OFFICIAL REPORT
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DRAFT

Finance and Public Administration Committee

Tuesday 3 December 2024

Session 6

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BUDGET SCRUTINY 2025-26 (UNITED KINGDOM CONTEXT) 1

FINANCE AND PUBLIC ADMINISTRATION COMMITTEE

34th Meeting 2024, Session 6

CONVENER

*Kenneth Gibson (Cunninghame North) (SNP)

DEPUTY CONVENER

*Michael Marra (North East Scotland) (Lab)

COMMITTEE MEMBERS

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

*attended

THE FOLLOWING ALSO PARTICIPATED:

David Phillips (Institute for Fiscal Studies)
Ben Zaranko (Institute for Fiscal Studies)

CLERK TO THE COMMITTEE

Joanne McNaughton

LOCATION

The Robert Burns Room (CR1)

Scottish Parliament

Finance and Public Administration Committee

Tuesday 3 December 2024

[The Convener opened the meeting at 09:30]

Budget Scrutiny 2025-26 (United Kingdom Context)

The Convener (Kenneth Gibson): Good morning, and welcome to the 34th meeting in 2024 of the Finance and Public Administration Committee. The only item on our agenda is an evidence session with the Institute for Fiscal Studies on the UK "Economic and fiscal outlook", which will inform our scrutiny of the 2025-26 Scottish budget. We are joined remotely by David Phillips and Ben Zaranko, who are associate directors at the Institute for Fiscal Studies. I welcome them to the meeting.

We will move straight to questions. I think that we all know what it is but, for the record, will you give a brief explanation of the acronym SCAPE, which you use throughout your analysis of the Scottish budget? My understanding is that it stands for superannuation contributions adjusted for past experience—nae wonder you use the acronym—but will you explain exactly what that means?

Ben Zaranko (Institute for Fiscal Studies): Good morning, everyone. Thank you for having us, and thank you in particular for facilitating our remote participation so that we can fit in other commitments. It is much appreciated.

SCAPE represents a horrible set of words and a real mouthful, so we stick to using the acronym. I will start with the technical definition, then I will zoom out and explain it in simple terms. It is the discount rate that the Treasury uses to set pension contributions for public sector employers. It is based on an assumption about the long-term gross domestic product growth rate, which is the discount rate that the Treasury uses when thinking about the trade-off between spending in the future and spending today, given that we expect taxes to grow broadly in line with GDP. The term tells us how much we need to contribute today in order to finance a future spending commitment.

In relation to a public sector hospital or school making a contribution to pensions on behalf of its employees, the SCAPE rate is what the Treasury uses to calculate how much the hospital or school should send back to the Treasury to reflect the future pension promise to its members.

The SCAPE rate has moved over time. It has come down as our estimates for future economic growth have come down, which means that it has become more expensive to provide public sector pensions. As a result of the reduction in the SCAPE rate, a hospital or school now has to send back to the Treasury a bigger percentage of each person's pay bill in relation to their pension.

The concept is really technical, but it is about trying to align the incentives of the centre with those of the employers of public sector workers.

The Convener: What will be the impact of that on the Scottish budget next year?

David Phillips (Institute for Fiscal Studies): We have not yet looked at next year's figures for the Scottish budget, but we have looked at the amount of funding that came through in the main estimates in order to make an assumption about how much might come through from the autumn budget in the current financial year. What proportion of the additional funding that has been received this year, since the Scottish budget was set in December last year, is not really additional funding to spend, but is to account for additional SCAPE costs?

Across the UK as a whole, about 80 per cent of the SCAPE costs came in the main estimates, with about 20 per cent still to come in the budget. In the absence of information, we made the same assumption for Scotland—80 per cent of the SCAPE costs were the itemised bits that came through in the main estimates for the Scottish Government, with the 20 per cent still to come through in the budget from October. However, that is not itemised—it is just our assumption. Altogether, there are just over £400 million of SCAPE costs. We have not looked at the situation specifically for Scotland next year, but my estimate is that the amount will be broadly similar, unless Ben Zaranko has alternative information.

The Convener: Digging deeper into your analysis, you say:

> "the Scottish Government looks set to continue to face tough trade-offs in future years. Carrying forward funding would ease trade-offs between services next year. But such funding can only be used once: it will only help the budgetary pressures facing the Scottish Government in later years if it is successfully utilised to help boost productivity, address the rivers of service demand, or boost economic performance and hence tax revenue."

You go on to say:

> "even if successful, such efforts may take several years to bear fruit, meaning that without further top-ups to UK spending plans or increases in Scottish taxes, some services will likely face cuts in future years."

That is a wee bit more pessimistic than other commentators have suggested.

David Phillips: Yes. The reason why we have said that is that there is no doubt that the UK budget and some of the top-ups that the Scottish Government has made in the autumn budget revision, through underspends last year and plans to draw down more from ScotWind, together with that Scottish funding and the additional funding through the UK budget in October, have transformed in a good way the short-term funding outlook for the Scottish Government.

Back in the original budget plans for 2024-25, the amount to be spent on public services, after accounting for inflation, would be 0.6 per cent lower in real terms than the amount that was actually spent last year. When you account for the changes that the Scottish Government made in the autumn budget revision, that pushes it to around a 2 per cent increase—an increase rather than a cut. If you also account for the money coming from the UK budget, it is close to a 6 per cent increase in real terms in the amount that can be spent on public services this year compared with last year, if all the funding were to be used in the current year.

If that was the case, given the amount that is available next year for the UK Government, given that you could not also draw down the ScotWind revenues and the reserves twice, and given that we now expect the income tax net position next year to be perhaps not quite as strong as was forecast by the Scottish Fiscal Commission back in December last year, if you spent all that additional funding this year and carried none of it forward, the increase in funding next year would only be around 0.5 per cent to 1 per cent in real terms. That is still an increase, but it is a substantially slower rate of increase than this year, and is the kind of rate of increase that could mean cuts to other services if you wanted to increase the national health service spend by, say, 2 to 3 per cent.

Then, of course, down the line from 2026-27 onwards, the UK Government has pencilled in a very front-loaded increase in funding, but we do not know the exact amount that the Scottish Government would get, because the UK Government has not yet allocated it between departments. We have run some scenarios based on the 1.3 per cent overall real-terms increases in resource spending that are pencilled in each year. If the UK Government follows what we think the national health service might need and its childcare, aid and overseas commitments, and we pass those on through the Barnett formula and look at what might happen to Scottish tax revenues and so on, we think that real-terms increases could be around 0.7 per cent a year on average for Scottish Government day-to-day spending from 2026-29.

Increasing health spending even by just 2 per cent a year, which is quite a bit slower than its long-run growth, would require small cuts on average to other areas, and increasing NHS spending by, say, 3.5 per cent a year, which is more in line with its long-run average, would require quite substantial cuts to other services. That is why we have said that unless that front-loaded spending allows you to boost productivity or substantially boost Scottish tax revenues—and because of the fiscal framework, not just boost Scottish revenues but boost them more than revenues from the rest of the UK—or there are increases in funding from the UK Government or substantial Scottish tax rises, the challenges in the second half of this decade will be really difficult.

Next year crucially depends on whether or not some of the funding from this year, which, as I said, allows a 6 per cent real-terms increase if it is all spent, is carried forward into next year, because that could ease the pressure in the short term, but would not really reduce the trade-offs in the longer term.

The Convener: Thank you for that. In your document, you say:

> “as with funding in 2024-25, part of the increase in resource funding ... reflects extra SCAPE costs rather than an increase in spending power.”

You have talked about the fact that the budget is increasing fairly modestly in real terms. However, that also means that the Scottish Government has to be very careful about how it spends its money. You have talked about behavioural response in relation to income tax, and mentioned tax revenues in that regard, too. You highlight that the SFC found that

> “such responses will offset half of revenues from the Scottish 45% rate and 85% from Scotland’s top rate of tax”

and that there is a need to better evaluate the impact of that. The document goes on to talk about

> “the complexity introduced by having 19%, 20% and 21%”

and suggests that that

> “is particularly unwarranted”.

Where do you think the Scottish Government is in terms of the issues of taxation and behavioural responses at this time? The document goes on to say that the Scottish Government should be

> “open to reversing course if new evidence again suggests bigger-than-expected behavioural impacts”

and that

> “a strategy should always be open to revision, not set in stone”.

David Phillips: I think that you are referring to the paper that we published a couple of weeks

ago on the evidence around Scotland's income tax changes.

I can say up front that, overall, we think that the Scottish income tax changes have raised a fairly substantial amount of revenue for the Scottish Government's budget. However, that is largely because of the lower higher rate threshold, the increase in the higher rate tax and the increase in the reduction of the advanced rate, although, as you mentioned, the SFC found that around half of that revenue will be lost as a behavioural response.

Looking at the evidence—international evidence and evidence from Scotland—we can see that the taxpayers who are eligible for the top rate of income tax, which applies to those earning above approximately £125,000 a year, are particularly responsive. As I said, the SFC estimates that, taken together, the actions that those taxpayers can take in response—which involve a combination of evasion, avoidance, some changes in the labour supply, migration decisions and so on—offset around 85 per cent of the mechanical revenue that you get through having that higher tax rate. That is what international evidence shows, broadly, although there is a big range.

The only evidence that we have from Scotland specifically are two studies, by what was then Her Majesty's Revenue and Customs, using the initial changes to Scotland's income tax rates in 2018-19. If anything, that evidence suggests that the behavioural responses were even larger than the SFC assumed and were large enough to suggest that the increases to the top rate might actually have reduced revenue slightly, rather than having increased revenue slightly.

However, we emphasise that there is a lot of uncertainty in that area. Furthermore, of course, since those initial changes in 2019, there have been subsequent much bigger changes in 2023-24 and 2024-25. On one hand, someone might say that those bigger changes make it even more worth while to engage in the costs and the hassle of changing their behaviour, so you might expect an even bigger response to those. However, on the other hand, it might be that people have already adjusted their affairs and, therefore, that the extra marginal effect of the new changes might be smaller. That is why we said that the Scottish Government should work with His Majesty's Revenue and Customs to evaluate those newer changes to taxes, which have really opened up the wedge for those higher earners. At the moment, the evidence for what is happening in Scotland is pretty limited, and we can learn more from those more recent changes.

We have said that, in the meantime, given that the evidence is that responses are large, and perhaps even a little bit larger than the SFC had assumed going into the policy changes, it might make sense to hold off from making further changes, certainly in an upwards direction, until you have more evidence about the scale of the effects.

The tax strategy is an opportunity both to set out plans for that evaluation and to take a view of tax in its wider context, which is important because, if the Scottish Government wants to continue to raise additional revenue and to do so in a progressive way, income tax is not the only tool that is available to it—there are property taxes, as well.

Furthermore, for quite a long time the Scottish Government has had on its to-do list a commitment to look at council tax, which is a tax that could be used to raise more from higher earners and higher-wealth individuals and is not subject to the same degree of behavioural response, because it is harder to move and hide a property than it is to move an individual or, certainly, their income.

09:45

The Convener: I will stick with tax for a minute. One of the issues that is being talked about is the coherence of the tax strategy. In relation to the UK tax system, IFS director Paul Johnson said:

> "if this government really wants to focus on growth, then part of the plan needs to be a much more coherent tax strategy than we saw"

in the 2024 budget. Will you explain what the IFS believes that "more coherent ... strategy" should be and how we in Scotland can build on that, bearing in mind that a lot of our tax strategies depend on what happens UK wide?

David Phillips: Ben, do you have any comments or should I answer this one?

Ben Zaranko: I am happy to start. I think that Paul Johnson's frustration around the budget was that it was felt that the Government's tax announcements were largely governed by what it felt might or might not be consistent with a particular line in the manifesto, rather than by any economic or fiscal strategy about what it is trying to achieve. The sympathetic view is that, in the relatively short space of time since the UK general election, the Government had not come up with plans for that, although it did have a long stint in opposition.

If you are serious about trying to jolt the UK out of its growth slump, tax is not the only thing that matters—it is not in the top three and maybe not even in the top five—but it clearly should be on the list of things that you are thinking about changing to make it more growth friendly. Obvious examples are stamp duty and other measures that hamper

mobility and people's ability to move where the jobs are, which makes the allocation of housing more inefficient.

You could talk about the design of taxes on work, including the incoherence of having a national insurance system and an income tax system alongside each other, and some of the peculiar incentives that that creates for people, with people who have their benefits, such as child benefit, withdrawn or their personal tax allowance withdrawn facing extremely high marginal tax rates. That can create perverse incentives. There are lot of other things besides those, such as incorporation tax and some of the incentives for companies to invest in certain things and not others, and how they finance themselves.

There is a litany of factors that you could look at. We would have liked to have seen, if not all the answers, at least a willingness to engage in consultations or to think about the questions, evidence gathering or even a direction of travel. That would have been appreciated because those are lacking.

David Phillips: There are many issues with the tax system, as Ben said. When you have a new Government with a large majority and a clearly stated ambition for growth making difficult decisions in order to get growth, it is disappointing not to see a more coherent strategy on tackling some of the inefficiencies in the tax system that distort behaviour but that have interest groups built around them.

We did see some changes to inheritance tax, which, although they were very controversial, probably move the tax a little bit in the right direction, in the sense that they will distort a little bit less how people decide to hold their assets, by reducing the benefit of holding assets in family businesses or in agricultural land in order to avoid tax.

There are two big areas of tax that are quite distortive. The first is how we tax different forms of remuneration quite differently: a person is taxed quite a lot less on their incoming dividends than they are as a self-employed person or as an employee. That distorts the production of the economy because there are more small businesses and self-employed people and fewer people in larger employers than there would be in the absence of those tax distortions. By increasing employer national insurance contributions and by increasing the small business allowance within that, the Government increases those distortions, thereby further encouraging small incorporated businesses and self-employment over working as an employee.

Given that the evidence shows that employee forms of working tend to be associated with higher productivity, the tax system is, on average, encouraging—if you like—lower-productivity activities rather than higher-productivity activities.

Addressing that requires looking at capital gains tax, income tax, national insurance and dividends tax, but only a small part of all that is devolved to Scotland. One of the reasons why we have said that devolving dividends and savings income tax might make sense is that it would allow Scotland to align those aspects with its own tax rates in order to avoid further increasing the distortions towards incorporation. You are right, therefore, that the Scottish Government has only a small part of the tax powers and cannot tackle all the problems on its own.

The other big issue is taxation of property, which Ben Zaranko mentioned. Scotland has a lot of the key powers in that regard—it has land and buildings transaction tax, council tax and business rates. Unfortunately, at UK level and Scotland level, the past 10 years or so have seen us move in the wrong direction with property taxes, by increasing the transactions tax, in particular on second homes and rental properties. Again, that is distorting how the property market works and is, by increasing the overall tax wedge, making moving more expensive. It makes it harder for people not only to get into the house that they want, but to take the jobs that they want.

An ambitious tax strategy in Scotland would set out some plans for property taxes, in which a lot of the powers are already devolved, and set out how they could be made more growth friendly and fairer to people who need to move around due to changes in their circumstances.

The Convener: You mentioned incorporation. The Office for Budget Responsibility has said that, across the UK, the measure is likely to encourage about 17,000 incorporations, costing about £0.7 billion in revenue. Have you seen higher rates of incorporation in Scotland, in relative terms, as a result of recent tax changes in the rest of the UK? Alternatively, is there no real difference, or do you not have the data to assess that yet?

David Phillips: We have not looked at that issue yet. A little while ago, I eyeballed the figures for incorporated businesses and, in aggregate, I could not see much of an effect in Scotland, but that was just from eyeballing. We would really want to see an analysis—a bit like the analysis that HMRC has done for labour supply, migration and participation—that looks at the incorporation margin and at those groups that have seen differential changes in their incentives to incorporate, given Scotland's income tax changes.

I might not have expected much back in 2018-19, given the size of the tax differences at that point. I might expect there to be more of an impact

now that, for example, the tax wedge for someone who is on £125,000 is, under Scotland's income tax, an additional £5,200. The data for 2023-24 should come through next year and the data for 2024-25 should come through the year after that, so we should look at the issue then. However, putting in a request to HMRC to extend its analysis to incorporation would be a really useful thing to do.

The Convener: Paul Johnson, in his assessment of the UK budget, said:

"the most striking aspect of the spending decisions is how incredibly front loaded the additional spending is".

You have touched on that to some extent. He also said that

"it would be odd to increase spending rapidly only to start cutting back again in subsequent years"

and that

"when it comes to settling with departments for the period after 2025-26 keeping within that 1.3% envelope will be extremely challenging".

He described that as a big gamble. However, how much of a gamble is it? Is there any way that you can assess how likely it is that the Government will be able to reach its goals? Saying that it is a big gamble does not really quantify it to any degree. Can you help us with that?

Ben Zaranko: I can certainly try. There are two ways to think about the front loading on the day-to-day spending side. One is that it is about dealing with temporary pressures and temporary issues in public services that arise from things such as resolving pay disputes or trying to inject funding in a bid to get through some of the backlogs that have emerged across different bits of public services. You spend money now to try to relieve those pressures, and it then becomes more realistic to have much more modest funding growth after that. That is one way of thinking about it. The gamble there is that, when you inject that funding, it might not resolve any of the pressures, so the services will come back asking for more.

The other way to view the situation is that it is part of a negotiation. The Treasury will pencil in tough spending numbers, because it is arguing with different departments, such as the Ministry of Defence, the Ministry of Justice and the NHS, about how much they should get. You start low—you low-ball—and then you adjust over time. Historical experience suggests that, when the Treasury gets round to actually allocating to departments, it decides that it wants to spend a bit more overall. If you assume that history repeats itself and you look at the sorts of increases that you might expect—the Office for Budget Responsibility has looked at this, as have we—you get a ballpark figure of about £20 billion of extra spending by 2028-29. The composition of that would determine how much goes to Scotland, but you would expect some non-trivial amount to flow through.

Of course, it depends. Rachel Reeves has been clear in interviews since the budget that she wants public services to live within their means and that she does not intend to come back with another package of big tax rises—she intends to stick to those numbers. Of course, that is what she would say if she was embroiled in tough negotiations but, taking her at her word, the UK Government plans to stick to the numbers. A lot then hinges on whether the additional funding can be translated into service improvements through reforms and so on, and how quickly. That is the judgment that the Government seems to be making.

David Phillips: With the first way of seeing it that Ben Zaranko mentioned—the hope that a substantial investment in the short term can help to address the backlogs and set things up for the future—one of the key issues is whether that can help to get productivity back up. In a number of public services, but particularly the health service, we have seen a decline in productivity, or at least in measured productivity. The numbers of doctors and nurses and the amount of funding are up substantially. In England, activity is up a bit in the health service, but it is not up anywhere near as much as the number of inputs. In Scotland, the inputs have not gone up quite so much and, therefore, activity is still a bit down on where it was in 2019-20, before the pandemic.

One of the real challenges when we think about the public finances is whether, at least over the space of a few years, we can get productivity in public services, especially in the NHS, to increase back up towards and perhaps above its 2019-20 levels. Without that increase, the situation will become more challenging. It looks likely that you will lose the gamble that Ben Zaranko talked about if you cannot do that.

The Convener: My colleagues will explore that in more detail. I have a couple more questions to ask. The OBR has suggested that the Chancellor of the Exchequer's headroom is only 0.3 per cent over the forecast period, which it thinks is extremely tight. How does the IFS feel about that?

David Phillips: Just to clarify, I think that that 0.3 per cent figure refers to how much the interest rate could go up while we still meet the rules.

Ben Zaranko: I cannot remember—

The Convener: It is 0.3 per cent of our expenditure targets, so it is about £10 billion.

David Phillips: Okay. Sorry. From reading the evidence, I thought that it was a 0.3 per cent increase in the interest rate that would—

The Convener: No—it is the cash headroom, which is £9.9 billion.

David Phillips: Oh, the cash headroom. Sorry about that.

Ben Zaranko: There is clearly a very fine degree of space against the fiscal targets. To say that it is £9.9 billion is almost spuriously precise, given the number of moving parts in the forecasts and how uncertain it all is. The way that I think about the situation is that it is almost on a knife edge—it is quite close to 50:50 whether the targets will be met. That is partly a function of how difficult the current fiscal dynamics are and the difficult fiscal inheritance that the UK Government has, which mean that even only just meeting the targets requires some really quite painful choices on tax and spend and on borrowing more than the Government might have liked.

The danger is that you end up in a world where, if you have a small margin against an uncertain forecast for where borrowing or debt will be in four or five years' time, when forecasts subsequently move, which is inevitable, policy overcorrecting will follow. If the forecast moves slightly against you, you end up announcing more tax rises or spending cuts. If the forecast improves somewhat, the Government says, "Great—we can spend every penny of that additional headroom". That adds to policy volatility and impedes the ability to plan.

10:00

If you are serious about wanting debt to fall or wanting to run a current budget surplus, you might meet those aims with a greater margin. That will entail more tax rises or spending cuts in the short term, so it is politically difficult, but maintaining a fine degree of headroom against targets and seeking to meet them almost exactly does not lend itself to sensible policy making.

The Convener: Yes—the OBR suggests that there is a 54 per cent chance of meeting the target, which is more or less the 50:50 that you suggested.

The last question from me is about a quote from your Scottish analysis. You say:

> "an increase in forecast whole-economy inflation since the Budget (from 1.7% to 2.4%) means that capital funding this year is little changed in real terms compared with what was expected at the time of the Scottish Budget—in stark contrast to the situation for resource funding."

What does that mean with regard not just to capital projects going forward, but to the likely impact on productivity?

David Phillips: I will comment on that first and I will then hand over to Ben Zaranko to talk about capital and productivity.

On the first point, there has been a small cash-terms increase in the amount of funding that is available for capital this year compared with the initial budget. Basically, underspends on capital last year have been carried forward. Even with cancelling the planned resource-to-capital switch, when we combine that with some additional UK funding—such as slightly higher city deals funding—the total amount of capital is up in cash terms this year. However, because inflation is going to be higher this year than it was at the start of the year, that does not translate to much more in real terms.

The key question for capital will be not what overall economy inflation has been, but what the cost drivers for capital projects have been, such as the costs of construction and construction materials, as well as equipment for the non-building variety of capital spending. I have not looked at what those cost drivers are, but it would not surprise me if they have been outpacing economy-wide inflation.

Ben Zaranko: On the question about productivity, it really depends on what the investment is going into. There is a tendency to equate capital investment with good, productivity-enhancing or growth-enhancing spending, but we need to think more about the composition. Building a new prison to enhance living standards and conditions for prisoners might well be a valuable thing to do for us as a society, but it is unlikely to boost our productive potential when compared with investing in roads, railways, digital infrastructure or something else that enables the private sector, for example, to become more productive. A simple model of more capital investment equalling more growth will probably not hold up, because it depends on what it goes into.

The Convener: I will open up the session now, and the first colleague to ask questions will be Liz Smith.

Liz Smith (Mid Scotland and Fife) (Con): Good morning. I will concentrate on the labour market and particularly on economic inactivity, which is, as you well know, a huge issue just now. I particularly want to focus on the report that the Centre for Social Justice published earlier this year, which flags up that, in Scotland, one in five of those who are classified as economically inactive want to work but are finding it difficult to get into the labour market for various reasons. In your research, do you have good-quality analysis of where the sticking points are in the labour market for those who want to work but are unable to get into work?

David Phillips: Before I answer, I note that that is not my specific area of expertise within the IFS's huge range of areas of work.

We have looked at issues around economic inactivity, and one of the factors that has been raised a lot is the increase in ill health. Some analysis that we have done of the transitions between employment and inactivity suggest that a lot of the rise in ill health has been among those who have already been out of work for a significant time. Among those who are just leaving the labour market, quite a lot of the impact has involved those who are moving towards retirement or other forms of inactivity, so we think that the concern around ill health and inactivity is a little more complicated than is sometimes suggested.

When it comes to accessing employment for people who are currently inactive and are not actively looking for work but would like work if it was available, several factors could be involved. One is the state of their health. They might feel that the jobs that are available are not compatible with their health conditions, if they are inactive for health reasons. It could be because of a mismatch between the skills that they have and the skills that are required by the labour market. It could also be related to issues around the support that the person requires. For example, if someone is on disability benefits, the degree to which they are required to seek work is pretty limited, and in that situation it might be quite hard for them to find work if they have been out of the labour market for a long time. If someone is on jobseekers allowance or that type of benefit, where there is conditionality, they are required to look for work pretty much full time. It might not be a particularly high-quality search effort, but that additional effort might lead them to find a job more quickly.

For those reasons, several factors are involved. They relate to people’s skills and health, to the skills and health requirements of the jobs and to the way in which the benefits system interacts with the incentives that people face given the conditionality that is involved in some benefits.

Liz Smith: Is it not the case, however, that there are differences among those who are in the economic inactivity group? There are some who actually want to work but are finding it very difficult to get into the labour market and some who are not really bothered, to be quite honest. If we want to attract people back into the labour market, do we need to pursue different policies for those two different categories of people?

David Phillips: To the extent that there are subsets among people who are currently inactive, such as those who are not incentivised to seek work at all and those who want to work but are finding it difficult, we would expect the regime to have a combination of carrots and sticks, if you like, to address the work incentive effects. On the one hand, we would expect there to be elements of targeted support for those who face particular challenges in getting back into the labour market, such as support with developing skills and confidence and with understanding how to apply for jobs—those intense workfare-type interventions.

However, many regimes have conditionality attached that requires people to search for work and, if they do not make those efforts, they can face sanctions. The sanctions regimes differ significantly depending on whether the person is on jobseekers allowance-type benefits or on disability benefits. A potential approach would be to blur that line somewhat so that there was less discontinuity depending on which type of benefit the person is on. I think that that was the intention behind the various types of employment and support allowance, whereby someone can be in the support group or the work-related activity group and they will face different types of interventions and conditionalities depending on that. It is important to look at that part of the system again to see whether we have that continuum, if you like, rather than a dichotomy.

Liz Smith: Thank you for that helpful answer. Do you, as part an institute that does so much economic analysis, feel that the UK has sufficient data to drill down into economic inactivity? It is a major factor in policy making. If we could solve some of the economic inactivity issues, we would not only increase revenue but increase productivity in the economy. However, it strikes me—I think that I also speak for another parliamentary committee in saying this—that the data is vague and not terribly helpful. Do you agree that, across the UK, we do not have enough data on the issue?

David Phillips: The labour force survey is certainly known to be increasingly poor at picking up employment inactivity trends and the factors that are leading to them. Colleagues have looked at what has caused the change in the level of inactivity as well as the transitions between employment and inactivity. Through the transitions-based analysis, as opposed to the levels-based analysis, we came to quite different conclusions about the underlying trends on inactivity, which suggests that the quality of data is lacking a little bit. I am also aware that, if we compare the LFS figures on unemployment with the data from HMRC’s real-time information on employment, the figures are quite different.

I echo something that the OBR said in its evidence last week: there is clear data on applications for benefits for health-related reasons. Those have increased substantially, and more than in other countries. In many countries, the rate of claims for incapacity and disability-related benefits is lower than it was pre-pandemic. The UK stands out in that regard. As the OBR has

said, it is difficult to distinguish the extent to which that is due to a health shock, the different economic situation in the UK or the incentives under the benefits system.

We do not have the answers, but I know that colleagues are planning research on which factors are driving the increase in disability benefit-related economic inactivity. It is a difficult question to get at. Research is under way at the IFS, but we are not ready to report on it at this stage.

Liz Smith: That information came across when the OBR gave evidence to the committee last week. In the UK, we seem to have higher rates of economic inactivity compared with other countries. All countries experienced Covid, but we seem to be an outlier in that regard. Do you have any reflections on why that is?

David Phillips: As I said, we have looked at the evidence. Whereas most European countries and the United States have higher labour force participation than they had before Covid, the UK has lower labour force participation. To some extent, that could be an artefact of the decline in the quality of the LFS. As the quality of the survey has declined and responses to it have reduced, it is possible that the survey may have become more selective and focused towards those who are, say, at home and are therefore more likely to be economically inactive. That could be part of the story. However, claims for disability benefits clearly point to the fact that something real is going on. It is less clear whether that relates to health or the ability to claim benefits or incentives to do so because of, say, the cost of living crisis.

Scotland's disability benefits were designed to make it easier for people to claim and less likely that claimants would be booted out after a short period by making the reassessment regime a little less stringent. In our work on that, we have noticed that, somewhat under the radar, similar things have been happening in the UK benefits system. The number of in-person appointments has plummeted—they are mostly done on the phone—and so has the number of reassessments. Those factors have reduced the hassle of applying for disability benefits and made it less likely that a claimant will stop getting a disability benefit once they are in receipt of it, which could be a factor in explaining the UK-wide increase in disability benefit claims.

Given that that is happening across the UK and not just in Scotland, it might be slightly beneficial to the Scottish budget, because it might mean that Scottish benefit changes do not cost as much more than the UK-wide costs. However, it is, of course, a really big challenge for the UK's public finances as a whole.

John Mason (Glasgow Shettleston) (Ind): I will start with national insurance and the increase in employer contributions . Your report says:

> "It is currently unclear whether the Scottish Government's share of compensation will be based on the Barnett formula, or its higher-than-population share of the public sector wage bill."

We seem to be a little clearer now on what is happening—I do not know whether you are clearer on that. It seems that, under either formula, we will not get the full amount of national insurance. Is that correct?

10:15

David Phillips: Since we wrote the report, there has been unconfirmed information from the UK Government that the Scottish Government could receive an amount of just over £300 million approximately. That appears to me to be consistent with a Barnett share—in fact, it appears a little bit less than what a Barnett share would be, but perhaps that is because slightly higher shares are going into non-Barnettable services such as the Ministry of Defence, and the Foreign, Commonwealth and Development Office than I have assumed. The figure of £300 million or so that is being talked about coming down the line would be more consistent with a Barnett-formula, population-based share, as opposed to a share based on Scotland's larger public sector and higher public sector wages.

The Scottish Government, using information collated from various departments, came up with a figure of around £550 million. The Fraser of Allander Institute came up with a figure a little bit lower than that, but that was, again, one of £500 million to £550 million. The cost for direct public sector employees in Scotland is around £500 million to £550 million. If the UK Government provides £300 million to £350 million, I would suggest that the Scottish Government would therefore, in the short term, need to find around £200 million from its other resources to help make up the difference. That is another reason why we said that the potential outlook, even for next year, could be quite difficult if funding is not carried forward.

I will make two further points.

First, the UK Government is providing funding only for direct employees of the public sector. It is not providing funding to cover the extra costs for universities, for example, or for providers of social care, a large part of which is outsourced to the private or voluntary sector. Those could therefore also be additional costs; I think that the Scottish Government estimated that those could come to another £200 million in Scotland. There could therefore be some pressures there.

Secondly, based on good evidence relating to previous changes elsewhere in the world and in the UK, the OBR assumes that, in the longer term, a large part of the higher national insurance costs for employers will translate into slower wage growth for employees, as the burden is shifted on to employees. We might therefore see some of the costs that public sector employers are facing in the short term get transferred, in the longer term, into costs that public sector workers end up paying, given that, in many instances, the public and private sectors are operating in and recruiting from the same labour market.

Some of the pressures on the public sector wage bill and employment costs might therefore become a little bit less acute over time, as lower wages in the private sector as a result of the increase in employer NICs allow slightly lower wage increases in the public sector as well. However, the public sector of course does not have the same ability to change prices, for example, and that will be less true of some of the lower-paying sectors, such as social care, where many people are paid at the minimum wage already and so there is not so much scope to hold down wages. The pressure on councils might therefore be more in the longer term than the pressure on, for example, the NHS, where most people are paid substantially above the national living wage and where, therefore, there might be a bit more scope for wage growth to be a bit lower in future, as the burden gets shifted on to workers.

John Mason: That was a very full answer, which leads on to about 20 supplementary questions. However, we can pin down one or two things. For starters, are the English departments for health or education getting fully funded for their extra national insurance costs, or are they also having to find some of that money from within their budgets?

David Phillips: Ben, do you know that?

Ben Zaranko: I do not think that we have enough information to answer that confidently. My understanding from reading the documents is that the intention is to fully compensate those who directly employ public sector workers for those costs relating to the workers that they currently employ. However, the information that has been coming out on that has been minimal. I think that even some UK MPs have put in freedom of information requests and got nothing back. We just do not know enough to say with 100 per cent confidence at this stage. My understanding is that the intention is to fully compensate, but I could be wrong.

John Mason: That is fair enough. If we just do not know at the moment, we will presumably find out in due course.

It strikes me that that is quite a big gap—between £500 million and £300 million—just because Scotland has a few extra workers. My gut feeling is that the UK Government is not fully compensating departments in England but, fair enough, we do not know.

You mentioned a few examples, such as the care sector. What about the case of general practitioners, for example, who most people would think of as being in the public sector? Am I right in saying that they are definitely not, in either England or Scotland, being covered for national insurance increases?

David Phillips: Yes, that is my understanding.

In Scotland, it would be the choice of the Scottish Government how it uses the funding that it is provided with, including whether to compensate on the same basis as England. I agree with you about the gap—it was bigger than I would have thought it would be just because of the difference between, say, a population share versus a share based on Scotland's higher public sector wage bill—but we should wait for full details to draw firm conclusions. The Scottish Government could provide compensation on the same basis as the UK Government, dipping a bit into its other funding to do that, or it could choose to provide less or to provide more and wider-based compensation.

John Mason: Fair enough. We have a choice here, but it sounds like there is a choice being made down south, as well. If the Department of Health and Social Care has to also fund GPs, it must also have a challenge with that.

You referred to the OBR's thinking that the national insurance increase will push down wages. I get that for the public sector or for places with a fixed budget, but I am not sure why the OBR assumes that when it comes to the private sector. If you are running a restaurant that is very expensive—I believe the convener was at one last night—do you not just put another pound or fiver on your prices, and that will boost inflation and push prices up?

David Phillips: According to the evidence internationally—we did a big review of this for the European Commission a few years ago—social security contributions are largely incident on employees. When social security contributions are increased, whether that increase is put on employers or employees, although it takes some time, a large part of the burden remains on employees. It is shifted to them.

That might differ across different sectors. For example, it is harder to raise prices if you are in what is called a tradeable sector. If you are competing internationally for business, it is harder to raise your prices when your employer costs

have gone up, because you are competing in an international market where the costs have not gone up in, for example, America, Germany or Japan, so you cannot raise your prices. If you are running a restaurant domestically, you are not competing that much with restaurants in, say, France and Germany—I do not know how much your convener has to spend on restaurants, but he is probably not travelling to France for a meal. Even though there is more scope to raise prices in the product market, you are also competing in the same labour market as the businesses that trade internationally. You would still expect that if, for example, the amount that the factories can charge does not increase, so they need to give slower wage increases, that reduces pressure on restaurants, shops and other businesses that trade locally to increase wages.

The combination of the different impacts in different markets and the competition in the labour market means that, even though you think that some places can increase prices and some cannot, there is a ripple effect across the economy, which is called a general equilibrium effect.

There is uncertainty about exactly what the breakdown will be. Some of the impact will probably be on prices—more so for those areas where you can increase prices and not face international competition. Some of it will be on wages—probably more so in those areas where the types of workers you have and the types of markets you are selling in are more exposed to international competition. For the public sector, it will probably be a combination—there will be higher costs for public sector employers but probably lower increases in workers' wages as well. At the bottom end of the labour market, the national living wage and employer costs will be going up at the same time, and that is where you can see the squeeze. That could mean either potential job losses or costs for things such as social care going up, which means that councils could face a real challenge.

John Mason: Thank you. You also mentioned the Barnett squeeze in your paper, which I will dig into just a little bit. In relation to this year's budget, there was a surprisingly large increase for public sector pay in England of, I think, 5.5 per cent. Although we get the Barnett consequentials for that, am I right in saying that, with the Barnett squeeze, we do not get a proportional share and so, based on that, we cannot afford to give all our workers 5.5 per cent?

There is the separate issue that we might have more workers and they might be paid a bit more to start with. However, even if they were not, that 5.5 per cent increase in England does not allow us to pay a 5.5 per cent increase here. Is that a fair understanding?

David Phillips: Yes. Let us put pay and employment to the side for a moment. The Scottish Government's funding per person starts at a higher level—I think that at the moment it is around 125 per cent of the English level—so, if you have the same cash per person increase, that is a smaller percentage increase in Scotland. That is basically the definition of the Barnett squeeze. When you start off with a higher level, a given cash increase is a smaller percentage increase. Then, over time, you would see funding per person in Scotland tend towards the English level.

Offsetting that is the fact that the Scottish population is growing less quickly and the Barnett formula does not fully account for that. When we ran the scenarios a few years ago, it looked as though the funding per person over the long term could fall from about 125 per cent to maybe 115 or 117 per cent of the English levels, given the combination of the Barnett squeeze and the slower population growth. It is all very sensitive, according to what happens to population growth in the two countries, what happens to inflation and what happens to public sector spending growth, but that is what would happen.

To come back to your point, because spending per head starts higher in Scotland and a large part of that is due to a higher public sector workforce and slightly higher public sector pay, an increase that comes from England translates into a smaller increase in percentage terms for Scotland. That makes it harder for Scotland to pay for these things without raising taxes itself or cutting other areas of spending.

That means that we think that it will be worth looking at the Barnett formula again because, in the long term, it will not be that friendly to Scotland. It has served Scotland well historically, but in the long term, it may not. The risk in trying to open up this can of worms at the moment is that, if you were to do a needs assessment, I would be very surprised if it suggested that spending needs here were 25 per cent higher than in England. Therefore, although Scotland might benefit from Barnett formula reform in the long term, it might be an unpleasant shock in the short term.

John Mason: That is very well put, thanks. That makes it quite clear.

I have another relatively minor point to ask about. My understanding is that the UK Government is planning to cut back on consultancy quite a lot. Consultancy can be seen as a bit of a bad word and people think that it is all a waste of money, but is it not the case that consultancy is needed, because neither the UK or the Scottish Governments has expertise in every

single subject—they need to buy in expertise? Is there a danger that, in cutting back too much on consultancy, you lose expertise?

Ben Zaranko: It is worth thinking about the two main reasons why a Government would be making heavy use of consultancy. The first reason is expertise, as you say. If you are running an information technology transformation project, that is the sort of thing that you do not do often, and you definitely want to buy in that expertise. If you are doing something that requires very specialist knowledge, it probably does not make sense to try and have that in-house capability—you want to be buying that in.

The other big reason to use consultancy is accountability. It is almost like outsourcing the accountability to somebody else. Often, businesses do that as well. They use consultancy to reach the conclusion that they already knew they wanted to reach, but now they can blame it on the consultant. The question is whether the Government is also using consultancy for those reasons on occasion, or whether we just do not have the capacity to do things that the state probably should have capacity to do.

Perhaps the state should have the capacity to deliver major projects and do in-depth analysis of what the public think about certain topics or what the data suggests about certain topics. There is a question about state capacity. To what degree should we buy in expertise, or should we develop expertise in-house? There is also a question about using consultants to outsource accountability for uncomfortable decisions.

John Mason: Thanks very much.

10:30

Craig Hoy (South Scotland) (Con): Good morning. I will jump around a bit, because some of the questions that I was going to ask have already been asked. On the back of what has been said, I have some follow-up questions that go to the heart of the sustainability of Scotland’s finances and tax system.

In your report, you identify a substantial uplift in the block grant in-year and next year. However, the Scottish Government says that the additional £1.4 billion that it is set to receive this year is already committed and that only about £300 million of the £3.4 billion that it will receive next year is additional new money that can be spent. We would say that it should be spent on tax cuts, but the Government might have other priorities in the budget. What does it tell us about the underlying health of the public finances when sums of that amount do not appear to touch the sides in relation to the Government’s expenditure?

David Phillips: It was clear that the initial budget that was set for this year would have been very challenging for the Scottish Government to meet. The 2021 spending review was also very front loaded. Although there were some top-ups in later years, the Scottish situation improved a lot because of improvements in the forecast net tax position. Even so, the increase in real-terms funding in the initial budget for 2024-25 was very tight—in fact, as I said, there was a 0.6 per cent real-terms cut compared with what was actually spent in 2023-24. Therefore, it was always clear that, without additional funding, very tough choices would need to be made in-year.

Additional funding has been provided during this financial year. In the autumn budget revision, there was about a £1.2 billion top-up for day-to-day spending on public services, and an additional £1.4 billion was provided in the UK budget in October. The Scottish Government has said that that funding is all accounted for, but I must say that I would be a little surprised if it had anticipated such a big in-year increase. Ben Zaranko might want to come in on this, but it is fair to say that we were surprised by the scale of the in-year top-up in 2024-25. The UK Government had talked about a £22 billion hole. It said that it had found £6 billion of in-year savings, and I think that, in the end, it provided a £26 billion top-up, which was somewhat larger than we expected. I do not know whether the Scottish Government had been receiving information through informal channels—I know that such information is sometimes passed between the Treasury and devolved Governments to help with their planning—but we were surprised by the scale of the top-up.

The Fraser of Allander Institute has considered a number of scenarios involving public sector pay growth and the use of funding, and it suggests that some funding in this year’s budget could still be allocated. However, given the somewhat tighter outlook for subsequent years, it would make sense to bank some of that funding.

As Ben Zaranko said earlier, it could be that a bit of negotiation is going on. If the Scottish Government says that it will not use all the available funding this year and will carry forward some into next year but the initial budget that will be presented tomorrow includes that funding, that will leave the Government with a lot less scope for negotiation. Given that the Scottish Government no longer has an agreement with the Greens, it is probably a bit more worried about getting its budget passed. In relation to budget process management, it might make sense for the Government to say, at this stage, that there is less money available this year to carry forward than we might expect there to be. Then, when we get to the stage of the February spring budget revision, the Government might say, “Actually, we’ve

managed some of the pressures." That would give it scope to say, "We've got a couple of hundred million pounds to play with—let's negotiate the budget."

In the same way that Rachel Reeves might argue that one of the reasons why the envelope cannot be tight for later years is that that might allow a stronger negotiating position with departments, in relation to the Scottish budget position, it might be the case that, if you say at this stage that you are using all the funding this year at the same as offering your plans for next year, but you subsequently find out in February that you have a bit more to play with, that could be useful in budget negotiations.

Craig Hoy: Yes. There is perhaps an element of smoke and mirrors at play.

You identify that the Scottish Government faces a challenging situation in future years, partly because of the projections in relation to public sector pay and the social security bill, and potentially also because of its income tax policies. You have recommended that the Scottish Government should set out its plans in a spending review next year and that it should

"evaluate key policies that increasingly differentiate it from the rest of the UK—including its higher public sector pay and income tax policies and wider tax strategy."

I would probably add social security to that list. Should those three or four issues be cause for concern with regard to the long-term sustainability of the Scottish public finances?

David Phillips: It is certainly worth exploring the impacts of those issues. As John Mason said, given the context of the Barnett squeeze, the higher levels of public sector employment and public sector pay will become more difficult to fund in future years. In that regard, it would be worth looking at whether the higher public sector pay awards in Scotland in recent years have led to, for example, improved recruitment and retention—improved quality of workers, if you like—in the public sector, and whether that has enabled productivity to increase. It would be difficult to do that, but by using a combination of data from the various public sector employers and data on the outputs that have been achieved, it might be possible to evaluate what the impact of higher pay has been. For example, you could compare how recruitment and retention has changed in Scotland with how it has changed down south in England or in Wales.

On the tax side of things, as I said, when the new evidence comes in, it would be worth looking at whether the increases—especially those in the very top rate of tax—have increased revenues or have pushed Scotland above the top of the Laffer curve. There is an element of uncertainty, but it would be important to know that.

As you said, the issue of disability benefits is one that should be looked at. Because similar changes have been made underneath the radar in England and Wales with the operation of the personal independence payment, the Scottish Government's changes might not have as much of an additional cost as was initially expected. We will find out what the SFC thinks about that tomorrow.

However, the fact that there are higher levels of spending on such benefits across the UK is still a problem for the UK as a whole, because that reduces the room for manoeuvre on public services at the UK-wide level, which reduces the Scottish Government's funding via the Barnett formula. It is important to look at all those issues.

With regard to the tax strategy, from rumours that are going around my understanding is that it will be less of a strategy for tax policy and more of a strategy for tax policy making. It would be useful if the Scottish Government set out more of a strategy for how it will reform the wider tax system. In the same way that the UK, with its ageing population, needs to raise more tax revenues to fund public services, it becomes even more important, as more is raised in tax, that the tax system is well designed and is not damaging the economy more than is necessary. The same is true for Scotland. There are things that the Scottish Government could do to raise as much as it does now, or even, potentially, to raise more, but in a way that is fairer across households and less economically damaging. The tax strategy should look towards that, as well.

Craig Hoy: You have pre-empted my next question. You said that you want the UK Government to provide a more coherent tax strategy. At this point in time, are you looking to the Scottish Government simply to provide a tax strategy, coherent or otherwise?

David Phillips: Ideally, it would be a coherent tax strategy that would set out not only the broad goals of tax policy but some concrete steps that will be taken to move tax policy in that direction. Of course, no chancellor or finance minister wants to write out their budgets for the next three or four years in full detail in advance, because that might lead to behavioural responses such as forestalling behaviours, or it might become a lobbyist's charter. However, there could be some sense of direction given, perhaps by saying, for example, "We think our tax system can be reformed to make it more growth friendly by shifting the burden of taxation away from income and property transactions and on to property values." That is a potential direction of travel.

I would like something that goes beyond just setting out the process by which tax policy will be made and what one could do with more powers from the UK Government. I would like the Scottish Government to say a bit more about how the powers that already exist in Scotland could be used either to raise more in a way that does not damage the economy too much, or to raise the same amount in a way that is fairer and more efficient.

Craig Hoy: I will close by asking about two issues that you have identified—sustainability of the NHS in Scotland and sustainability of Scottish universities and higher education. You said that the inputs into the English health service might be slightly higher than those in Scotland. However, this year, at the autumn budget revision, there was a significant resource increase of £1.1 billion for the Scottish health service. From today's Audit Scotland report on the NHS, it is clear that the Scottish health service continues to be in crisis and is underperforming, compared with the service in the rest of the UK. That implies that money alone will not solve the NHS's ills.

How clear would you be in suggesting that urgent reform is now required to the Scottish NHS, particularly given the concern that public sector pay, including NHS pay, is absorbing a greater proportion of the overall budget?

Ben Zaranko: The term "reform" is quite a broad one that captures all sorts of things. It could involve a huge reorganisation of the service, or it could be tweaking some of the financial incentives in various parts of the NHS. The Audit Scotland report echoes many of the things that we have found in our analysis. Direct comparisons of performance between parts of the UK are hard, because things are measured and defined slightly differently, so we want to be careful not to compare apples with pears. However, it looks as though the NHS in Scotland is not recovering from the pandemic quite as quickly as the NHS south of the border is.

That is not to say that the NHS in England is firing on all cylinders and doing fantastically, but it looks as though, in Scotland, on lots of measures, and on hospital waiting times in particular, performance is still getting worse and is not improving.

There is the big-picture problem about why more resources are going in—not just cash, but real things such as more doctors and nurses and more clinical support staff—but are not translating into greater volumes of treatment. That is a major issue for the health service and a major fiscal issue, and it deserves absolute political attention, because it is a huge chunk of what Government does.

Before leaping to grand reforms in how the system is structured, the simplest thing is to look at the mix of inputs that go into the health service. Front-line staffing has been prioritised, perhaps to the detriment of other areas. That is partly a function of higher pay awards when there has been high inflation, but there has also been a decision to increase the number of front-line staff in the NHS, which has not been matched by increases in capital investment. In Scotland, capital investment is falling in cash terms year on year. If you are not giving the front-line staff the equipment, the buildings, the beds, the information technology and all the other things that they need in order to work productively, you are throwing more and more staff into a system that is not working.

The analogy that works best for me is to think about a kitchen in a restaurant—perhaps the one where the convener ate last night. If you double the number of chefs but keep the number of hobs fixed, you will not get twice the number of meals at that lovely restaurant. You need to think about the other inputs, and not just about the front-line staff. That productivity question is at the heart of some of the fiscal challenges in Scotland and the UK as a whole.

Craig Hoy: Finally, in relation to the future sustainability of Scottish universities, you identify a heavy reliance in the Scottish higher education system on overseas students, the numbers of whom are falling. At the same time, there has been no increase for 15 years in the tuition fees that are paid for Scottish students, which is leading to a looming cash crisis in Scottish higher education. What needs to change in the system to put it on a more sustainable footing?

10:45

David Phillips: Our report on Scottish HE finds that the amount spent per student for Scottish students is around 22 per cent lower in real terms than it was in 2013, with more than half of that fall happening over the past three years, given the high rates of inflation. Looking ahead, you have the issue of a decline in the number of applications from international students, especially for masters programmes—applications for undergraduates have held up rather a lot better. However, the big increase in numbers and in income over the past couple of years has been from masters students.

To address the issue, the Scottish Government could increase the amount of resources that it provides to Scottish universities through its own funding: it could increase the implicit tuition fee or its teaching grant to Scottish universities. To maintain real-terms spending in the area, it would need to increase funding by around £10 million to £20 million a year. We estimate that increasing it

to cover the cost of national insurance could mean that it is pushing towards around £50 million a year. That is quite small in the context of the overall Scottish budget, therefore, if the Scottish Government wanted to prioritise HE, it could choose to do that. However, that comes in the context of there being many pressures on the Scottish Government's budget.

In its medium-term financial strategy, which was published in May 2023, I think, the Scottish Government said that because of the rising pressures on public spending and the challenging financial outlook, it would look at the extent to which universal provision was the more effective use of funding, versus more targeted use of funds for those who have particular needs or affordability issues. It did not say that in the context of HE specifically; it said it more generally. There was a question about whether the current model of HE financing in Scotland needs to be looked at again if the Scottish Government does not feel that it is able to prioritise HE funding in its budget.

Craig Hoy: Thank you very much.

Ross Greer (West Scotland) (Green): Good morning, guys. Like Craig, I will jump around between a couple of different topics because so many threads have opened up this morning. The first is income tax and the starter, basic and intermediate rates. In your paper, you make a perfectly legitimate point that it would be more progressive to have a zero per cent rate and then go straight to 21 per cent. Therefore, the progressivity point is fair enough.

However, on your other point around complexity—that word is beginning to feature quite a lot in commentary around the Scottish income tax system—I struggle a little bit, because half a dozen bands are still not that many. I have met plenty of workers who are on much higher incomes and who are interested in what their marginal tax rate will be and are somewhat interested in the relative complexity of having that many bands. I do not know whether I have ever met a worker on an average income—in that range—who is concerned by the apparent complexity of a system that has half a dozen tax bands.

Will you talk me through what the problems are? The word "complexity" is used with negative connotations here, so what are the negative impacts of having a number of different bands?

David Phillips: I should say that compared with many of my colleagues, I am a little bit less concerned about having additional tax rates of 19, 20 or 21 per cent. It does add a bit to the complexity of the operation of the system for employers and HMRC, but not to a huge extent.

My main concern is that, if your aim is to make the tax system more progressive, that approach is both a little bit more complex and not the best way to make it more progressive. I think that it was chosen largely for political reasons at the time, because at that stage you could say that half of Scottish taxpayers paid less than taxpayers in the rest of the UK: it was £20 a year less, at that point. However, if you had, instead, effectively increased the personal allowance by having a zero per cent band, you would have seen a bigger cut for those with the very lowest incomes, but you would not have seen that "half of Scottish taxpayers" number.

The approach also adds a little bit to the complexity of things such as, for example, the operation of gift aid. If there was a single Scottish rate of income tax of 21 per cent, you could have a specific Scotland gift aid scheme of 21 per cent relief for charities. It used to be the case that it operated at 20 per cent in Scotland, so some people were getting under gift aid and some were getting over it. It would have some benefits like that.

There are also some issues around certain forms of pension that could have been simplified in Scotland by having a single rate for that level of income.

However, the main issue is that the approach is not as consistent with the aim of progressivity as a slightly simpler system would have been.

Ross Greer: That is useful. Thank you. The SFC assumptions about behaviour change and some in your work are because we have limited evidence in Scotland, so far. Are you aware of any UK-wide and international evidence that significant differences in sub-state and state-level changes in tax policy make a difference to people moving over the border from France to Belgium when France increases its income tax rates, for example, compared with people moving between cantons in Switzerland? Is there a significant difference in the effect on behaviour, particularly migration?

David Phillips: When we reviewed the evidence as part of our piece on income tax, it was clear that the degree of migration response varies across contexts. For example, there seem to be significant migration responses in Swiss cantons, where we see people moving from Zurich to Zug because of the lower taxes in Zug.

In Spanish provinces, there was a degree of response that seemed to be fairly similar to the estimates that HMRC was getting from the data for Scotland for 2018-19. In the US, there was a lower degree of migration response on average, although some more recent studies suggest slightly higher responses. In general, we would

expect that the further that people need to move to avoid taxes through migration, the lower the response, because the adjustment costs are higher the further they need to travel.

As well as varying distances and the sizes of areas that tax laws apply to, it is also clear that different types of people are more or less responsive. Some evidence from the US and across countries in the European Union suggests that people such as inventors or footballers are more responsive to things like tax rates than, say, people who work in the public sector as highly paid doctors and so on. That might suggest that they are particularly concerned about attracting those more footloose international people such as inventors, who might care more about tax rates, while you are less concerned about that and more concerned about retaining public sector workers or people who have a stronger attachment to Scotland in the first place .

Ross Greer: You have made a number of recommendations, as have the SFC and others, about the kind of data that we need to start gathering to get a good sense of the effect on behavioural impact, payroll, monthly payroll and things like that. Could you talk a little bit about how long we would need to gather that data for before we had a robust enough evidence base, and about the impact of the fact that we would be starting to gather that data now, by which I mean years after some of the changes were made? How do we account for the fact that we will always have that initial period of income tax changes without a richer base of data to draw from?

David Phillips: We could ask HMRC maybe not to go back as far as 2018-19, but instead to provide the monthly pay as you earn data from 2023-24 and 2024-25 sooner, so that you do not have to wait for the full self-assessment returns data to come in towards the end of next year for 2023-24 and the end of 2026 for 2024-25. We could ask HMRC to bring that data forward for the years that have just gone by.

One could also look at bank account data. Some banks now share data on expenditures and incomes from bank accounts—it is anonymised, obviously—with the Office for National Statistics. One could use that data to look at not just employees but self-employed people transferring money from their business accounts to their personal accounts, although it is challenging to work out what is income and what is transfers for expenses and so on.

We could get some data for the past few years' changes, and that is the most important thing, because it is the changes since April 2023 that have really opened up the wedge. Back in 2018-19, people in Scotland who earn £125,000 paid, I think, around £1,800 a year more in income tax, which is not insubstantial, but it is not that large an amount in the grand scheme of things. By 2022-23, the figure was £2,500, and it is now £5,200. Those gaps have opened up in the past couple of years, so if we get data a bit more quickly from HMRC for the past two years or so, that would help the Scottish Government to do some initial analysis, at least, over the next 18 months before the full data comes through.

Ross Greer: I have two final questions. The first sticks with HMRC and relates to two studies that it did on the potential behavioural impact on migration from income tax. One of them showed an immediate net negative effect on migration in 2018-19 for higher earners, but then essentially no effect in 2019-20. The second study showed positive inward migration of higher earners up to 2021-22.

The first study shows what appears to be, on first reading, an immediate negative behavioural impact on migration for higher earners in 2018-19. Should we discount that, given that, although some behavioural changes happen immediately, that does not generally happen with migration, and given everything else that was happening at that point, particularly around Brexit, as well as the fact that the effect did not reoccur the following year? Should we assume that what appears to be an immediate behavioural impact on migration resulting from the 2018-19 tax changes was, in fact, down to other factors and was probably unrelated to income tax that year, and that the longer-term studies are a better indicator?

David Phillips: I can tell that you have read what I wrote on that point pretty well. I would not say that we should "probably" discount it; I would say that I was a little surprised that the estimates all said that the response happened immediately in the first year of the policy and that there were no impacts in the subsequent year. Most of the international evidence suggests that migration responses build up over time, because it takes a while for the stock of high-income individuals to change—people do not just move immediately; their decisions are affected by various things. For example, when an offer comes along for a job in Scotland, which does not happen every year, someone might be more or less likely to pick it up.

I would not want to say that we should probably discount it, but I would treat the figure with not just the usual heavy pinch of salt, given statistical uncertainty, but a bigger shovel of salt, given the additional issue whereby the figure is not in line with the expectation that the effects would take some time to build up. That is another reason why I would say that waiting for information on the 2023-24 and 2024-25 changes before making any radical changes to income tax policy makes sense. That information will give much more

evidence, given that much bigger tax changes will have taken place by that point.

Over the period from about 2017 to 2022, there was a net flow of higher income taxpayers into Scotland. We saw a similar trend in Wales, and it looks as if something similar happened in England, at least if you look at the net migration figures—England does not have the specific taxpayer figures. It looks as if that was driven by Covid-related factors to do with people wanting more space and so on.

What you can draw from that is that up until at least March 2022, any behavioural response to Scotland's tax changes was not big enough to offset those other broader changes. Again, it ends in 2022 at the point at which the tax changes start to get much bigger.

11:00

That is why it is really important to look at the most recent changes. If they suggest that migration responses are not that significant, the policy does not need to be looked at again; if they confirm the initial estimates, it comes back to the point that a tax strategy should be one that you are open to revising.

I am sure that you would agree that, when thinking about the tax system, it is not only income tax that can be made more progressive; there are other elements of the tax system, particularly council tax, that are currently highly regressive and less subject to behavioural responses.

Ross Greer: Thank you. I am conscious of the amount of time that I am taking up, convener, but I have one last question.

On exactly that point about other taxes, I will pick up on something that you said in response to, I think, the convener around LBTT. You were somewhat critical of the impact that it has had on people's ability to move, which is fair enough, but you singled out the additional dwelling supplement. Will you expand a bit on that? My assumption is that the rate for the additional dwelling supplement is not having a negative impact on people's ability to move because they do not live in their holiday home—they live in their primary home, and they do not pay ADS if they are buying another primary residence.

Surely, if ADS is set at the right rate, it should have a positive impact on people's ability to move home because it is designed not only to raise revenue but to have a behavioural impact by discouraging people from buying holiday homes. That will free up more properties for people to live in as their primary residence.

David Phillips: Yes—there will be multiple effects of ADS. ADS does not just apply to holiday homes; it also applies to rental properties. Increasing the cost of a property for a second home owner or a landlord to purchase will reduce the number of properties that are purchased by them. That might slightly reduce the cost for an owner-occupier to purchase that property, so there is that impact.

In addition, reducing the ability of landlords to purchase properties might lead to a reduction in the supply of rental properties, which in turn might mean an increase in the cost of rental properties. That might make it harder for those who do not have access to the bank of mum and dad to save up for a deposit to purchase a home, even though the cost of the home is a little bit lower.

It is also possible that the overall slightly reduced cost of properties might reduce the overall supply of new properties, given that the return to developers will be slightly lower.

Part of this is about an affordability issue, and another part is about mobility. One of the easiest ways for someone to move to a new place is to rent a property first, and if the supply of rental properties is lower due to a tax penalisation, that might reduce people's ability to move and take new jobs in new places. It might act to reduce social mobility, where people move from places where there are fewer jobs to those where there are more jobs. If there are fewer rental properties because of their tax treatment, that might stop that first run of social mobility.

Ross Greer: Thanks very much. That was all really useful.

Michael Marra (North East Scotland) (Lab): I have a couple of quick questions.

On this year's budget, I think that the committee has probably shared a little bit of your confusion, David, about where we have ended up. You identified an additional £2.6 billion in recent sets of consequentials this year, but we are being told by the Government that it has assumed that that money was coming. Is there any indication as to where we would have ended up if that money had not arrived?

David Phillips: Of the additional top-up from the UK budget, £1.2 billion was found through a combination of money from the UK March budget—from the main estimates, although, as was said earlier, a large part of that was for the SCAPE costs.

The Scottish Government has found some money by cancelling a resource-to-capital switch, carrying forward underspends from last year and saying that it will draw down more ScotWind revenues. Already it has found, I think, just over £1.2 billion in relation to public services. Without that, you would have been in a really difficult

situation in Scotland. You would have needed to see much bigger cuts to services outside the health service through which to meet the pressures facing the health service and to cover public sector pay bills.

With that £1.2 billion, there was enough to move from a 0.6 per cent cut in day-to-day spending after inflation to around a 2 per cent increase. That would still have been very difficult. The additional £1.4 billion that has come through in the UK budget, takes you to an overall increase in day-to-day spending of around 6 per cent—around 5 per cent once you net off those SCAPE figures.

That is quite a substantial increase. It would surprise me if there was no scope either to carry some of that forward or to undo some of the cuts that have already been made. You will get an additional £1.4 billion next year, but given some changes in potential income tax forecasts and so on, next year will see nowhere near as big an increase, year on year, as this year will, so carrying some of that forward would probably make sense.

In the absence of those top-ups, yes, the Scottish Government would have had to make really quite deep cuts in order to pay for higher public sector pay and pressures in the NHS.

Michael Marra: Do you think that, in the budget statement tomorrow, we will see the ScotWind money being put back, for instance? Is that the kind of measure that you are anticipating?

David Phillips: I do not know what we will see tomorrow. As I mentioned, one possibility is that the Scottish Government will wait until February and the spring budget revision to confirm what it will do with the consequentials that came forward for this year. If it does that, we might see some quite tight settlements for the coming year, at least initially in the budget, and then, potentially, after the February budget revision, it might say that it has been able to manage down some of the pressures and can carry some of that funding forward. It might then use that money to top things up in negotiations over its budget as it goes through the parliamentary process in February. I do not know; that is just one option.

We might also see the Government confirm that it will hold some money back, which then allows it to do some bigger year-on-year increases next year.

The key thing to look at will probably not be the Scottish Government's budget, but the table in the SFC's report that shows what the Scottish Government is assuming about resource funding this year and next year. That often gives a clearer picture of the true year-on-year changes than the figures in the Scottish Government's budget document.

Michael Marra: What you describe is, to me, very opaque in terms of our ability as a committee, as a Parliament and, frankly, as members of the public, to scrutinise and understand what the Government is doing with the money. I go back to the previous year, where we had the second of three in-year emergency spending reviews—emergency budgets halfway through the year—but at the end of the year there was a substantial carryover into the following year, so there was a significant underspend.

We are in the situation where we appear to have panics from the Government around spending and measures being taken or not taken. To illustrate that further, we had evidence from the minister a few weeks ago on the autumn budget revisions. The target of £500 million in cuts was set in the emergency crisis budget in September, but then we were told that only £180 million—I believe it was that, or £188 million, perhaps—of those savings had been made.

I suppose that my question is whether we should be concerned about that on-going, up-and-down management panic between one budget that is set in December and what happens in various different fiscal statements throughout the year, in relation to our ability to understand what resources are available to public services—and, frankly, public services' ability to understand what resources are available to them.

David Phillips: I will come in first, and then I will hand over to Ben Zaranko to talk about how it is done at the UK level.

First, if you plan to carry forward money, and you know about that as of December, it makes sense at that stage to announce that and put the money into the budget so that it can be fully scrutinised as part of the budget process in the Parliament, as opposed to waiting until the spring budget revision, or potentially afterwards, when you get the outturns data further down the line. Traditionally, outturns data has not been very well publicised in Scotland.

It could still be the case that you think that you may need the funding, and you do not want public sector service providers to be running out of cash authorisation before the end of the year, but in the end, you are able to manage down the pressures. We should not, therefore, kick the Government if it is able to manage down pressures.

Over the past few years, we have seen regular emergency budgets, not just in Scotland but in Wales. It is more difficult for the Scottish Government to manage its financial position in-year. If the UK Government decides part way through the year that it cannot manage within its budget, it can just decide to borrow more. The Scottish Government cannot currently do that—

there is borrowing only for forecast errors. We have said in our review of the fiscal framework that there should probably be some small amount of borrowing for spending to meet pressures on public services, as well as for forecast errors on taxes and social security.

The Scottish Government has less room for manoeuvre, but in the past few years in particular, we have seen an issue with the assumptions being made around public sector pay, for example. There was quite a big difference between what the SFC was saying and what the Scottish Government had implicitly assumed. We have seen a regular pattern start to emerge, to some extent in Wales but more so in Scotland, of having to cut back during the course of the year to free up money for the NHS and for public sector pay down the line.

The Welsh Government has actually started to learn the lessons a little. It did what I have described in 2022-23 and 2023-24, but in the 2024-25 budget, it set a much tighter settlement for areas outside the NHS so that it could actually pre-empt those pressures and put in that money in the first place. That meant that it has not had to take the same emergency budget measures this year as it has had to in previous years.

Michael Marra: We are talking about the macro level in terms of how the Government is managing the budget, but I am thinking about the impact of that kind of up-and-down, back-and-forth approach that the Government has taken on public services. I will give you an illustration. NHS Tayside, in the region that I live in and represent, told me and my colleagues at the end of last week that, at the start of the year, it had been set a deficit cap of £37 million. A few months ago, the board told MSPs that it was going to manage about £20 million of the deficit. It went through a process of trying to understand how it could save money and then, lo and behold, at the start of November—unsurprisingly, to be frank, after the UK budget—the Scottish Government agreed, “No, you can go full hell-for-leather and have the £37 million.”

Do you agree that that up-and-down approach is not driving efficiency and promoting responsible management, and that there is actually a real cost to it? Do you think that that is the case in terms of the way that public services are managed?

David Phillips: Ben, do you want to come in on that one?

Ben Zaranko: Yes—I have some thoughts on that. I agree that it is important to have a degree of certainty—to know, for example, that if you hire someone, you will have the budget there to pay for them next year, and that if you invest in a multiyear project, the funding will be there to see it through. All of that is massively important, and it adds to efficiency.

However, there is a trade-off that has to be made, in the Treasury or the Scottish Government, between certainty and flexibility, and the past four years have been particularly hard in that respect. When plans were set in 2021 at the UK Government spending review, which largely governed what happened in the interim, we were expecting inflation to be a little bit above the 2 per cent target, or thereabouts, with public sector pay awards in the 2.5 to 3 per cent zone. However, things turned out very differently, and so there have been subsequent changes and plans have adapted in response to changing circumstances. The Government could have stuck exactly to the plans that had been set out—it could have rigidly adhered to those—but that would have had fairly damaging impacts. It is quite hard to strike that balance.

11:15

In a more predictable world, you could perhaps be better at sticking to budgets, and not doing the back and forth and messing with the ability of NHS managers to plan, as you were referencing.

There is sometimes almost a chicken-and-egg problem—there is a reluctance perhaps to offer a more generous settlement to services and say, “Here’s your budget—go and live within it.” The Treasury in Westminster in particular has learned that departments have a tendency to come back and ask for more, whatever you give them, so it deliberately lowballs it and then gives itself space to top it up later, but then ends up hitting efficiency later on.

It would be much better if we could shift to a new, higher level of trust and a more stable equilibrium but it is very hard to just make that jump immediately.

Michael Marra: Finally, we have headlines in Scotland this morning about the Auditor General sounding alarm bells, which chimes closely in many regards with your recently published analysis of the NHS. However, is the overall management of the finances that I have described not part of the problem? You have described the significant uplift in finance this year. Is now not the moment to try and find a new direction and to try to change and reform services, rather than doing that when spending is decreasing or there is a huge amount of panic? Is now not the time to change direction?

Ben Zaranko: Yes, I think that it is. It is much easier to rebalance between services or between different pots within the overall whole when funding is going up. To give just one example of where attention should be paid, investing in the

physical side of things is very important in boosting productivity within hospitals. That is about beds, new equipment, and particularly IT and data infrastructure. It is much harder to prioritise that stuff if doing so is going to mean cutting front-line staff or cutting the pay bill.

If funding is going up overall, you can hold the pay bill more or less flat or increase it slightly but increase capital investment by much more. Therefore, it is much easier to do that rebalancing. Similarly, shifting care from hospitals into the community or shifting away from treating illness and more towards prevention are easier when a rising tide is lifting all boats and you can push resources into priority areas.

I worry a lot that, in Scotland and in the UK as a whole, there are clear targets and a desire to have more nurses, more doctors and more NHS clinical staff but there is a risk that doing that will squeeze out the ability to invest in those other things. You will then end up in a downward spiral where, despite adding more and more staff, you do not get as much bang for your buck as you should because they are not being equipped with what they need—you have not got more beds to treat more patients, the investments in data infrastructure to share data between different bits of the system, or all the sorts of things that you really need to be doing alongside adding more staff.

The evidence is clear that the recovery in the NHS is stalling in Scotland and I think that it might require a change of approach. Now is the time to try and jolt it out of that situation and try to make up some of the lost ground.

Michael Marra: Thank you.

Michelle Thomson (Falkirk East) (SNP): Good morning. I have a mix of questions as well, given that we are nearly at the end of the evidence session. I will start almost at the beginning. You have been quite critical about the extent to which you really see the UK budget as a budget for growth. Indeed, you suggest that the OBR thinks that

“the Budget will eventually boost output in a sustainable way, but only from 2032”.

We have also heard commentary about the front loading.

Given that wider context of really limited growth—of course, Brexit is in the room as well—and the limitations on the Scottish Government, on which David Phillips is obviously an expert, having done the work on the fiscal framework, in what ways can the Scottish Government really focus on making its budget one for growth?

Ben Zaranko: If we look at the UK budget from about six weeks ago, or whenever it was, it is worth distinguishing between the short term and the long term. There was a focus—which was commendable, in a way—on doing things that might not yield results over a single parliamentary session. Often, when finance ministers are presented with tough decisions, they think, “I’ll cancel the road project”, or “I’ll cancel this investment programme”. The first things to go are projects that they think that people will not notice because the work has not started yet.

In a difficult fiscal context, prioritising investment is something that should—we hope, if it is spent well—pay off in the long term, and in the short term it will inject some extra demand into the economy. It is almost like a sugar rush in the short term, but the sustainable growth impacts will come further down the line from spending well—one would hope—on infrastructure projects and the like.

What was lacking in the UK budget were the other parts of a coherent growth agenda. There are no right answers here—if there were simple levers that Governments could pull to simply boost growth, they would already be doing that, in particular if those things were politically easy.

Some of the difficult stuff concerns things like planning and making it easier to build. There is a growing movement calling for that as the key to unlocking the answers to all the UK’s problems. There are other issues around regional imbalances and transport infrastructure in certain bits of the UK, and around skills and supporting our growth sectors, such as they are, in the areas where the UK genuinely has a world-leading comparative advantage.

I will pass over to David Phillips for the difficult bit, which is to say what that means for Scotland. It is worth noting that the UK Government does not have much beyond more investment and a bit more stability, and saying, “Maybe we’ll build some more houses”. We have to go beyond that if we really want to shake the UK out of its slump.

Do you have any thoughts, David?

David Phillips: With regard to Scotland specifically, some of the things that the UK Government is doing at a national level could be considered in Scotland. For example, Scotland could potentially reform its planning system to make it a bit more growth friendly.

There are issues around education and skills. Scotland has seen its rankings in international attainment for schoolchildren fall over time, so we need a focus on trying to stop that and improve aspects of it. In fact, Scotland has seen its position fall not at the lower tail of attainment—it has actually been doing relatively well at keeping the lower tail up towards international standards—but at the higher end, where there has been a decline.

The higher end might, in many cases, be those students who go on to work in the industries of tomorrow, such as artificial intelligence. Looking at education, and at how we stretch the most able pupils, is therefore important.

I come back to the tax strategy. It will probably have a focus on growth, in the context of not just how growth can help to ease the challenges in the tax system, but how the tax system can help to boost growth. As I said, we are looking at the design of Scotland's property tax system, which—like the system in the UK as a whole—is not doing as much as it can to support growth, and is actively reducing people's ability to move in order to get better accommodation or to take up jobs.

There are a number of things the Scottish Government could do. Michelle Thomson mentioned the fiscal framework. There are things that the framework could be changing in some ways to provide the Scottish Government with a little bit more flexibility in its budget. I do not think that that would be the big answer, but it might reduce the extent to which we need quite as many short-term changes in-year such as Michael Marra mentioned.

Michelle Thomson: I was going to ask about the fiscal framework, in which the IFS had quite a key role. You raised some concerns at the time around limits, noting that,

“rather than link the limits to inflation, it would make more sense to link them to the amount of revenue and social security spending at risk, which will typically grow faster than inflation.”

With the benefit of hindsight, what further recommendations might you have made, and do you still stand by what you said at the time?

David Phillips: I completely stand by what we said when we reviewed the fiscal framework update. David Bell, David Eiser and I were involved in a report that looked at the block grant adjustments specifically. I think that the agreement to continue with the index per capita method for the block grant adjustments was a pragmatic recognition of the status quo and that it balances the different competing objectives of the Smith commission in a way that probably makes sense for both Governments—they can both live with it.

On the borrowing side, it was a step in the right direction. You mentioned both income tax revenues and social security, and there is real-terms growth in revenues. Revenues are, luckily, still growing faster than inflation. On the spending side, disability benefit spending in particular is growing substantially faster than inflation. Indexing to the forecast growth of those revenues and spending items in the rest of the UK probably would have made sense, rather than indexing to inflation.

The other issue at the moment is that the Scottish Government has borrowing powers just in relation to forecast errors for social security and taxes. However, pressures can hit budgets for other reasons. An unexpected increase in the cost of public services, a fall in income tax revenues or an increase in social security costs, even if forecast in advance, still causes a temporary hit to revenues or a temporary boost to spending.

We recommended giving the Scottish Government the power to borrow perhaps 1 to 2 per cent of its budget in order to cover those forecast-in-advance changes or public service pressures. Given that there is no England-only borrowing, we do not think that we could recommend giving Scotland full borrowing powers. At the moment, any UK borrowing either is for UK-wide things, such as the state pension, or it leads to Barnett consequentials for Scotland, so if Scotland had full borrowing powers, there would be an imbalance against England in the system. Given that the Scottish Government has to manage a larger and more demand-led budget now than it had in the past, some additional flexibilities would make sense, and they would not put either fairness or the fiscal sustainability of the UK at risk.

Michelle Thomson: Yes. You make a fair point about the budget being demand led and the implications of that.

A third aspect, which my colleague Liz Smith asked about earlier, is data. I have asked questions before about the lack of Scotland-specific data. I am thinking about inflation in particular. A lot of interesting geopolitics is going on that could impact on oil and gas, and Scotland's economy has a reliance on that. We also have changes to national insurance contributions that could affect interest rates. What appetite is there in all the relevant institutions to make advances by starting to collect Scotland-specific data?

David Phillips: First, we should recognise the significant progress that has been made on Scotland-specific economic data over the past few years through the work of the Scottish Government's economic division, which has led to a significant improvement in the data that is collected on the Scottish economy.

On inflation, which you mentioned, there are no Scotland-specific figures at the moment. In the past, the Office for National Statistics has collected information on price levels in different parts of the UK, and we used that data to look at poverty rates and incomes adjusted for differences in the cost of living across the UK. However, the ONS collected that only on an ad hoc basis. One option would be to have it collected on an on-going basis. That could be done by the ONS, or

the Scottish Government could add it to the work of its economic division.

I expect that, although the price level is somewhat different in Scotland, the inflation rates year on year would be pretty similar to those for the UK. Spending patterns are quite similar across Scotland and the rest of the UK, and the drivers of cost increases will be similar as well.

The one area where I think that the Scottish Government might choose to invest a bit more is in adding booster samples to various surveys. The Scottish Government pays for boosters in certain surveys to get an enhanced sample size for Scotland, and it could also do that for the labour force survey and the family resources survey. The Scottish Government is focusing on child poverty, but it is difficult to fully work out what is going on with Scottish child poverty rates by using the sample size that is available in the family resources survey. Given how much the Scottish Government is now investing in trying to tackle child poverty, some investment in data collection there might make sense.

Michelle Thomson: The idea of boosting the Scottish sample size is one that I have taken up directly with the ONS.

My final question is one that I tend to ask every year. I am not up to date with the latest statistics, but we know that the cost of corruption has a fairly significant impact on UK GDP. A figure of about £262 billion each and every year for money laundering and so on was being touted three years ago. What is your thinking on that? A while ago, at the start of this year, the UK again dropped down the Transparency International corruption index, but corruption continues to take a significant amount off UK GDP.

David, I may have asked you this last year or the year before, but to what extent do you take account of the cost of corruption, given the constraints on public finances? Do you have any thoughts on that?

David Phillips: Ben, do you have any thoughts on that before I come in with a comment?

Ben Zaranko: Nothing immediately springs to mind.

David Phillips: That is not an area that we have looked at in depth. Corruption, tax avoidance and tax evasion impose costs and, unfortunately, the optimal amount of money lost to them is not zero, because the actions that one takes to tackle those things, such as rules and regulations, and the paperwork that people have to fill in to get a paper trail to tackle them impose costs on the economy.

I say that to make the fairly uncontroversial point that investments to tackle corruption, tax avoidance and tax evasion have real benefits in reducing those harmful behaviours but they come with potential costs. That applies whether we are trying to tackle tax avoidance via HMRC or the corruption of organised crime. We must ensure that, in tackling those real and significant problems, we are not also imposing large costs on the legitimate economic activity of legitimate taxpayers.

Michelle Thomson: I do not disagree, but I think that we would struggle to get to £262 billion.

The Convener: We have gone well over our time and I know that our witnesses and members have other meetings to go to, so I bring the session to an end. I thank everyone for their contributions.

The Scottish budget be published tomorrow, 4 December. The committee will take evidence on the Scottish Government's tax and spending plans at future meetings in December and January and all members have been given details of the budget timeline.

As that was the only item on our agenda, I close the meeting.

Meeting closed at 11:34.

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