SCOTTISH TRENDS

(Press Release - 6th June 2018)

Commentary on recent reports of Scottish economic and fiscal prospects

Over the last fortnight there have been three important releases in relation to the economic and fiscal prospects for Scotland:

- the SNP's Sustainable Growth Commission report;
- the Scottish Government's first Medium Term Fiscal Strategy report;
- the Scottish Fiscal Commission's latest Economic and Fiscal Forecasts report.

Each has been a valuable addition to the on-going debate about the state of the Scottish economy and Scotland's public finances and how they might change over time.

However, in each case there have been areas of the reports that have been less than clear or whose conclusions have been under-reported. This commentary concentrates on a few of the more important omissions and attempts to clarify what is going on.

SNP's Sustainable Growth Commission report

It is perhaps unsurprising that a 354 page report leaves some queries over parts of its contents. In particular there has been confusion over two central points with regards to the public finances (Part B of the full report) if Scotland becomes independent.

Scale of public expenditure growth in the 10 year transition period

Part B of the report lays out in some detail what needs to happen for Scotland to move to a more stable state with respect to its fiscal position. Moving from a deficit of almost 6% in 2021-22 to one below 3% within a decade.

This is a prudent course of action but it clearly involves a tighter fiscal strategy over this period than is likely for the rest of the UK. The Office for Budget Responsibility (OBR), currently expects the UK to have a deficit equivalent to 2.3% of GDP in 2021-22 and falling, which should allow for an easing in public expenditure settlements over time. Meanwhile Scotland will be moving from a deficit equivalent to nearly 6% of GDP towards a 3% target. It doesn't take a mathematical genius to work out the implications.

Note that, as the report states, this does not mean that public spending will not be growing in real terms, year-on-year, simply that it is likely to be growing at a consistently slower pace than seen at the UK level. Whether this is labelled as some form of relative austerity or not, the key point is the, inevitable, slower rate of growth during this phase.

Some legitimate qualifications to the above apply:

- if Scottish GDP growth is stronger, as anticipated in Part A of the report, then the effect is lessened;
- a fiscal boost may be introduced if growth continues to disappoint, but that simply delays the period of transition.

Neither of these points alters the general conclusion that, in order for the transition to succeed, a lower rate of growth in the public sector budget than is seen for the rest of the UK will be involved.

Scale of public sector debt after independence

Part B of the report also claims that an independent Scotland would have a debt to GDP ratio cap of 50%. In doing so it assumes that no UK debt will be inherited by Scotland but that Scotland would make an annual payment with respect to UK debt interest, at a level consistent with its notional (population) share of the level of UK debt.

This seems an odd way of going about things. Surely if such a payment is being made then the debt itself should also be recognised, even if it is of a different kind to the new debt being built up in an independent Scotland. It seems highly likely that this is how the markets and the EU, for example, would see it.

What would happen to the debt-to-GDP ratio of this path were followed? The report is not entirely clear but some of the data contained within it suggest a ratio of around 90% of GDP by 2031-32. This consists of the debt built up post independence (36% of GDP by 2031-32 according to the report) and the population share inherited. The latter is more difficult to calculate but looks likely to be around 50-60% of GDP. (Note: this figure can be implied from the size of the annual debt interest payment, £3 billion a year, and the assumed interest rate that applies, 2.83%, and also by the assumed £90 billion net position (all outlined on page 15 of Part B). However, determination of such figures remains unclear in places. For example, how debt owed to the Bank of England, as opposed to market issued debt, is treated in such figures.)

It is also interesting to note that while the Scottish debt-to-GDP ratio for Scotland is rising over the decade to 2031-32, for the rest of the UK the OBR expect the debt ratio to be falling, having peaked in 2017-18, at 86%.

In both of the above cases the lack of clarity is unusual in a report which, in general, is notable for its willingness to confront difficult decisions.

Taking the two points made up above together, it is clear that the transition period envisaged will involve (i) lower annual public spending settlements than within the current system and (ii) a debt-to-GDP ratio that is rising rather than falling and an annual deficit that remains larger than for the rest of the UK.

However, such a scenario need not be a problem for an independent Scotland, so long as markets and investors believe in the strategy that is in place to move to a sustainable debt and deficit position, which is exactly what the full report outlines.

Scottish Government’s first Medium Term Fiscal Strategy (MTFS) report

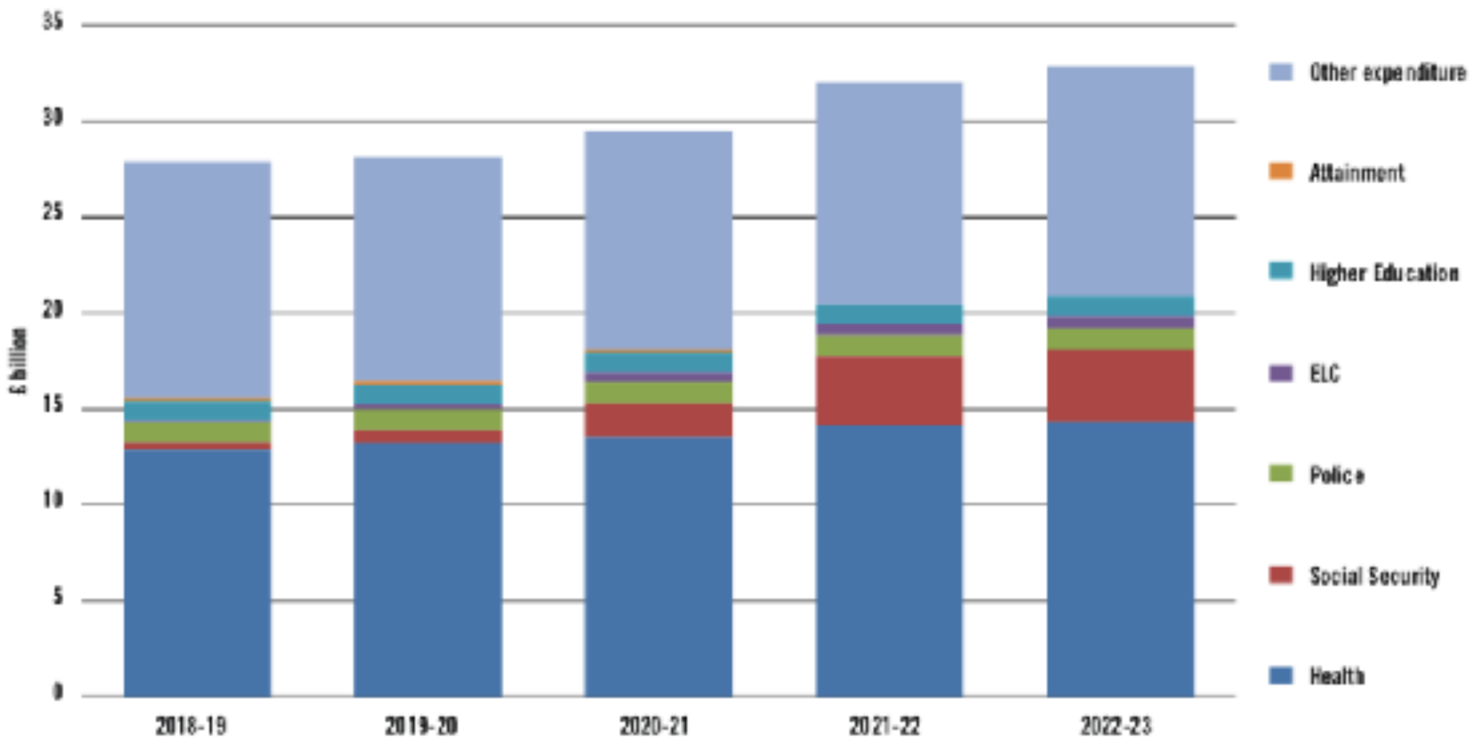
The MTFS outlined intended spending decisions for the next 5 years, to 2022-23.

In doing so it highlighted six areas of spending priority within the Resource Budget (which is the budget for day-to-day spending and which dominates the overall Budget). These are: Health; Police; Early Learning and Childcare; Higher Education; Attainment; and Social Security.

However, these six areas account for well over 50% of the resource budget, and growing. As a result, non-prioritised budgets (like Local Government, Further Education, Economic support, Courts etc) will need to carry the burden of any future cuts.

As the Chart below (taken from the MTFS report, see page 61) shows, this means that non-prioritised public services experience no cash terms increase over the next five years. (This can be seen as the top block (Other expenditure) remaining unchanged at around £12 billion.)

CHART 7.1 – RESOURCE EXPENDITURE CENTRAL SCENARIO



Furthermore if the Scottish Government’s lower range scenario comes about then, as the six priority areas are still protected, the non-prioritised areas will see annual cash terms cuts over the next five years.

Scottish Fiscal Commission’s latest Economic and Fiscal Forecasts report

In their latest report the Scottish Fiscal Commission (SFC) now forecast **GDP growth** of under 1% for the foreseeable future, that is at least until 2022-23. Previously the SFC had anticipated the modest 1% barrier being broken through by 2021-22.

However, even the sustaining of just under 1% is reliant on Scottish productivity climbing back from zero to over 1% a year and managing to counteract the slowing in employment growth. This too at a time when the OBR forecasts UK productivity to be recovering more slowly. Clearly there are downside risks in such a productivity revival occurring much faster in Scotland.

As a result of these trends GDP per capita in Scotland is forecast to pick up over the forecast period while it falls for the UK. A hopeful state of affairs.

On **wages**, the SFC highlight a worrying differential between Scotland and the UK. The SFC forecast that, on average, Scottish wages fell in real terms in 2017 and will do so again in 2018 and with no growth in 2019. This contrasts with a return to real wage growth at the UK level in each year. In effect Scottish wages will not surpass their 2016 level until 2022.

This divergence in performance is worrying and difficult to explain at present. The forecast by the SFC of a return to near parity with the UK is based on a shift back to past averages but is by no means certain.

Table 1: Scotland (SFC) vs UK (OBR) latest forecasts

Variable	Country	2017	2018	2019	2020	2021	2022
GDP	Scotland	0.8	0.7	0.8	0.9	0.9	0.9
	UK	1.7	1.5	1.3	1.3	1.4	1.5
GDP per capita	Scotland	0.2	0.3	0.5	0.6	0.6	0.7
	UK	1.1	0.9	0.7	0.7	0.8	0.9
Real wages	Scotland	-1.0	-0.5	0.0	0.2	0.6	0.9
	UK	0.5	0.5	0.6	0.6	0.8	1.0

Source: SFC, Scotland’s Economic and Fiscal Forecasts, May 2018; OBR, Economic and Fiscal Outlook, March 2018

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