A Sustainable Future for Scotland’s Public Finances

Friday 15 June 2018

The Royal Society of Edinburgh

EVENT REPORT PRODUCED BY SCOTLAND’S FUTURES FORUM

BACKGROUND

Scotland's new budget process is designed to include a long-term outlook and focus more on prioritisation, addressing fiscal constraints and the impact of increasing demand for public services.

As part of the process, the Scottish Government published a Medium-Term Financial Strategy for the first time on 31 May 2018. At the same time the Scottish Fiscal Commission [SFC] published revised forecasts for devolved tax revenues and Scottish onshore GDP growth forecasts and demand-led social security expenditure.

With this information, this seminar considered the Scottish Government's expectations on the outlook for public finances over the next five years and explored the long-term sustainability of Scotland's public finances.

WELCOME AND INTRODUCTION

Dr Rebekah Widdowfield, chief executive of the Royal Society of Edinburgh, welcomed participants to the RSE.

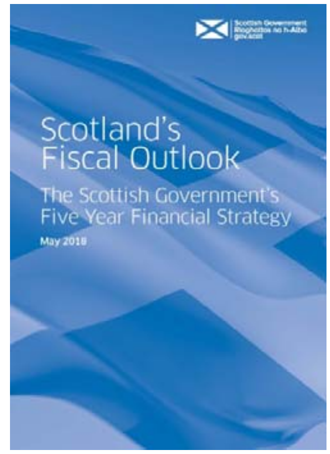
As chair of the event, Bruce Crawford MSP, convener of the Scottish Parliament's Finance and Constitution Committee, introduced the event. This would contribute to the Scottish Parliament's scrutiny of the Scottish Government's budget and to help build longer-term thinking into the discussion of Scotland's public finances.

[L-R Derek Mackay MSP, Cabinet Secretary for Finance and Constitution,
Dr Rebekah Widdowfield, Chief Executive of the RSE, and
Bruce Crawford MSP, Convener of the Scottish Parliament's Finance and Constitution Committee]

Scotland's Medium-Term Fiscal Outlook

Derek Mackay MSP, Cabinet Secretary for Finance and Constitution

Scotland's Fiscal Outlook - the Scottish Government



The Cabinet Secretary opened his comments with a reflection that, as the Scottish Parliament gains control of more economic and fiscal levers, this is a good time to consider the financial outlook for Scotland in the context and framework that Scotland is operating within.

He highlighted that the Scottish Government's Medium-Term Financial Strategy outlines how population change in Scotland is an important factor and that, although it is obviously good that people are living longer, this means a relative decline in working age-population, which is driving some of the productivity, financial performance and taxation challenges that Scotland faces.

As such, Mr Mackay said that we have to grow our economy in a sustainable way, improving our productivity, wage earning and participation levels in the workforce. Mr Mackay described the Government's strategy to do that as one based on innovation, high tech and high skills, making Scotland an attractive country to live, work and invest in.

The Cabinet Secretary noted specific interventions that he believed will make a difference:

- expansion in childcare entitlement
- investment in digital and the infrastructure of our future, and in skills
- 50,000 new affordable homes
- supporting private sector growth
- tackling the attainment gap, social exclusion and inequality

Overall, Mr Mackay noted, there is a real focus on productivity, participation and population.

Mr Mackay finished by welcoming the depth of interest in the Medium-Term Financial Strategy. He noted that the political parties have to work together to deliver responsible, competent and confident government in a balanced and progressive way.

Questions

The Cabinet Secretary answered questions including on tax strategy and the balance between income and property tax rates, the predicted fall in the budget outlook, and the pressures on local government.

There were also questions on the investment gap, a Scottish Government balance sheet and the potential in leveraging Scottish public sector assets, and lessons from other small economies, including the need for political unity to agree on Scotland's priorities.

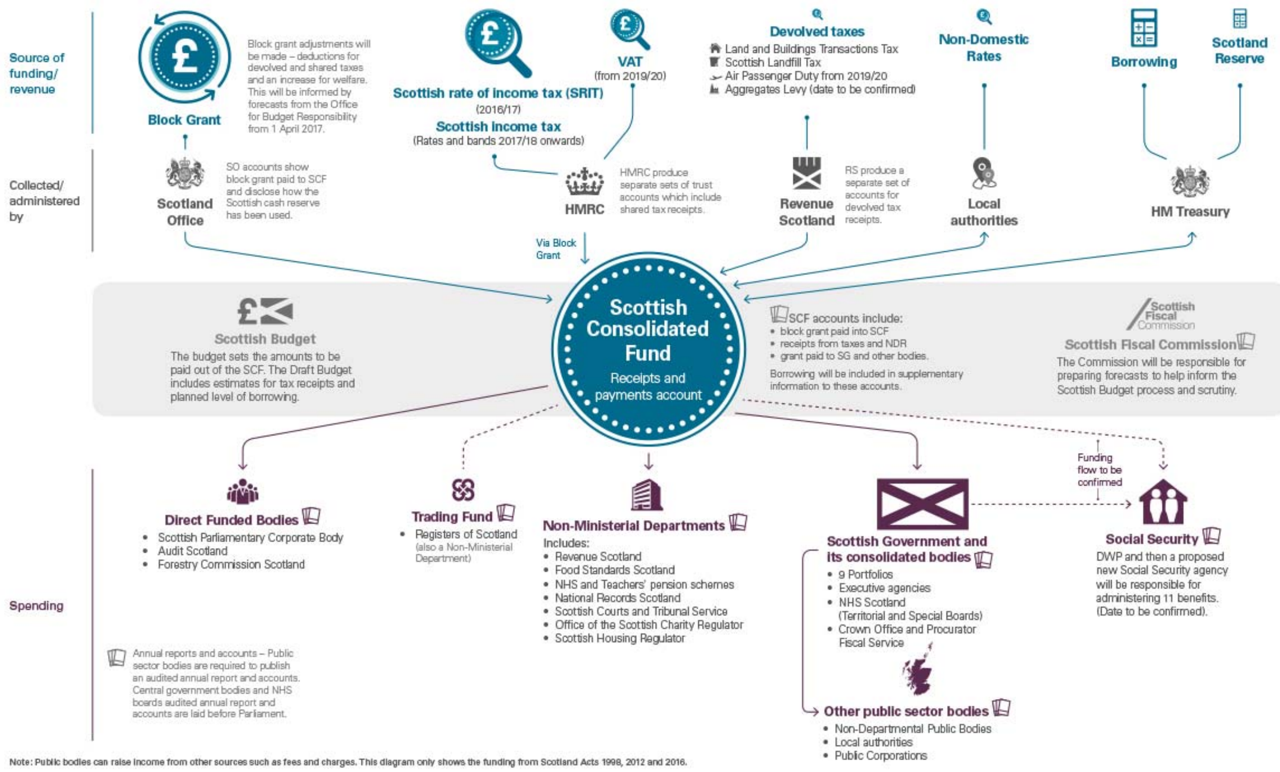
Opportunities and Challenges for Scotland

Scotland's Changing Public Finances: Caroline Gardner, Auditor General for Scotland

The Auditor General began by pointing out that, as well as significant new tax-raising powers, Scotland has new powers over borrowing and reserves for the first time, and responsibility for 11 social security benefits that are worth around £3 billion.

This means that the proportion of devolved spending that is raised directly in Scotland increases from around 10% of spending in 2014-15 to around 50% as all the new powers come into effect.

Ms Gardner pointed out that the Scottish Parliament is therefore moving from a spending parliament to one that balances spending with revenue raising in much more complex ways. Her key message was about the impact of that complexity and the related uncertainty.



The Auditor General noted that the state of Scotland's economy will influence both the money available for spending and investment and the level of demand-led spending. Economic growth is therefore important to the sustainability of Scotland's public finances.

Ms Gardner also reflected on the interaction between the SFC forecasts with the Office for Budget Responsibility [OBR] forecasts of UK tax revenues. The SFC forecasts determine the Scottish Government's budget, while the OBR forecasts determine the block grant adjustments.

The Auditor General suggested that, to manage financial sustainability and hold the Scottish Government to account, there needs to be clarity about our long-term financial commitments; the long-term implications of policy decisions, such as the expansion of early learning and childcare; and how spending, revenues and economic performance are expected to change over the medium term.

In particular, Ms Gardner suggested, the Parliament should ensure that it has a good understanding of the economic and fiscal context, and how the revenues, borrowing, spending and reserves all interact. On top of that, there needs to be longer-term thinking to understand how things are likely to change, and a balance between short-term flexibility and long-term direction.

The Auditor General also pointed to the existing financial pressures on public services, which are not expected to ease any time soon, along with other challenges such as demographic change and the need to tackle inequalities, improve outcomes and respond to advances in technology and the UK's withdrawal from the European Union

To meet these challenges, Ms Gardner noted the importance of laying the foundations for sound fiscal policy through, for example, strong budget institutions, disciplined budget allocation processes and a structured approach to the Government's balance sheet.

The Auditor General finished by welcoming the steps taken towards longer-term thinking and planning, and by looking forward to working with the Parliament, the Government and others to develop a world-class approach to public financial management for the years ahead.

The Scottish Fiscal Commission Forecasts

Dame Susan Rice, Chair, Scottish Fiscal Commission

Dame Susan Rice started by describing the Fiscal Commission's approach to forecasting: an iterative process of intelligence gathering, learning from previous forecasts, reflection and refinement, testing conventional wisdom and looking at the outliers.

Dame Susan explained that the Fiscal Commission draws widely on expertise and insight to make its judgments but, despite all the hard work, the SFC's understanding of the economy will inevitably be imperfect—as is true of everyone. She referred to the welcome increase in Scotland-specific data, but noted that, with the new fiscal powers for the Scottish Parliament, this is new territory for us all.

SFC Forecasts - May 2018

Dame Susan described the the outlook for growth in Scotland as subdued. On a positive note, the SFC's forecast is that the economy is growing: unemployment is expected to remain low, with employment continuing to increase over the next five years. However, the SFC's view remains that an overall pattern of slower growth is likely to persist for the next five years. Poor productivity growth and a declining population in the 16 to 64 age group are the most significant factors, although Brexit also contributes to the outlook.

Dame Susan also noted that the relationship between real wages and productivity growth may be weaker in Scotland than conventional wisdom would suggest. Considering this, the SFC has reduced its real-wage forecast, which has an impact on the expected income tax revenues.

Structural Challenges for Scotland: Ageing, Migration and Skills
Professor David Bell, Vice-President, the RSE

Professor Bell suggested that, as in the OBR "Fiscal Sustainability Report", it can be useful to take a generational approach to tax and spending.

Population

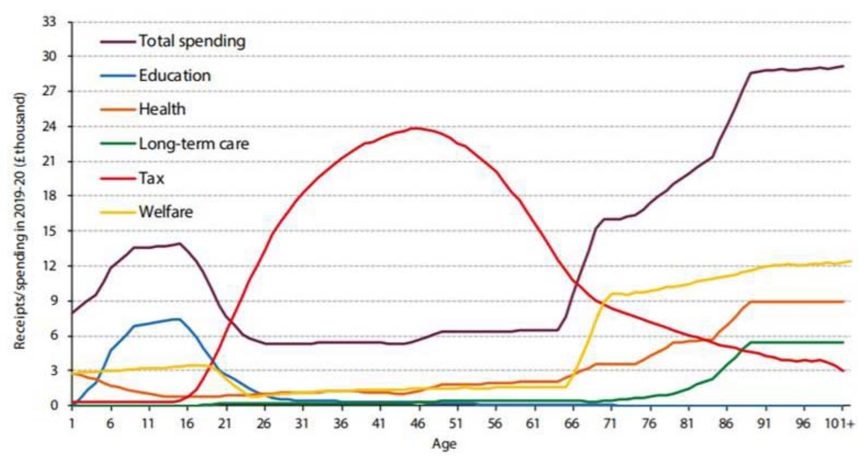
Professor Bell noted that the the Scottish population is changing: the number of those aged 0 to 15 is declining slightly; the working age population is declining slowly; and the older population is increasing quite rapidly. He highlighted that at the moment, there are 1 million people aged over 65; by 2031, there will be 1.5 million. This brings a rapidly changing workforce, and Professor Bell suggested that we have to think about an economy in which a third of the workers are over 50.

Tax and spend over a lifetime

Professor Bell showed the following graph, which shows representative profiles for tax revenue and public spending over a lifetime in the UK.

With this analysis, he said, we can question our spending decisions. For example, education spending peaks early in the lifecycle—should we be spending all our money in the early years? Is there a case for much more part-time adult education?

Representative Levels of Tax and Spend over a Lifetime



Source: OBR Fiscal sustainability report – June 2015

Employment

Professor Bell noted that, since the great recession in 2008, there have been large increases in self-employment. Scotland has seen a relatively small increase in full-time workers and a big increase in part-time workers. Those changes all have implications for tax revenues.

Productivity

On productivity, Professor Bell noted that output per job in 2017 varied from just over £30,000 in distribution, accommodation and food services, to nearly £80,000 in manufacturing.

The firm level productivity distributions show that, like the rest of the UK, we have a long tail of not very productive companies. Professor Bell asked where we should intervene to increase tax revenues: at the top end or with the aim of moving up the companies stuck at the tail end.

Inequality

On inequality, Professor Bell noted that earnings progress has stalled for young adults today. He quoted the Resolution Foundation: "Millennial families are only half as likely to own their home by age 30 as baby boomers were by the same age". Overall, Professor Bell noted, there is an issue of generational fairness in the same way as there are issues of fairness across different groups within the population.

OPPORTUNITIES AND CHALLENGES FOR SCOTLAND

The Macroeconomic Situation

Jeremy Peat, Vice Chair Business Innovation Forum, the RSE

Mr Peat started by quoting the statement from the Medium-Term Financial Strategy that "we want Scotland to be the best place to do business in the UK and Europe" Although he suggested that no one would disagree, Mr Peat noted that we are not starting from a positive point.

Pointing out that productivity growth is likely to be weak—and weaker in Scotland than in the UK—Mr Peat asked how Scotland can stabilise and accelerate growth and our tax revenues. He pointed out that the budget is going from tight to tighter, especially for what might be termed non-priority areas. They may be non-priority but, Mr Peat noted, to many people they are extremely important.

For Mr Peat, the question is how to enhance economic and fiscal performance, and he pointed to three areas in which the RSE had noted opportunities.

First, Mr Peat suggested that we should encourage more skilled migration into Scotland. Second, he agreed with the suggestion of a short-term time-limited infrastructure commission to determine priorities for physical and digital infrastructure.

Thirdly, Mr Peat thought a time-limited productivity commission would also make sense, particularly if it considered not only the high-skills sectors but the domestic sectors where productivity growth is low.

Mr Peat also noted that the low-skill domestic-facing sectors can be a sink for a lot of the millennial generation. They can find it difficult to escape from the jobs because of the lack of training that takes place beyond schools, further education and higher education. Raising productivity in that sector, according to Mr Peat, would help to raise skills and average earnings among that group and allow them to progress through society.

Finally, Mr Peat reflected on the fact that, although we have a wonderful story on higher education research and development, we have been at the bottom of the table for the past 20 years in business investment in research and development. He believed that we are not getting the benefits that we should be getting from our higher education successes.

Mr Peat concluded by saying that the real secret to ensuring sustainable public finances is encouraging better growth and more productive activity.

Post-presentation Discussion

In a post-presentation discussion, the following points were made:

We need to look at every penny we spend. Professor Bell's slide on the lifetime costs showed that we do not spend much on lifelong learning, which is vital for training our workforce. We need to look at the spread of spending over the lifetime and ask whether we spending the money at the right time.

There is too much inertia in spending: we fund what we funded before. We need to be much more systematic and disciplined in ensuring that public money is spent on outcomes aiming to improve, that actions are taken based on evidence of what works and theories of learning, and that we stop doing things that do not work. That chain of thought is not always there.

We do not have enough diversity in education. Higher education is funded to prioritise research and teaching but not lifelong learning, adult education and part-time education. We need innovation in education and should experiment with some previous ways of working. Technical schools used to major on vocational education but were wiped out by the introduction of comprehensive education.

We need to discuss how to fund social care. The discussion has started in England and Wales, and needs to start here. The most popular tax increase is in national insurance, but that only hits workers and young people, which increases unfairness. Equally, national insurance is not devolved, so Scotland could not hypothecate the income from it. In Wales a funded contributory system has been suggested in which older people pay a higher contribution rate to reflect that they are paying for a shorter period of time. The contributions can be invested to earn a return to help pay for social care in the long term.

There is a question of equity in the rising costs of social care. We should consider the healthy life expectancy in places such as Glasgow and Dundee, where many people do not reach pension age without some kind of disability or a serious health problem. The healthy life expectancy can be the mid-50s. Such people will not enjoy the benefits of pensions, so should they contribute at same rate as those who will benefit? It is a tricky question to answer but one we should think about.

We should use enterprise support for the private sector to support underperforming businesses, and not worry about the ones who are doing well and would innovate to improve anyway. It is too easy to go to the account managed companies; instead, we should encourage more companies to have ambition. One way to involve smaller companies would be to work with sectors rather than individual companies. Equally, this is not just an issue for the Government: encouraging established and experienced businesses to work with other companies can help develop innovation.

There is a question about the reliability of our productivity statistics but the trends are clear. We know that since 2000 there has been a major change in productivity for the worse. The UK and Scotland have underperformed more severely than most of our peer countries.

Individual industry stories make a difference. There was a mini boom in construction in 2015-16 that is coming to an end, and the signs of improvement in oil and gas are taking time to come through. The uncertainty around Brexit also has an effect, but there will be clarity over time. To some extent, therefore, some factors are temporary but still have an effect over several years. The situation will not turn around instantly.

Workshop Feedback

The workshop groups were asked to consider Scotland's strengths, weaknesses, opportunities and threats in relation to a sustainable future for public finances. They were also asked to give their priorities for action.

This is a summary of the main points to arise.

Strengths

Aspects of our economy
Some sectors are great strengths: we have a good engineering and science base, strong financial services and a health sector that does well considering the ratio of inputs to the outputs achieved. Our tourism sector has seen positive growth, including in areas such as the Highlands and Islands which see low growth otherwise.

There is international recognition of the strength of our higher education institutions, with excellent levels of research and development, although we need to build a stronger link between our universities and the business base.

More generally, it was noted that unemployment and youth unemployment levels are good in comparison with others, and that Scotland can be more agile as there are fewer large employers. The flexibility that situation brings was seen as a strength.

Our lifestyle and environment
Brand Scotland is a strength. With our natural and cultural heritage, Scotland is a good place to live, work, study and invest in. This could be leveraged more.

Weaknesses

Aspects of our economy
There are some structural weaknesses in the economy: business investment is weak, productivity is still very low compared to non-UK countries, and pay and the quality of employment are both poor.

Lots of our onshore economic activity is also tied to the oil and gas industry, while our digital connectivity is not consistent enough throughout the country. Furthermore, our higher education sector is not focused on areas that might generate economic growth.

We have seen a thinning out of larger conglomerates and a loss of major companies with Scottish HQs. Indeed, high growth companies that could have large HQs in Scotland always sell out before they become large scale. We need more help for medium-sized firms to scale up.

Changes in employment patterns, particularly the increase in self-employment, mean that more tax goes straight to the UK.

There are also limited opportunities for career growth in Scotland, particularly in SMEs, and to progress in a career path many people leave Scotland to seek opportunities elsewhere, particularly in London. This is specifically the case for higher-skilled jobs.

We also have a weak record on entrepreneurship: there is a need to improve business links with schools and encourage apprenticeships.

WORKSHOP FEEDBACK

Strengths

Political and policy context
Scotland's National Performance Framework was identified as a strength as it identifies priorities for public spend, although it could be argued that it lacks focus.

In comparison with others, Scotland is not a high-tax economy. Equally, the lack of fees for higher education was seen as a positive, although there appears to be limited evidence that this is supporting social mobility.

The nature of the constitutional settlement—the fact it is fluid and non-codified—was also seen as a strength, although this can also be a weakness.

Our people and our culture
Scotland is a small country where people know each other and can easily network.

Within the country, there are positive attitudes to society and a focus on community.

We also have a high quality of individuals coming out of Scottish universities, and of research carried out in Scotland. The university sector has been very successful in attracting talent. What can we learn from that?

Weaknesses

Political and policy context
There is an unwillingness to acknowledge that trade-offs are required in public spending. We have a policy agenda trying to do everything, and we need cross-party consensus on the need to be more focused on doing a few things and doing them well.

Scotland's public sector lacks ambition and can be very cautious in the choices it makes. It needs to be bolder.

Our education system has become too politicised, so it is difficult to discuss in a constructive way. We need to improve both access and excellence—just improving access is not enough.

Scotland does not have access to all the fiscal and social levers, such as National Insurance rates and migration policy. This creates a non-coherence in fiscal approach.

Finally, there is a major lack of Scotland-specific data in some areas. This can compromise ability to come up with evidence-based policy solutions.

Our population and our culture
We have a population that is ageing more rapidly than the rest of the UK, combined with health inequalities throughout the country.

There is a lack of recognition of own strengths. Scotland can be too self-critical, and others recognise our strengths far more than we do.

We also do not value successful innovation or recognise the positive role of competition, and we are sometimes hampered by our constant need to compare and benchmark to the UK.

Workshop Feedback

Opportunities

Political and policy context

The outcome approach to public finances provides an opportunity for government spending to make a difference. As part of that, greater participation in the political process, through participatory budgeting for example, can help achieve greater public understanding and consensus on the difficult decisions.

There are opportunities to increase migration to Scotland, from both within and outwith the rest of the United Kingdom.

Aspects of our economy

There are lots of opportunities in the low-carbon economy, although we may need to jump ahead to next stage of technology and not just take a step-by-step approach. In particular, smaller innovative companies could offer real opportunities in this area.

A growth in tourism also represents an opportunity, given Scotland's particular offering.

More structurally, the nearshoring of good jobs presents an opportunity for Scotland, as does the size and scale of the country, which provides an opportunity for policy innovation and a culture of entrepreneurship.

We can take the research and development success in the higher education sector and translate it into business opportunities within Scotland. In particular, there are opportunities to capitalise on the skills in our universities to develop the fintech sector.

More broadly, the opportunities offered by digital technology should be explored. Gains can be made in all sectors through innovative deployment of big data, artificial intelligence and machine learning.

Taxation

With our new tax levers, we can look at more developed taxation options to generate revenue by, for example, leveraging land, building, local and tourism taxes in different ways.

Threats

Political and policy context

Cross-party support can be increasingly hard to achieve in the context of the recent referendums on Brexit and Scottish independence.

There are also challenges in local government and the way in which short-term funding settlements from central government limit forward planning.

Aspects of the economy

Forecasts all point to weak economic growth over coming years. With such low GDP growth and the new powers to raise income tax, there is a danger that we will get into a cycle of loss of skills and low productivity. We may also lose corporate headquarters.

Scotland may become very dependent on a single form of taxation—income tax—as a source of revenue.

Culture

The changing approaches to work—greater desire for a work-life balance, an increase in part-time work by choice, and changes in traditional roles—may affect the tax base.

Technology

Digital technological innovation through big data and artificial intelligence may lead to a loss of jobs and therefore tax revenues through automation of jobs and tasks currently undertaken by people.

Structure and population

Edinburgh may become the focus for economic and political activity in Scotland and divert resources from other parts of the country, in the same way that London does at a UK level.

Scotland has an ageing population and limited powers to attract working-age migrants to the country.

Environmental change

The environmental impact of climate change on Scotland cannot be accurately predicted. Our economy is heavily dependent on tourism, which in turn is dependent on our natural heritage and ecosystems—historic buildings, wildlife and natural environment. There are many unanswered questions about the scale of possibilities, ranging from ecological harm to ecological collapse.

Workshop Feedback

Priorities for action

Structure of economy

- Improve links between business and young people
- Understand future skills needs better and improve lifelong learning
- Get a better understanding of why businesses make their investment decisions, and react accordingly

Taxation

- Rethink the tax system to make it more robust to changes in employment and ageing and ensure that it is redistributive
- Revisit the question of the devolution of the personal allowance as well as devolution of savings income
- Offer incentives to grow SMEs and keep people in an “employed” status, ensuring the tax take stays in Scotland

Focus

- Position Scotland as an ethical voice in the context of new technologies, in skills and in certain industries
- Focus on future ways of working and the need for more evenly distributed connectivity, and link in to the natural assets of Scotland

Population

- Develop a differentiated migration policy and focus on retaining high-skilled graduates and young people
- As part of that, reintroduce the post-study work visa

Approach to public finances

- Produce a fiscal sustainability to help change the debate and expectations
- Highlight the data gaps to improve evidence-based policy making
- Ensure we understand the impacts of the fiscal framework, and look to the bigger picture of where Scotland fits in with the UK, the EU, and internationally
- Fully embrace and embed outcomes within the new budget approach
- Include more emphasis on “monitoring and evaluation” and learning around what works’

DELEGATE LIST

First Name	Surname	Organisation
Clare	Adamson MSP	Social Security Committee
Jo	Armstrong	Business Economist and Non-Executive Director
David	Bell	Royal Society of Edinburgh
Elise	Black	Scottish Government
Hugh	Buchanan	Scottish Government
Ailsa	Burn-Murdoch	Scottish Parliament Information Centre
Ross	Burnside	Scottish Parliament Information Centre
Allan	Campbell	Scottish Parliament Information Centre
Viv	Cockburn	Scottish Futures Trust
Stephen	Coliston	Sheppard & Wedderburn
Bruce	Crawford MSP	Finance and Constitution Committee
Jim	Cuthbert	Independent Researcher
Mike	Danson	Heriot-Watt University
Chris	Deerin	Reform Scotland
Mure	Dickie	Financial Times
Paul	Diggle	Aberdeen Standard Investments
Hugh	Dunn	City of Edinburgh Council
Gordon	Eadie	Royal Society of Edinburgh
David	Eiser	Fraser of Allander Institute
Angela	Flynn	Scottish Government
Angela	Flynn	Scottish Government
Murdo	Fraser MSP	Finance and Constitution Committee
Caroline	Gardner	Auditor General
Doreen	Grove	Scottish Government
Russell	Gunson	IPPR Scotland
Rachel	Gwyon	Scottish Government
Jamie	Hamilton	Scottish Government
Emma	Harper MSP	Finance and Constitution Committee
Patrick	Harvie MSP	Finance and Constitution Committee
Clare	Hawthorne	Finance and Constitution Committee Clerk
Daniel	Hinze	Scottish Government
Nicola	Hudson	Scottish Parliament Information Centre
John	Ireland	Scottish Fiscal Commission
James	Johnston	Finance and Constitution Committee Clerk
Morag	Johnston	Glasgow City Council
James	Kelly MSP	Finance and Constitution Committee
Elaine	Lorimer	Revenue Scotland
John	Macintosh	Deloitte
Derek	Mackay MSP	Cabinet Secretary for Finance
Helen	Martin	Scottish Trades Union Congress
John	Mason	Economy, Jobs and Fair Work Committee
Donald	McCrae	Royal Society of Edinburgh
Ivan	McKee MSP	Finance and Constitution Committee

DELEGATE LIST

First Name	Surname	Organisation
Philip	Milne	Ernst & Young
James	Mitchell	University of Edinburgh
Claire	Murdoch	Scottish Fiscal Commission
John	Nicholson	Scottish Government
Alison	O'Connor	Scottish Parliament Information Centre
Silvia	Palombi	Scottish Fiscal Commission
Jeremy	Peat	Royal Society of Edinburgh
David	Phillips	Institute for Fiscal Studies
Peter	Reekie	Scottish Futures Trust
Susan	Rice	Scottish Fiscal Commission
Jonathan	Sewell	Scottish Government
Donella	Steel	Historic Environment Scotland
Jenny	Stewart	KPMG
David	Stone	Scottish Fiscal Commission
Paul	Stuart	Royal Society of Edinburgh
Mark	Taylor	Audit Scotland
Shane	Taylor	Scottish Chambers of Commerce
Mari	Tunby	CBI Scotland
Joanne	Walker	Chartered Institute of Taxation
David	Watt	Institute of Directors
Rebekah	Widdowfield	Royal Society of Edinburgh
Jane	Williams	Finance and Constitution Committee Clerk

A Sustainable Future for Scotland's Public Finances, 15 June 2018, at the Royal Society of Edinburgh

Scotland's Futures Forum
www.scotlandfutureforum.org
@ScotFutures