Outlook and appraisal

Overview

Scottish economic growth continues to match growth in the UK and has done so as UK economic growth improved from the first quarter of 2005. Normally, Scottish economic growth would be expected to be stronger relative to the UK in a downturn and weaker in an upturn due to a flatter growth cycle. This picture of relative buoyancy is clouded by an effective downturn in Scottish service sector performance in the final quarter of last year. There has been a relative strengthening of manufacturing output growth in Scotland and business surveys suggest that this continued into the first half of 2006. But this improvement in orders and output concerns firms that remain in production and clearly does not include those electronics firms that announced cutbacks and closures of plants during the first quarter of the year.

Our forecasts for 2006 and 2007 are based around a scenario of a weak but continuing improvement in manufacturing growth as export prospects improve. The difficulties of the service sector at the end of last year are expected to be overcome, with domestic demand relatively strong reflecting the comparative strength of the Scottish housing and labour markets. Scottish growth broadly keeps pace with the UK in 2006 and 2007 with an expected outturn of 2.1% and 2.3%. Potential instability in the world commodity and financial markets could threaten this relatively sanguine picture.

GDP and Output

Scottish Executive GVA data for the final quarter of last year continue to suggest overall that Scottish economic growth continues to match, indeed slightly out perform, UK growth. During the fourth quarter Scottish GDP at basic prices rose by 0.61% compared to growth of 0.56% in the UK. For 2005 as a whole Scottish and UK GDP growth were the same at 1.75%. A further indication of the comparative performance of the Scottish economy, as shown in Figure 1, is that it continues to outperform its quarterly average since 1998 of 0.46%, whereas the UK economy is underperforming its 0.64% quarterly average growth rate. What is fairly heartening for Scotland is that Scottish GDP growth has kept up with UK GDP growth as UK economic growth has improved from the first quarter of 2005. Normally, Scotland has a flatter growth cycle, holding up well in a UK downturn and picking up less well in an upturn. Whether this continues, however, if growth in the UK economy continues to improve, remains to be seen.

What clouds the picture of buoyant Scottish performance is the weakening of the service sector during the fourth quarter while growth in the sector in the UK strengthened – see Figure 2. The growth of Scottish services fell from 0.98% in the third quarter of last year to 0.65% during the final three months, below its quarterly average since 1998 of 0.72%. Growth in UK services, in contrast, went from 0.83% to 0.91% in the two periods, above the quarterly average of 0.84%. During 2005, overall service sector growth was a fairly robust 2.8% in both Scotland and the UK. But the concern must be that Scottish services is weakening, after three quarters of successive improvements while UK service growth continues to blossom. We must await further data to see whether the faltering in services is simply a one-off 'blip' or whether it represents something more permanent. One would hope that the continuing comparative strength of the Scottish housing and labour markets would sustain high street spending and strong service sector performance.

However, in the fourth quarter both retail & wholesale and hotels and catering were weaker in Scotland growing at 0.1% and –0.9%, respectively, compared to 1.1% and 1.5% in the UK. The performance of real estate & business services was also weaker in Scotland at 0.6% compared 1.2% during the fourth quarter in the UK. Conversely, other services grew by 3.2% during the quarter in Scotland with the sector growing by only 0,3% in the UK. But over the year, other services in the UK grew faster at 4.4% compared to 2.9% in Scotland. Two other service sectors – from the 8 for which data are published – out performed their UK counterparts: transport, storage & communication (1.6% in Scotland, 1.4% in UK) and financial services (0.7% compared to 0.5%.)

With weaker Scottish service sector performance during the fourth quarter, the broadly similar overall GDP performance in Scotland and the UK reflected stronger construction and manufacturing sector growth. Construction grew by 2.1% here compared to 1% in the UK and in 2005 the outturn performance was also higher in Scotland at 1.3%: UK 1.1%. However, construction only accounts for around 6% to 7% of the economy, so it was the more robust performance of manufacturing – 16% of the economy in GVA terms – that ensured comparable GDP performance overall.

Figure 3 indicates that manufacturing again contracted in Scotland during the fourth quarter, by 0.2%, but UK manufacturing cut back output by 1.1%. UK manufacturing had been recovering in the previous two quarters and in the third quarter had achieved some positive growth (0.3%). The setback in UK manufacturing in the fourth quarter parallels the deterioration in electronics performance in the UK in the quarter. As Figure 4 shows, electronics output fell by 2.8% in the UK compared to 0.4% in Scotland. But other Scottish manufacturing sectors also did well in the fourth quarter. Food and drink, which now has a weight comparable to electronics, grew by 1% in Scotland compared to a fall of 0.6% in its UK counterpart. Chemicals grew by 2% in Scotland compared to 0.4% in the industry in the UK, while metals & metal products grew by 3.9% as the sector stagnated in the UK.

The relative strengthening of Scottish manufacturing performance is to be welcomed but with the weakening of service sector performance questions must be raised as to how much longer Scottish growth can keep pace with the UK.

Financing Scottish Devolution

There is growing interest across the political spectrum in the question of the appropriateness of the current funding arrangements for Scottish devolution with the present Barnett-based system increasingly being called into question.

Scotland's public spending per head has tended to be significantly higher than in England. The Barnett Formula allocates to Scotland a population based share of increments to public spending on comparable programmes in England. Given that spending per head is higher here, and in Northern Ireland and Wales, the strict application of the formula should eventually bring about convergence of spending per head levels between England and the devolved territories. English critics of the present funding system focus on the higher levels of spending in the devolved areas, while concern exists in Scotland, Wales and Northern Ireland that the continuing operation of the formula will drive relative spending below needs. Others worry that the present system does not encourage economic efficiency and growth and leads to a burgeoning public sector.

In the light of this, the leader of the Liberal Democrats, Sir Menzies Campbell, has recently argued for Barnett effectively to be replaced by a needs-based approach to funding the devolved territories. The Liberal Democrat *Steel Commission*, which reported this year, argues the case for a new fiscal settlement for Scotland based on fiscal federalism. The new funding framework would be set within the context of a redefined constitutional relationship with further devolution of powers from Westminster to Holyrood. The specifics of all of this would be decided in a new cross-party Constitutional Convention, which would seek to build a consensus on the way forward. The Labour Government in London is also reported[i] to be considering a review of Barnett in the not too distant future. The Scottish Conservatives have expressed support for the notion of fiscal autonomy for Scotland, while the SNP have re-iterated their belief that "the only change from the Barnett Formula acceptable to Scotland is full fiscal autonomy with the full responsibility for Scotland's resources and spending."[ii]

Against this background, there is clearly a need for further objective research, analysis and informed comment on the appropriate funding options for Scotland, including an assessment of the status quo.

In this issue of the *Commentary* we publish a paper by Ashcroft, Christie and Swales (ACS) of the Fraser of Allander Institute and Centre for Public Policy for the Regions, which seeks to expose the flaws and myths in the case for Scottish fiscal autonomy. That case received strong support in a paper published in May under the auspices of the Policy Institute by Paul Hallwood of the University of Connecticut and Ronald MacDonald of the University of Glasgow (H&M).

ACS contend that H&M signally fail to establish a case for fiscal autonomy in Scotland, and that the arguments deployed in their previous work for the Allander Series in favour of a form of fiscal federalism in Scotland do not, as they suggest, have even greater force in the case for fiscal autonomy within the Union.

ACS compare fiscal autonomy with the present Barnett-based system of funding the Scottish parliament using a standard set of criteria for an efficient and effective fiscal system at the sub-central government (SCG) level. Their analysis suggests that there is little difference between the two systems in terms of static economic efficiency but that under fiscal autonomy the incentive to politicians to grow the economy is different and may be greater. But even here ACS introduce several caveats that throw doubt on the inevitability of faster growth under fiscal autonomy, both from a theoretical standpoint and in terms of the evidence. Any improvement in growth, if it were achieved, would be bought at the heavy price of the loss of the stabilisation and equalisation benefits that flow from being part of an integrated UK economy.

Under fiscal autonomy the structural budget deficit as charted in successive Government Expenditure and Revenue in Scotland reports would cease to be financed by the UK government. Current levels of benefit from public expenditure in Scotland could only be met by higher taxes or would fail to be met through public expenditure having to be lower. Stabilisation benefits following an economic downturn, such as increased social protection payments, and reduced income tax and corporation tax outlays, would be lost. The Scottish economy would become more cyclically unstable under fiscal autonomy, with all the implications that would have for investment intentions and growth.

Added to these economic consequences are several key political and administrative implications of introducing fiscal autonomy that would have economic and fiscal consequences. These include the issues surrounding the resource transfer from Scotland to the UK that would have to be paid under Scottish fiscal autonomy for the public or merit goods, such as defence and foreign affairs, which remain UK-wide; the question of how to apportion the repayment of existing and new UK-wide debt; and complications to the West Lothian Question as more responsibilities are effectively shifted to Scotland e.g. for social protection payments diminishing further the responsibility of UK MPs for Scottish matters, while allowing Scottish MPs unchanged responsibility for English affairs.

ACS conclude that their analysis suggests that in adopting fiscal autonomy Scotland would lose many of the benefits of economic and fiscal integration with the rest of the UK for little or no gain compared with even the present system of financing Scottish devolution. It is therefore not surprising that in their earlier work Hallwood and MacDonald (2004 and 2005) could not identify one example of an advanced federal or devolved country that had opted for fiscal autonomy at the sub-central government (SCG) level.

Fiscal decentralisation is another matter. But, as ACS also note, some of the claimed advantages of fiscal federalism

may not be as robust as asserted by its proponents so that further research is advisable before serious consideration is given to the adoption of new funding arrangements for Scotland.

Outlook

Growth remains strong in the world economy. Inflationary pressures are muted but sufficient to prompt some monetary authorities to raise interest rates. High oil and commodity prices run the risk of feeding into wages and precipitating an inflationary spiral, but little sign of this is evident across the major economies. Japan is beginning to exhibit strong growth, with strong growth in China and the rest of Asia being maintained while the Euro area is expected to grow above trend in 2006 and 2007. Stronger growth on the European mainland will benefit UK and Scottish exporters in particular.

Recent surveys indicate that the benefit to UK exporters is being realised with foreign orders rising. Net exports are expected to contribute modestly to UK growth over the next two years after a largely neutral contribution in 2005. The contribution of public expenditure to growth will eventually begin to diminish as planned expenditure growth reduces. Further some slowing of consumers' expenditure must be anticipated as unemployment rises and the labour market slackens. Some pick up in investment might be expected as international trade opportunities strengthen. UK growth overall is expected to increase from 1.8% in 2005 to 2.3% this year and 2.5% in 2007.

Growth in Scotland is also expected to rise (See *Forecasts of the Scottish Economy*) in 2006 and 2007 in parallel with the rise in UK growth. Business surveys indicated strong growth in orders and output during the first quarter and optimism, or confidence, amongst Scottish businesses is high. A key cause of concern is the weakening of Scottish service sector performance and whether this will continue. However, the relative strengthening of Scottish manufacturing performance is to be welcomed and business surveys for the first half of the year suggest that the improvement in the fortunes of Scottish manufacturing may be continuing.

We continue to believe that the comparative strength of the Scottish housing and labour markets will sustain high street spending and buttress service sector performance, with manufacturing activity strengthening as trading opportunities, particularly in mainland Europe, increase. Accordingly, we now feel able to raise our GDP growth forecasts for 2006 and 2007 to 2.1% and 2.3%, respectively from 1.9% and 2.1% in our previous *Commentary*. Scottish growth parallels improvements in the UK but remains a little weaker. Net employment change continues with just under 17,000 and 21,000 net new jobs forecast in 2006 and 2007. Unemployment remains broadly stable at around 5.3% on the ILO count.

The main threats to this relatively sanguine picture over the forecast horizon stem from the risks of higher oil and commodity prices and instability in world financial markets, in response to the security situation in the Middle East and continuing current account imbalances. An increase in such instability will almost certainly worsen inflation prospects and damage growth.

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[i] *Sunday Times*, 25 June 2006.
[ii] Alex Salmond, quoted in Lib Dems back Scots cash review, BBC News Scotland website, 26 June 2006.

Figure 1: Scottish and UK Quarterly GDP Growth, 1998q2 to 2005q4

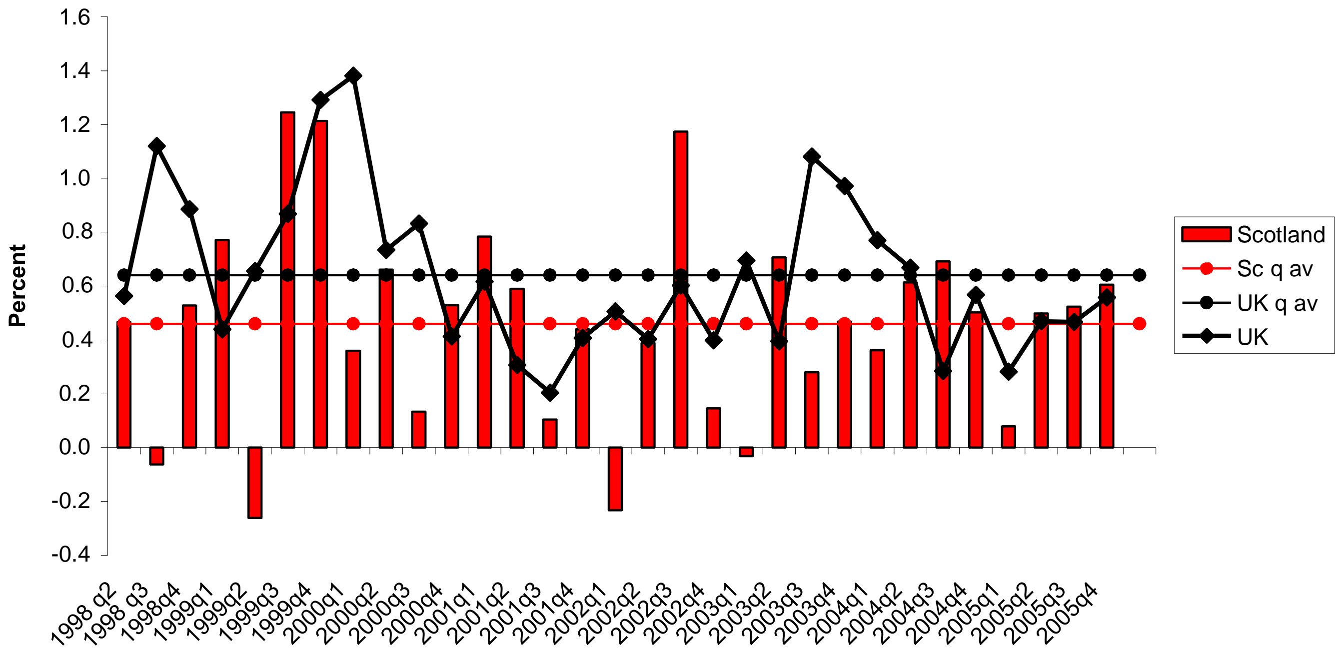

Figure 2: Scottish and UK Services GVA Growth at constant basic prices 1998q2 to 2005q4

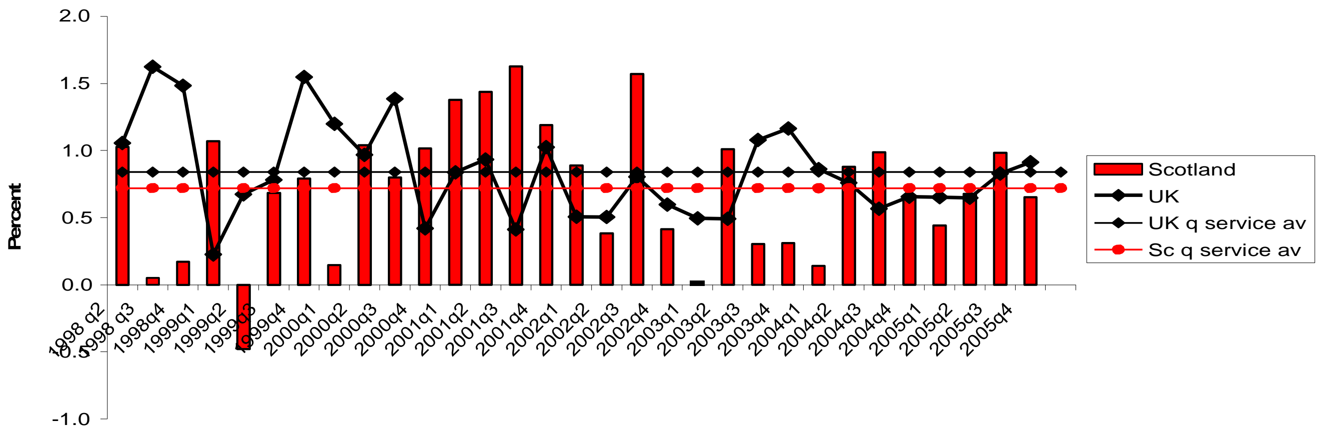

Figure 3: Scottish and UK Manufacturing GVA Growth at constant basic prices 1998q2 to 2005q4

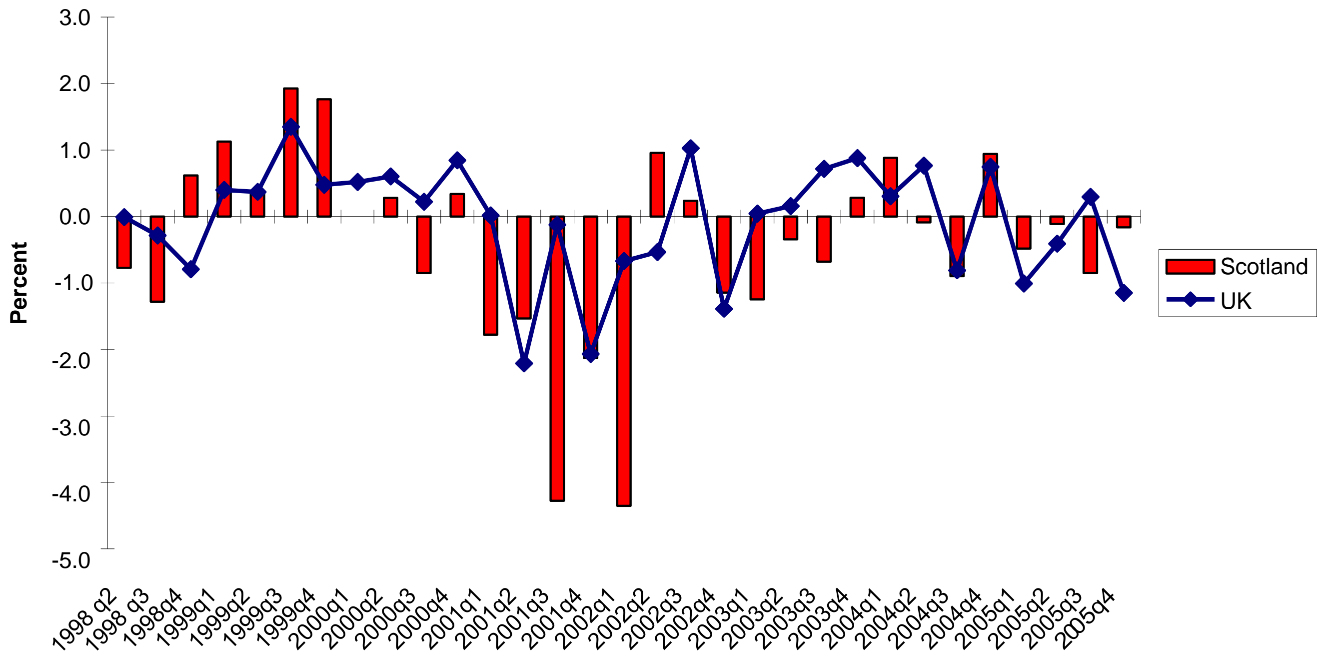

Figure 4: Scottish and UK Electronics GVA Volume Growth 1998q2 - 2005q4