy. Essentially, because of the demographics that we have spoken about before—we will speak more in March about the challenges that Scotland faces with its ageing population—productivity is key. It is the one thing that drives growth in the economy, and it has gone down in most global economies, particularly in the UK and Scotland, since the financial crisis.

However, evidence shows that one of the reasons why productivity in Scotland has caught up with that in the UK and why we do quite well is that we are overweight in two highly productive sectors—financial services and energy. The success of those sectors in the economy is important for feeding through to productivity then to earnings. We know that oil and gas will go through a transition. You are therefore entirely right to ask how we get those high-value jobs into other highly valued sectors because that is crucial for income tax revenues in the future.

We consulted quite a bit with various people in making the forecasts, from which, interestingly, we have evidence that suggests that earnings are holding up a bit better in the north-east because of changes in the energy sector. There were also some interesting reflections from people about the future composition of energy jobs in oil and gas and whether they will be as highly paid as the oil and gas jobs of the past. There is an open debate about that. They might not be as highly paid for a variety of reasons—not the least of which is that many oil and gas jobs are done in difficult circumstances that require a wage premium.

The issue is interesting and, in our fiscal sustainability work, we have spoken about how, if we are overweight in a sector that we know is going to ease off in the next 10 to 15 years, we need to make sure that we maintain productivity performance by growing newly highly productive jobs to create tax revenues.

John Mason: I will stay on the inflation theme, which has been dominant today. I get mixed up about which witness gave us which evidence at previous meetings, but someone suggested that inflation would become quite severely negative, and someone also used the word “permanent” in that context. Is it possible that oil and gas prices will come back down to where they were?

Professor Roy: Yes. Figure 1 in our report shows the forecast fall in inflation. We think that it will tip slightly into the negative in 2025. Inflation will come down. We are all confident about that, and the Bank of England will make sure that it happens because that is its job. However, the point is about the difference between inflation and the price level.

Our assessment is that the price level will be higher as a result of the different shocks that we have seen. Some of that is the energy shock and some is the on-going supply chain challenges, particularly the effects in China. Those are global trends. One of the reasons why global inflation has been low is that China has been producing very large volumes of manufacturing products at very low cost. That is not likely to continue to the same extent over the next 10 to 15 years and that will have an effect on price the level and inflation. Inflation will come down, but the price level will be high. That is why the cost of living crisis will not go away overnight. When inflation comes back down again, our living standards will not suddenly go back to where they were, because our cost of living has gone up 10 per cent or even 15 per cent for people on lower incomes, but earnings and social security payments will have gone up by much less. Even though inflation will be low, it will still feel much more challenging because the actual cost of living will now be higher.

John Mason: Normally, negative inflation would be seen as a bad thing, but is that not necessarily true in this case?

Professor Roy: Normally, we would be quite worried about negative inflation, because it changes people’s incentives: they do not buy something today, because they think that it will be cheaper tomorrow. That acts as a brake on growth and investment. In normal times, negative inflation is something to be concerned about and avoided. There is a question about the volatility in inflation in the short run. There was a huge spike, but because energy prices have come back down it might tip negative. The Bank of England will be really concerned and will be watching whether any negativity in inflation feeds through to expectations, rather than being purely volatility. Yes, inflation will be negative, but in a few months' time it will come back towards trend.

Professor Breedon: Not only have energy prices risen, they have become very volatile and therefore the inflation forecast is very volatile. It is purely as a result of that rather than anything that the Bank of England has done or anything else that is going on. Gas prices may have risen 20 per cent while we sit here and that will suddenly change the forecasts—that is the sort of environment that we are in at the moment.

John Mason: The committee heard from the expert panel earlier and the witnesses made the point that the UK has failed to address the accumulation of debt following all the different crises that we have had. If I remember correctly, when I was younger—I believe that I am the oldest member of the committee—interest rates had to rise because the pound was getting weak, and the UK debt was so great that interest rates had to be above inflation. Is there any risk of that happening again?

Professor Breedon: I will take that question as the oldest witness. [*Laughter.*]

That is what the Bank of England is very much trying to avoid. You will have seen in its internal debates that it has the same profile that we have: inflation is very high now, but the Bank of England expects it to fall naturally, although not to go negative. Therefore, there is a debate within the Bank of England about why it is raising interest rates when inflation is going to fall anyway and the answer to that is very much the answer to your question, which is that we have to be very careful that that brief surge in inflation does not become an embedded surge in inflation like those that we had in the 1970s and early 1980s, when we had to raise interest rates above inflation in order to control it. I suspect that that is the debate that is going on in the Bank of England right now.

John Mason: Thank you.

In your report you say:

> "Over the longer term, the size of Scotland's economy is determined by its potential output. In the current context, both the underlying capacity of the Scottish economy to produce goods and services"

and

> "its potential output".

I am unclear about the phrase "underlying capacity". Can you explain what that means?

Professor Roy: Economists try to think about how our economy grows either on the demand side, which is how much is being spent at a given time—how much the Government or consumers are spending—or on the supply side, which is what matters in the long run and is essentially the stock of the population, how many people are working, the demographics, the unemployment rate and productivity. Those are the fundamental drivers that determine the long-term potential of the Scottish economy. It is not day-to-day spending that drives the economy but, ultimately, things such as productivity, how many people we have in the economy, how many hours they are working and the participation rate. That is what we mean by the underlying capacity of the Scottish economy, which, in the long run, is the key driver of economic growth.

John Mason: I presume that normally that does not change very much from year to year.

Professor Roy: Yes. Basically, the underlying capacity is driven by what we call fundamentals: things such as population participation rates and unemployment rates, which do not tend to change. For decades, that meant that the economy was growing by around 2 to 2.5 per cent in real terms. However, the big change that we have seen over the past 12 years—rather than year on year—is that there has been a fall in productivity, which is why the economy is growing much more slowly. The core trend element of productivity has fallen in Scotland and the UK.

John Mason: Professor Breedon, in your answer to Daniel Johnson, you mentioned the change in the retirement age, which I assume would be a factor in this. How big a factor is it?

Professor Breedon: It is relatively big for Scotland, because everyone talks about the demographics and the fact that there is a bigger group of people in that category. It is not a big effect, and how much raising the state retirement age affects participation is a slightly open question; you might say that a person can carry on working and receive a pension, so why would raising the age affect that? However, we have observed in practice that the rise in the state retirement age has had quite a noticeable impact—there is more participation as the pension age rises. Obviously, there is a set of planned rises in the state retirement age, which will then increase participation in that group of people.

John Mason: There is no public pay policy for 2023-24, which is a point that has already been made. We all understand that that is because we do not know what the public pay policy for 2022-23 is. Was that a problem for you when you were forecasting? How did you take that into account?

Professor Roy: No, not really. Usually, we would factor in the specifics of a public pay policy. However, I will come back to the point that I made to Ms Smith about the additional dwelling supplement. Similarly, we are dealing with macro numbers, so we put in a forecast for average earnings. Our expectation is that that will not be influenced significantly by the specifics of the Government's pay policy.

John Mason: We have mentioned capital expenditure. There is a borrowing limit of £3 billion. Where are we with that? How close are we getting to the borrowing limit, and how scared should we be?

Professor Roy: We have a discussion of that, which I cannot for the life of me find. Actually, on page 35 of the report, we talk about where we are in terms of the borrowing trend. Paragraph 2.50 says:

> "the capital debt stock is currently at 60 per cent of the overall limit."

The report talks about the Government's policy of trying to borrow £250 million and top that up with £200 million of other funding. It did not have £200 million of other funding last time, so the plan was to use the full £450 million of borrowing. Going forward, the plan is again to use £250 million, but if that is not available, the Government will have to use the full £450 million.

That illustrates the point that I was making to the convener. Capital budgets will go down in real terms, probably by more than our report states because of the effect of inflation. Obviously, that will increase the potential pressure to try to do more with the existing budget and to maximise borrowing powers. However, if you do that, as we talk about in that part of the report, you will rub up against the borrowing limit much more quickly.

John Mason: Do you have a date as to when we are going to hit that limit?

John Ireland: No, but we think that the current 2022-23 borrowing plans, which set out that more will be borrowed because of the shortage of money, would take the capital debt stock ratio up to 73 per cent. You can work it out on the back of an envelope.

Professor Breedon: There is a certain element of difficulty with the idea of borrowing £250 million and then having other income. We are not entirely sure that that other income will transpire, and therefore we could reach the debt limit faster than under the current plan.

John Mason: It is a bit uncertain.

Daniel Johnson: I will follow up on one of John Mason's questions regarding figure 1 and your assumption about what will happen to utility prices. Is it your position, as of December 2022, that we will see a fall in utility prices? If so, what assumptions is that based on? It strikes me that we have a classic supply and demand situation. Supply has been reduced because, in essence, the taps in Russia have been switched off, so the only way in which there will be a significant fall in prices is if there is a replacement for gas or if that supply increases or alternative supplies are found. Those seem to be big counterfactuals. Are falling utility prices factored into the forecasts?

12:15

Professor Roy: I will say a couple of things on that. For our forecasts, we have largely drawn on the OBR's UK forecasts, because we do not think that there is a difference between Scotland and the UK in that context.

A number of things are going on in relation to inflation. We have spoken a lot about energy and utility prices, which are obviously the key driver of inflation. We have also mentioned the supply-side shocks and the legacy effects of Covid. There has been a huge spike in energy prices, and the general expectation is that those prices will come down slightly but remain high.

We should think about how we calculate inflation. If the price of something goes from £100 to £110, there has been inflation of 10 per cent. If the price falls back to £108 in the next year, there has been negative inflation of approximately 2 per cent from one year to the next but, over the two years, the price has gone from £100 to £108. Therefore, it is the price level, not inflation, that is important. Inflation measures the change. As Francis Breedon said, if energy prices have spiked and come down slightly, that will be reflected by an initial spike in inflation and it then perhaps tipping negative as prices come back down. However, prices will still have shifted up compared with where they would otherwise have been. That has a debilitating effect on Government spending, and it has an impact on households, too.

Professor Breedon: The point about utilities is interesting. The price that I was talking about was the futures supply price in the market. There is a pretty strong relationship between the market price of oil and the price of petrol at the pump, and we are already seeing that effect. There is a more complicated picture—it is more complicated than I can understand—relating to the extent to which changes in gas prices affect people's electricity and gas bills. The companies do a huge amount of hedging. When gas prices come down, they say that they cannot immediately cut their prices, because they probably hedged by already paying for their future supply. I am not 100 per cent sure that the utility prices that we pay will fall, even if the market price falls.

Daniel Johnson: That is a helpful clarification.

The Convener: I thank our witnesses for answering our questions and, indeed, my colleagues for their questions.

Before I close the meeting, I wish everyone a very merry Christmas, a restful festive break and a happy and prosperous new year.

Meeting closed at 12:17.

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