SCOTTISH TRENDS

(Press Release - 17th May 2016)

Challenges facing the new Economic Secretary with regards to Scotland's economic performance

This note looks at some of the issues that will face the new Economy Secretary in the Scottish Government Cabinet.

Key Points

- **Growth - Scotland's economy did not perform well in 2015 and prospects for 2016 and beyond remain gloomy. The Construction sector is likely to stall or even fall back after the recent, record breaking, performance in 2015; and the downturn in North Sea activity is likely to be on-going for some years to come. Meanwhile long term problems with the 'Hotels & Catering' and the 'Transport, Storage & Communications' sectors are unlikely to be resolved. Continuing austerity means that the public sector is unlikely to contribute much.**
- **Trade - 2015 saw a record trade imbalance for Scotland, with the fall in Scottish exports to the rest of the UK a particular worry. The current account is a key statistic in understanding the health of an economy but is understudied and data is only partially available for Scotland.**
- **Tax Revenues - the new Fiscal Agreement means that lower economic growth would feed through more directly to lower tax revenues and public expenditure. This could more than offset the 'increase' in taxes brought about by not following the UK's uprating of the higher rate threshold for Income Tax.**
- **Council of Economic Advisers - to maximise its usefulness this body needs to be reconfigured so that it is more pro-active in investigating Scottish economic issues; this includes employing active academic economists and researchers.**

GROWTH (GDP)

The Scottish economy did not perform well in 2015.

- In cash terms, it fell by 1%, including North Sea activity (UK equivalent was up 2.6%)
- In real (adjusted for inflation) terms, it grew by 1.9%, excluding North Sea activity (UK equivalent was up 2.3%)

Within this relatively poor performance it should also be noted that the Construction sector is adjudged to have grown by 20% in real terms. Without this stellar performance, overall real terms Scottish economic growth would have been well under 1%.

Looking forward, prospects remain poor due to both new challenges and to on-going under performances. (Note: all figures below are in real – adjusted for inflation – terms.)

- **Construction** - with the completion of major public sector projects, including the Forth Road Bridge replacement, Construction activity is likely to fall. The expansion of this sector by 33% over the last 2 years (and over 15% higher in 2015 than in any other year post 1998) may now go into reverse, reverting back to more normal levels of activity

- **North Sea** - this sector is likely to continue to shed jobs, both offshore and onshore. Oil & Gas UK predict a net loss of 26,000 jobs by 2019. Sir Ian Wood has predicted a far higher job loss figure of 45,000 this year alone. Furthermore, these jobs are high quality and highly paid, so this loss will have a bigger than average effect on the economy. The most likely areas of onshore activity that could be affected are certain areas of Manufacturing and Private sector services, especially business support services.

- **Accommodation & Catering/Tourism** - the long term underperformance of the sector covering hotels and restaurants continues. Since its peak in 2006, Scottish output has fallen by over 6%, whereas for the UK it has grown by over 10%. This also implies a long term poor performance for the tourism sector. Such an impression is reinforced by the fact that Scotland's net tourism position has significantly worsened in recent years, from a deficit averaging around £600 million a year between 2005 and 2012 to one averaging over £1,350 a year between 2013 and 2015.

- **Transport, Storage & Communications (TSC)** - this sector barely grew in 2015, while for the UK as a whole the sector grew by over 4%. Since its peak in 2007 Scottish output has fallen by 10% whereas for the UK it has grown by over 10%. While the 2015 situation may be linked to the decline in North Sea activity this is unlikely to explain the longer term deterioration. The lack of any further disaggregation of TSC in published data makes it difficult to judge exactly where the problem lies.

- **Financial services** - this sector continues to struggle post the financial crisis, with output unchanged over the past 5 years, although a similar pattern is seen at the UK level.

- **Public Services** - on-going austerity means that it is unlikely that public services will add much in the way of growth. However, there remains a puzzle as to why Scottish growth has lagged behind UK growth in this area since 2008. The main culprit has been Health & Social Work which has grown by just over 1% a year in Scotland, little more than a third of the annual increase seen for the UK as a whole (3%).

Clearly there are a large number of industry sectors causing concern at present but little in the way of explanation for why this might be the case.

Unless more effort is put into understanding where and why the Scottish economy under performs, it will be very difficult to identify policies that might help remedy the situation.

TRADE IN GOODS AND SERVICES

The most recent trade data for Scotland highlighted some worrying trends.

- For 2015 as a whole Scotland's deficit was almost £15 billion, well above the previous record annual deficit level seen in 2007 (£-11.7 billion) and over £5 billion worse than was seen in 2013.

- This rising deficit is due in large part to a deteriorating trade position with regards to the Rest of the UK, with imports rising and exports down in 2015.
- In terms of the trade balance as a % of GDP (including North Sea activity), 2015 was also the highest figure seen post devolution, at -9.8%, well above the previous high seen in 2007 (-8.5%).

Again, there is very little in the way of data or analysis to help determine where the problems lie in explaining this deterioration.

The Current Account (of which the trade balance is only part, along with earnings on foreign investments minus payments made to foreign investors and net cash transfers overseas) is a key measure of an economy's health as it helps signify whether a country is living within its means or is over extending itself.

As such the recent deterioration in the trade balance is a concern, although shifts in the net transfer of interest, profits and dividends (IPD) could make the situation better or worse. Unfortunately, data for IPD is not currently published for Scotland, a situation that needs to be rectified as soon as possible in order to gain a fuller understanding of where Scotland sits.

The First Minister recently commented that *"we have already achieved a lot in terms of employment, inward investment and export successes"*. Given that exports to both the 'rest of the UK' and to 'overseas' fell in 2015 and, in total, for 2015 were below the level seen in 2013 (in cash terms) this seems like an overly optimistic take on the current position.

PUBLIC SECTOR REVENUES AND FUNDING

As the First Minister has put it *"none of our pledges….stand a long-term chance of success if we do not keep a laser like focus on the economy and the need to generate revenue to invest in our future."*

This is truer now than ever before as the Scottish Government gains control of Income Tax (IT). The new arrangement means that if the economic problems envisioned above come about then there will be a knock on effect on government expenditure. Previously Scotland was largely sheltered from any such effect by the workings of the Barnett formula (equally it could be argued it was restrained in its growth potential by such an arrangement) but now the performance of the Scottish economy will have a much stronger bearing on the funding of Scottish public services.

To help quantify this:

- if the UK's economy growing faster than the Scottish economy resulted in UK IT revenues increasing by, say, 4.5% a year (cash terms), while those in Scotland grew by only 4% a year, then the differential, in terms of the tax take, would amount to £370 million by 2021-22;

- this is slightly more than the £350 million that the Scottish Government expects to 'gain' by 2021-22 through slowing the rate at which the higher rate threshold increases. (Note: As the Scottish Government makes its own tax decisions now it could be argued that these are not really gains/losses at all. However, as much of the current discussion of the impact of tax changes is based on such an interpretation, the terminology is also used here.)

This means that as well as a poor Scottish economic performance having ramifications for individuals (in terms of lower wages or lost jobs) it also has direct implications for the Scottish Government (as opposed to indirect ramifications via the impact of the UK economy on UK public finances) through lower tax revenues.

The forecasts of devolved tax revenues to be made by the Scottish Fiscal Commission will be important in understanding and quantifying the impact of such relationships. However, there must be doubts over the robustness of any such forecasts given the inability of any model to accurately take into account the impact of issues like the decline in North Sea activity and the lack of understanding with regards to trends in key industry sectors in the past, as outlined above.

COUNCIL OF ECONOMIC ADVISERS (CoEA)

The current council is not an integral part of economic policy decision making in Scotland. This is illustrated by the fact that:

- since the latest version was set up it has met only three times;
- Nobel prize winner Joseph Stiglitz has failed to attend any of these meetings;
- it has failed to publish anything (other than the minutes of the meetings) since 2014.

The basic problem is that it is not a working group of active economists but rather an occasional meeting place for a group of experts (where, given Professor Stiglitz’s regular absence, economists are outnumbered by business representatives and others and where few members have a deep knowledge of the Scottish economy) to listen to and discuss, usually government led, presentations.

Such a wide make up may be appropriate for an Advisory Board or a complementary body, however, if the CoEA is to help fill in some of the gaps in our understanding then it needs to be composed of active economists (with research support) to carry out work on a proactive basis.

While there is not an over-abundance of such applied (practical) economists available (a long term problem in itself), some good candidates would include: David Bell (Stirling), Richard Harris (Durham), Alan McGregor (Glasgow), Charles Nolan (Glasgow), Campbell Leith (Glasgow although already on the Scottish Fiscal Commission) and Mary O’Mahony (NIESR and Kings College London).

Identifying younger researchers to work alongside these experienced economists would also be a valuable exercise as it would help train up the next generation of experts available to work on the Scottish economy.

Such an active and focussed body could go some way to filling in the large gaps in analysis of the Scottish economy that currently exist, and to helping identify key policies to improve its performance.

Quotes:

"The imminent appointment of a new Economic Secretary to the Scottish Cabinet is a welcome move by the Scottish Government given the current headwinds being confronted."

"*Scotland's economy faces many challenges in the short to medium term, from the decline in North Sea activity to trying to reinvigorate the financial sector. At present, our understanding of Scotland's performance is not good and the subject is understudied. Better data is needed and more analysis of it in order to be able to identify, and correctly administer, good economic policies that can help to overcome these headwinds and to help move the Scottish economy forward."*

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