

Outlook and appraisal

Overview

The Scottish economy weakened appreciably during the first quarter of this year. The growth of consumer demand is weakening in Scotland and the favourable position relative to the UK is closing. Rising energy and transport costs are the consequence of the surge in the price of oil and this disproportionately disadvantages Scotland, with its relatively large land mass and dispersed population outside the central belt. Manufacturing output continues to be weak and tradable services such as finance and business services have not picked up from weakness in the latter part of 2004. But the jobs market remains buoyant.

Against this background we continue to forecast somewhat weaker growth this year in Scotland compared to 2004 of 1.8% in 2005, 1.9% in 2006, and 2% in 2007. These forecasts for Scotland should be compared with UK forecasts of 2%, 2.3% and 2.6% for 2005, 2006 and 2007, respectively. Strong

net jobs growth is forecast to continue with increases of 27,000, 28,000 and 36,000 forecast for this and the next two years. This in turn has the effect that the outlook for unemployment is low and stable, with the ILO rate predicted at 5.3% this year, 5.2% in 2006 and 5.1% in 2007.

The scale and effects of public spending in Scotland is increasingly scrutinised. A paper in this Commentary by Jim and Margaret Cuthbert offers a constructive critique of the UK Treasury's country and regional analysis of public expenditure in PESA 2005. Using previously unpublished data obtained under the Freedom of Information Act they highlight a range of systematic errors in PESA, which have the effect of overstating general government expenditure in Scotland by £500 million, or 1% of aggregate expenditure and 1.5% of identifiable expenditure from 116.5 to 114.3 relative to UK. This analysis has implications for the Scottish Executive's estimates of Scotland's public expenditure, tax revenues and the fiscal balance between the two, serving to slightly lower the net borrowing estimate from 11.3% to 10.6% of GDP in 2002-03. This makes relatively little difference to the outcome of the GERS' estimates but we do share the Cuthbert's concern at the Scottish Executive's failure to adequately check its source data.

In this Outlook & Appraisal, we also scrutinise the estimates provided by Scottish Enterprise of public spending levels in the LEC areas of Scotland and its significance to economic activity in those areas. These estimates led Sir John Ward, Chairman of Scottish Enterprise, to assert that the public sector was at "Eastern Bloc" levels in areas such as Ayrshire.

Our examination concludes that in producing estimates of public sector spending in relation to gross value added or GVA in the LEC areas of Scotland, Scottish Enterprise have conflated three separate issues affecting such areas: first, the degree of *benefit* from public spending; second, the

relative scale of public activities, and finally, whether on account of this scale there are harmful, or crowding out, effects on private sector activity.

In relating public spending to GVA, Scottish Enterprise offer an indicator, which neither measures the benefit of public spending to residents, or measures the scale of public spending activity in relation to economic activity in the areas.

As an estimate of the scale of public spending to local area economic activity, their measure fails to compare like with like and tends to inflate the implied scale of the public sector and artificially deflate actual economic activity in some areas such as Ayrshire. Their measure of public spending does not adjust for imports, indirect taxes and subsidies, while their measure of economic activity would require the addition to GVA of an estimate of net income from outside the areas. Only with these adjustments would the two measures of public spending and area economic activity be compatible. Lack of data prevents the full reconciliation of the errors in the Scottish Enterprise measure.

The debate in the media surrounding Scottish Enterprise's (distorted) figures implied that crowding out effects of the public sector on the private sector were identifiable. This Outlook & Appraisal describes how the real risk of any public sector crowding out of private sector activity at the local area level is most likely to occur on the supply side. This is best measured by relative value added in the public sector to total value added, or given the lack of such data public employment relative to total employment. On this latter measure there is no evidence that the public sector dominates the LEC area economies of Scotland, with shares ranging from 32% down to 23%. However, this does not deny the case for a more efficient public sector, and a critical perspective on the public supply of certain goods and services.

GDP and Output

After growing faster than the UK in the second half of 2004, the latest data from the Scottish executive suggest that the Scottish economy weakened appreciably during the first quarter of this year. GDP, or gross value added in volume terms, remained flat in the first quarter compared to a rise of 0.4% in the UK (See Figure 1). Over the year to the first quarter, Scottish GDP grew by 2% while the UK economy exhibited growth of 2.7%.

The stagnation of Scottish GDP between January and March came as something of a surprise, since business surveys could be interpreted as suggesting positive growth in the first quarter, if weaker than in the final quarter of last year. The first quarter weakness of the Scottish economy cannot be attributed to a specific sector and was fairly generally spread. Manufacturing output fell substantially by 1.2% thus reversing the recovery of 0.7% experienced in the fourth quarter of 2004. However, UK manufacturing behaved similarly, contracting by 1% compared to an increase of 0.6% in the fourth quarter (See Figure 2). So, while the swing from recovery to contraction was slightly more pronounced in Scotland the direction was much the same as in the UK. In the service sector, output rose by 0.6% in the first quarter, which was only a little slower than the 0.7% rise experienced in the UK. But Scottish service sector growth slowed down from the 0.9% growth of the fourth quarter and the 1.6% growth exhibited in the third quarter last year. UK service sector growth, in contrast, picked up from the 0.6% expansion in the fourth quarter and growth of 0.7% between July and September of last year (See Figure 3).

Within services, we noted in the July Commentary that Scottish tradable services appeared weaker than in the UK in the fourth quarter. This would seem to have continued into the first quarter of 2005. The financial services sector was particularly weak in the first three months of the year contracting by 0.3%. This was mainly due to a fall of 2% in the estimated output of the Scottish banking sector, the first contraction of activity in the sector since the fourth quarter 2003. Financial services in the UK, in contrast, expanded by 1.3% in the first quarter. However, over the year to the first quarter Scottish financial services grew by 9.6% compared to growth of 4.4% in the UK. In addition, hotels & catering services in Scotland strengthened considerably in the first quarter, with output rising by 2.4% compared to no change in output in the sector in the UK. But over the year to the first quarter, the performance of the sector in the UK was stronger with activity rising by 4.2% compared to growth of only 0.8% in Scotland. Of the 8 service sectors for which quarterly data are produced only a further 2 sectors out performed their UK counterparts. Business services & real estate grew by 1.2% in Scotland compared to 0.7% in the UK. Although over the year, the sector was more buoyant in the UK with growth of 5.3% easily exceeding the performance of its Scottish counterpart of 3.2%. The retail & wholesale sector grew by 0.5% in Scotland during the first quarter compared to a small

contraction in UK retail sales activity of 0.1%. These outturn data provide some confirmation of the survey findings that the Scottish high street and retail sales have been holding up better than UK spending during 2005. However, over the year to the first quarter 2005, UK retail sales were stronger with growth of 3.8% compared 2.6% growth in the UK. Of the other sectors, transport & communication (0.1%), the public sector (0.2%) and other services (0.8%) were weaker than their UK counterparts in the first quarter, which grew at 1%, 0.6% and 1.5%, respectively.

Within manufacturing, the sub-sectors most responsible for the overall decline of 1.2% in the first quarter were engineering & allied, metals, drink, textiles and other manufacturing, which contracted by 1.9%, 5.2%, 2.7%, 3.1% and 0.4%, respectively. And within engineering, electronics further cut back production by 2.7% compared to a contraction of 3.4% in UK electronics. However, over the year to the first quarter, Scottish electronics suffered a fall of 5.1% compared to a rise of 1.6% in the sector in the UK. The main Scottish manufacturing sectors turning in a positive performance in the first quarter were the food industry, which grew by 4.2% compared to a small contraction of 0.1% in the UK, and the transport equipment sector which exhibited growth of 6.3% during the first 3 months of the year compared to a fall in output of 3.2% in the sector in the UK. Paper, printing and publishing grew by 0.4% in Scotland in the quarter while the sector cut back production by 1.9% in the UK.

Public Spending Data: Measurement and Use In this Commentary, we publish an article by Jim and Margaret Cuthbert, which offers a constructive critique of the UK Treasury's country and regional analysis of public expenditure. Their paper highlights the importance of getting estimates of public spending right, both in terms of accurate measurement, and the correct assignment to UK countries and regions in a post-devolution world. At the beginning of October, we also witnessed a debate in the Scottish media fuelled by statistics produced by Scottish Enterprise on the scale of public spending at the local area (Local Enterprise Company) level in Scotland. This debate highlights the care that is required in the use and interpretation of such data. We shall explain below how the widespread misinterpretation and misuse of the local public spending data engendered a debate that was, with honourable exceptions, uninformed and ultimately sterile.

UK Country and Regional Expenditure Analysis

Each year the UK government publishes its Public Expenditure Statistical Analysis (PESA), which contains an analysis of identifiable public spending in each of Scotland, Wales, Northern Ireland, and the regions of England. Identifiable expenditure is spending that is to the specific benefit of the residents of each country and region. Non-identifiable expenditure is spending that is to the collective

benefit of the people of the UK as a whole, with defence expenditure being the classic example.

The Cuthbert's paper is based on an analysis of the detailed database for 2003-04 that underpins country/regional expenditure tables in PESA 2005. The database was obtained by the authors under the Freedom of Information Act. What this previously unpublished information allows the Cuthberts to establish is that

- for certain important services such as prisons, court services and nature conservation, the Treasury classifies the spending as identifiable for Scotland but non-identifiable for England, thus the classification between Scotland and England is inconsistent;
- for certain spending by the Scottish Executive, PESA identifies it as wholly Scottish e.g. spending on national museums, art galleries and libraries, while for comparable spending in England a portion of spending is assigned to Scotland, thus there is an asymmetry of treatment between Scotland and England; and
- some spending, such as that on export and tourism promotion, which is wholly to the benefit of England is recorded as being of benefit for all of the UK, thus PESA contains incorrect allocations.

One implication of the Cuthbert's analysis is that the errors in PESA are not random but are systematic, affecting the exercise in each year. For 2003-04, PESA appears to have overstated general government expenditure in Scotland by over £500 million, just above 1% of aggregate expenditure and 1.5% of identifiable expenditure. One implication of this, taken with the underestimate of identifiable English spending, is that identifiable Scottish public spending relative to the UK may be lower than previously thought. Further calculations, undertaken by the Cuthberts at the request of the Institute, suggest that identifiable expenditure in Scotland relative to the UK would fall from 116.4 to 114.3.¹

A further implication is that the annual report published by the Scottish Executive Government Expenditure and Revenue in Scotland (GERS), which seeks to provide estimates of government expenditures, revenues and the balance between the two, will be affected by the errors in PESA. GERS draws on PESA for its expenditure estimates and so, on the Cuthbert's analysis, would appear to overstate Scottish public spending. This also implies that the estimate of fiscal balance will be distorted in GERS, with net borrowing (broadly the imputed fiscal deficit) somewhat lower. On the Cuthbert's further calculations, net borrowing in 2002-03, excluding North Sea Revenues (Table 5.1 in GERS, 2003 – 2003) falls from £9,260 million to £8,710 million, that is from 11.3% to 10.6% of GDP. The revision makes relatively little difference to the outcome of GERS' estimates but we do share the Cuthbert's concern

at the Scottish Executive's failure to adequately check its source data.²

Moreover, the Institute strongly supports the Cuthbert's recommendations for fundamental change in the way that the Treasury prepares both PESA and the Treasury Funding Statement. The recommendations require inter alia

- comparability of treatment of expenditure in England and the devolved territories,
- the creation of a non-identifiable expenditure category within England,
- improved guidance on the attribution of identifiable expenditure within PESA, and
- the publication of comparative analyses of expenditure on devolved services for the devolved territories and England.

One real policy benefit of implementing these changes is that it might force Whitehall departments to "take devolution seriously". That is, consider whether the way they are delivering their services is compatible with the evolving reality of their responsibilities under devolution.

Public Spending Within Scotland

In early October, Sir John Ward, Chairman of Scottish Enterprise, addressed a meeting of MSPs in Edinburgh on boosting Scotland's growth rate. Reportedly, Sir John argued that Scotland was too dependent on the public sector. Indeed, he went further and suggested that in some areas of Scotland, such as Ayrshire, with public spending at more than 70% of economic activity, the dominance of the public sector was at "Eastern Bloc levels". A short paper from Scottish Enterprise staff, which offered supporting data and statistics, buttressed Sir John's speech. The speech brought criticism from local MSPs and led to an extensive debate in both written and electronic media.

Unfortunately, while some newspapers reprinted some of the key data from the Scottish Enterprise paper, no one, as far as we are aware, sought to examine the accuracy of the data and statistics supplied by Scottish Enterprise. The Institute has looked closely at these data and we conclude that there is no basis for the charge that there are areas of Scotland where the economy is so dominated by the public sector that it resembles the old Soviet Union or Eastern Bloc. Of course, such a conclusion should be unexceptional. Had Sir John been aware that, even in the years immediately before the Wall came down, the public sector in the Eastern Bloc economies produced almost all the net national product, he presumably would not have made such a remark.³ But we can go further and suggest that the public sector in Scotland and in LEC areas such as

Ayrshire is far from the dominant economic activity painted by Sir John and some in the media.

Conceptualising public spending and local economic activity

The paper from Scottish Enterprise expresses estimated public spending in each LEC area as a share of estimated net output or gross value added (GVA) in the area. The paper cautions that there may be some methodological errors in both sets of estimates because “assumptions and judgement” are used to allocate public spending and GVA to LECs. However, our concern is that in expressing their measure of public spending over GVA at the local area, and even Scottish, level Scottish Enterprise have made several conceptual errors.

The effect of these errors is to inflate the implied scale of the public sector in the measure of public spending and to artificially deflate actual economic activity in some areas, such as Ayrshire. In other parts of Scotland, Lothian and Grampian for example, some of the errors may work in reverse, to artificially inflate economic activity. In fact, by expressing estimated public spending as a proportion of GVA Scottish Enterprise is comparing apples with pears and not like with like. Here’s why.

It is useful, first, to remind readers that when discussing the economic activity of an area, or nation, output, expenditure and income are identical by definition. In other words, measures of output, expenditure and income in an economy are simply three ways of looking at the same thing. This follows intuitively because individuals produce goods and services (output) for which they are paid an income, which is then spent. Of course, some income may be saved and not spent by the income earner. But national income accounting definitions treat saving as identical to investment, thus ensuring that expenditure, income and output are the same.

It is, therefore, perfectly meaningful to express a component of spending over a measure of output to gauge the importance of the component, in our case public spending, to economic activity in the area or nation. However, the spending and output measure must be measured on the same basis. This is not the case with the measures adopted by Scottish Enterprise.

Spending (E)⁴ adds to economic activity (Y)⁵ in an area when all the elements of spending that flow outside the area are removed. The most significant element flowing outside the area will be on imports (M) of goods and services into the area and payments outside the area, while indirect taxation (T) to central government will be another outflow. In addition, any subsidies (S) associated with the spend coming from central government in the area will be an inflow. So,

$$Y = E - M - T + S$$

The measure that Scottish Enterprise has for public spending in each area is composed of estimates of spending on 3 big expenditure categories: local authorities, social protection, and health. These categories account for 72% of public spending in Scotland, with the residual other spending category accounting for 28%. This latter category is found by subtracting the other 3 elements from the GERS estimate of public spending to the benefit of the Scottish people. Other spending therefore includes other identifiable elements such as transport and higher education spending, and non-identifiable elements, such as defence, UK debt interest, EU transactions and international services provided by the UK government.

It should be clear from this description of the spending elements that Scottish Enterprise’s measure is essentially E and not Y. That is, public spending is measured at market prices, with no adjustment for indirect taxes (T) or production or price subsidies (S), and with imports (M) not removed. The failure to remove M is crucial because there will be large public and private import components.

It is important to understand that spending that is to the benefit of the Scottish or Ayrshire citizen may not be incurred in the country or area, either directly or by local suppliers to the public sector, and so is part of M and will have no direct impact on area economic activity. On the public side, spending on capital equipment for the health and local authority services is likely to have a high import component. Similarly, in the other public spending category, the services of defence may be obtained from spending on ships, missiles, aircraft, and military bases none of which may be produced or located in Ayrshire or Scotland. Much the same can be said for UK debt interest and international services.⁶ Likewise, on the private side there will be a high import component at the LEC area level. This is relevant to a key part of public spending because social protection payments are made direct to private individuals who will spend a large part of this income on goods and services produced outside the area.

We now turn to Scottish Enterprise’s measure of economic activity (Y). This is gross value added at basic prices estimated on a workplace basis.⁷ GVA is an estimate of the sum of value added by resident firms, i.e. total sales (including exports) minus total purchases (including imports). GVA is therefore a measure of the supply of goods and services from the domestic economy. But as a measure of activity in the economy, viewed as the economy’s spending or its income, GVA is deficient because it does not equal Y. GVA omits net income from outside the country or area (N). This is the balance of income received from ‘abroad’ minus income paid ‘abroad’. Hence,

$$Y = GVA + N$$

So, in summary, Scottish Enterprise actually measure:

E_G / GVA

when for consistency they should have measured:

$$(E_G - M - T + S) / (GVA + N)$$

where E_G is government spending to the benefit of an area.

E_G will be greater than $(E_G - M - T + S)$ at the LEC area level and even at the Scottish level. Looking first at M , identifiable public spending in Scotland on public administration is, from the Scottish input-output tables, associated with imports of 13% of spending. For the non-identifiable elements such as defence and international services, the import element will clearly be much higher and will be close to 100% in some areas. For public spending such as social security payments that are paid directly to households the import element will be high. From the Scottish input-output tables, 56% of Scottish consumer expenditure at purchasers' prices is satisfied by imports from outside Scotland, and at the smaller LEC area levels the import component will be considerably above that. Finally, the size of net taxes that is indirect taxes minus subsidies ($T - S$) is just above 8% of total final demand in Scotland and should be much the same at the local area level.

Turning again to the measure of economic activity, the size relative to the local economy of the flows (N) of income from and to 'abroad' is likely to increase the smaller the country or area. There will be a greater likelihood of 'foreigners' holding property rights, e.g. to profits, in the local economy, and of local residents having property rights to income streams from 'abroad'. The use of GVA as a measure of economic activity might be more acceptable at the nation state level where the flow of net income from abroad is relatively smaller with GNP and GDP, or GVA, more closely aligned. But not we would submit at the local area level.

There are several key factors that are likely to make N large in relation to the GVA of many Scottish LEC areas. First, in regions such as Ayrshire, Fife, Dunbartonshire, Renfrewshire and Lanarkshire, there are large commuting flows out of areas. So, the estimate of workplace based GVA will be much lower than if estimated on a residence basis – i.e. in moving from the former to the latter some of N is transferred into GVA. Conversely, in Glasgow and Lothian it is likely that there are net inflows of commuters, so workplace GVA will be much higher than a residence based estimate. Either way, the use by Scottish Enterprise of a workplace estimate of GVA alone has depressed the measure of economic activity in the former and raised it in the latter areas.

Another income flow entitlement is to social security payments, or social protection, which will tend to raise N in many Scottish LECs. The flows of transfer payments

between the regions and areas of the UK do not constitute spending on the UK national product because they are redistributive within the economy and are balanced by tax flows. But they do augment income and expenditure in regions and areas within the UK when the inflow is greater than the tax outflow. Conversely, area income and expenditure is reduced when the tax outflow is greater than the spending inflow.

The flows of social protection payments are large, amounting to 33% of public expenditure in Scotland, and will tend to rise as GVA falls at the sub-national level. So, in Glasgow, Ayrshire and Renfrewshire they amount to 43%, 36% and 35%, respectively, of public expenditure. However, they are inversely related not because the public sector is 'crowding out' private sector activity but because they are, in part, the consequence of weakness and decline in production in the local economy. And historically, in areas such as Ayrshire, Lanarkshire and Fife, declining production in traditional public industries such as coal mining and iron and steel, has played a key role. So, activity will be higher in these economies, not less, due to the net inflow of such income and subsequent spending. There is no intrinsic difference, in terms of the impact on the local economy, between £1 of spending financed by unemployment benefit and £1 of spending financed by dividend payments, or wages earned at a workplace located outside the area of residence.

In producing estimates of public sector spending and GVA in the LEC areas of Scotland, Scottish Enterprise and its Chairman appear to be conflating three separate issues affecting such areas: first, the degree of benefit from public spending; second, the relative scale of public activities, and finally, whether on account of this scale there are harmful, or crowding out, effects on private sector activity.

The degree of benefit from public spending

We note above that public spending may be made for the benefit of an area even though the spending may not be incurred in the area. Scottish Enterprise's estimates of public spending, like the GERS spending data from which it draws, pulls together all of this spending for each of the LEC areas. But the correct measure of how each citizen in each area benefits, on average, from public spending is not spending divided by GVA but, rather, spending divided by population. Scottish Enterprise provides these data in the paper accompanying Sir John's speech but they were little discussed by Sir John or by much of the media.

What is interesting is that there is no correlation at all between spending per head and the measure of public spending to GVA.⁸ So Ayrshire, which has the headline rate of 74% of spending to GVA and ranks 1st, has £8,199 per head and ranks 5th. Of even more interest is Dunbartonshire, which also has 74% of public spending to GVA but has only £6,633 per head and ranks 13th and last on the benefit measure. Conversely, Glasgow has only

51% of public spending to GVA ranking 11th, but has £11,879 per head and ranks 1st on the benefit measure. These differences should have set the alarm bells ringing within Scottish Enterprise on the appropriateness of its spending to GVA measure, as either a measure of benefit or a measure of relative scale.

Measures of relative scale of public spending

On this issue, our analysis above suggests that Scottish Enterprise have significantly over emphasised the importance of public spending and the public sector to economic activity in the LEC areas of Scotland. However, we are unable to directly compute $(E_G - M - T + S) / (GVA + N)$ for each area. Instead of the inadequate proxy used by Scottish Enterprise a better option would be to examine the relative importance of the public sector supply of goods and services using a measure of value added to economy-wide GVA. This is not perfect because it excludes the public spending that goes straight to households in the form of, for example, social security payments, some of which is then spent in the local area. The estimate for this statistic for the Scottish economy is 22%, based on the 2001 weights used in the Executive's GDP series. Indeed, this could be an over estimate since the sector public administration, education and health, will include some private sector provision, although there will be some public sector workers classified to other industrial sectors e.g. construction, and public corporations. But it is worth noting that there is a debate as to where the public sector begins and ends, so some measures as above include higher education but exclude HM forces whereas other measures exclude the former and include the latter.

Unfortunately, at the local area level in Scotland we do not have published GVA estimates for the public services. However, we have the next best thing, which is the employment in those services. The Scottish Enterprise website provides this information for each LEC area and when expressed as share of total employment gives us the information presented in Figure 5. These data show that, in 2002, 28% of Scottish employment could be classified to public services. But in so-called 'Eastern Bloc' areas such as Ayrshire, public sector employment is only a little higher at 30%. Indeed, at this level it is nowhere higher than 32% in Tayside and no lower than 23% in Grampian and 25% in Lanarkshire. If one reduces the spatial scale one can find 43% in the Western Isles, 38% in Orkney and 38% in Skye and Lochalsh, but there is no suggestion from these figures that they are being ground under the heel of some people's soviet.

Crowding out effects

The final issue is whether the scale of the public sector has harmful, or crowding out, effects on private sector activity in LEC areas. Scottish Enterprise presented no evidence on this, but this didn't stop its Chairman and some media

commentators from implying that such crowding out effects were great.

So, how can crowding out occur?

Such effects can occur either from the supply side, or from the spending side.

On the supply side, we have seen that the public sector constitutes less than 28% of employment. This is not dominant. However, there may be a case that the growth of the civil service in Scotland, paying a premium in terms of job security, pension rights, and holidays on comparable private sector jobs, may have served to reduce the incentive to private sector initiative such as new firm starts and so served to crowd out some private sector activity. But it must be said that, so far, there is no evidence to prove the point. Nonetheless, there may be a strong case for improving the efficiency of public sector supply in Scotland, which is not subject to the market incentives experienced by the private sector. And, there could reasonably be some areas of public sector supply, such as water, where private sector supply might be more efficient.

On spending, it is clear that spending to the benefit of local residents is greater than the supply of goods and services by public sector in an area. It is also the case that when allowance is made for imports and net taxes public spending is still greater than public supply. This is because income is transferred, through for example social security payments, to households, who will spend some of that income on private sector supplied goods and services in the area.

So, can this public sector spending crowd out the private sector in other ways?

At the level of the national monetary union, one possibility is that public sector borrowing to finance spending will cause the interest rate to be higher and so crowd out private sector investment through that route. But since the UK interest rate is given to Scotland and areas such as Ayrshire there can be no local specific crowding out through that route.

Since the bulk of public spending is financed by taxation then one clear possible negative effect is the disincentive effect of such higher taxation on private sector supply. Again the jury is out on whether higher taxation generates economy-wide disincentives, dampening growth and supply. Some of the most progressive, fast growing economies such as Finland and Sweden have high tax rates and tax burdens, while others such as the USA are low tax economies. There does not appear to be much relation between the level of taxation and economic efficiency and growth. Moreover, much of the public spending in LEC areas such as Ayrshire, Dumfries, Lanarkshire and Fife is financed by taxation levied outside the area, so no local crowding out effect there. Indeed, the same can be said to a lesser extent of Scotland, which

while ostensibly bearing a public spend that is 55% of total GVA, the amount financed by taxation of Scottish residents is only 43% of GVA. The difference is paid by the English taxpayer, which will not squeeze the private sector in Scotland.

Another potential route for crowding out is that public spending decisions may divert local resources by price and other routes away from more efficient outcomes that would result if the private sector had instead made the spending decisions. This is indeed a possibility and is the obverse of the supply-side disincentive effect of higher taxation. If public spend and taxes are lower then more spending decisions are made by the private consumer rather than civil servants and public sector workers and they may indeed be more allocatively efficient. But again Scottish Enterprise's aggregate public spending figures offer no guidance as to whether this might in fact be occurring. It is worth recalling that around 33% of Scotland's public spending, and 36% of Ayrshire's, is accounted for by social protection payments, where there is no distortionary effect, since it is private individuals who make the decisions on the spending of that income. And, as we have seen, in Ayrshire's case, particularly, such spending will be only partially financed by the Ayrshire taxpayer, while in Scotland as a whole it is only four fifths financed by Scottish taxation.

So, Scottish Enterprise, in relating their chosen measure of public spending to GVA, have failed to compare like with like. Public spending should be measured and compared according to the issue or question that one wishes to address. If one wishes to establish the degree to which such spend is to the benefit of an area's population then total spend per head of population would appear to be the appropriate measure.

However, if one wishes to identify the relative scale, or contribution, of such spending to economic activity in an area then spending should be estimated net of imports and net taxes, while workplace GVA should be adjusted to allow for net income from 'abroad'. In the absence of these adjustments, the two measures of public spending and workplace GVA cannot sensibly be related to one another as Scottish Enterprise has done.

In these circumstances, and given that the greatest risk of public sector crowding out at the local level would appear to be on the supply side, then an indication of the relative dominance of the public sector is best measured by its relative value added, or failing that, relative employment. On this latter measure there is no evidence that the public sector dominates the local economies of Scotland, although this does not deny the case for a more efficient public sector, and a critical perspective on the public supply of certain goods and services.

In the light of this, we suggest you think again Sir John.

Outlook

There is considerable uncertainty in the world economy, particularly about the course of oil prices. The rapid rise in the price of oil, which has doubled in dollar terms since the beginning of 2004 although softening somewhat in recent months, has begun to fuel inflationary expectations. This appears particularly to be the case in the United States, where further interest rate rises above the current 3.75 per cent are anticipated. This expectation has further affected the performance of equity markets in the US, Europe and London specifically, where the largest fall this year occurred on the anniversary of the 1987 stock market 'crash'.

But while inflationary expectations appear to be on the rise, GDP growth is weakening. But this weakening is occurring from a high point, with output expanding at 5.1% in the world economy in 2004, the strongest growth seen for 28 years. The growth of world trade was also strong in 2004 at 9.1%, with GDP growth in China and Japan clearly benefiting from a strong expansion of net trade. However, growth of the world economy is still forecast to be around 4.5% this year and at the same rate in 2006. So, we are seeing the risk equation rebalancing towards a greater fear of higher inflation in the first instance rather than lower growth. But, of course, such an outturn would inevitably damage future growth performance especially if the monetary authorities misjudge the scale and timing of future interest rate rises in their attempt to dampen inflationary expectations.

In the United Kingdom, growth appears to have weakened by more than in the US but still remains a little stronger than in the Euro zone. The UK economy grew by 0.5% in Q2 compared to 0.8% in the US, 0.8% in Japan and 0.3% in Europe. Moreover, revisions to earlier UK GDP estimates reveal that growth over the 4 quarters to 2005 Q2 was, at 1.5%, the lowest annual growth rate for twelve years.

Prospects for the UK economy in the second half of 2005 and into 2006 are uncertain. Consumption growth continues to be sluggish, with retail sales particularly weak, as the savings ratio has risen. However, there are some signs that the housing market has begun to strengthen again and the jobs market remains unusually strong despite the weakening in GDP growth. Indeed, some observers have gone so far as to argue that official measures of output growth, particularly in the service sector, may be understating the true rate of economic growth, which would fit better with the position in the jobs market. Yet, employment growth may have been over recorded, or firms may be hoarding labour in anticipation of an upturn in the New Year. One other favourable indicator is the contribution of net trade to growth, which was positive in the first half of the year. While the desired improvement in net trade, with switching away from domestic consumption, was mainly driven by a slow down in the growth of imports as consumer demand growth

weakened, there has been some pickup in export performance.

With UK growth now below trend, and no evidence of much earnings pressure in the labour market, the risk of a take-off of inflation through excess demand pressures would appear to be low. In addition, the labour supply would appear to be growing fairly quickly, in part due to the higher rate of population in migration, which offers the possibility, if sustained, of a welcome rise in the trend rate of overall GDP growth. The main inflationary risk then comes from the rise in the price of oil, its effect on fuel costs, the consequent lowering of the real consumption wage of the workforce and the potential threat of rising inflationary expectations leading to higher wage and price claims. So far, there is little evidence of rising inflationary expectations. But the MPC is being understandably cautious in holding interest rates at 4.5%, which are likely to remain unchanged into the New Year.

In Scotland, as noted above, the economy stagnated in the first quarter and was generally weaker than the UK. Official data are about to be published for the second quarter and we would expect to see some improvement on the unrevised first quarter results. The Institute's Scottish Chambers' Business Survey (SCBS) for the second quarter revealed a rising sales trend in manufacturing, construction, wholesale and tourism. However, sales growth weakened in retailing and business confidence weakened in all sectors. The latest SCBS findings for the third quarter again showed trends in firms' sales and order books continuing to weaken. Yet, confidence rose in manufacturing and the tourism sector. Evidence from the SRC/RBS retail sales monitor also suggests a slowdown in sales with the favourable gap between Scotland and the rest of the UK beginning to narrow.

One key factor that appears to be starting to influence consumer spending, prices and economic activity in Scotland is rising energy and transport costs as fuel prices rise, following the surge in the dollar price of oil. The latest SCBS clearly shows that many more firms in the third quarter were under pressure from this source to raise product price than in the second and third quarters of the year. Yet, while there are apparent downward pressure on the rate of growth of output in Scotland and upward pressures on the rate of growth of prices, the labour market remains remarkably buoyant. The bank of Scotland's labour market barometer for August signalled an improvement in Scottish labour market conditions for the 25th consecutive month, with the rate of improvement above the UK average. However, there was some evidence of a softening in the strength of the jobs market, which is also evident from other sources in the UK. These figures might also indicate that output growth may be being under-recorded to a degree in Scotland as speculated in the UK.

Bringing all these influence into our forecasting process, we continue to forecast somewhat weaker growth in Scotland this year compared to 2004. Despite the uncertainties we expect that growth will be stronger here in the second half of this year and so continue to predict growth of 1.8% this year and much the same performance, 1.9%, in 2006. We anticipate that while growth will remain a little below trend, financial services, business services, hotels & catering, construction, and a still better performance from retailing than in the UK, will keep the growth rate up. But manufacturing will continue to contract in 2005. Further slight improvement in the rate of growth is predicted in 2007, with a forecast of 2%. These forecasts for Scotland should be compared with UK forecasts of 2%, 2.3% and 2.6% for 2005, 2006 and 2007, respectively.

The relative strength of the jobs market in relation to output growth is maintained in our present forecast, reflecting the continuing net job creation in key service sectors. Net job increases of 27, 000, 28,000 and 36,000 are forecast for this and the next two years. This in turn has the effect that the outlook for unemployment is low and stable, with ILO rate predicted at 5.3% this year, 5.2% in 2006 and 5.1% in 2007. The claimant count rate is forecast to be 3.6%, 3.4% and 3.3% over the same the same three years.

The main downside risk to these forecasts is an unexpected deterioration in inflation expectations that forces the MPC to push rates further than anticipated. As of today this looks unlikely. A further caution is caused by the volatility of the stock market, which if additional major falls were to be experienced could along with the earlier contraction of house prices produce a negative wealth effect on consumption and investment. And that could be the harbinger of recession.

Brian Ashcroft
21 October 2005

Endnotes

¹ This estimate uses the PESA 2003-04 data to adjust the 2002-03 data in GERS, which assumes no change in the relevant relative expenditure data between the two years.

² The Cuthberts have wider philosophical and data differences with the GERS publication, which the Institute does not share.

³ In East Germany, for example, the private sector contributed no more than 3% to net national product in 1985.

⁴ Spending (E) in an economy will normally comprise consumption (C), investment (I), government spending (G) and exports (X), where X includes income received from abroad.

⁵ Technically, Y is defined as Gross National/Regional Expenditure at *basic prices*. The removal of all indirect taxes and subsidies adjusts expenditure at *market prices* to expenditure at *factor cost*. To get to GRE at basic prices we add in net production taxes, which in the UK is the cost of local authority rates, to GRE at factor

cost. GVA, which is discussed below is measured at basic prices. At the UK level in 1997, the disparity between the basic price and factor cost estimate was around 2%.

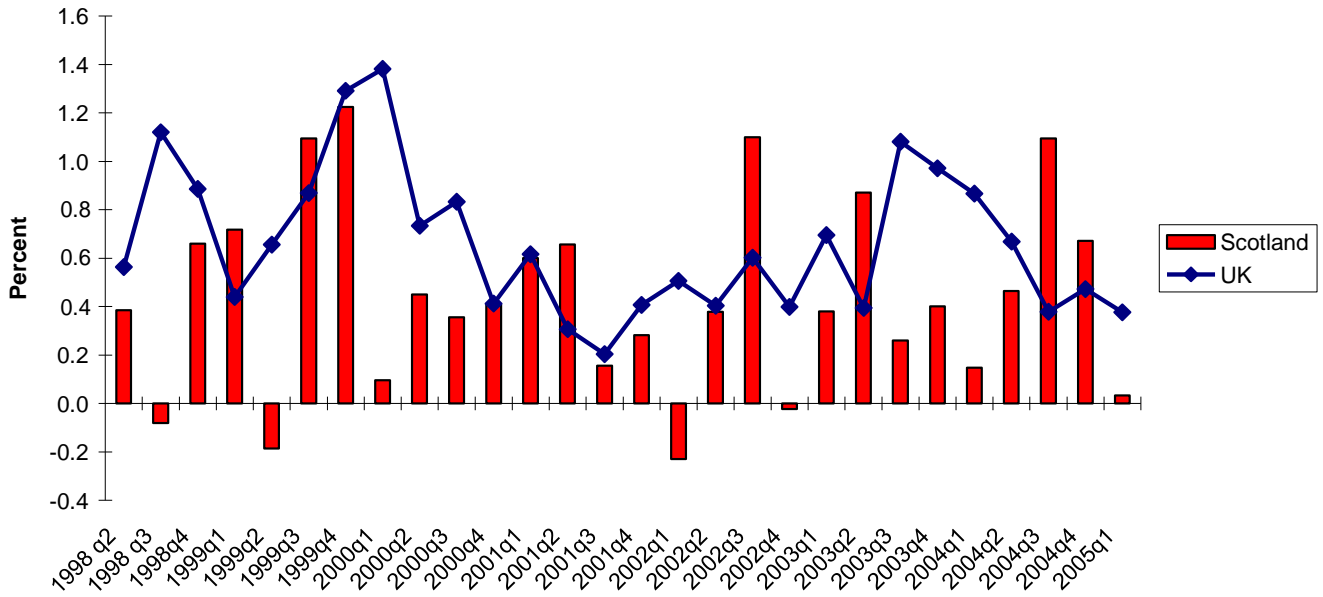
⁶ Defence, international services, and UK debt interest account for 11% of the GERS estimate of Scottish public expenditure in 2002-03.

⁷ 'Workplace' basis means that the measurement of GVA is assigned to areas where production establishments are located. The alternative measurement is a 'residence' basis, where the

measurement of GVA is assigned to where people live. Clearly, dormitory areas with few firms will have much lower GVA on a workplace basis, and much higher GVA on a residence basis: think Bearsden! The difference between the two therefore becomes greater the smaller the area and the more the area cuts across commuting flows i.e. is just a part of a functional economic area such as travel to work area (TTWA). Most LEC areas in Scotland cut across or are only part of a TTWA.

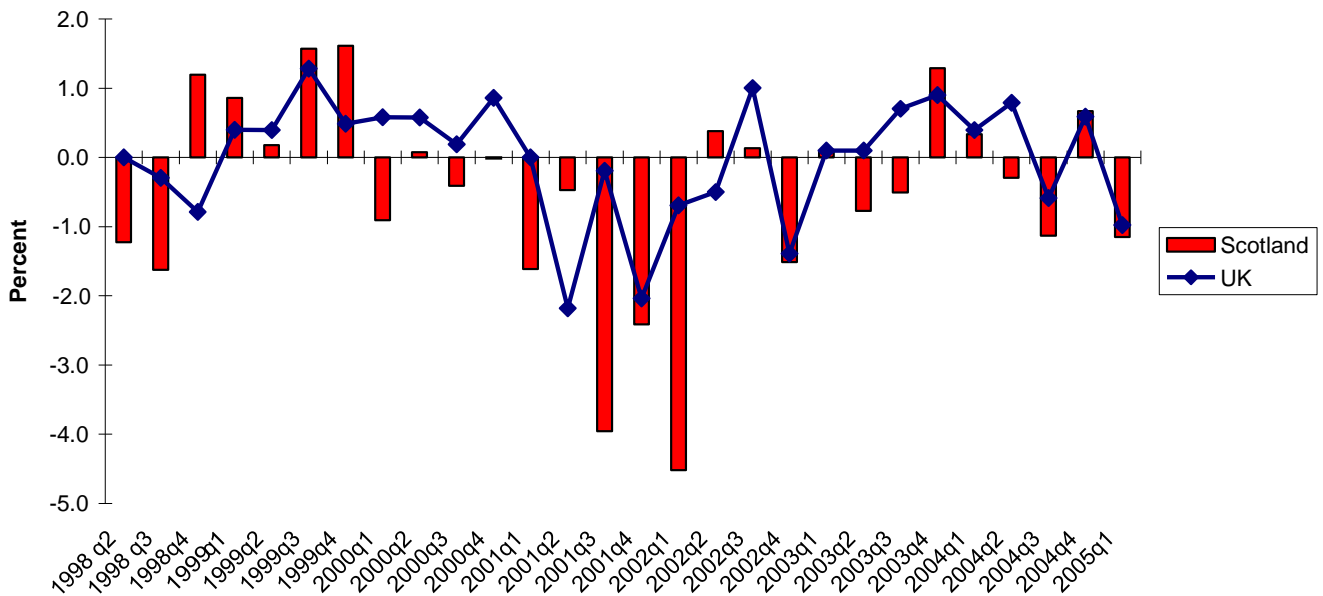
⁸ The Pearson product moment correlation coefficient is 0.077.

Figure 1: Scottish and UK Quarterly GDP Growth, 1998 q2 to 2005q1



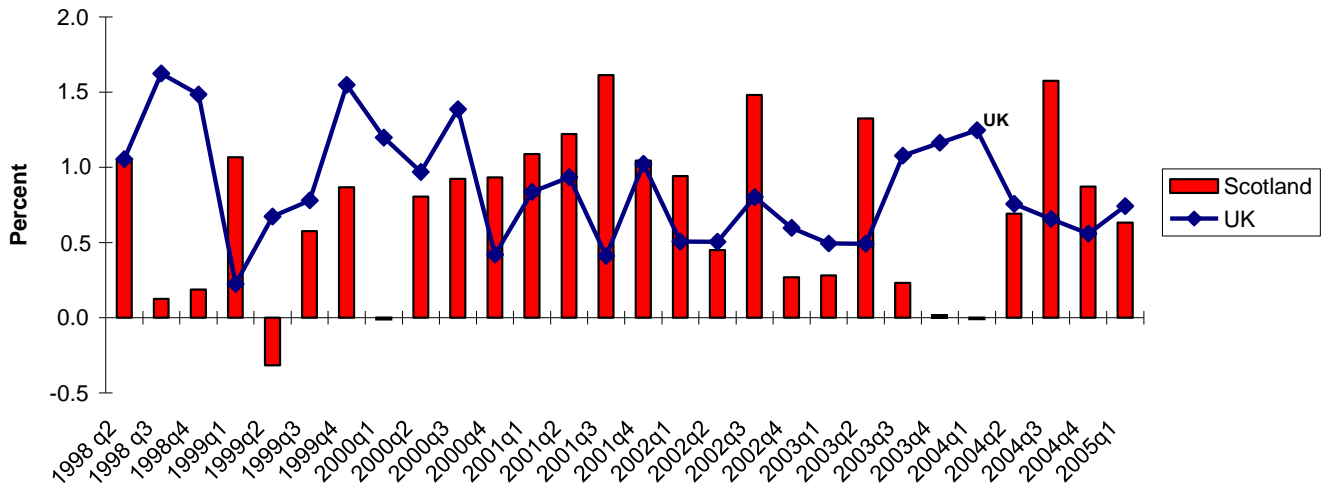
Source: Scottish Executive and FAI calculations

Figure 2: Scottish and UK Manufacturing GVA Growth at constant basic prices 1998q2 to 2005q1



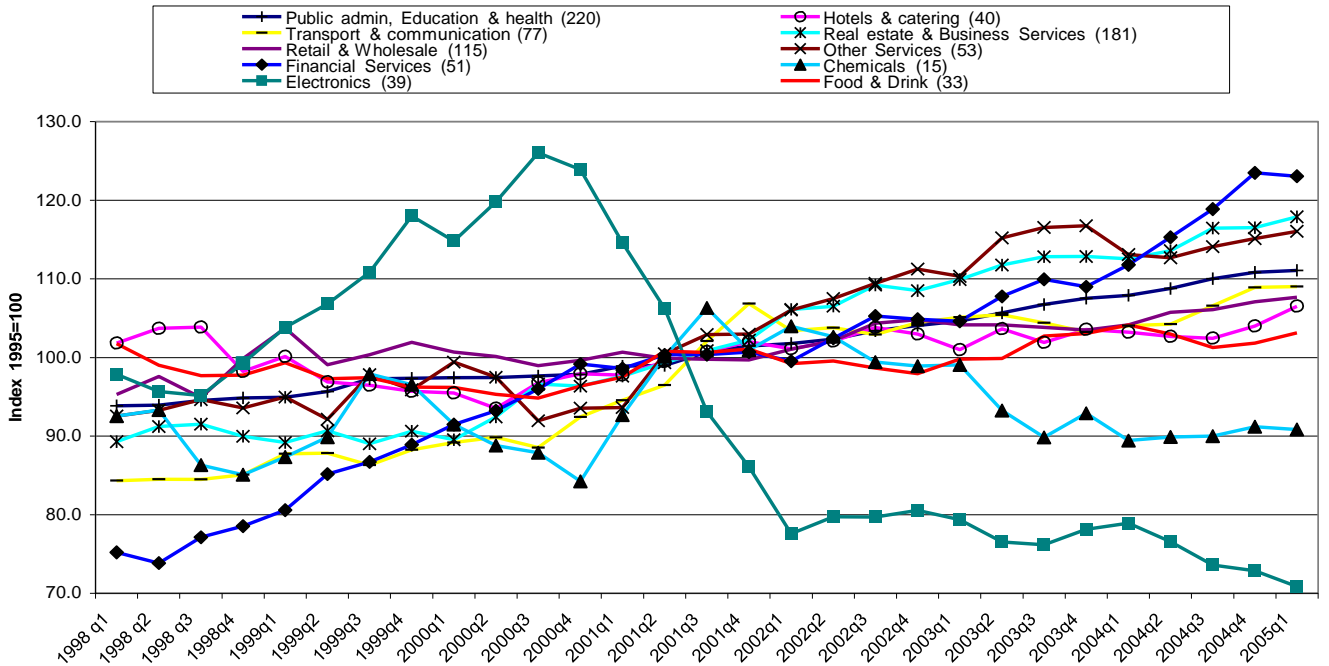
Source: Scottish Executive and FAI calculations

Figure 3: Scottish and UK Services GVA Growth at constant basic prices 1998q2 to 2005q1



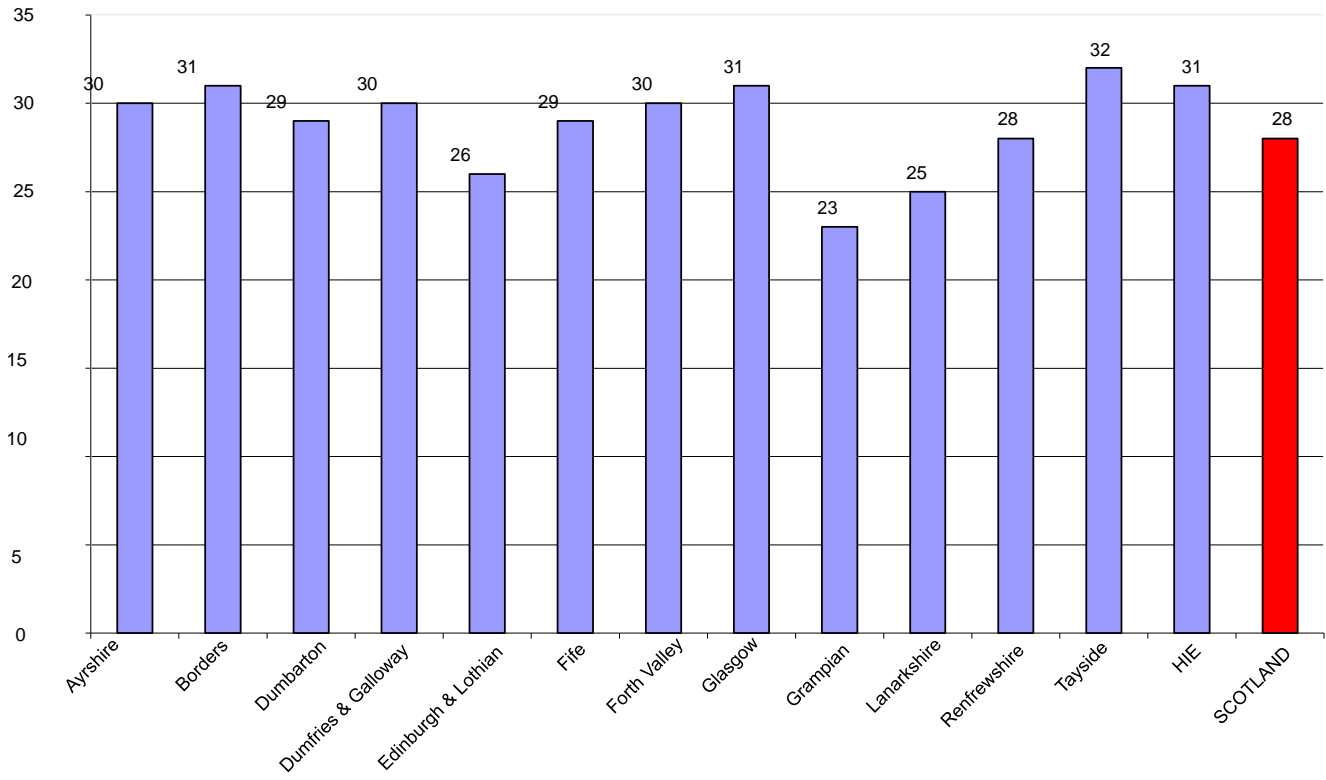
Source: Scottish Executive and FAI calculations

Figure 4: Growth of Key Sectors 1998Q1 to 2005Q1



Source: Scottish Executive and FAI calculations

Figure 5: Public Services Jobs in Scottish LEC Areas Percent Total, 2002



Source: Annual Business Inquiry, 2002

