OFFICIAL REPORT
AITHISG OIFIGEIL

Finance and Public Administration Committee

Tuesday 13 December 2022

Session 6

The Scottish Parliament
Pàrlamaid na h-Alba

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CONTENTS

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FINANCE AND PUBLIC ADMINISTRATION COMMITTEE
33rd Meeting 2022, Session 6

CONVENER

*Kenneth Gibson (Cunninghame North) (SNP)

DEPUTY CONVENER

*Daniel Johnson (Edinburgh Southern) (Lab)

COMMITTEE MEMBERS

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

*attended

THE FOLLOWING ALSO PARTICIPATED:

Richard Hughes (Office for Budget Responsibility)
Andy King (Office for Budget Responsibility)
Professor David Miles CBE (Office for Budget Responsibility)

CLERK TO THE COMMITTEE

Joanne McNaughton

LOCATION

The Robert Burns Room (CR1)

Scottish Parliament

Finance and Public Administration Committee

Tuesday 13 December 2022

[The Convener opened the meeting at 09:30]

Budget Scrutiny 2023-24 (United Kingdom Context)

The Convener (Kenneth Gibson): Good morning, and welcome to the 33rd meeting in 2022 of the Finance and Public Administration Committee.

The first item on our agenda is an evidence session with the Office for Budget Responsibility on the United Kingdom autumn budget statement and the wider UK context, with a view to informing our scrutiny of the upcoming Scottish budget 2023-24.

We are joined remotely by Richard Hughes, chair of the budget responsibility committee, and Andy King and Professor David Miles CBE, both of whom are members of the budget responsibility committee. Good morning, and welcome to the meeting.

I move straight to questions. I ask members to direct their questions to the chair, Mr Hughes, who can bring in other members of the panel as he wishes, but the other panellists should indicate if they wish to speak. We are two members down this morning, because of the weather conditions, we believe. At least one of them should be here within the next 30 minutes.

Mr Hughes, in our pre-budget scrutiny, we called for

“an open and honest debate with the public about how services and priorities are funded, including the role of taxation in funding wider policy benefits to society.”

Do you believe that that is happening, either north or south of the border?

Richard Hughes (Office for Budget Responsibility): Good morning, and thank you for the chance to appear before the committee. I apologise for not being able to do so in person but with the snow yesterday and the transport strikes today, we figured it would be better to be safe online than sorry en route. I hope that we will be able to appear before the committee in person next time.

By the time we got to the autumn statement, it was possible to have a more informed debate about tax and spending, the outlook for both and the policy choices that are involved. South of the border, over the course of the autumn, it has been challenging to get to a set of forecasts from the OBR and a set of policy decisions from the Governments that aligned with their medium-term fiscal policy objectives.

The context for UK-wide policy making has changed dramatically since the Westminster Government presented its most recent budget in March and the Scottish Government produced its budget in May. That changing context has also required adjustments to tax and spending policies to accommodate new realities.

The Convener: I think that we are in a more optimistic place in that at least we know what is happening. The OBR’s position has been strengthened by events in recent months, as I am sure that you will agree.

On the UK’s economic and fiscal outlook, you said:

“the medium-term fiscal outlook has materially worsened since our March forecast due to a weaker economy, higher interest rates, and higher inflation”.

You also talk about a number of those areas. For example, you said that rising prices

“erode real wages and reduce living standards by 7% in total over the two financial years to 2023-24 (wiping out the previous eight years’ growth), despite over £100 billion of additional government support.”

Obviously, that 7 per cent fall in living standards will not affect everyone equally. Who does the OBR feel will be most adversely affected by it?

Richard Hughes: I will start with that one, but I am sure that my colleague Professor Miles will also want to come in on it.

The 7 per cent fall is a UK and economy-wide figure and it will clearly be felt more acutely by those who are on lower incomes because so much of the price rises have been in essential goods, such as electricity, heat and food, and they account for a larger share of the budgets of people who are on low incomes. People are likely to find it harder to substitute away from that type of expenditure because if they only have one house, they have to heat it, but if they have more than one home or more rooms in their home, they have more choice about how much heat they consume. One would therefore expect rising heating, electricity and food prices to hit those who are on lower incomes harder. They might also have fewer opportunities to find other sources of income or increase their hours of employment.

David Miles might want to add to that.

The Convener: Before he comes in, I ask you to be a wee bit more specific. I anticipated that you would talk about people on lower incomes, but who do you mean by that? Do you mean people who are on benefits, people who are on low wages who are getting pay rises that are below the rate of inflation, pensioners, or some elements of the above?

Richard Hughes: A larger share of the incomes of people who are on benefits or other low incomes will be taken up by the cost of living. However, people who are on benefits and pensioners are unique at the moment as they will get inflation-linked uprises in their benefit payments. Their incomes are keeping pace with this year's 11 per cent rise in the consumer price index. However, the nominal wages of people who are not on benefits and have earned incomes are rising by something closer to 4 to 6 per cent, which is much less, at around half of the increase in benefits or basic state pension.

Professor David Miles CBE (Office for Budget Responsibility): It is hard to imagine any group avoiding a material fall in their standard of living, partly because the underlying drivers are likely to hit people pretty much wherever they are in the income distribution. Those drivers are increases in the cost of heating, lighting, filling the car with petrol, and interest rates. Anybody who has a mortgage might soon find their monthly payments going up fairly sharply.

Richard Hughes is right to say that people towards the lower end of the income distribution who are not on benefits but earn low wages that are just above benefit levels will find it tougher than most. However, no group is likely to escape a material cut in their standard of living in the next year to 18 months or so.

The Convener: Yes, and people who are on benefits are likely to be hit by fiscal drag, are they not?

Professor Miles: That is right, and people will be pushed up into higher tax brackets or become taxpayers because of the freezing of the tax thresholds.

The Convener: To be fair, everyone will be hit by fiscal drag between now and 2028. Andy King, did you want to come in?

Andy King (Office for Budget Responsibility): I just want to add that amid all the pain that the energy crisis is inflicting on everyone, fairly enormous amounts of fiscal support are being added through the energy price guarantee and the cost-of-living payments for those who are on means-tested benefits. The sharper or proportionately larger hits to those who are on lower incomes or means-tested benefits are therefore being offset to a degree.

The Convener: Thank you. I am pleased to say that our remaining committee colleagues, John Mason and Ross Greer, have now joined us.

Your latest outlook goes on to talk about higher borrowing pushing underlying debt

"sharply, from 84.3% of GDP last year to a 63-year high of 97.6% in 2025-26."

Of course, your analysis also predicts that gross domestic product will contract by around 2 per cent. You touched on one of the main concerns around debt when you spoke about the impact on householders of mortgage rates going up. In terms of UK debt, however, you say that the

"near tripling of interest rates since March means the shares of revenues consumed by servicing that debt rises from under 5% in 2019-20 to 8.5% in 2027-28, leaving the public finances more vulnerable to future shocks or swings in market sentiment."

What does that mean in cash terms? The UK economy has more than £2.2 trillion in GDP, so what are we talking about as the economy grows after the recession ends? What are we talking about in cash terms? If servicing that debt rises by 8.5 per cent in 2027-28, what will the debt payments be now and in 2028?

Richard Hughes: Debt interest spending will be about £45 billion higher by the fifth year of our forecast than we forecast back in March. That is partly driven by the fact that we have a higher debt stock than was forecast because the Government will borrow more in the near term to fund the additional support for energy bills and the cost of living that Andy King talked about. However, most of it is driven by the fact that global interest rates have made a big jump and started to renormalise after the post-financial crisis period, during which they were very low, and during the pandemic, when they dropped even lower to close to 0 per cent.

As you said, interest rates have tripled since we did our March forecast from below 1 per cent to just under 3 per cent. With the Government's debt stock approaching 100 per cent of GDP, that will have a big impact on public finances.

For reasons that we can come on to, the maturity of our debt has been getting shorter during this period. Rises in interest rates hit public finances much more quickly because the Government rolls over more of its debt in a given five-year period than it used to, which means that more of that interest rate rise feeds through to the Government's debt stock more quickly than it has in the past. This has been an abrupt and dramatic turnaround in Government borrowing costs, and they eat into the headroom that it had to fund other public services as well as meet its fiscal targets and get debt under control by the fifth year of the forecast.

The Convener: What will be the debt repayment level in 2027-28 under current forecasts?

Richard Hughes: What do you mean by the debt repayment levels?

The Convener: How much is the UK forecast to be paying in debt interest in 2027-28?

Andy King: It will be £102 billion, which is £48 billion higher than we forecast back in March. It is unusual for a forecast to almost double in the space of a few months but, as Richard Hughes explained, the big rise in global interest rates is by far the biggest reason for that change, as well as higher debt.

The Convener: Another issue that we have talked about is fairness. For example, the UK Government abolished the cap on bankers' bonuses on 23 August, and it did not reverse that. The Office of Tax Simplification will also be closed. What are the implications of those measures?

Richard Hughes: Andy, do you want to come in on what bankers' bonuses do to our income tax?

The Convener: I am thinking about the impact that you think those measures will have on the wider economy, not the amount that is paid in bonuses, which is not necessarily significant in itself. What impact will those measures have on how other people perceive their position when asking for pay increases, and on feeding the view that certain people in society are favoured over others, which makes other people feel that they should get the pay rises that they deserve?

Richard Hughes: We have to be a bit careful because our remit does not extend to either distribution analysis or commenting on Government policy decisions.

The overall distributional impact of the decisions that were made in the autumn statement is that the incomes of two groups will be protected from the cost-of-living increase: people who are on index-linked benefits such as universal credit; and those who are on the basic state pension. Those who are on benefits at the lower end of the income scale get some protection. Almost all tax thresholds are now frozen so working people are now subject to substantial fiscal drag. At the top end of the scale, the higher rate threshold was reduced, which means that some additional income tax is being taken from the top end of the distribution.

The Convener: Paul Johnson of the Institute for Fiscal Studies said that borrowing will take the strain in the near term, with

"the great majority of the planned consolidation … due only after the next election".

He added,

"what we are really doing is reaping the costs of a long-term failure to grow the economy, the effects of population ageing, and high levels of past borrowing",

and concluded by saying that

"we are in for a long, hard, unpleasant journey … that has been made more arduous than might have been by a series of economic own goals".

Do you agree with that?

09:45

Richard Hughes: I might leave out some of the adjectives, but a general assessment of the profile of the policy action that has been taken for the next five years shows a consistent pattern in the budgets being presented by successive chancellors, which is a fiscal loosening in the near term to provide support to businesses and households and get them over the latest shock to their incomes, whether it be from the pandemic or the energy crisis, and committing to claw that back in year 3 to year 5. In previous statements, that has come from the tax side through the rises in corporation tax. In the latest statement, much of that consolidation will come from cuts to public services in years 3 to 5, which is beyond the current Westminster spending review period.

A caveat to that is that the Government plans to cut approximately £30 billion out of the overall envelope for departmental spending by the fifth year of our forecast, but it does not have any detailed spending plans beyond 2024-25. The Government also has a pattern whereby, when it comes time to do its own spending reviews and allocate public spending to Whitehall departments, it tends to put approximately £30 billion back into the envelope to grease the wheels of negotiations and make the numbers add up so that it can meet its political priorities. One must therefore cast a jaundiced eye on Government plans to reduce the level of departmental spending five years out without seeing detailed plans in support of them, because when it comes time to set those departmental plans, Governments tend to find ways of greasing the wheels by putting a bit more money into the pot.

The Convener: What about the plan to address most of the difficulty with the debt after the next general election?

Richard Hughes: It is certainly the case that the level of debt will begin to fall only in the final two years of the forecast, which are 2026-27 and 2027-28. Until then, debt will still rise and the Government will meet its fiscal objective of getting debt to fall by slightly cutting back departmental spending in the final two years.

The Convener: You have been quite optimistic about the growth in Scottish income tax receipts over the next few years. It looks like solid growth of about 25 to 30 per cent. Will that come mostly through fiscal drag, economic growth, or a combination of the two? Where does the balance sit?

Richard Hughes: Andy King, will you answer that?

Andy King: The nominal economy, of which wages and salaries on which income tax is levied form the largest part, will grow over that period. In the near term, the downturn will be in the real economy because it is driven by inflation. In cash terms, the economy is not hit as hard. Wages and salaries are performing better than the economy as a whole, partly because high inflation, to an extent, feeds through to higher wage growth.

On top of that, there is a lot of fiscal drag in the system because all the tax thresholds are frozen. Normally, growth in income tax is driven by the difference between wage growth and inflation because tax thresholds rise with inflation. They are now frozen, so growth in income tax is entirely driven by wage growth and, although real wages are going badly, nominal wages are rising at a faster rate than they have been doing for quite some time, which boosts income tax.

Our forecast assumes that, in the medium term, as energy prices come down, the economy will recover, which is good news for income tax in Scotland and the UK.

The Convener: Touching on energy, your outlook says that

"a rapid end to Russia's invasion of Ukraine that stabilised energy markets and lowered prices"

would be positive and reduce inflationary pressure. However, there is no sign of that happening in the foreseeable future. From what I can see, the situation seems to be a stalemate. If that conflict continues, will gas prices stabilise and reduce as we go forward and as countries look for a way around the problem?

Professor Miles: I agree with your assessment of the situation in Ukraine. It is grim and no obvious end is in sight, and that has been true for several months. We have not pretended that we have any great insight into where oil and gas prices are going, but we used the futures prices or the market assessment of the most likely outcome of future oil and gas prices. Despite the rather grim news from Ukraine, the pattern of futures prices has been materially lower for several months than they are right now. That is particularly true for gas and less true, to a certain extent, for oil. However, if we look 18 months to three or four years down the road, those oil and gas prices will be a lot lower than they are right now, while still being much higher than they were a year or so ago, before the Ukraine invasion. Relative to the middle of 2021 and for many years before that, gas prices were certainly dramatically lower than it looks like they might settle down at in the long run, a few years down the road.

Who can know exactly how this will play out? Even if you are not optimistic about the situation in Ukraine, it seems more likely than not that oil and gas prices will be somewhat lower a few years down the road than they are now. That is what underpins what some people might call an optimistic forecast that the inflation rate, which is high at the moment and will be high for much of next year, will drop back pretty sharply once we get into 2024 and beyond.

The Convener: That is one of the Government's arguments for trying to ride out some of the current pay demands and not build them into the system.

Professor Miles: Absolutely.

The Convener: If we have stability in gas prices at a lower level than at present but still higher than before, will that not make other forms of energy such as renewables more competitive, which might open up the market a bit more in the long run?

Professor Miles: That seems to be entirely plausible. Again, using those futures prices, gas prices are three or four times as high as they were in the middle of last year and before. It is hard to imagine that that will not have some impact on the relative usage of different sources of energy. That is one of the positive side effects—if there are any—of higher energy prices.

The Convener: I was trying to put a positive spin on what is a depressing situation, as you have pointed out.

I have another couple of points and then I will open the questioning up to colleagues.

The Institute for Public Policy Research has said that there should be

"a root and branch review of the tax system ahead of the 2024-25 Scottish budget to examine reforms to rates and bands, and how local tax raising powers could be used to address wealth inequality in Scotland".

Do you have a view on that?

Richard Hughes: Perhaps I could offer a few reflections and then ask Andy King, who I am sure is much deeper into the workings of this, to offer some thoughts.

My main reflection is that we reflect the political settlement between Westminster and Holyrood, and taxation and spending responsibilities have been progressively devolved to the Scottish Government. Political decisions have economic and operational implications and it is important to take those into account. Colleagues on both sides of the border work hard and earnestly to make things operate well and effectively, but we bump up against some fundamental limitations, often around the availability of data and information.

Devolving more tax powers down to Scotland presumes that one can identify who is a Scottish taxpayer and what the tax base is in the year in which you collect it. Between ourselves and the Scottish Fiscal Commission, we spend a lot of time trying to improve data sources so that we can provide decision makers such as yourselves with the most up-to-date picture of what things look like UK-wide, and what they look like in Scotland.

As one thinks through those decisions, it is also important to think about the plumbing that sits behind them and make sure that you can make timely decisions based on reliable information. We are just getting to a point at which the information that we need to accurately and effectively forecast the things that have already been devolved, such as Scottish income tax, is improving and becoming more timely. It has taken several years to get the process to where we are now.

Andy King: I just want to reinforce that message. Reading through the previews of the Scottish budget, it is striking to see how many pages are devoted to the difference between Scottish income tax and the block grant adjustment. It is a very technical thing that I have to relearn each time we go through the forecast and I cannot imagine that it is very easy for the man in the street to understand what is going on with the Scottish budget and why. I can see why each item was put in place, but I can also see why it generates challenges for those who have to scrutinise it.

The Convener: That is why we need an Office for Tax Simplification.

Andy, my final point will probably come under your area. I do not know whether you will have had time to look at it because it was published on 5 December, but in a paper commissioned by the Scottish Trades Union Congress, Landman Economics set out

> “a proposed package of tax increases to fund an increase in public sector pay and investment in public services, in Scotland”,

including short and long-term measures, which would raise £3.3 billion. Have you had the opportunity to look at that and consider what its implications might be for service delivery and behavioural change, and so on?

Andy King: I am afraid that I have not seen that paper. I presume that the proposed package is an income tax package and, in general, when we look at tax measures on that scale and the evidence base on behavioural responses, the ones to worry about are people who are able to move so as not to pay higher taxes in Scotland or, and perhaps this is a bigger concern, those who have two residences and can choose their main residence and therefore where they pay their tax.

The risks around behavioural responses can be quite large. If someone changes their residence, the Scottish Government would lose all the tax that they pay and the Westminster Government would gain it.

The Convener: Thank you. I now open questioning to colleagues. Our deputy convener, Daniel Johnson, will go first, to be followed by Liz Smith.

Daniel Johnson (Edinburgh Southern) (Lab): In the set of forecasts that it made in the summer, the Scottish Fiscal Commission recommended that the Scottish Government should prepare its budget on the basis of the Organisation for Economic Co-operation and Development COFOG principles. Does the OBR have a similar view about the UK budget and what improvements it could make to transparency? Do you have any particular views on the transparency and clarity of the way in which the Scottish Government sets out its budget?

Richard Hughes: I will just do some acronym busting. COFOG is a way of classifying Government spending into standardised categories that are consistent over time and comparable internationally. That was the OECD’s recommendation. COFOG stands for classification of the functions of government.

Looking just at UK data, because the Government is constantly chopping and changing ministerial boundaries and combining and separating ministries, one challenge that we have is that it can sometimes be difficult to see what has been spent on transport or health, for example, during the past 20 years.

10:00

It is very useful to have a standard classification so that, regardless of whether transport is being moved in and out of an infrastructure department or is in its own department, we can see what is being spent on it over a long period. It is also really important in relation to our ability to make international comparisons and benchmark ourselves against other countries. I would therefore very much support the idea of presenting and classifying spending based on standardised classifications that are consistent both over time and across countries.

The Treasury does that for the UK in a publication, but only for historical data. In our forecasts, we have, on occasion, presented a version of a COFOG classification looking out over the next five years, but doing so means having to ask an awful lot of questions of Government, because ministerial boundaries do not always coincide with COFOG definitions of health, education, transport, and defence. It can therefore require a lot of work on the part of Government accountants to decide based on vague five-year plans where exactly a certain amount of money will fall between those boundaries. From the point of view of transparency, consistency and communication, following international standards in the presentation of spending helps to inform the debate and to put our own numbers in context.

Daniel Johnson: I quite agree. It is useful to hear that on the record.

I will follow on from the early set of questions from the convener. Although we were all aware of the interactions in the economy between different budget decisions before, the autumn certainly brought that into very sharp focus, including in relation to spending plans versus debt.

The other issue that has become clear in recent months as we look at UK economic data compared with that of other countries is that our difficulties are confined not only to recent months—UK growth has lagged that of our comparator nations over the past decade, which seems to be a function of investment.

I also put this question to the previous week's panel, which consisted of the IFS and others. Do we need a renewed focus on what spending within UK or Scottish Government budgets is genuine investment in order to track that consistently and have a good overall view of the level of Government investment and therefore what the likely longer-term impacts on the economy will be from an individual budget and over time when we see funding being altered?

Richard Hughes: I will ask David Miles to come in on the business investment side. Andy King might also have some thoughts on the public investment side.

Professor Miles: It is certainly true that levels of investment spending across the UK are low. They are low relative to other comparable economies, and they are probably also low relative to the more distant past of the UK.

The classification of Government spending into things that are clearly investment and things that are consumption or transfers, but not investment, is a murky area. For example, a very high percentage of education spending is not considered investment; however, although teachers' salaries, for example, are not counted as investment, we probably all agree that investment in human capital is crucial for productivity and long-run growth in the economy. There are probably also examples of things that are counted as investment and capital spending that perhaps do not generate much increase in longer-term productive potential.

The question of quite where to draw the line is a murky area. Having said that, if we look at how the Government has responded to the very difficult fiscal situation, and at cuts in spending down the road, it is certainly true that capital spending has taken quite a substantial hit.

Andy King: I will add a little bit of flavour on the things that count and do not count in public investment. The way that I tend to think about it is that public sector net investment is the economic category that covers investment, whereas capital spending by departments is the administrative category.

Within public sector net investment, however, there are things that you would think of as investment in public assets, such as road building, and things that are better thought of as investment in private assets, where the Government transfers capital to a private entity that is investing.

Then there are a lot of things that are not what you would think of as investing in a capital stock. These days, the biggest of those by far is the student loans system, because a lot of what is transferred to students in loans is not expected to be repaid. The portion that is not expected to be repaid is accounted for as a capital transfer to those students, so it is scored as an investment. After what David Miles has said, you might think that that is an appropriate investment in human capital, or you might also think that writing off loans is not what you are thinking about when you think about a capital stock. I would just agree that it is difficult to look at any particular number and think, "Oh yes, that's what we're thinking about with public investment."

Daniel Johnson: From the answers that you have just given, it seems that, in effect, you are saying that we might be talking about one of those things that politicians cannot be trusted to categorise, and that more objective bodies should perhaps be taking a broader view. It is clear to me that we need to have a much clearer and tighter focus on what spending is genuine investment, otherwise we will be doomed to end up in a downward spiral.

Is this area one that the OBR and the Scottish Fiscal Commission could take a broader view on? I am cognisant of the fact that there are lots of grey areas where spending could be categorised as consumption or investment, but it is important that we at least try to take a view of the overall balance between consumption and investment over the longer term. Is that a potential area of focus for your work or that of other bodies?

Richard Hughes: I will say two things on that point. The first is that we are at pains to follow international standards on financial reporting, rather than make up our own. That comes back partly to your point that if we start making up our own standards, it becomes very difficult to do before and after comparisons, or to compare countries. The standards that we use to classify investment are, in essence, United Nations international statistical standards, which say that if something creates a fixed asset, it is investment, and if it does not create a fixed asset, it is current spending. We use that definition when we say that something is current spending or investment.

With regard to Government fiscal frameworks making an explicit distinction between spending on those two different things, you might remember that, in the UK, we used to have a golden rule that allowed the Government to borrow to fund investment but not to fund current spending; it just had to balance the current budget. We monitored that very closely and reported on whether the Government was meeting its commitments in that area.

We would be reluctant to try to identify a category of spending that went beyond purely fixed investment but which also somehow captured “things that are good for growth”. There is too lively and too inconclusive a debate at the moment about what elements of public spending are good for growth. David Miles has made a strong case for spending on education. One could also make a strong case for health spending, because we have so many people on waiting lists who, if they got off national health service waiting lists, might conceivably go back into the labour force. I think that you would quickly get a lot of people knocking on your door to explain, through an elaborate chain of logic, why spending in their area would achieve growth in the long run.

In some ways, that is why we are left with the slightly unsatisfactory distinction between something that creates a structure that is around for more than a year counting as investment and something that just goes into someone’s bank account and gets spent counting as current spending.

Daniel Johnson: It sounds as though you are saying to me, “No luck—I’m afraid that it’s back to you politicians to make those sorts of tricky decisions.” In all seriousness, it is an interesting point, on which I am clear that we need to have a sharper focus.

This will be my final question. In recent—

The Convener: Just a second—Andy King would like to come in.

Daniel Johnson: I apologise, Andy. I cut you off.

Andy King: Not at all.

What we present is all based on national accounts, as Richard Hughes said. Your earlier question about COFOG classification is useful here, because it is possible to have a COFOG classification within investment that allows you to look at things in different ways. However, as Richard said, that is available only for the past, not for the forecast.

The things that we are talking about are all inputs. I have been around such debates for long enough to remember the cycle that we go through. Inputs are only the start of the process. We want the outcomes via the outputs. That goes beyond things that the OBR or, I guess, the Fiscal Commission would typically do. You want to see how the input translates into not only the output of the physical asset, but the outcome of whether it is a growth-enhancing physical asset.

Daniel Johnson: My final question is on a related issue. In recent weeks, Frances O’Grady from the Trades Union Congress and Roz Foyer from the STUC have been involved in an interesting discussion about the true cost of public sector wages. That is interesting from the base point that, given that tax is paid on those wages, the Government needs to consider not the gross amount but the net amount. I wonder whether that is a sharper point in Scotland, given that we have a higher proportion of public sector workers, and given the way in which the fiscal framework works, which is about per capita growth in tax receipts.

Do we need to be more sharply focused on the true costs of the public sector wage bill and how that works its way through the tax system, in particular the fiscal framework in Scotland? I am thinking, in particular, of the true net cost of public sector wage increases, given that it is such a sensitive topic at the moment.

Richard Hughes: Andy King might want to add something to this, but when it comes to the way in which we forecast and the UK Government controls departmental spending, in essence, departments are set a cash limit for their budgets for the next two years. That includes the period for which pay negotiations are happening, so to the extent that departments get larger pay rises than were assumed at the time at which those budgets were set, that means that they can employ fewer people doing fewer things over that period. We do not assume that the total amount of departmental spending goes up because the Government has given a higher wage settlement. It just means that the Government can hire fewer doctors and nurses to do the additional activity. In that sense, it does not push up Government spending; it probably just reduces the overall amount of public sector activity that can be done.

Unless the pay settlements that were given in the public sector were far out of line with those that were given in the private sector, it would not generate significantly more in income tax, either. We have an economy-wide forecast for income tax receipts, which makes assumptions about settlements for public sector and private sector workers. In the absence of any explicit public sector pay policy, we assume that, in the long run, those things grow more or less in line with each other because, otherwise, we have recruitment and retention problems.

From a fiscal point of view, I do not think that the effects are as dramatic as might be suggested.

Daniel Johnson: Given the way in which the fiscal framework works and the size of the public sector workforce, might there be some additional considerations in Scotland?

10:15

Andy King: I think that that is definitely possible, particularly in the short term. There are two worlds that you could be describing. In one world, the amount of public spending in Scotland shifts towards pay and away from procurement and other things, so the composition changes, which could have an effect. However, the thing that should always be borne in mind, and which I always think about when reading these things, is that there is more than just the one effect. It is probably easier to see that, if you pay public sector workers more, they will pay more in income tax. If you cover that cost by reducing what is spent on procurement, that reduces the income of the companies that provide goods and services to the public sector, and that will reduce income tax.

If, in the other world, you just increase public spending, that is a fiscal loosening, which will tend to have a short-term positive effect on income tax. However, if the effect were big enough to move the dial for the Bank of England, which manages the size of the economy, there would be an offset there. The Bank of England would have to raise interest rates and bear down on other private sector activity, because it wants to balance supply and demand. There are always further knock-on implications.

I imagine that, in the very short term, if the change were Scotland specific, it is unlikely that that would move the dial for the Bank of England, but it would depend on the size. If it was compositional, with more being spent on pay and less being spent on other things, that less being spent on other things would also have implications for income tax in Scotland.

Daniel Johnson: Thank you. I will leave that there, but it is an interesting topic.

The Convener: It is indeed.

Liz Smith (Mid Scotland and Fife) (Con): Good morning. Professor Miles, I will take you back to the issue of inflation. When you discussed that with the convener, you rightly identified the problem with Ukraine. What you said is very much in line with other evidence that we have taken, which suggested that the larger part of the inflationary situation just now is due to cost factors.

I am interested in a remark that you made in your November forecast, in which you said that although,

> "In the UK, CPI inflation is set to peak at a 40-year high of 11 per cent in the current quarter",

it is expected to fall back "sharply" during the course of next year. Given that the cost-push factors are likely to still be quite strong, where does the "sharply" come from?

Professor Miles: Even if there were not to be a reduction in oil and gas prices over the next 18 months or so—even if they just levelled off—the cost of living for households would start to fall quite sharply in percentage terms, certainly as we get towards the end of next year and into 2024, simply because the huge increases in energy prices and the cost of people filling up the car with petrol that are showing up right now, and which are a big driver of inflation, would fall out of the year-on-year comparisons from around this time next year. In itself, that would bring inflation down pretty sharply. In fact, in our forecast, we go quite a bit beyond that by using the market's forecast of the central guess for gas and oil prices—it is not much more than a guess—which is that, in the case of gas in particular, they will fall quite significantly as we go through next year and into 2024. That is a big factor behind the very sharp fall that we predict in the consumer price inflation rate as we go through next year.

There are multiple ways in which that prediction might be wrong, and the most likely way in which it would turn out to be incorrect is if, instead of levelling off or declining, those oil and gas prices again spike substantially. Who can say whether that will happen? Thankfully, that does not look like the most likely outcome and it is not what the financial markets—the people who trade in forward contracts for oil and gas—have been thinking pretty consistently for many months. Even though there have been substantial changes in the short-run price of gas, in particular—there have been spikes and then quite sharp falls—it has been a consistent story that the markets have at least anticipated that we will not stay at the current levels of 350 or so pence per therm.

Liz Smith: On the demand side of the economy, given that nominal wages are obviously increasing, when do you expect there to be an uptick in demand in the economy that might have some impact on inflationary pressure?

Professor Miles: Our central forecast, around which there is a lot of uncertainty, is that we are probably already in a recession right now in the UK and that, although output might be declining by what are, historically, relatively small amounts, it will decline right throughout next year. That would be—again, by historical standards—a relatively short recession and a relatively shallow one. Nonetheless, we think that it will knock almost 2 per cent off GDP next year, in 2023.

Our central forecast is that, after that, there will be something of a recovery that prevents unemployment from continuing to go up. That depends to a significant extent on what we were just talking about, which is the view that the squeeze on household incomes will come to an end, very largely because of falling inflation reflecting lower oil and gas prices. That is very much linked in with the view on inflation.

If that turns out to be right and household disposable incomes are no longer contracting, it seems pretty plausible that consumption spending will pick up and we will get back to something that looks a little bit more normal—in terms of the rate of growth of GDP, anyway—in 2024 and the years after that.

One of the reasons why we are what I suppose you would call relatively optimistic—certainly relative to a Bank of England forecast that we saw recently—that it will be a short-lived recession and that we will get back to more normal growth a little way down the road is that we assume in this forecast, which I think is plausible, that household savings will drop to very low levels as people dip into past savings, or those who have been saving money stop saving to cushion the blow of a much higher cost of living. That means that consumption expenditure will be protected a little, if you like, from the shock to disposable income by people dipping into savings when they can, or by those who are able to smoothing consumption by borrowing a bit more.

Therefore, in our forecast, we assume that there will be a very low household savings rate for the next couple of years. That assumption is partly based on a belief that the extraordinarily high savings rate—on average, anyway—in the UK in 2020-21 generated a bit of what you might call false savings during lockdown, when it was more difficult to spend money, and that some people, at least, might dip into that significantly over the next year or so.

Liz Smith: Thank you very much for that answer. I have one more question. Obviously, there are predictions that America is likely to have a recession in 2023—not a real crisis, but nonetheless quite a downturn. Do you have any thoughts as to how that might impact on the world economy, and on the British economy, in particular?

Professor Miles: In some ways, what happens in the US is rather significantly less important for the UK than what happens in the rest of Europe. That is certainly true in terms of trade and trade links. Nonetheless, the US is very important because what the US central bank—the Federal Reserve—does has an impact on global interest rates. The sharp rise in the cost of borrowing for the UK Government and for households is partly a reflection of what the Fed has done and of a perception that interest rates in the US were much too low. It has been a sort of global phenomenon in which the US has a disproportionate weight.

If the view is correct that the US is going into a recession, that the US economy will cool down quite rapidly and that inflation might come down by more than people thought a short while ago, that might mean that there will be a reappraisal of where the US central bank is taking the Fed funds rate—the interest rate.

It is possible that that will have a favourable effect on interest rates here in the UK. We have seen that happening in the past month or so, when longer-term interest rates on UK Government bonds softened a bit. That is certainly already having an impact on the mortgage market. In the course of October, it looked as though households might be facing mortgage rates of 6, 6.5 or 7 per cent, but the position looks less grim now.

Liz Smith: Thank you.

John Mason (Glasgow Shettleston) (SNP): First, I apologise for being late. I will not blame the buses or the trains. I am sorry that I missed the first couple of minutes of questions and answers, and I hope that I will not duplicate anything that was said then.

In the foreword to your report, you go over the timescales for this year's forecast, and you make the point that it has been a little different from normal. It took, I think, 16 weeks instead of the usual 10. Can you confirm whether we are now where we would have been had we not had all the changes of Government and so on? Have they had a material impact on your forecasts?

Richard Hughes: By the end of the process, we had got to a place where we felt comfortable and which reflected the legal framework for fiscal policy making at Westminster. What should happen is that the Government presents all its tax and spending decisions together, in one comprehensive fiscal statement. In this case, that was the autumn statement that was presented by Jeremy Hunt. The statement is usually presented alongside and informed by an up-to-date economic and fiscal forecast that is produced by us.

It was clearly quite a journey, but we got there in the end and I think that the destination was the right one. Here at Westminster, we, the Treasury and the UK Parliament's Treasury Committee are reflecting on the lessons from that exercise. I am conscious that there are also consequences for the budget process that you have in Scotland. There are certainly lessons to be learned.

John Mason: You make the point that the tax burden will rise from 33.1 per cent to 37.1 per cent of GDP. I am interested in your use of the word "burden". It suggests a slightly negative connotation, which I am not sure that you intended. How does that figure compare with the position in other countries, particularly in Europe? Is it much the same?

Richard Hughes: I stress that the phrase "tax burden" is not meant to be a normative statement; in essence, it is a term of art. Much like "investment spending", it always sounds good to the ear. Sometimes it involves spending money on tanks and other things that do not necessarily do much that is productive in the world. "Tax burden" is a term of art is used by the International Monetary Fund and the OECD, and we use it in our documents because people understand it. The alternatives are very wordy, which is why we use the term. In essence, it refers to the share of GDP that goes in taxation. It is not meant to be a normative statement in any way.

The burden is going up over the medium term, partly because of historical decisions taken by previous chancellors and partly as a result of decisions in the autumn statement. In particular, this time round, it relates to the freezing of the remaining income tax thresholds that were not frozen in the previous budget. It will continue to rise over the next five years.

If we compare the figures internationally, we are not at the top of the international league table by any measure, but the position does mean that we go from being a relatively low-taxed jurisdiction among advanced economies to being one that is closer to the OECD average.

John Mason: That is helpful. I picked up on the word "burden" because the committee recently had a conference on taxation at which we discussed the way in which we talk about tax and trying to make the public more enthusiastic about it.

Another figure that you have come up with is that debt is rising from 84.3 per cent to 97.6 per cent of GDP. We also talk about interest rates, which are currently well below inflation. Traditionally, however, one of the reasons for raising interest rates would be that a country's currency is struggling; presumably, the higher the debt, the more questions there are about the currency. Should we be concerned about the 97.6 per cent figure or should the fact that it is planned to come down again reassure us?

10:30

Richard Hughes: There are reasons to be more concerned about the level of debt than one might have been six months ago. That is because the interest rate has risen very dramatically. The steady state era that persisted between 2010 and March of this year, where interest rates were very low—in some years, they were below 1 per cent—appears to be over, for the reasons that David Miles mentioned.

Other central banks started to raise interest rates even sooner than our Bank of England. That has driven up the cost of borrowing globally, which is pushing up our interest rates. That is eating up fiscal space that Government would otherwise have to spend on public services, welfare benefits and, if it wanted, cutting taxes. The single largest increase in the Government's costs in this fiscal event has come from the fact that interest rates have risen so dramatically.

To illustrate that point, I note that, in a short period of just three months in our forecasts, what the Government spends on interest as a share of public spending has gone from below 5 per cent to 8.5 per cent. That is a dramatic eating away at the Government's effective spending power, because a much bigger share of what it takes in as taxes is now going to pay interest on its existing debt holdings. Next year, it will reach a peak of more than 12 per cent as a share of revenue, which we have never seen at any point in UK history. A dramatically higher share of Government resources is being eaten up by interest rates, which is a cause for concern whether we care about public services, the tax burden or the overall sustainability of public finance.

John Mason: You finish that paragraph in your report by saying that it leaves

> "the public finances more vulnerable to future shocks or swings in market sentiment."

What goes into market sentiment? Is that about confidence in the Government or the country?

Richard Hughes: It is. Another thing that has changed over the past decade or so is that a growing share of our Government debt has been held abroad by foreign central banks and foreign investors. That means that perceptions of the UK as a whole as an investment proposition matter more to the cost of our borrowing than they would if all the people who lent us money were here in the UK, earning money in sterling, having their outgoings in sterling and being invested in the UK's economic future.

Foreign investors have a lot more choice about where they put their money, and if they suddenly take a different view of a given country as an investment proposition—for either fiscal reasons or exchange rate reasons—the Government's cost of borrowing can start to change quite dramatically, as we saw happen in mid-September.

The Convener: Ross Greer has a wee supplementary question.

Ross Greer (West Scotland) (Green): It is not on that particular point, convener.

The Convener: When do you want to come in?

Ross Greer: I can come in at any point.

The Convener: I am sorry—I had understood that you wanted to come in at this point.

John Mason: You talk about several measures where costings are particularly uncertain, and one of those is around the Department for Work and Pensions and His Majesty's Revenue and Customs. You highlight that there are meant to be efficiency savings, but also that there are meant to be more resources to tackle fraud. You say that you sought reassurance from the Treasury, which you quote. Are you satisfied with that? Has the balance between trying to do more and being efficient been sorted?

Richard Hughes: Andy King is the person who sought those reassurances, so he may want to comment on that.

Andy King: The short answer is yes. We have sought that kind of reassurance before, and it is particularly important when the Government is putting additional resource into something such as tackling fraud and error beyond the point at which it has given the DWP or HMRC a budget in the spending review. In a sense, it is adding to something that does not yet exist. When that happens, we always seek reassurance that, when it comes to the sums being allocated in the spending review, the baseline will have been protected. We had something similar in 2015.

John Mason: It seems that there is a degree of uncertainty around that and we will just have to see what happens.

Another aspect that, I have to confess, was completely new to me was the pillar 2 corporate tax reforms, which are meant to yield £2.3 billion a year. Am I right in thinking that they are part of an international effort to sort out corporate tax? Is there quite a lot of uncertainty around that, too?

Andy King: On your first question, you are correct: there are two parts to the OECD-led base erosion and profit shifting—or BEPS—agenda, and what you have highlighted relates to the establishment of a minimum effective corporate tax rate. Several jurisdictions are already signed up to that, but the UK is one of the earlier ones to start the process of getting it on the statute books.

The reason for the uncertainty is twofold. First, the reforms are relatively complicated and it will take time to implement them. Secondly, the calculations that underpin them require what is essentially new information. In the corporate tax world, there are several cross-border agreements that require new forms to be filled in, and this particular move takes things to a new level.

It is worth saying, though, that the uncertainty on the matter could go in both directions. We are not saying that we do not think that it will really raise money. Indeed, it could raise more if the calculations have been worked through incorrectly in the other direction. Basically, the number in question has been calculated on the basis of information that is currently available via other systems to try to proxy what will become available when all the new forms are in place and the information is flowing across jurisdictions.

John Mason: Thank you. I think that I followed some of that.

Another point that you make—I mean "you" in the plural, as I am not sure who will want to answer this question—is that the energy price guarantee and the business equivalent, which is the energy bill relief scheme, will impact on inflation by reducing it, while the £400 energy rebate that everyone is getting will not have any impact. I had not realised that that distinction exists. I do not know whether we are splitting hairs here, as we were over capital and revenue expenditure, but will you explain why the two things are treated differently?

Andy King: Yes. The Office for National Statistics has to look at those policies against the background of the international guidance on price indexes. Because the EPG lowers the price of energy for consumers and the EBRS does the same for businesses, they affect the consumer prices index and the producer price index respectively. However, because the £400 rebate is for every household, it is treated as a £400 boost to incomes rather than a £400 reduction in the price of energy. There is a line in the statistical guidance that says that, if something does not change the unit price, it is a transfer to income and therefore does not affect measured prices.

This is, of course, splitting hairs, but at the same time it is important, because anything that affects the measured price index feeds into any other part of the public finances that is indexed, and index-linked Government debt is particularly important in that respect. Everything that affects the price index reduces the cost of Government debt in the short term.

John Mason: Thank you. I have a couple more questions that touch on things that have already been mentioned. The first is on the health impact and the suggestion that investment in health might get people back to work. Is there any concern about long Covid and, indeed, the effects of Covid, hospital waiting times and all the rest of it? Is that having an actual effect on the economy?

Professor Miles: It is likely that it is having an effect. There has been a big fall in the participation rate—that is, the size of the labour force—in the UK, which means that, although the unemployment rate looks, at least recently, to have gone back to where it was before Covid, total employment is still well short of that. That reflects the fact that perhaps 500,000 or 600,000 people seem to have left the labour force and have not come back.

It is hard to know how much of that relates to health and specifically to Covid. It seems plausible that part of it does, but the participation rate has fallen most among people in their 50s and 60s, and it seems likely that health will be a factor in that respect. It is difficult to work that out, however, because people do not have to fill in a form that asks them for their main reason for leaving the labour force. There could be other reasons. Some people might have decided to retire a little bit early because they can afford to do so. Work might have become less fun, and they might have discovered during the lockdowns that there were more interesting things to do than work.

As I said, it is therefore hard to be sure about how much of the reduction in the labour force is health related, but it seems plausible that a significant part of it will be. It certainly affects our forecasts for the size of the economy and the level of gross domestic product, and that has knock-on effects on the fiscal situation. It is likely to be a material factor. We will certainly spend some time investigating it in a bit more depth over the summer.

John Mason: That was very helpful. It has also been mentioned that the debt stock has a historically short average maturity. Why is that? My understanding is that that makes it more susceptible to interest rate changes.

Professor Miles: I will have a go at answering that, given that my microphone is on. The impact of any change in market interest rates will feed through to the cost of Government debt much more quickly when that debt is rolling over more frequently. In effect, a very big chunk of that debt is rolling forward every month, depending on the interest rate that the Bank of England sets, because asset purchases that have been made by the bank have in effect caused a large chunk of overall Government debt to indirectly pay the Bank of England rate. The bank holds something like £800 billion of Government bonds, which are now paying the Bank of England's short-term interest rate.

That is the main reason for the maturity of debt coming down so significantly. As I said, it accelerates the period in which some change in interest rates in the financial markets will affect the UK Government's debt interest costs. It has been a very material factor. In fact, this has been building up since the Bank of England started buying Government bonds back in 2009.

Michelle Thomson (Falkirk East) (SNP): Good morning and thank you for attending. I want to ask about a totally different matter that has not yet come up this morning—the B-word, or Brexit. I note your comment in November's economic and fiscal outlook that

"Brexit has had a significant adverse impact",

with trade volumes declining. Indeed, they are to fall by 8.3 per cent below the present level by quarter 4 in 2023.

An area that I find very interesting is trade intensity, which you say is

"15 per cent lower ... than if the UK had remained in the EU."

My understanding is that trade intensity is a measure of a country's integration with the world economy. Given that we will not be able to replicate what we had with the fairly paltry and thin-gruel deals that have been made thus far, can you say anything about the prospect of trade intensity increasing or, indeed, maintaining the percentage that you set out in your report over the next five years and beyond? It would be useful to hear an answer to that question from whoever is best placed to give us one.

10:45

Richard Hughes: Since the referendum, we have had to include in our forecasts a judgment of the impact of leaving the European Union on the volume of UK trade with the rest of the world and the implication of that for long-run potential growth in the UK economy, based on looking at a wide range of independent studies and taking into account that, in 2016, we did not know the outcome of the Brexit referendum.

We had assumed that the deal that we would ultimately strike with the EU would look something like the free-trade agreement that the EU had struck with Canada. In the end, the trade and co-operation agreement that we concluded looks very much like the kind of trade deals that the EU has done recently with other advanced country trading partners.

That judgment is based on an assumption that, in the long run, which means over a 15-year period, trade intensity, which means the share of trade in UK output, will fall by around 15 per cent. It is a sort of measure of the UK's openness to the outside world. If you look at the gearing ratio between trade intensity and connectivity that you see in the macroeconomic literature, the long-run effect on the UK's potential output would be that supply capacity after a 15-year period would be about 4 per cent lower.

So far, what we have seen in the trade data since we made that assumption has not given us any reason to diverge from that assumption. As Michelle Thomson cited, we have seen trade intensity start to fall since 2016. Some of that may have been a temporary effect due to the pandemic interrupting trade. However, even post-pandemic, our volume of trade has not recovered as quickly as trade volumes in the rest of the world. It recovered a bit, but it has levelled off at a lower level. So far, we seem to be more or less on that trajectory, but we keep the assumption under review.

Michelle Thomson: Thank you for putting that on the record. I commented at the beginning that we had talked about that issue, and I understand and appreciate the difficulty in disaggregating data on the impact of Covid, the pandemic and Ukraine.

That said, we are now able to predict with slightly more certainty the impact of Brexit over the long term. Do you think that that issue is being talked about enough? Obviously, I have read your November report, but the issue keeps disappearing as though it is not going to have any long-term impact when, according to your figures, it quite clearly will have.

Richard Hughes: We talk about it in every forecast and we have done a number of papers on it. From time to time, when there are new and important pieces of data, we do an in-depth analysis of the impact not just on trade flows but on things such as migration flows.

One thing on which we have revised our assumption is that we expected our departure from the EU and our setting our own migration policies on EU migrants to mean that we would see a significant reduction in migration volumes after 2020 when the new regime came in. However, according to the latest data, we appear to have seen a significantly higher volume of inward migration. To the extent that it means more people coming into the UK and, therefore, into the UK workforce, it supports the UK's potential output in the medium term.

As a result, we have, in this forecast, revised slightly upwards our assumption for net migration in that respect. I should say that this is mostly coming from non-EU countries, not from the EU, but it is compensating for the fact that net migration from the EU has actually turned negative.

Michelle Thomson: I saw that, too. It is an interesting area to look at, because it relates to the skills agenda as well as, for example, labour shortages.

Another question that I have is more about the scope of the OBR's approach to the sustainability of public finances. The convener mentioned the removal of the Office of Tax Simplification; one area that I often like to ask about—indeed, I asked the IFS about it last week—is the cost to the UK's GDP of money laundering and corruption. It is an absolutely significant factor, because it runs into billions every year.

I am not entirely sure whether the OBR has started to make an assessment of that, but it has a real cost. I was just wondering where issues such as the effect on the sustainability of public finances of this sort of cost to UK GDP fit within your organisation. Where in your organisation would you consider the implications of that, if at all?

Richard Hughes: We do not take an explicit view on that; indeed, to the extent that it is included in our forecast, it would probably show up in tax that is avoided and not paid. Andy King might have something to add on whether we have ever made any explicit assumptions about money laundering or other forms of tax criminality.

Andy King: Richard Hughes is right to say that we do not have an explicit view on it. We take some issues one at a time, say, the various attempts to clamp down on funds that are held overseas and on which income tax is not being paid. Such issues are largely implicit in those places where our forecasts start from: the ONS estimate of GDP and what we actually see in tax revenues. HMRC makes efforts to understand and quantify tax gaps; however, we do not use that information, except where policy measures are taken to close tax gaps, because we forecast how the revenue that we are seeing today will grow as a consequence of growth in tax bases.

Michelle Thomson: Would you consider taking an explicit look at that? I am thinking, for example, of the proposal to remove the Office of Tax Simplification, despite the fact that, as we know, it is the complexity of tax codes that provides the wriggle room in a variety of areas. We also know from the National Crime Agency and Transparency International—although the latter's figure is an estimate—that we are talking about a loss to UK GDP of approximately £267 billion each year, and the effects of that will flow through in the availability of public finance for doctors, nurses, teachers and so on.

You do not need to answer this just now, but you might consider looking at that explicitly, because it is a very real issue that could ultimately have quite a significant impact on the sustainability of our public finances. If it is “implicit”, as you have said, it is not overtly understood, and it is overt understanding that will drive action. Any comment on that would be helpful—or you could just tell me that I am wrong.

Richard Hughes: Let us take your suggestion away with us. Every summer, we produce a report on fiscal risks that looks at what might be eroding the sustainability of the public finances and areas where there might be missed opportunities for Government to raise revenue. In that report, we try to take a comprehensive look at the things that, although not included in our forecast, could pose a risk to it, and it would be in that context that we might take a look at the kinds of issues that you have described.

As Andy King has said, where Governments make heroic assumptions about how much revenue they can raise from tackling those issues, our role is to look at the realism of those particular policy measures. We have to be careful about giving the Government explicit advice on where to look, as that is not our role, but with regard to analysing risks to the tax base and the public finances, and sources that might erode Government revenue in the future, that is something that we could consider.

Michelle Thomson: Thank you for that. I appreciate the complexity of the matter and your role in all of this, but it strikes me that the issue must at least be approaching that tipping point where it becomes of interest from a public finance point of view.

The Convener: What Michelle Thomson has just talked about—fraud, corruption and money laundering—can be called tax evasion, but what about tax avoidance, which is somewhat different? Does the OBR analyse the impact of tax avoidance on the public finances?

Richard Hughes: The short answer to that is certainly yes. Andy King can say even more about this, but I would just highlight one of the biggest sources of tax avoidance that has progressively and steadily eroded the Government’s income tax base over time: tax-motivated incorporation—that is, someone setting themselves up as a one-person corporation and paying tax at the corporate rate instead of paying income tax and national insurance. Various tax changes made by the Government can make that problem either better or worse, depending on the income tax differential between corporate and income tax. However, we do look at that issue, and we can say that it has played a significant role in eroding the income tax base over time.

Andy King: We might have given the wrong impression earlier, but monitoring the evolution of tax gaps and looking into what we can learn from that is very important for the forecast. After all, if those gaps change and get larger or smaller, that will affect growth in tax revenues.

In our fiscal risks report three years ago, we looked at complexity in the tax system and what that seemed to imply for tax gaps. It did not reveal anything in the international money laundering sphere, but it did reveal lots of areas where tax gaps seemed to be affected by changes in the tax system. One example was the research and development tax credit, which, as it became more generous for small firms, seemed not only to incentivise R and D itself but to incentivise people to badge their activity as R and D in order to get the subsidy. One of the policy measures in the autumn statement looked to address that, to some extent.

We are also seeing something happening not in the tax system but in the universal credit system, where the rate of fraud and error as calculated by the DWP has risen very sharply. I do not think that we really understand that fully yet, but it is one of the reasons for the announcement in the autumn statement of very large numbers of new staff to work through that. Because universal credit covers lots of previous legacy benefits, the award can be large, and that can increase the incentive for what seems to be a rising number of criminal attacks on the system.

We look at those sorts of things all the time. The issue of money laundering per se has not come across my desk recently, but the issues that I have highlighted are day-to-day forecast issues for us and policy issues for the Treasury and others.

The Convener: What tax take is being lost across the UK as a result of those tax gaps—or tax avoidance measures, if you want to call them that?

Andy King: HMRC’s estimate of the tax gap at the moment is that it is a little more than 5 per cent. However, it varies greatly. It can be as low as 1 per cent in the pay-as-you-earn income tax system, because people do not really have an opportunity to game that system, but it can be as high as 20 per cent in the self-assessment income tax system, where there is much more discretion.

The Convener: Is that 5 per cent of total tax income or 5 per cent of GDP?

Andy King: The tax take could be around 5 per cent higher if there were no tax avoidance or evasion and no tax gap.

The Convener: What would that mean in cash terms?

Andy King: I do not have the number in front of me, but I think that it would be of the order of £35 billion.

The Convener: Okay. Thank you for that.

Douglas Lumsden (North East Scotland) (Con): I have a question about negative inflation, which we are due to have by the middle of the decade. Should that be universally welcomed, or does it provide any risks to the Scottish economy?

Richard Hughes: David, do you want to have a go at answering that question?

Professor Miles: [*Inaudible*.]—negative inflation and the danger of falling into deflationary traps. In this case, if it turns out that inflation dips a little into the negative, as our central forecasts suggest, that will actually be a good news story, because the most likely reason for that happening will be energy prices—particularly for gas and, to some extent, oil—falling back a little, perhaps, which will bring inflation down very sharply and possibly take it into negative territory.

As I have said, that would be a good news story for the UK and, indeed, for disposable incomes, as we are major net importers of those things. It would reflect a reduction in the cost of something that generates income outside the UK and is a cost to the UK. This is not always true, but, in this case, to have inflation sitting below the Bank of England target by a significant amount for a relatively long period—say, 18 months to two years—will be not so much a cause for concern as a side effect of something that will ease the pressure on households.

11:00

Douglas Lumsden: Would you expect interest rates to come back down as quickly as that?

Professor Miles: With regard to Bank of England policy, I would be very surprised if we got back to the interest rates that we had at the beginning of this year, when they were close to zero. Indeed, it seems plausible that interest rates will go up a bit further from where we are right now. At the end of this week—on Thursday—we will see the Bank of England's latest decision, and it is likely that rates will go up. Our forecast was based on an assumption that interest rates might get close to 5 per cent in the near term, then start to fall back down, ending up at 4 per cent or perhaps a little below that.

Even if inflation were to fall to zero or be slightly negative, I rather doubt that the Bank of England would react by cutting interest rates right back down to zero, just because we had undershot the inflation target by a meaningful amount. It would probably see it as a temporary undershoot, as reflected in the message in our forecast and in the same way that we have a very much larger but hopefully temporary overshoot of inflation right now. It would look through that and think that, perhaps a little further down the road, we are likely to get back to the 2 per cent target level and that it would therefore be a mistake to overreact by cutting interest rates right back down to zero, where they have been for most of the past 14 or 15 years.

Douglas Lumsden: We would also expect wage inflation to come down to almost zero, which might well have an impact on the forecast for income tax take.

Professor Miles: That is right. At the moment, wage settlements across the economy are coming in at somewhere around 5 or 6 per cent on average, and it would be very unlikely that we would have those sorts of settlements if inflation were at zero. The situation reflects the fact that inflation is sitting at 10 or 11 per cent. Wage settlements will probably not fall right back down to zero—which would mean no increase in people's real income—but they might fall back to 1.5 or 2 per cent, which would at least mean an increase in people's real income, as opposed to where we are now, with wage settlements at 5 or 6 per cent on average and inflation at 10 or 11 per cent.

Douglas Lumsden: Thank you.

Richard Hughes, you said that fiscal policy changes over the past six months will have added £40 billion of borrowing by 2027-28. Will you give us a breakdown of what has caused that? Is it due to the Bank of England having to step in on the bond market? Is it because of policy decisions such as the energy price guarantee? What is behind that rise?

Richard Hughes: It is a net figure. Basically, it is the total change in the borrowing outlook at the five-year horizon now, compared with what we forecast back in March—how much more the Government will be borrowing by the time we get to the middle of the decade, compared with what we thought back in March.

The single biggest factor pushing upwards is higher interest rates. That creates pressure of the order of £45 billion to £50 billion of extra spending that the Government has to accommodate. On top of that is the added cost of welfare spending, because the Government has inflation-indexed universal credit, the basic state pension and other welfare commitments.

If the Government had left that alone, that would have added, in total, £75 billion to £85 billion of extra spending that the Government needed to find from non-discretionary sources. It gets back down to £40 billion through the fact that the Government has taken around £30 billion out of public spending and found another £5 billion to £10 billion through tax rises to offset those additional spending pressures. That is how we get to the £40 billion overall increase in Government borrowing as a result of all the changes that have happened since March.

Lots of forecasting pressures have been pushing upwards on interest costs and on welfare, and the Government has taken some policy action, mostly through cutting departmental spending but also through some net tax rises—freezing some of the personal allowances and thresholds and reducing others, in order to increase the tax take.

Douglas Lumsden: So most of that £40 billion is due to inflation, which is really a global factor anyway. Is that correct?

Richard Hughes: Most of it is due to interest rates; the second biggest factor is inflation.

Douglas Lumsden: Right, okay—that explains a lot. Thank you.

Ross Greer: Like John Mason, I apologise for having been late this morning. It had nothing to do with buses or trains, either; it was due to a much more mundane issue about my pass and gaining entry to the building.

Convener, may I check something so that I will not be wasting time by duplicating matters? In its initial questions, which I missed, did the committee cover the GDP deflator?

The Convener: No.

Ross Greer: Grand.

The Convener: You only missed five minutes.

Ross Greer: Excellent—thanks.

My question might be best put to Richard Hughes, in the first instance. I am interested in hearing your thoughts on how appropriate the GDP deflator is as a measure of inflation for Government. At the moment, there is quite a gulf between the 3.7 per cent that it states, on the one hand, and, on the other hand, the consumer price index and retail price index levels, which are into double figures.

In the wider debate on the issue, it seems to be broadly recognised that neither method is quite right for measuring the impact of inflation on a Government, but the GDP deflator is the one that is used officially. I am interested in hearing your thoughts on how appropriate it is in the current financial context.

Richard Hughes: That is right. I will set out the distinction between the two different measures of inflation. CPI inflation is a measure of the increase in the costs of things that consumers purchase in shops, which in recent months has reflected the large increases in the costs of energy, heating our houses and putting food on the table—so, for consumers, prices are rising dramatically, which greatly erodes our real spending power. That measure is currently in double-digit figures.

The GDP deflator is used to measure the increase in the cost of things that the UK produces. Because the country does not produce all its own energy and food, much of which is imported, that measure has not been rising by as much, because those are the factors that have been driving the increases in consumer prices.

If we examine what that means for the effective volume of Government spending, we traditionally use the GDP deflator as a way of measuring real increases in such spending because, in essence, Governments mostly provide public services with things that we produce here in the UK. Their single biggest cost is for payroll and personnel. As we have been discussing, across the economy, wages have been rising by the order of 5 per cent or 6 per cent—not in the double digits. In that sense, one of the single biggest cost pressures for the Government is not rising by anywhere near 10 per cent or 11 per cent; it is rising by the order of 5 per cent or 6 per cent, depending on where wage settlements are.

Governments also do not spend as much on energy to produce what they do as we spend in order to live our lives, and they tend not to spend great amounts of money on feeding people. However, they obviously have to deal with the consequences of paying people wages that are sufficient for employees to feed themselves. It is also important to say that Governments have to pay world prices for some of the things that they provide. For example, they purchase fuel and military equipment, both of which can have high inflation rates, especially when, as is the case at the moment, there are shortages of the military equipment that the Government wants to procure.

It is for that reason that we say that the best measure of inflation for Government services—and the best way to adjust the cost of provision of such services for inflation—probably lies somewhere between the lower number of the GDP deflator and the higher number of CPI inflation.

Ross Greer: Thanks very much. Is there a measure that currently lands somewhere between the two, which might be a more appropriate one on which to base assumptions on the impact of Government spending?

Richard Hughes: I am not sure whether Andy King might want to come in on that. There is something called the Government consumption deflator, which measures the increase in the cost of providing a given volume of Government services. It is calculated in a different and even more complicated way. Factors such as the pandemic had a great effect on it, because it resulted in a large reduction in the volume of activity in some parts of the public sector. That number has therefore jumped around a lot in the recent past, and it can also be subject to large measurement changes. Andy might want to come in on the topic of different measures of inflation.

Andy King: There is no simple answer on that; it will vary between public services, depending on the share of their costs that is wages and the share that is other forms of procurement, and whether they are imported or not.

The Government consumption deflator, which is a public services-specific number, is, in some places, measured by asking what the cost of providing education is; the volume is the number of pupil days of teaching, and you reveal the price between them.

The main issue that I see is that the difference between the GDP deflator and CPI inflation is a very good measure of how much poorer the country as a whole has become because of the energy price shock, because it is imported prices that have pushed CPI inflation above the GDP deflator. None of those is perfect as a price measure for public services, but that is a good indication of how much more difficult it is for both public and private sectors to do what they had intended to do when there has been a shock like the energy price shock.

Richard Hughes: David Miles might want to come in at this point.

Professor Miles: I have one small point to make. It is certainly true that CPI inflation is much higher than the in the GDP deflator rise at the moment. In our central forecast, for what it is worth, that situation actually flits around. For example, in 2025-26, the rate of change in the GDP deflator is something like 1 or 1.5 per cent higher than CPI inflation.

Ross Greer: That is great—thank you. The context for asking that question is that we are all limbering up for another debate on Thursday about whether the Scottish budget has gone up or down in real terms, which depends entirely on how we measure "real".

I have one final question, on the Scottish tax base. Income tax makes up the majority of our devolved tax base. As was just mentioned, the rate of growth in wages is currently far lower than inflation, but wages are certainly set to grow by far less than wealth—in particular, the wealth of the wealthiest people in our society.

Given that income tax is devolved and makes up the majority of our devolved tax base, and that the lion's share of what is left is land and buildings transaction tax and council tax, are Scotland's public finances overexposed to short-term shocks in the economy in comparison with UK-wide public finances, which can be supported by a much wider range of taxation measures on wealth or corporate tax, as was mentioned earlier?

Richard Hughes: Andy King might want to say something more, but the short answer is probably no. Of all the taxes from which Government benefits in terms of revenue, income tax tends to be one of the more stable sources. As a devolved source of taxation, therefore, it is less volatile than other taxes that rely not only on how much people are earning every year but on other things. For example, capital gains tax relies both on what happens to asset prices, which can be very volatile, and on what happens to the volume of transactions in assets, which can also be very volatile.

When stock markets do very well and there are a lot of transactions, Government makes lots of money. When stock markets do not do well, Governments can lose money. The same applies to things like stamp duty on shares. For that reason, one of the more volatile items in the Scottish revenues is on the property tax side. LBTT is actually proving very volatile in the coming year, because both prices and volumes are dropping as a result of higher interest rates. Fewer people are moving house, and when they do move they are paying less on the transaction.

At present, therefore, Scotland has a mix of a relatively stable tax and a more volatile tax. I know that there are debates about devolving some of the VAT base to Scotland. That has also, traditionally, in the UK, been a more stable source of taxation, because consumption tends to be more stable than other sources of tax.

I do not know whether Andy King wants to add anything to that.

Andy King: Yes, that is right. The other aspect is the block grant adjustment, which means that the Scottish budget is insulated from shocks that hit the whole of the UK. There would need to be volatility in the tax base in Scotland relative to other parts of the UK, which one might expect to see; there is certainly a risk of that happening in the coming period, as very high energy prices could boost the income tax base in Scotland relative to the rest of the UK, given the composition of the economy.

Ross Greer: Thank you—that is everything from me.

The Convener: I thank the witnesses from the OBR for their comprehensive answers, which are much appreciated. That concludes our public session.

11:15

Meeting continued in private until 11:36.

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