FRASER OF ALLANDER INSTITUTE

# *Quarterly* ECONOMIC *Commentary*

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# *Fraser of* ALLANDER *Institute*

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# *Quarterly*
# ECONOMIC
# *Commentary*

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# *Outlook* AND *Appraisal*

The latest data on output growth in Scotland's production and construction industries are interesting to read. In the fourth quarter of 1997, output in production and construction (less oil and gas) grew by 0.8% compared with a 0.4% fall in the UK. The production industries expanded by 1.1% in Scotland but contracted by 0.9% in the UK, while manufacturing output rose by 1.7% compared to a fall of 0.5% in the UK. At this aggregated level, only the construction sector performed less well in Scotland, contracting by 0.3% while the sector expanded by 1.4% in the UK. The annual data for 1997 are just as encouraging. Output in the production industries expanded by 7.5% in 1997 compared to 1.4% in the UK. Manufacturing output rose by 7.7% in Scotland while rising by only1.5% in the UK. However, in construction the UK performance was superior with the sector growing by 2.3% as against 1.4% in Scotland. We agree with Scottish Industry Minister Brian Wilson that "this represents a very impressive performance by Scottish industry." However, we are concerned that the recent strong performance of the Scottish economy masks significant structural problems within the economy, which require sustained policy intervention. A failure to make this clear runs the risk that the apparent economic "renaissance" will be used by other nations and regions of the UK to argue for a lower level of funding for the Scottish Parliament than the current Scottish Office block.

### A Comparative View of the Scottish Economy

Recent aggregate data appear to support the view that the Scottish economy has ceased to be an economic problem region of the UK. In Scotland GDP per head, the conventional measure of economic well being, has traditionally lagged behind the UK. However, since 1987 per capita GDP relative to the UK has risen from 94.7 to just below par in 1995. As Figure 1 indicates, the same has not happened in Wales, the North East and the North West of England. In the North East, the relative remained static at 85.7. In the North West (including Merseyside), the relative fell from 95 to 91.3, while in Wales the fall was from 86.4 to 83.3.

Certain data for the labour market also appear to sustain the view of relative buoyancy in the Scottish economy. The Scottish activity rate, which shows the share of the adult population that is in employment, self-employment and training, stood at 62.6% in 1995 and was much the same as the UK rate of 62.5%. The Welsh rate, on the other hand, was considerably lower than both at 57.1% (Figure 2). The Scottish job ratio, which measures full-time equivalent work as a proportion of the population of working age, stood at 61% in the same year, only slightly below the UK rate of 63% but above the Welsh rate of 58% (Figure 3). When earnings and household income are considered the Welsh position also compares very unfavourably with Scotland. For average male/female full-time weekly earnings Scotland stood at 94%/94% of the UK figures and ranked 3rd/2nd respectively out of the 11 UK regions. Wales, in contrast, stood at 89%/91% and ranked 10th/10th respectively. Similarly, while household income in Scotland averaged 93% of the UK average between 1993-95, the Welsh figure stood at only 86% of the UK average.

It is data such as these that have led some commentators outside Scotland to call for a review of the Barnett formula. The formula allocates government expenditure[i] to Scotland, Wales and Northern Ireland on the basis of changes in departmental spending in England weighted by the respective 1991 population ratios in the territories. Identifiable government expenditure per head of the population in Scotland has been consistently above that in Wales. While the gap has narrowed following the adjustment of the Barnett formula in 1991 to reflect the decline in Scottish and the rise in Welsh populations since 1978, the gap still remains fairly wide. In fiscal year 1996-97 Scotland received 119% of the UK spend per head while Wales received 114%. So, in a recent monograph Mackay *et al* (1997) argue that the formula should be adjusted ".... to reflect (the) improvement in Scotland's level of prosperity relative to England and Wales." [ii] (p.31).

Two general responses can be given to the view that Scotland receives more than its fair share of public spending. First, indicators of economic well being, such as GDP per head and the labour market indicators discussed above, are poorly correlated with the *need* for public spending. Differences between areas in demographic structure, the spatial distribution of population, the incidence of social deprivation, sickness rates, participation in secondary and higher education etc, are much more strongly related to need than indicators of economic performance. And in the Scottish case, the level of relative need as defined by these social and demographic indicators is higher than is apparent from the aggregate economic data. Secondly, GDP per head and other aggregate economic data have serious weaknesses as indicators of economic well being.

### Deconstructing Scotland's Relative Economic Performance

A sense of the inadequacy of changes in relative GDP per head as an indicator of economic well being is provided by the data presented in Figures 6 and 7. Figure 6 charts the relative growth of GDP in the peripheral regions of Britain between 1987-95. Scotland grew slightly more quickly than the UK at a relative of 104, while the North East of England and Wales grew somewhat more slowly at 96% and 94% respectively. Only the North West of England could be described as laggard with an overall growth performance of 88% of the UK figure. So, faster GDP growth does appear to have contributed to the rise in Scotland's GDP per head relative. However, this is not the whole story. Figure 7 illustrates net migration as a percentage of working population from the peripheral regions of Britain over the period 1979 to 1993. From this figure it is clear that the decline in the Welsh GDP per head figure and low activity/job rates, is just as much to do with the net *in*-migration experienced by the Principality as low overall GDP growth. During the period Wales experienced net in-migration amounting to 1.1% of its working population in 1979. Scotland, on the other hand, lost population through migration at a faster rate (-4.3%) than any of the other areas. So, part of the rise in the Scottish GDP per head relative is due to faster net out-migration, *an indicator of relative economic disadvantage*. A further point to note here is that many in-migrants to Wales are retirals from England and elsewhere who bring their wealth and pension income with them. In consequence, they are not dependent on Welsh GDP, yet their arrival depresses the GDP per head figure.

Some interesting insights are also provided by a sectoral disaggregation of the economic performance of Scotland and Wales. Between 1987 and 1995, financial and business services made the greatest contribution to GDP growth in both Scotland and Wales, at 27% and 29% respectively. The next most important contributor to growth in both countries was the manufacturing sector. However, while manufacturing grew at about the same rate in Scotland and Wales, the sector contributed appreciably more to Welsh GDP growth (27%) than to the growth of Scottish GDP (17%). What these data suggest is that Scotland's stronger GDP growth performance is a reflection of more broadly based sectoral growth. The Welsh economic problem must therefore in part be related to a lack of diversification in sectoral structure and growth.

In Scotland, the principal area of concern is the structure and performance of the manufacturing sector. While the sector is less significant to overall GDP than in Wales, it would be foolish to dismiss expressions of concern about manufacturing simply on that account. The main areas of concern about Scottish manufacturing are as follows:

- Despite the importance of electronics to manufacturing in Scotland, the sector has a smaller percentage of "modern" manufacturing sectors than Wales (67% of employment as against 81% in Wales)[iii].

- Investment per head in manufacturing in Scotland (£3,300) is less in Scotland than in Wales (£3,500) which in part reflects the bias towards more 'modern' sectors in Wales.

- The greater importance of 'traditional' manufacturing in Scotland where competition is largely on the basis of price rather than on product differentiation and innovation, makes the sector less able to withstand exogenous price and cost shocks. The damaging effect of the rise in sterling on Scottish textiles provides the most recent example.

- Productivity growth in manufacturing was higher in Wales than in Scotland between 1982-93 at rates of 6.8% and 3.8% per annum respectively. The Welsh rate was above the UK rate of manufacturing productivity growth of 4.9% per annum.

- The foreign sector is as important to manufacturing in Wales (23% of manufacturing employment) as it is in Scotland (22%) but between 1981-92 employment in foreign manufacturing grew by 12% in Wales while *falling* by 3% in Scotland.

- Scottish manufacturing is over dependent on the performance of the electronics industry. Scottish manufacturing has considerably outpaced UK manufacturing growing by 34% compared to 11% in the UK between 1992 Q1 and 1997 Q4. However, comparison of the relative performance of non-electronics manufacturing reveals a *contraction* of 3% in the Scottish sector compared to growth of 8% in the UK.

- R&D and product innovation rates in manufacturing in Scotland are lower than in other UK regions.

- New firm formation rates are also lower in Scotland, although there was a relative improvement in the overall VAT registration rate in Scotland relative to Wales and Northern Ireland between 1980-86 to 1990-96. However, there was a relative deterioration in new firm formation within manufacturing compared to the UK between the two periods.

This summary of some of the key indicators suggests that there is no room for complacency about the structure and performance of Scottish manufacturing. Moreover, when combined with the above analysis of movement in Scotland's GDP per head relative there would appear to be some doubt about the extent to which Scotland's underlying economic prosperity has improved relative to the UK and even Wales.

25 June 1998.

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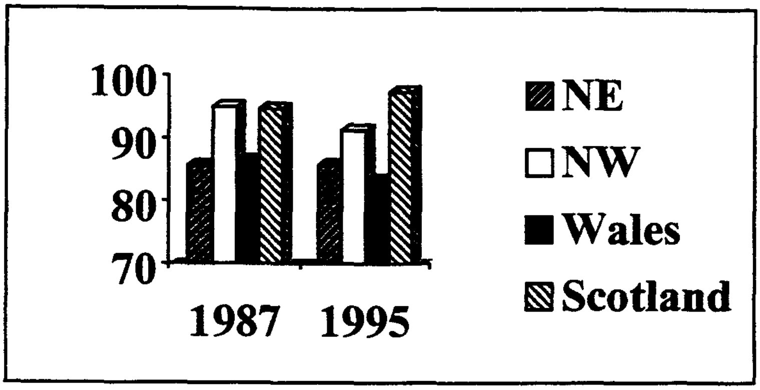
[i] Strictly spending that is part of the block administered by the Secretaries of State in Scotland, Wales and Northern Ireland. This block is less than total public spending in the territories. For example, social security spending is not included in the block since it is the responsibility of the UK Secretary of State for Health and Social Security. In addition, in Scotland and Wales, items not included in the block include national and regional expenditure on agriculture, fisheries and food and spending on industry, energy and employment.

[ii] Mackay, R. *et al* "The Economic Impact of the Welsh Assembly", Institute of Welsh Affairs, Cardiff, 1997.

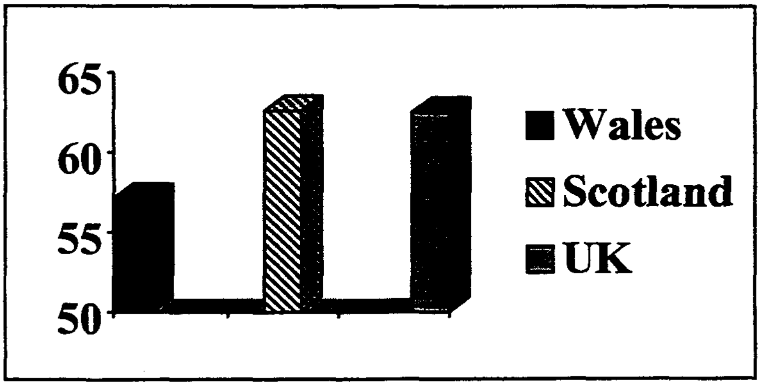
[iii] The "non-modern" or other sectors are defined as food, drink & tobacco, textiles, leather and wood products.

## Figure 1: GDP per Head Relative to the UK in 1987 and 1995 (UK=100)



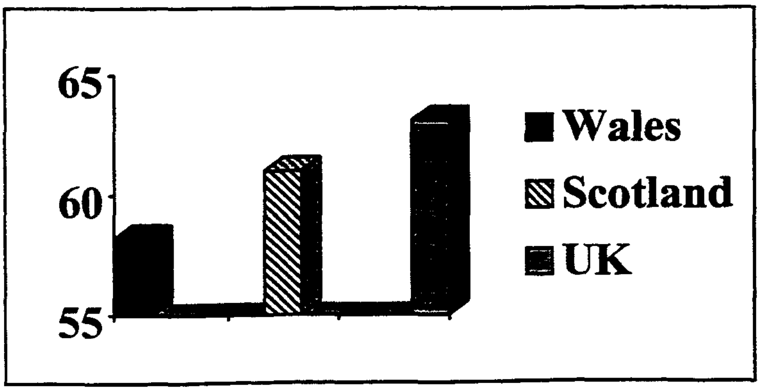

*Source: Regional Competitiveness Indicators, DTI, 1997*

## Figure 2: Activity Rates in 1995 (Percentages)



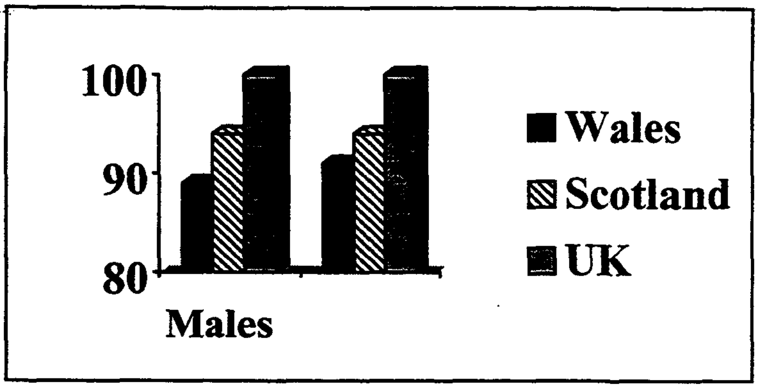

*Source: Regional Trends*

## Figure 3: Job Ratios in 1995 (Percentages)



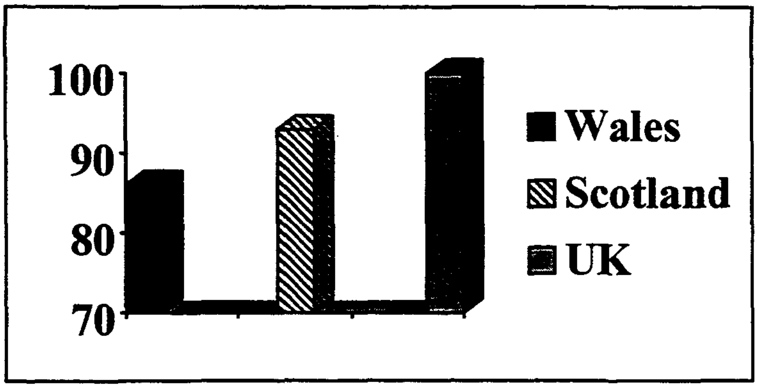

*Source: Regional Trends*

## Figure 4: Earnings Relative to the UK in 1995 (UK=100)



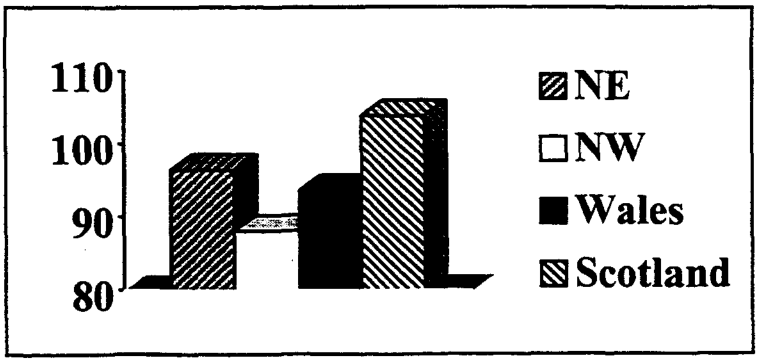

*Source: Regional Trends*

## Figure 5: Household Income Relative to the UK in 1995 (UK=100)



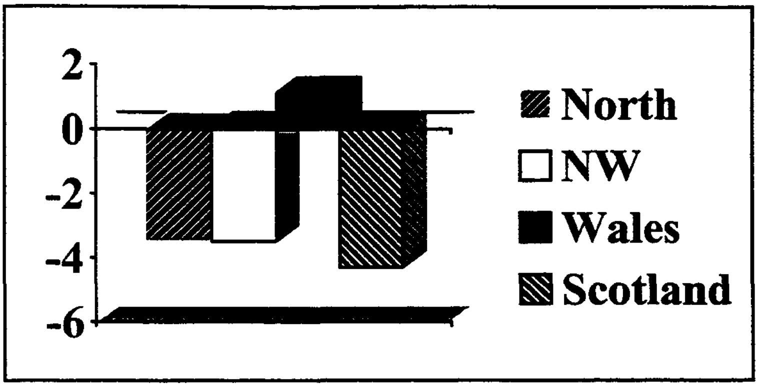

*Source: Regional Trends*

## Figure 6: GDP Growth 1987-95 (UK=100)




*Source: Regional Trends*

## Figure 7: Net Migration 1979-93 (Percent of 1979 Working Population)




*Source: Gudgin (1995).*