SCOTTISH TRENDS

(Press Release - 5th April 2017)

Analysis of latest Scottish GDP (2016 Q4) statistics

'Active' Scottish Economy in recession over 2016

Todays official figures are for the Fourth Quarter of 2016 and also allow for the analysis of the calendar year 2016 as a whole.

Key points

- The underlying health of the Scottish economy weakened in 2016 with the **'Active Economy' contracting by 0.6%**.
- **Since the end of 2013** the 'Active Economy' measure has grown by just under 2% in Scotland, compared to over 13% for the UK.
- In terms of **GDP per capita** (i.e. standard of living) there has been no increase in Scotland since the start of 2015
- Latest data reveals a decline in the **Scottish economy in the Fourth Quarter** (Q4) **of 2016 of -0.2%**, which compares very poorly with **UK** growth of 0.8% in Q4.
- For the calendar year **2016**, Scottish growth was 0.4%, against 1.8% for the UK.
- During 2014 and early 2015 general economic weakness was largely disguised by rapid growth in Scottish Construction. However, in 2016 Construction output fell.
- If such relatively slower growth is maintained it will have significant **budgetary implications for a Scottish Government with Income Tax powers or under full independence**. In particular, it highlights the potential Budget losses relative to what would have been the case under the Barnett formula.
- For example, if the Scottish vs UK GDP per capita growth differential was maintained at around half the level seen in 2016 (0.5% a year), then after 5 years the Scottish Government would have **between £370 million (control of Income Tax) and £1.5 billion (full independence) less revenue than under the recent (full Barnett) system**.
- This simply reinforces the importance of ending the current slowdown in Scottish economic growth, although **simple solutions are not readily available**.

(Note: As North Sea related activity is allocated to the UK as a whole, and not on a regional basis, the UK measure shown throughout this analysis excludes it in order to make overall UK GDP growth more comparable with the Scottish figure. Hence both effectively refer to 'onshore' GDP growth.)

The ‘Active Economy’ measure (see Figure 1)

(As discussed in a recent Scottish Trends paper [see http://scottishtrends.co.uk/wp-content/uploads/2016/11/New-GDP-measure.pdf], an alternative measure of economic activity can be calculated which excludes the more erratic and the more difficult to measure elements of GDP in order to concentrate on activities based around Manufacturing and Private Sector (non financial) Services.)

In Q4, the ‘**Active Economy**’ in Scotland **fell** by -0.3%, compared with growth of +1.4% at the UK level, while over the past year, the active economy in Scotland also fell, by -0.6%, compared with growth of +3.6% in the UK.

Over the past 3 years, growth has been much slower in Scotland than the UK and this differential, over 10%, has been consistent across all the main components (see Table 1 and Figure 1).

Given this, todays quote by the Finance Secretary Derek Mackay that “*the foundations of our economy are strong*” seems at odds with the published data.

Other points of interest

Manufacturing

The main sources for the decline in Manufacturing output in 2016 have been ‘Metals & Machinery’ (-13%), ‘Chemicals’ (-8%) and ‘Other’ (which includes ‘Repairs and Installation’) (-9%).

So far the decline in sterling appears to have done little to boost Manufacturing exports, but this may yet change.

Construction

Output fell by 3% in 2016, but continues to operate at a historically high level.

ONS Construction data for Scotland shows that this mild overall downturn hides a decline of a third in infrastructure output, which had been driving the very fast growth in 2014 and 2015, offset in part by a rise in private housing new build and in ‘other’ new work.

There remains a considerable risk that, as activity returns to more normal levels, the Construction sector will continue to have a dampening effect on overall growth through 2017.

North Sea (offshore) oil and gas activity

With the oil price recovering to some extent and with production rising, there may be hope of a boost in 2017 for those industries badly affected by the recent decline in the North Sea’s fortunes. However, the extent to which this happens remains highly uncertain.

Financial Services

For the first year since the financial crisis ‘Financial and Insurance activities’ grew substantially in 2016, up 9%. This was considerably more than the rise seen for the UK as a whole (2%). It is unclear why last year turned out to be such a good year for this sector.

Longer Term Overview (see Table 1)

Table 1 illustrates how growth in UK GDP has been faster than in Scotland since the start of 2015 in every major sub sector bar Financial Services and Public Sector Administration.

If the fast growing Construction sector is excluded then this widespread underperformance extends back over the last 3 years. As a result it is not simply the down turn in North Sea activity that has resulted in Scotland's poor performance of late.

Potential impact on the Scottish Budget of a continuation in the current, relatively low, Scottish GDP growth rate (see Table 2 and Annex 1)

If Scotland's low GDP per capita growth rate was to be maintained, then there would be consequences for the Scottish Budget. In particular, it would highlight the affect of faster or slower growth on the Budget as a result of moving to a more devolved system of taxation.

Lower economic growth translates into lower growth of tax revenues. This will be the case in both the current intended set up (i.e. control of most Income Tax revenues) or under full independence. The principal difference is that Income Tax accounts for about 8.5% of Scottish GDP, whereas all taxes account for around 36% of GDP, so in the latter case the impact will be greater.

Table 2 illustrates the potential impact that a continuation of the growth differential will have, year by year and in cumulative terms. It is based on the calculations shown in Annex 1, which looks at two scenarios, first Scottish growth 0.5% slower than the UK and second 1% slower. By way of comparison, the GDP p.c. differential in 2016 was 0.9%, so the latter essentially continues this differential, while the former reduces it to half the level seen in 2016.

The figures in Table 2 illustrate how much less revenue is available to the Scottish Government than if the old 'Barnett formula only' system was still in place and in turn imply lower spending on public services. (Note: this does NOT mean falling revenues or spending, rather it implies slower growth in these sums the greater the degree of domestic (Scottish) tax devolution.)

Due to the cumulative effect of slower growth then after 5 years a differential of somewhere between £370 million (0.5% slower and IT only devolved) and just over £3 billion (1% slower and independence) is built up. Such a sustained slowdown, relative to the UK, seems unlikely but its potential effect highlights the need for the Scottish (and UK) Government to do everything in its power to help improve growth.

(Note: If the reverse were to occur, i.e. if the Scottish economy were to grow relatively faster than the UK economy, then the Scottish Government would be relatively better off in terms of tax revenues. Such a scenario is likely to represent the position of pro-independence supporters in any second independence referendum. However, at present, the likelihood is greater that the current under performance continues.)

Table 2: Cumulative impact on Scottish tax revenues of a slower Scottish GDP p.c. growth rate

	2016-17	***2017-18***	***2018-19***	***2019-20***	***2020-21***	***2021-22***
0.5% differential						
Income Tax only	0	-64	-132	-206	-285	-369
All Taxes	0	-128	-264	-410	-565	-732
1.0% differential						
Income Tax only	0	-270	-560	-872	-1,206	-1,564
All Taxes	0	-540	-1,118	-1,735	-2,395	-3,098

Sources: see Annex 1

Quotes:

"*2016 has been a very disappointing year for the Scottish economy. This is in part due to the impact onshore of the decline in offshore North sea activity, although other, less well understood, effects may also be at play. While this situation is a worry on its own, the concern is compounded by the potential impact on the future Scottish Budget if such a poor performance is maintained, given the new Scottish government tax powers.*

As a result, it is imperative that such a poor performance is remedied as soon as possible. However, the current uncertainty based around both Brexit and a second independence referendum, suggests that stronger, rather than weaker, headwinds await."

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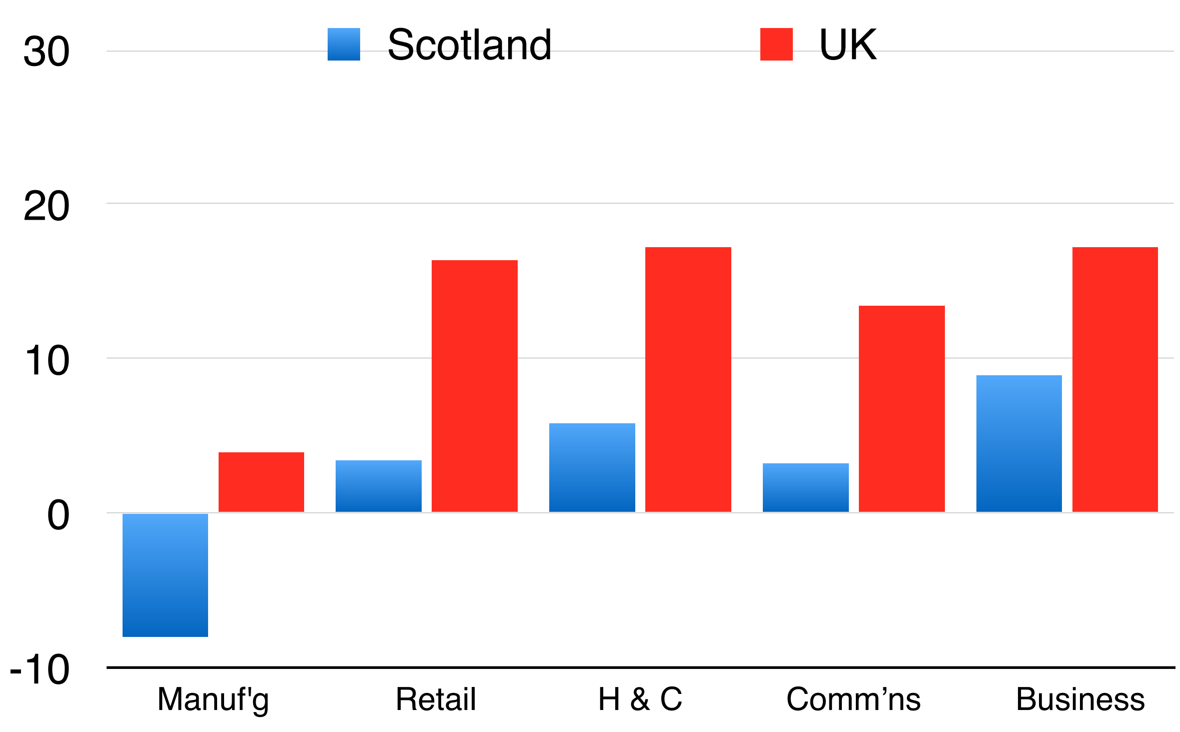
Figure 1: 'Active' economy components relative growth rates, 2013Q4 to 2016Q4



Source: Scottish GDP, Q4 2016 release, Scottish Government.

Table 1: Economic growth comparison: Scotland and the UK, % change

	% change since 2013 Q4			% change 2015 Q1		
	Scotland	UK	Difference	Scotland	UK	Difference
GDP*	4.3	7.9	-3.6	0.4	3.3	-2.9
GDP per capita*	3.3	4.9	-1.6	0.0	2.1	-2.1
Active Economy**	1.9	13.2	**-11.3**	-1.1	6.7	**-7.8**
By main sectors:						
- Manufacturing	-8.0	3.9	**-11.9**	-10.0	1.2	**-11.2**
- Construction	27.0	13.8	**13.2**	-1.2	3.5	-4.7
- Services	4.3	9.5	**-5.2**	2.4	4.9	-2.5
Of which:						
Private sector						
- Wholesale & Retail	3.4	16.3	**-12.9**	2.7	8.9	**-6.2**
- Hotels & Restaurants	5.9	17.2	**-11.3**	1.8	9.6	**-7.8**
- Transport & Comm’ns	3.2	13.4	**-10.2**	-0.3	7.2	**-7.5**
- Financial Services	5.2	3.3	1.9	7.8	1.0	**6.8**
- Business Services	8.9	17.3	**-8.4**	3.2	8.0	-4.8
- Other Services	3.7	12.6	**-8.9**	3.2	6.9	-3.7
Public sector						
- Admin & Defence	-3.9	-5.2	1.3	-1.4	-3.4	2.0
- Education	0.8	2.2	0.2	0.3	0.5	-0.2
- Health & Social Work	4.8	7.4	-2.6	1.6	6.0	-4.4

Sources: Scottish Government GDP release (April 2017); ONS UK National Accounts.
* Excluding extra regio (mainly North Sea related) activity.
Colour Code for end column: Orange = UK very much (>5%) better than Scotland; Green = Scotland very much (>5%) better than the UK.

Annex 1: Detailed scenarios for Scottish GDP and tax revenues, £ billion

Scenarios	*2016-17*	*2017-18*	*2018-19*	*2019-20*	*2020-21*	*2021-22*
GDP I (4%pa)	150	156	162.2	168.7	175.5	182.5
- growth £,bn		6	6.2	6.5	6.7	7.0
GDP II (3.5%pa)	150	155.25	160.7	166.3	172.1	178.2
GDP III (3%pa)	150	154.5	159.1	163.9	168.8	173.9
Diff I-II		0.750	1.556	2.422	3.350	4.345
Diff I-III		1.500	3.105	4.821	6.652	8.607
IT Sc (8.5% of GDP)						
IT I	12.750	13.260	13.790	14.342	14.916	15.512
IT II	12.750	13.196	13.658	14.136	14.631	15.143
IT III	12.750	13.133	13.526	13.932	14.350	14.781
Diff I-II		0.064	0.132	0.206	0.285	0.369
Diff I-III		0.128	0.264	0.410	0.565	0.732
All Tax Sc (36% of GDP)						
All Tax Sc I	54.000	56.160	58.406	60.743	63.172	65.699
All Tax II	54.000	55.890	57.846	59.871	61.966	64.135
All Tax III	54.000	55.620	57.289	59.007	60.777	62.601
Diff I-II		0.270	0.560	0.872	1.206	1.564
Diff I-III		0.540	1.118	1.735	2.395	3.098

Sources: tax share estimates taken from the latest edition of GERS

Notes:

1) **Annex 1 illustrates the impact on Scottish tax revenues of GDP growing at 4%, 3.5%, and 3% (in cash terms). On the assumption that the UK economy is growing at 4% (i.e. 2% in real terms and 2% inflation) then the lower growth rates estimate how much less tax revenue is available than if the old Barnett formula only system was still in place.**

2) **Income Tax (IT) in the table above, includes ALL IT, whereas currently only non-savings non-dividend (NSND) IT is devolved. As a result the figures slightly exaggerate the impact that a relatively slower growth would have.**