

# Quarterly economic commentary

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## **Information for subscribers**

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## **Notes to contributors**

The editors welcome contributions to the Economic Perspectives section. Material submitted should be of interest to a predominately Scottish readership and written in a style intelligible to a non-specialist audience. Contributions should be submitted to the editors.

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# 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 outperform, 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 – outperformed 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<sup>i</sup> 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."<sup>iii</sup>

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.

Brian Ashcroft  
28 June 2006

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<sup>i</sup>*Sunday Times*, 25 June 2006.

<sup>ii</sup>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

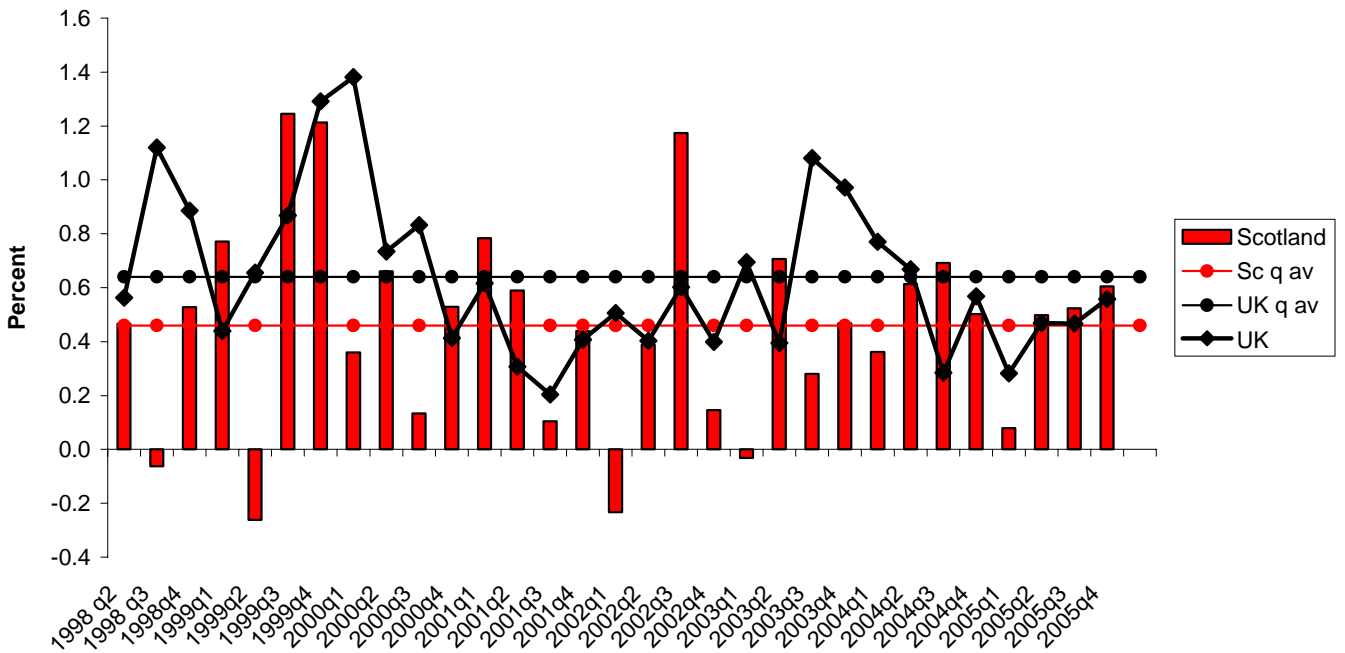


Figure 2: Scottish and UK Services GVA Growth at constant basic prices 1998q2 to 2005q4

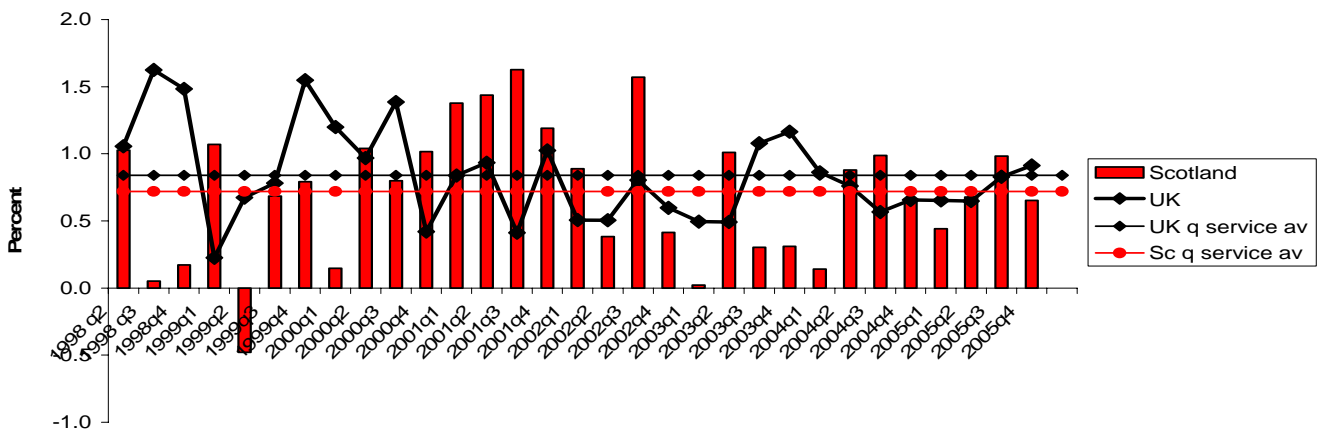


Figure 3: Scottish and UK Manufacturing GVA Growth at constant basic prices 1998q2 to 2005q4

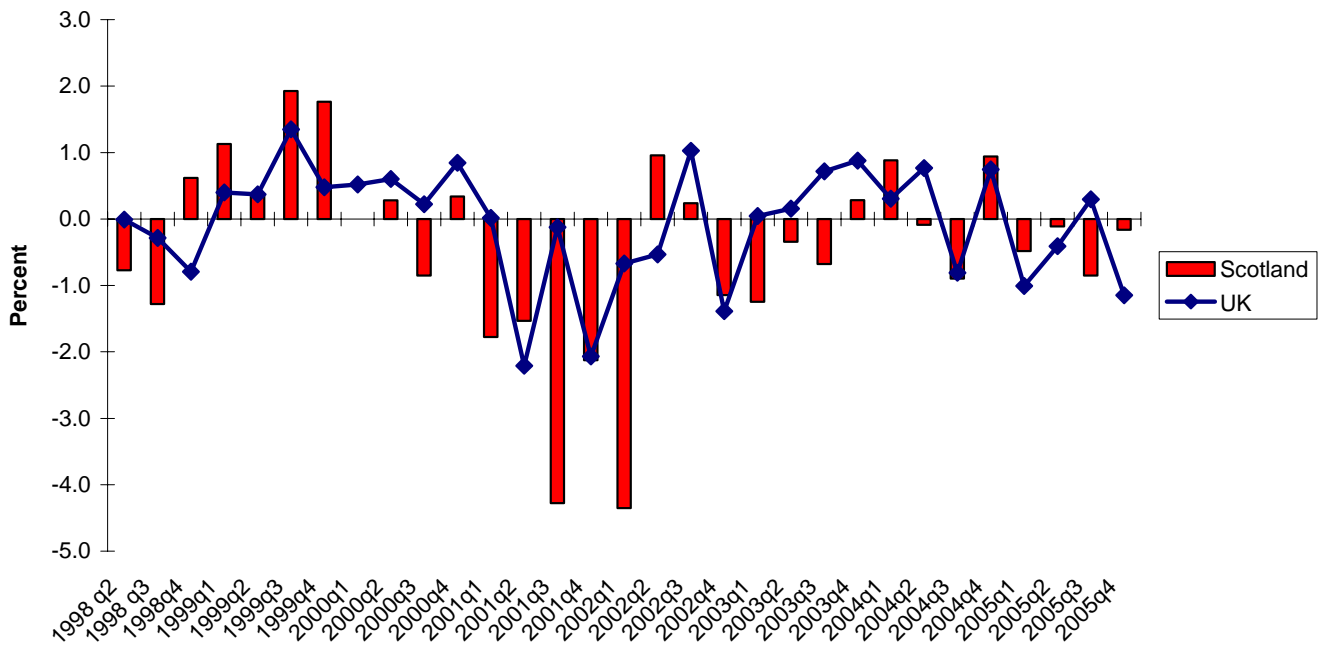
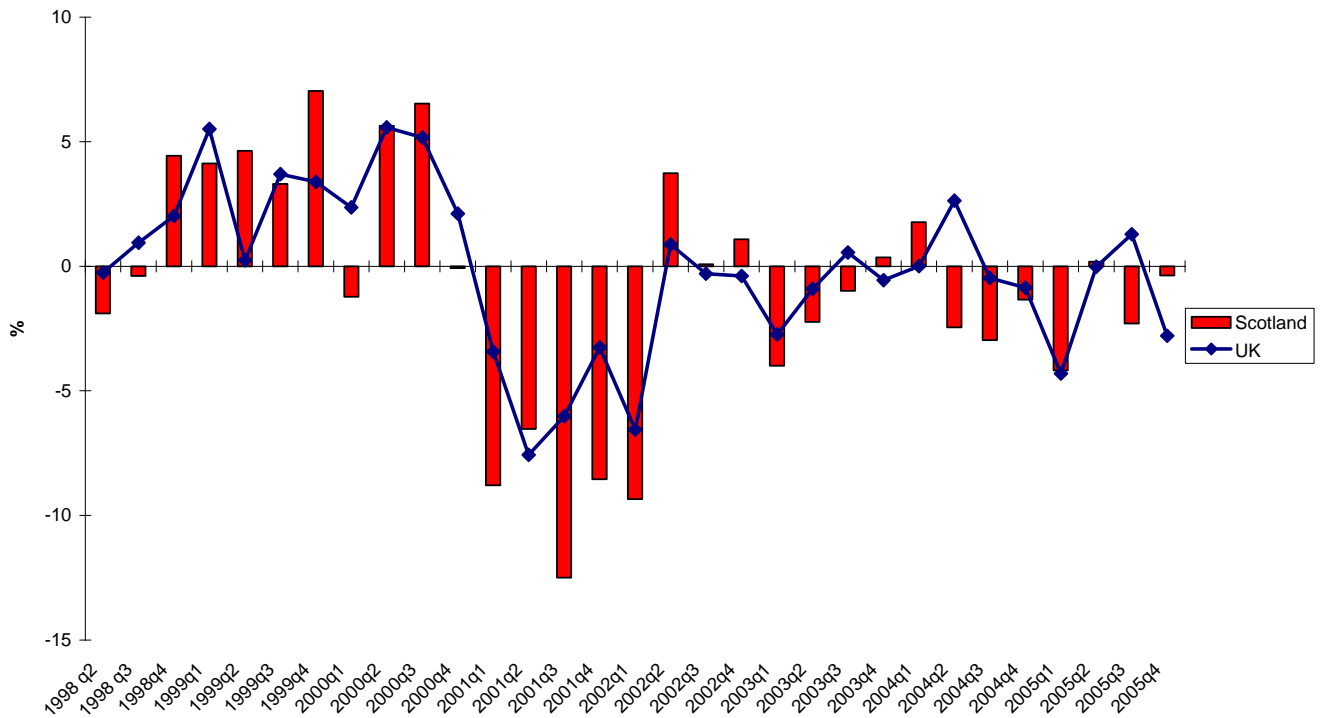


Figure 4: Scottish and UK Electronics GVA Volume Growth 1998q2 - 2005q4





# The economic background

## The world economy

### Overview

Growth in the world economy remains robust with both China and India experiencing fast growth. The US continues to have strong growth despite a slight weakening in the last quarter of 2005. Consumption and investment are much more important in Japan now, driving growth forward. Exports are also contributing significantly to Japanese growth. The Euro Area grew below trend in 2005 but is forecast to have stronger performance in both 2006 and 2007. However, the main impetus to growth is external to the OECD. World growth is forecast to be 4.8 per cent per annum for the four years ending in 2007 compared to average growth of 3.4 per cent per annum for 1975 to 2003. Oil prices are expected to be close to \$60 but the decreased dependency on oil of the advanced economies has meant that it has had little impact on inflation.

China's current account surplus has risen by 4 per cent and their contribution to the goods market means that the world interest rate has been effectively reduced by about 0.5 percentage points. This has constrained global inflation and squeezed nominal interest rates. Confidence in world markets is rising despite several setbacks in financial markets and business confidence now suggests that even in Germany a broad based recovery is taking place.

The main risks to the world economy continue to come from current account imbalances and house prices although a sharp correction to oil or commodity prices would have a significant impact on growth and inflation. The surplus in Germany, Japan and China are forecast to grow to 4.5, 5.5 and 6 per cent of GDP respectively whereas the deficit in the US and Spain are forecast to be 7.5 and 10.0 per cent respectively. While some of these data are alarming there are no signs of policy makers allowing a sharp unfolding of these imbalances. Should current account problems worsen then the weaker economies (in terms of growth) are more likely to suffer the most from output loss.

### Outlook

Growth in the US is forecast to be 3.3 per cent this year and be 2.9 per cent in 2007. There is significant uplift to the 2006 forecast but only a marginal increase for 2007 compared to our previous forecast. Exports are expected to have a neutral effect on growth but the housing market slowdown will contribute more significantly to GDP growth slowing in 2007. Japanese growth is forecast to be 2.9 per cent and 2.3 per cent in 2006 and 2007 respectively. This is a significant improvement on previous economic performance. Although the Euro Area has been slow to sustain recovery it appears that growth will strengthen over

2006 and 2007. Table 1 presents the forecasts of main economic indicators for the period 2005 to 2008.

Table 2 illustrates the components of demand and main macroeconomic indicators for the period 2005 to 2007 for the US, Japan, the Euro Area and the UK. Investment is forecast to rise in the Euro Area and in the UK over 2006 and 2007 but the housing slowdown in the US could be quite pronounced looking at the US data over the same time period. Government spending is forecast to peak in 2006 in most developed economies except Japan where it peaks in 2007. The US deficit is forecast to decline slightly over 2005 to 2007 which will be encouraging for the rest of the world economy, although this depends on how policy achieves this. Table 2 highlights the likely future drivers of change and main trends over the period 2005 to 2007, specifically the decline in the US housing sector; relatively strong and balanced growth across the major economies of the world and signs of an improving situation in both the Japanese and Euro Area economies.

### United States

GDP grew by 4.8 per cent on an annualised basis in 2006Q1 (or 1.2 per cent on the preceding quarter) compared to 1.7 per cent (0.4 per cent) in 2005Q4. The 2006Q1 estimate was revised up slightly. Clearly US growth remains relatively strong. It looks likely that GDP growth will return to its trend rate of growth.

Consumption growth in 2006Q1 was 5.2 per cent compared to only 0.9 per cent in 2005Q4. Gross investment increased by 8.3 per cent in 2006 compared to 16.1 per cent in the previous quarter. Residential investment grew by 13.4 per cent while non-residential investment increased by 11.3 per cent. The increase in government spending was 10.5 per cent compared to a contraction of 2.6 per cent in the previous quarter. Exports rose by 14.7 per cent in the latest quarter compared to 5.1 per cent in 2005Q4. Overall exports are expected to have a neutral effect on US GDP this year. Imports grew by 12.8 per cent in 2006Q1 compared to 12.1 per cent in the previous quarter.

Investment and consumption are expected to remain significant drivers of growth in the US however we expect a significant slowdown in housing investment. There is also likely to be a slight slowing of both business and government investment towards the end of the forecast horizon. Services grew by 4.1 per cent in the latest quarter with the slowing in real estate adversely affecting the sector, consequently services prices only rose by 2.6 per cent. Manufacturing increased by 4.0 per cent in 2006Q1 and prices increased for the first time since 1995. Industrial production declined by 0.1 per cent in May but had increased by 0.8 per cent in April. Capacity utilisation was 81.9 in April but declined slightly to 81.7 in May. Manufacturing productivity grew by 3.8 per cent over the quarter and by 4.0 per cent over the year. In the business

sector productivity increased by 3.9 per cent in 2006Q1 compared to 2.5 per cent in 2005Q4.

The US current account deficit: improved by \$14.4 billion to \$208.7 billion in 2006Q4 (6.4 per cent of GDP) from \$223.1 billion in the fourth quarter of 2005 (7.0 per cent of GDP). The surplus on services declined from \$17.7 billion to \$17.2 billion however in the first quarter of 2006. Of course a sharp correction to oil prices that was sustained could adversely affect the US current account position.

Annual CPI grew by 4.2 per cent in the twelve months to May 2005 and increased by 0.5 per cent over the quarter. Core inflation (excluding food and energy) increased by 2.4 per cent on an annual basis. Producer prices increased by 0.2 per cent in May compared to an increase of 0.9 per cent in April. The lower inflation in the early part of the year is unlikely to remain the pattern over 2006 and we expect inflation to gather pace because of the high capacity utilisation in the US and because oil price increases are more likely to feed into wages than say in the Euro Area.

The Federal Open Market Committee (FOMC) raised interest rates by 25 basis points to 5.00 per cent in May 2006. Given the significant rise in core inflation it is very likely that the FOMC at its meeting at the end of June will raise rates again by another 25 basis points to 5.25 per cent. Ben Bernanke (the Chairman of the Federal Reserve) has been criticised as not being willing to cut rates in order to avoid a significant slowing of the housing market and of growth in general. The saving rate remains a problem in the US as it is -0.5 per cent of disposable income.

Non-farm payrolls increased by 75,000 in May 2006 and employment rose by 2.4 million over the year. Employment has increased from 134,161,000 in 2005Q4 to 134,722,000 in 2006Q1. In the three months prior to April 2006 US full time employment was rising but this has declined in May while part-time employment has increased. Services employment grew the most significantly while manufacturing and construction remained relatively static. Unemployment stood at 5.1 per cent in May 2005 (or 7,629,000 persons unemployed) and has declined to 4.7 per cent (7,123,000 persons unemployed) in April 2006 and then to 4.6 per cent in May 2006 (7,015,000 persons unemployed). The increased income from employment is a key driver to sustained growth in consumption.

The outlook for the US economy remains promising with relatively strong growth. Most forecasters have increased their forecasts for the US certainly for 2006 and 2007. The forecast for US growth is 3.3 per cent in 2006 and 2.9 per cent in 2007 and like other forecasters this is above our forecasts for the previous quarter. Inflation is forecast to be slightly lower at 3.0 per cent for 2006 and 3.3 per cent in 2007. The Federal Funds rate is expected to be between 5 and 5.25 per cent for 2006 and 5.25 in 2007. The current account remains a concern of policymakers.

**Table 1: Forecasts of the main world economy indicators**

	Growth in real GDP (%)				Unemployment rate (%)			
	2005	2006	2007	2008	2005	2006	2007	2008
US	3.5	3.3	2.9	2.8	5.1	4.8	4.7	5.0
Japan	2.7	2.9	2.3	2.2	4.4	4.1	3.7	3.5
Euro zone	1.4	2.1	2.0	2.1	8.6	8.2	8.0	7.9
Germany	1.1	2.0	1.6	1.8	9.5	8.9	8.6	8.6
France	1.4	1.9	2.1	2.1	9.5	9.1	8.9	8.8
OECD	2.8	3.1	2.9	2.7	6.5	6.3	6.0	5.9

	Inflation rate (%)				Short term interest rate (%)			
	2005	2006	2007	2008	2005	2006	2007	2008
US	2.8	3.0	3.3	2.7	3.5	5.0	5.2	5.2
Japan	-0.8	-0.2	-0.1	0.4	0.0	0.2	1.1	1.7
Euro zone	2.0	2.2	2.2	2.0	2.2	2.9	3.8	4.3
Germany	1.3	1.9	2.4	1.8	n/a	n/a	n/a	n/a
France	1.2	1.5	1.7	1.8	n/a	n/a	n/a	n/a
OECD	2.1	2.4	2.5	2.2	n/a	n/a	n/a	n/a

**Note:** Inflation rate is measured by consumer prices.

Sources: OECD Latest Release, [www.oecd.org](http://www.oecd.org), the *National Institute Economic Review*, **196**, April 2006.

## Europe

Euro Area GDP increased by 1.4 per cent in 2005. Growth weakened significantly in 2005Q4 to 0.3 per cent but rose by 0.6 per cent in 2006Q1, giving growth of 2.0 per cent on the same period last year. One of the problems of the Euro Area is the weakness of domestic demand, particularly consumption and investment. Consumption grew by 1.4 per cent last year but is forecast to increase by 1.8 per cent this year. The quarterly growth estimate for consumption initially indicated a contraction of 0.2 per cent but this has been revised up to growth of 0.1 per cent for 2006Q1. Investment grew by 1.1 per cent last year and is forecast to grow by 3.4 per cent this year and 3.5 per cent in the following year. The estimate for investment in 2006Q1 was growth of 0.8 per cent but this has been revised down to 0.3 per cent. Export growth has been revised upwards and net trade has contributed 0.2 percentage points to Euro Area GDP. The forecast for Euro Area growth for 2006 and 2007 are 2.1 and 2.0 per cent respectively. This should be compared to EU25 growth forecasts of 2.3 for both years. The downside risks to the Euro Area continue to be global imbalances and any sharp correction to oil prices or the housing market.

Table 3 indicates the strength of growth in some of the leading East European economies. Clearly the New Member States (NMS) are forecast to expand rapidly but convergence of growth within the NMS will begin in 2007. Thereafter there will be a slow period of harmonisation with

the rest of the EU. The outlook for Europe therefore is improving (see Table 1 for the forecasts of growth) and recovery seems to be broadly based across sectors. The NMS are still expected to grow more quickly than the Euro Area but consolidation is expected in the future. Their growth is supported by strong exports to the Euro Area and by the absorption of EU funds. A danger for the EU NMS is that as their growth is broad based, and migrants leave their economies then consumption increases leading to an increase in investment (primarily from EU funds); then their will be a significant increase in domestic demand but this could lead to a current account deficit.

German GDP grew by 0.4 per cent in the first quarter of 2006 compared to in the last quarter of 2005. For 2005 as a whole GDP growth was 1.1 per cent. The forecast is for GDP to grow by 2.0 per cent in 2006 (having a significant temporary boost from the World Cup) but to slow to 1.6 per cent in 2007. Germany is set to have a substantial VAT increase (close to a 3 per cent increase in total indirect taxes) which should raise €24.4 billion. Employee insurance taxes will be cut by €1.5 billion and unemployment insurance will be decreased by €14.5 billion. There will be an increase of €3.0 billion in the contribution to public pensions and of €2.0 billion in public healthcare insurance. Overall the package should improve the budget balance by 0.4 per cent of GDP in 2007. The leading indicator for Germany increased by 0.4 per cent in 2006Q1 and by 1.4 per cent over the year.

**Table 2 Change in Components of Demand and Main Macroeconomic Indicators for the US, Japan, the Euro Area and the UK, 2004-2006**

	The US			Japan			Euro Area			The UK		
	2005	2006	2007	2005	2006	2007	2005	2006	2007	2005	2006	2007
Consumption	3.5	3.2	3.0	2.2	2.4	1.4	1.4	1.8	1.8	1.7	2.2	1.9
Investment	7.1	3.6	1.0	-0.7	2.0	0.0	1.1	3.4	3.5	3.2	3.4	3.5
Government	1.5	2.1	1.3	1.8	1.8	2.2	1.4	2.1	1.5	2.9	2.5	2.3
Domestic Demand	3.6	3.4	2.9	2.6	2.3	2.0	1.4	2.2	2.1	1.9	2.5	2.3
Exports	6.9	5.3	4.8	6.9	8.6	6.0	3.9	6.1	4.9	5.6	6.1	4.7
Imports	6.3	5.2	4.4	6.2	5.3	4.6	4.7	6.4	5.2	5.3	5.9	3.1
GDP	3.5	3.3	2.9	2.7	2.9	2.3	1.4	2.1	2.0	1.8	2.5	2.8
Unemployment	5.1	4.8	4.7	4.4	4.1	3.7	8.6	8.2	8.0	4.8	5.2	5.3
CA (% GDP)	-6.4	-6.2	-6.0	3.6	2.5	2.6	-0.3	-1.0	-0.9	-2.6	-2.7	-3.0
Effective Ex. Rate	91.7	92.2	92.5	79.2	71.5	71.0	119.0	119.4	119.4	95.0	94.4	94.2

**Notes:** US investment is housing investment, others are private investment. Effective Exchange Rate = 100 in the year 2000. Forecasts are those of the National Institute for Economic and Social Research, see NIER (2006) April, **196**.

German consumption grew by 0.2 per cent in 2005 but investment increased by 1.5 per cent in 2005. The forecast for consumption and investment in 2006 is 0.6 and 2.9 per cent respectively. One of the main problems in the German economy are structural factors where depressed consumption growth has led to a moderation of wage growth and this has led to an increase in competitiveness with respect to Eastern European states. This moderation of consumption and gain of competitiveness is however at the expense of gains in real wages thus impacting on German growth. To a lesser extent this is also observed in Italy.

**Table 3, Growth in the New Member States, 2005-2007**

	2005	2006	2007
Czech Republic	6.0	4.8	4.4
Slovenia	6.0	5.9	4.8
Lithuania	7.5	6.4	6.1
Latvia	10.2	7.6	6.9
Estonia	7.8	7.9	5.5

**Notes:** Forecasts are those of the National Institute for Economic and Social Research, see NIER (2006) April, **196**.

French GDP grew by 0.5 per cent in 2006Q1 and by 1.4 per cent in 2005. The leading indicator in France grew by 0.2 per cent in the first quarter of 2006 and by 3.4 per cent over the year. French GDP is forecast to increase by 1.9

per cent this year and by 2.1 per cent in 2007. French consumption increased by 0.5 per cent in 2005Q4 while household consumption of manufactured goods increased by 0.5 per cent in January 2006 and by 1.5 per cent in February. The indicators suggest that French consumption will rise by 2.5 per cent in 2006 compared to 2.1 per cent in 2005. Further the French economy is not being assisted by tax breaks but investment is strong. French investment grew by 3.5 per cent in 2005 and is forecast to increase by 2.8 and 3.1 per cent respectively in 2006 and 2007. Business investment is strong (growing at more than 10 per cent in 2004 and 2005) but government spending remains relatively muted. Exports are expected to make a positive contribution to GDP in 2006 despite a significant increase in imports in the last quarter of 2005. Most French exports go to the Euro Area and they have little penetration to fast growing regions of the world whereas Germany has considerable penetration to these countries. French exports are also less competitive than German exports. French employment growth has been significant, particularly in services growing at 0.9 per cent over the year compared to total employment growth of 0.4 per cent. Unemployment is forecast to decline slowly.

The European PMI survey and the ifo index indicate that there will be strong growth in European manufacturing and investment while the recession in construction will come to an end. Increased profits are leading to higher household demand and residential construction orders are up. Essentially the upturn is cyclical and fundamental. The German ifo index reached a 15 year high in April 2006 and

there are signs of robust growth this year. The recovery is underpinned by employment growth and a slight pick up in wages.

Annual HCIP inflation was 2.2 per cent in 2005 in the Euro Area and is forecast to be 2.2 per cent in 2006 and the same in 2007. HCIP inflation was 2.4 per cent in April, up from 2.2 per cent in March. The price of services may have contributed significantly to this. Moreover, a contribution from oil may also have declined to this as up to February the growth of energy prices was 0.5 per cent but this has moderated. Producer prices slowed to 5.1 per cent in March from 5.4 per cent in the previous month. Again this was driven by a deceleration in energy prices. The ECB increased the base rate in March 2006 by 25 basis points to 2.5 per cent. It is forecast that interest rates will rise to 2.75-3.0 per cent this year.

The outlook for the Euro Area is now much more promising than previous expectations. The forecast of the Euro Area GDP growth is 2.1 per cent this year and 2.0 per cent next year. Inflation is forecast to be 2.2 per cent in 2006 and interest rates are expected to be tightened by a further 25 basis points to combat any rising inflation. Unemployment will only decline at a relatively slow rate over 2006 to 2008. The main risks are global imbalances, the fiscal consolidation in 2007, a sharp correction to the housing market and sustained higher oil prices.

## Japan

Japanese GDP grew by 2.7 per cent in 2005 and by 0.5 per cent in 2006Q1 or by 3.0 per cent over the year (2005Q1 up to 2006Q1). Consumption grew by 2.2 per cent over 2005 and is forecast to grow by 2.4 per cent in 2006. Business investment increased by 7.9 per cent in 2005 and is forecast to grow at 4.5 per cent in 2006. Government spending rose by 1.8 per cent last year and is forecast to be the same this year. Exports grew by 6.9 per cent in 2005. Exports are mainly to the US and Asia. The forecasts for export growth differ according to source: the National Institute indicates Japanese exports will grow by 8.6 per cent whereas OECD estimates 12.3 per cent for 2006. Import growth was 6.2 per cent in 2005 but forecasts range from 4.9 to 5.3 for 2006. Exports, business investment, rising labour incomes and personal consumption will be the main drivers of growth in 2006.

The short-term interest rate in Japan is maintained at 0.0 per cent although the tone of the Bank's statement has differed with the Bank now referring to 'economic expansion' as opposed to the previous 'economic recovery'. The output gap is close to zero and is forecast to turn positive in 2006. The official inflation rate is 0 to 2 per cent and the lower end of this range needs to be increased. The April CPI increased by 0.3 per cent and over twelve months rose by 0.4 per cent. There have been several consecutive increases in inflation (excluding fresh food) but this is more limited when core inflation (excluding fresh food and energy) is taken into account. However with

robust recovery, increasing employment, rising inflation and a closing output gap it seems definite that the Bank will move sooner rather than later to increase rates.

The Tankan survey continues to demonstrate rising confidence and Japan's main leading indicator increased by 0.7 per cent in April on a quarterly basis and by 2.7 per cent over the year. The Tankan survey showed particularly strong growth in 2006Q1 and Japanese manufacturing reported significantly buoyant results. The dampening effect on the survey reflected the sensitivity of the energy and commodity based industries. Unemployment was 4.4 per cent in 2005 and is forecast to be 4.1 per cent this year and 3.7 per cent in 2007. Overall the future for the Japanese economy is very promising.

Growth in China was 9.9 per cent in 2005 and it is forecast to be 9.7 per cent in 2006 and 9.5 per cent in 2007. Exports, investment and strong corporate profits are underpinning the expansion in the Chinese economy. Inflation was 3.8 per cent in 2005 and is forecast to be 3.4 per cent this year. The surplus (as a percentage of GDP) is forecast to decline slightly to 5.9 per cent compared to 6.3 per cent in 2005. India also exhibits very strong growth, 8.5 per cent in 2005 and forecast growth of 7.5 per cent in 2006 and 7.1 per cent in 2007. Inflation is forecast to peak at 4.8 per cent in 2006 before slowing to 4.3 per cent in 2007.

Kenneth Low  
16th June 2006

# The UK economy

## Overview

The world economy continues to grow at a relatively strong rate with the US, Japan and some non-OECD countries being the principal areas driving growth. China and India in particular have experienced very fast growth and are forecast to continue at a similar pace over the next two years. Although the Euro Area has been growing at below trend there are now strong signs of a broad based recovery

that appears to be robust in nature and therefore growth is expected to return to trend in both 2006 and 2007. Global inflationary pressures remain relatively muted despite significant increases in the oil price but this reflects a decreased dependency on oil in the developed economies.

In the UK real GDP growth was 0.6 per cent in the first quarter of 2006, just as it was in fourth quarter of 2005. Growth for 2005 was 1.8 per cent and for the four quarters up to 2006Q1 growth was 2.2 per cent. As before services continue to drive the UK economy particularly financial services although there is much more broad based growth than previously seen.

**Table 1: Independent forecasts of the UK economy**

	2006	2007	2008
Real GDP growth (%)	2.3	2.5	2.6
Inflation rate (CPI %)	2.0	1.9	1.9
Inflation rate (RPI %)	2.5	2.4	2.3
Inflation rate (RPIX %)	2.3	2.2	2.3
Claimant count, (million)	0.98	1.02	0.99
Employment growth (%)	0.4	0.5	0.4
Average Earnings (%)	4.0	4.3	4.5
ERI (1990=100)	99.3	97.9	99.5
Current account (£ billion)	-31.8	-32.9	-35.0
(per cent of GDP)	-2.5	-2.5	-2.3
PSNB (£ billion)	38.1	37.3	34.4
(per cent of GDP)	3.0	2.8	2.5

**Source:** National Statistics, *National Institute Economic Review*, **196**, April 2006 and "Forecasts for the UK economy", HM Treasury, 228, June 2006 and 227, May 2006. Note: PSNB is given for financial years, e.g. 2005 is 2005/06

## Outlook

The consensus forecasts for the main UK economic indicators are taken from a monthly survey by HM Treasury of City and other independent forecasters and are presented in Table 1. Real GDP growth was 0.6 per cent in 2006Q1 or 2.2 over the year. The forecast for UK GDP growth is 2.3 per cent in 2006 and 2.5 per cent in 2007. Investment and government spending are forecast to be important drivers of UK growth while there may have been a shift away from consumption towards investment and trade.

Inflationary pressures are steady but relatively subdued e.g. average earnings are well within expected bounds and there appears to be no significant pass through effects from high oil prices. The labour market is expected to

perform strongly. The current account is forecast to improve in the medium-run (to -2.3 per cent of GDP) a slight deterioration from our last forecast. The PSNB is forecast to rise to £38.1 billion in 2006-07. As a percentage of GDP this is 3.0 per cent.

## Output growth and components of demand

UK GDP (chained volume measure) grew by 0.6 per cent in 2006Q1 which was the same as growth in 2005Q4. Growth was 1.8 per cent for 2005 and for the four quarters up to 2006Q1 growth was 2.2 per cent. GVA at basic prices grew by exactly the same as GDP (in the latest quarter and for over the year). The service sector remains the principal driver of UK GDP growth (the percentage contribution to GDP in 2006Q1 was 0.4 percentage points) although significant contributions were made in virtually all sectors. Only in distribution, retail and wholesale was quarterly growth below 0.5 per cent although on an annual basis

mining and quarrying, manufacturing and production made negative contributions.

Consumption growth in 2006Q1 was poor at only 0.2 per cent compared to 0.7 per cent in 2005Q4. On an annual basis consumption has grown by 1.7 per cent. Growth in government spending was 0.6 per cent (compared to 1.2 per cent last quarter) taking annual growth to 4.6 per cent. Investment grew by 1.5 per cent in the last quarter (compared to a contraction of 0.5 per cent last quarter) or by 3.7 per cent over the year. Export growth has strengthened significantly from 2.2 per cent in 2005Q4 to 4.7 per cent in 2006Q1 giving growth of 11.9 per cent over the last four quarters. Import growth in 2006Q1 has however, accelerated more quickly from 1.0 per cent in 2005Q4 to 5.5 per cent in the latest quarter. Thus imports over the year have grown by 12.0 per cent. This has meant that the deficit in net exports widened from £10.8 billion in 2005Q4 to £12.0 billion in 2006Q1. The contribution of net trade to growth over 2005 was broadly neutral but the Bank of England expects a slight improvement in 2006 although it may remain a marginal situation.

While the pattern of expenditure is uneven the most significant factor is the slowing of consumption growth from 0.7 per cent to 0.2 per cent. This leaves average consumption growth around 0.5 per cent. Given the lack of any sizeable revision by ONS to the data it may be that the change is not a temporary one due to discounting or a change in a seasonal pattern but could be evidence of a significant change towards investment and trade expenditure.

Growth in services was 0.6 per cent in 2006Q1 or 3.0 per cent on an annual basis. Within financial and business services growth was strongest at 0.8 per cent over the quarter and 3.9 per cent over the year. Growth in retail, wholesale and distribution was disappointing at only 0.4 per cent in 2006Q1. Growth in financial intermediation was 2.7 per cent for the first quarter (5.4 per cent on an annual basis). Hotels and restaurants grew by 1.7 per cent in 2006Q1. On an annual basis the strongest growth came in financial intermediation (5.4 per cent); real estate and business services (5.2 per cent); other services (4.2 per cent) and in post and telecommunications services (3.6 per cent).

Production increased by 0.8 per cent in 2006Q1 but declined by 0.9 per cent over the year. Manufacturing grew by 0.7 per cent as did mining and quarrying while electricity, gas and water supply increased by 1.8 per cent. It would appear therefore that most sectors of the economy are growing relatively strongly and that the slowdown towards the end of 2005 has passed. Output in the construction industry increased by 0.7 per cent in the first quarter and advanced by 1.0 per cent on an annual basis. The UK current account widened to -£19.2 billion in the fourth quarter of 2005 compared to -£10.1 billion in the same quarter of 2004. The UK deficit on trade in goods and

services fell from -£5.2 billion in February 2006 to £4.0 billion in March and was unchanged in April. For the three months ended April 2006 the deficit was £13.2 billion, unchanged from the previous three months. The balance on trade in services remains positive and close to trend.

A current budget surplus of £3.0 billion was recorded in April 2006 compared to £1.7 billion in April 2005. Net debt was estimated to be £418.4 in April 2005 (34.3 per cent of GDP) and rose to £457.1 billion in April 2006 or (36.3 per cent of GDP). The public sector had net borrowing of -£1.4 billion in April 2006 compared to -0.9 billion in April 2005. The PSNB requirement for 2005/06 is £38.9 billion compared to £39.7 billion in 2004/05.

### Prices

CPI inflation was 2.2 per cent for the 12 months to May 2006 compared to 1.9 per cent in April 2005. Growth of the RPI in the same period was 3.0 per cent compared to 2.9 per cent 12 months ago. RPIX grew by 2.9 per cent in May 2006 while in May 2005 the 12 month growth rate was only 2.1 per cent. Housing, water, fuel and electricity were the components that increased the index most significantly. Other items contributing to a rise in inflation included food and non-alcoholic beverages and clothing and footwear. Notably the cost of air travel fell slightly although it increased considerably a year ago. The output price for manufactured products increased by 3.0 per cent to May 2006. This compares to 2.5 per cent to April and 2.7 per cent in May 2005. Average earnings growth is non-inflationary and interest rates were kept on hold at 4.5 per cent but it is increasingly likely that the mpc will vote for another increase of 25 basis points in 2006. The outlook for inflation and interest rates is presented in Table 1.

The RBS/CIPS PMI survey for the UK showed that manufacturing strengthened with the index at 53.2, slightly down on the 54.0 recorded in April. In the service sector the result was similar; the May index was 57.2 compared to 57.9 in April. Average earnings grew by 3.8 per cent (excluding bonuses) or by 4.3 per cent (including bonuses) in the private sector in March 2006. In the manufacturing sector growth was 4.6 per cent and 4.8 per cent respectively.

### The labour market

UK employment stood at 28,896,000 in January-March 2006, an increase of 127,000, giving an employment rate of 74.7 per cent up from 74.5 per cent on the previous period. ILO Unemployment was 1,586,000 or 5.2 per cent for January-March 2006 compared to 1,541,000 (5.1 per cent) in the previous period (October to December 2005). January-March 2005 recorded employment of 28,679,000 (74.9 per cent) and ILO unemployment of 1,409,000 (4.8 per cent). Claimant count unemployment for April 2006 was 945,500 or 3.0 per cent compared to 937,800 (3.0 per cent) in March 2006 and 839,200 (2.7 per cent) in April 2005.

Unemployment on this measure has increased by 106,300 or by 12.7 per cent over the year. The unemployment rate has only increased by 0.3 percentage points. There were 30,482,000 (78.8 per cent) economically active people in January-March 2006 compared to 30,087,000 (78.6 per cent) in January-March 2005. The change over the year is 395,000 (0.2 percentage points) respectively. The numbers of economically active people have increased by 1.3 per cent on an annual basis. There was a small change (-79,000) in those who were economically inactive (17,568,000) and the rate fell slightly to 21.2 per cent.

Self employment increased by 48,000 over the latest quarter to 3,748,000 and this was a change of 119,000 over the year. Full-time employment increased to 21,577,000 in January-March 2006, up 85,000 over the quarter and by 158,000 over the year. Part-time work increased from 7,297,000 to 7,339,000, a rise of 43,000 over the period and up 60,000 over the year. The number of people with second jobs declined slightly; by 4,000 over the quarter but by 31,000 on an annual basis. Employment increased in virtually all sectors of industry with the exception being retail, wholesale and distribution. The largest gains were in the financial and public sectors. Employment growth was much less marked in energy and water; manufacturing and construction. There were 568,700 vacancies in the three months to April 2006 which is down 4,100 from the previous three months and by 32,000 on an annual basis. This gives a ratio of 2.3 vacancies per 100 jobs which is unchanged from the previous quarter. Redundancies are up by 1,000 from the previous three months and by 10,000 from the previous year. Manufacturing productivity increased by 2.9 per cent in January-March 2006 while unit wage costs rose by 1.9 per cent, compared with the same period earlier.

The UK labour market remains flexible and competitive with the second highest employment rate in Europe and a very low rate of unemployment. Caution is needed here however, as unemployment is clearly increasing and at a rate greater than the economic activity rate – we are not creating enough jobs for those who wish to have a job. One of the sources that impact significantly on this is the number of immigrants, particularly from Eastern Europe. This has been a boost to the economy and has meant the pressure on average earnings has been lower thus helping to mitigate the effects on inflation from higher wage costs. Furthermore the number of long-term unemployed is rising and is now approaching 40 per cent of the total number unemployed. The second half of 2006 and 2007 are forecast to have an improved labour market.

The outlook for the UK economy remains promising despite a slowing of growth in 2005. The forecast for growth in the medium-term is 2.5 per cent. Inflationary pressures are subdued and it is still unlikely that there will be any shocks in the UK economy especially arising out of higher oil prices. The main risks to the economy are global imbalances, a significant correction either to the US or the

UK housing market or oil prices feeding into the wage bargains through second round effects. On balance however there is a greater sense of optimism and the balance of risks have moved towards the positive. There could be just a temporary blip in consumption spending resulting in higher than forecast consumption, looser monetary policy could expand output slightly above expectations and exports could get a greater boost than expected due to the sustained recovery in the Euro Area.

Kenneth Low  
24th June 2006



# The Scottish economy

## Forecasts of the Scottish economy

### **Economic background**

While the world economy slowed slightly in 2005 it is now clear that strong growth remains in the US, Japan, China, India and several other non-OECD countries. While the Euro Area has been a slow performer there are now signs of a broad based recovery even in Germany. We suggest that there is still a problem translating increased activity into higher incomes and therefore Germany could be losing out on some consumption gains. The US is forecast to grow by 3.3 per cent in 2006 and by 2.9 per cent in 2007 with Japan growing by 2.9 and 2.3 per cent respectively. However across the Euro Area domestic demand is strengthening and this bodes well for UK exporters. The only significant downward effect on demand in Europe is likely to come from the VAT increase in Germany. The forecast for the Euro Area is 2.1 per cent in 2006 and 2.0 per cent in the following year. Global inflationary pressures are relatively subdued but not absent as there is a decreased dependency on oil on behalf of the major economies of the world. There is little expectation that the recent high oil price will be transmitted into a wage-price spiral. The indications are that there will be further monetary tightening in the world economy as economic activity gathers pace. Labour markets are also expected to perform well over the forecast horizon. The outlook for non-OECD countries especially China and India remains very healthy.

UK GDP growth was 0.6 per cent in 2006Q1 after 2005Q4 growth of 0.6 per cent. Growth of GDP over the four latest quarters was 2.2 per cent. GVA at basic prices also grew by 0.6 per cent in the latest quarter. Consumption growth slowed dramatically to 0.2 per cent in 2006Q1 after growth of 0.7 per cent in 2005Q4. This may be temporary, resulting in average consumption growth of around 0.5 per cent but it could be a signal that the composition of spending is changing towards investment and trade. The contribution made by net trade recently has been relatively neutral but this is expected to improve modestly. UK inflation is close to target and interest rates have been maintained at 4.5 per cent although there are increasing signs that a further 25 basis point rise is coming this year. The UK labour market has performed strongly although unemployment and long-term unemployment are rising. The economy simply is not creating enough jobs for those joining the labour force. The main risks to the economy remain imbalances in the global economy, a significant correction to the US or UK housing market although it is unlikely that high oil prices will feed through into the wage bargain in an adverse manner. The UK economy is gaining

momentum with the balance of risks shifting towards the positive. UK survey evidence is promising and the forecast for UK GDP growth is 2.3 and 2.5 per cent in 2006 and 2007 respectively.

### **The Scottish economy**

GVA growth in the Scottish economy was 0.6 per cent for 2005Q4 on 2005Q3 or 1.8 per cent for the four latest quarters on the preceding four quarters. Comparing the Scottish GVA index to the UK index it can be seen that both economies grew by 1.8 per cent in 2005. If oil and gas are excluded however the UK marginally outperforms Scotland with growth of 2.0 per cent compared to 1.9 per cent in Scotland. The service sector grew by 0.7 per cent in the latest quarter compared to 1.0 per cent in the UK while annual growth was 2.8 per cent, identical to that of UK services. Scottish manufacturing contracted by 0.2 per cent in 2005Q4 (-1.1 per cent in the UK) and over the year the decline was 0.8 per cent (-1.1 for the UK). Agriculture decreased by 0.8 per cent in the latest quarter compared to a contraction of 0.6 per cent in the UK. The annual figures were 0.5 per cent and -0.8 per cent for Scotland and the UK respectively. Although we had previously warned of four consecutive quarters of decline in electronics in 2005, the sector had significant data revisions that saw no change in the second quarter and growth in the third quarter. Growth in Scottish construction was 2.1 per cent in 2005Q4 compared to 1.3 per cent in the UK. On an annual basis the figures were 0.2 and 1.1 per cent respectively.

Labour market performance remains strong despite the fact that the recent trend in employment is broadly flat. The employment rate is close to that at the same time last year. Unemployment is decreasing but similarly is not significantly different from this time last year. Scottish employment declined by 4,000 in January-March 2006 and over the year only grew by 3,000 whereas UK employment increased by 127,000 (up 0.6 per cent) in January-March 2006 and by 217,000 (up 1.3 per cent) over the year. Scottish employment was 2,464,000 in January-March 2006 or an employment rate of 75.3 per cent. For January-March 2005 the data were 2,606,000 and 75.3 per cent. The UK employment rate is currently 74.7 per cent and one year ago was 74.9 per cent. ILO unemployment in Scotland was 1,586,000 in January-March 2006, an increase of 44,000 (up 2.9 per cent) over the quarter and a rise of 177,000 (up 12.6 per cent) over the year. The unemployment rate is similar to the UK rate at 5.3 per cent (UK is 5.2 per cent) and one year ago the rates were 5.6 per cent and 4.7 per cent respectively. Claimant count in Scotland was 88,000 (3.3 per cent) in April 2006 compared to 945,500 (3.0 per cent) in the UK. Last year Scottish claimant count was 86,100 (3.2 per cent) compared to 839,200 (2.7 per cent) in the UK. Clearly, UK claimant count is lower than the Scottish rate. The economic activity rate in Scotland for January-March 2006 was 79.6 per cent compared to 79.9 per cent one year ago. In the UK these data are 78.8 per cent and 78.6 per cent respectively. The Scottish labour market continues to slightly outperform the

UK in some respects (higher employment rate, maintaining the unemployment rate, UK relative deterioration in claimant count and a marginally better economic activity rate).

Scottish manufactured exports grew by 1.9 per cent in 2005Q4 but declined by 1.9 per cent over the year. The sectors with the strongest growth include: metals at 9.0 per cent (5.6 per cent annually); transport equipment at 8.0 per cent (3.2 per cent annually); chemicals 7.8 per cent (-4.7 per cent annually) and other manufacturing at 5.5 per cent (1.3 per cent over the year). The weakest sectors were drink, contracting by 5.9 per cent (growth of 7.1 per cent over the year); textiles declined by 4.3 per cent (decreased by 3.9 per cent over the year) and electronics which grew by 2.5 per cent in 2005Q4 but over the year contracted by 11.5 per cent.

The Scottish Chambers of Commerce Business Survey demonstrated a rise in business confidence in construction and retail, a level rate in wholesale and an easing in manufacturing and retail. The rising trends were reported by both small and large firms which, indicates that this optimism is evenly spread across these sectors. Tourism respondents reported better than anticipated activity while the service sector reported increased demand for wholesale and logistics. Manufacturing respondents reported a modest rise for work in progress but average capacity remained at 79 per cent although the number working below optimum levels eased to 39 per cent. The main concerns expressed related to raw material and transport costs and to a lesser extent fuel costs. Pay increases in the first quarter ranged from 3.2 per cent in retail to 5.2 per cent in construction. Recruitment activity was higher in manufacturing and tourism but was lower in construction, retail and wholesale. Respondents were more cautious about the next twelve months with regard to turnover and profitability. Price pressures also appear to be getting stronger.

The Scottish economy continues to perform relatively well and the signs for the manufacturing sector are now much more positive. Several manufacturing sectors have steady output growth although the annual trend in textiles, ORNF and electronics remains a cause for concern. The stimulus from European export markets is expected to strengthen as activity picks up in the Euro Area and this will have significant benefits for the Scottish economy. This is the context to our forecasts for the Scottish economy.

### **The forecast in detail**

#### **GVA**

The forecast for GVA for 2006 is 2.1 per cent. In 2006 the forecast is for growth of 2.1 per cent followed by 2.3 per cent in 2007. Services are forecast to grow by 3.0 per cent in 2006 and by 2.8 per cent in 2007. Manufacturing is forecast to grow by 0.1 per cent in 2006 and by 1.5 per cent in 2007. Agriculture is forecast to increase by 1.1 per

cent in 2006. Growth in this sector is forecast to be relatively mediocre over the forecast horizon. Construction growth appears to be hampered by supply constraints.

**Table 1 Main Forecasts of the Scottish Economy, 2005-2008**

	2005	2006	2007	2008
GVA	1.8	2.1	2.3	2.2
Agriculture	0.5	1.1	1.0	0.6
Manufacturing	-0.8	0.1	1.5	1.3
Construction	1.3	0.8	1.2	2.4
Services	2.8	3.0	2.8	2.6

**Source:** Fraser of Allander Institute, June 2006

### Final demand

Consumption, investment and government spending remain the key drivers of the economy in Scotland. Export growth is improving and is expected to be much more important in 2007 and 2008. The main factors affecting the forecast are given below:

The Scottish economy does not appear to have experienced the same sort of slowing as the UK economy at the end of 2005 consequently it is unlikely that Scottish consumers have cut back on consumption as that reported in 2006Q1 in the UK where consumption growth slowed to 0.2 per cent from 0.7 per cent in 2005Q4;

Investment growth is forecast to pick-up more strongly in 2007 and 2008 than we previously expected;

Tourism has been better than anticipated but there is still a significant pick-up in tourism which may come when the Euro Area growth strengthens further in 2007 and 2008 and

Exports have grown at 1.9 per cent in 2005Q4 but contracted by 1.8 per cent over the year. Exports are still affected significantly by electronics but textiles and food also contracted their activity in 2005.

### Output

Agriculture has continued to be a mediocre performer and the forecast for 2006 is 1.1 per cent and a similar rate of growth is expected in 2007. There are several challenges facing the sector in the short and medium-run. Electricity, gas and water supply is forecast to contract although at a decreasing rate over the forecast horizon. A significant expansion in the manufacturing sector and a solution to the energy question (nuclear or renewables) will reduce the uncertainty that surrounds this sector. Construction only grew by 1.3 per cent in 2005 and it is forecast that if the

housing market does not slow down and the number of PPP projects remain at the current level then growth will be constrained by the lack of supply of labour, finance and equipment. The contributions of both construction and manufacturing to Scottish GVA would normally be expected to be more significant.

Manufacturing contracted by 0.8 per cent in 2005 and the forecast for 2006 is 0.1 per cent and for 2007 it is 1.5 per cent. Survey data and anecdotal evidence all point to a stronger degree of confidence in the sector and European demand is expected to help stimulate exports from the sector in 2007. The strongest sectors within manufacturing in 2005 were: chemicals (7.0 per cent growth on an annual basis) transport equipment (3.2 per cent) and both drink and mechanical engineering (1.5 per cent). ORNF remains volatile and the weakest performers were textiles (-12.9 per cent); electronics (-8.2 per cent) and ORNF (-7.8 per cent). For 2006 and 2007 the sectors with the strongest forecasts include transport equipment, chemicals and food.

Services drive growth and employment in Scotland, more recently and are forecast to continue to do so. The forecasts for services for 2006 and 2007 are 3.0 per cent and 2.8 per cent respectively. Within services the fastest growing sectors include financial services and real estate and business services. Public services are very important with respect to employment. Both stronger expected tourism flows and increased retail sales drive forward increases in service sector growth. Financial services and the housing market are two key drivers of growth in this sector. Growth in the service sector is forecast to be 2.7 per cent per annum for 2006 to 2008 compared to 1.4 per cent per annum in manufacturing in the same period.

### Employment

Our forecasts of employment are presented in Table 2 with the net employment change figure in brackets. The employment figures are calibrated on the employers' quarterly survey series as given in Table B.16 in Labour Market Trends, National Statistics.

The employment (jobs) forecast for 2006 is 2,288,500 and 2,309,200 for 2007. This is a net job change of 16,700 and 20,700 respectively. The employment forecast for 2008 is 2,329,700 which is a net job change of 20,700. Services are the critical driver of employment across the medium-term although manufacturing employment will become more important from 2007 onwards. Employment growth in construction is likely to be more significant towards the end of the forecast period.

The service sector is forecast to have 1,814,000 jobs in 2006 (an increase of 14,700 jobs) and 1,830,300 jobs in 2007 (a rise of 16,300). In 2008 the service sector will provide 1,844,700 jobs (a net change of 14,400 on the previous period).

In manufacturing we forecast a net gain of 1,400 jobs in 2006 taking the number of jobs to 250,100. In the following year we are forecasting 3,300 new jobs in manufacturing giving 253,400 jobs overall. Manufacturing output and employment is mainly driven by the exporting sectors in 2007 and 2008.

Construction employment is forecast to be 146,400 in 2006 (an increase of 700 jobs) and 147,600 in 2007 (a rise of 1,200 jobs). In 2008 employment is forecast to increase to 150,000. Construction employment gains may be limited because of the supply constraints on the industry. Agricultural jobs have little change in this forecast.

**Table 2 Forecasts of Scottish Employment (000s) and Net Employment Change, 2005-2008**

	2005	2006	2007	2008
Total Employment	2,271.8 (13,200)	2,288.5 (16,700)	2,309.2 (20,700)	2,329.7 (20,500)
Agriculture	36.8 (0)	36.9 (100)	37.1 (200)	37.1 (0)
Manufacturing	248.7 (-900)	250.1 (1,400)	253.4 (3,300)	257.2 (3,800)
Construction	145.7 (-1,000)	146.4 (700)	147.6 (1,200)	150.0 (2,400)
Services	1,799.3 (15, 600)	1,814.0 (14,700)	1,830.3 (16,300)	1,844.7 (14,400)

**Source:** Fraser of Allander Institute, June 2006

## Unemployment

We present our forecasts of unemployment in Table 3. Both the ILO measure and claimant count measure are given. The preferred measure of unemployment however is ILO unemployment as given by the LFS.

**Table 3 Forecasts of Scottish Unemployment, 2006-2008**

	2006	2007	2008
ILO Unemployment Rate	139,000 5.3%	136,900 5.3%	134,200 5.2%
Claimant Count Rate	84,200 3.2%	83,700 3.2%	82,900 3.1%

**Source:** Fraser of Allander Institute, June 2006

As in previous forecasts the outlook for unemployment is relatively upbeat. Our forecasts of unemployment for 2006-08 demonstrate a gradual downward trend despite the recent small rise in unemployment. The forecast for the ILO unemployed is 139,000 (5.3 per cent) in 2006 and 136,900 (5.3 per cent) in 2007. The claimant count is also forecast to decrease across the forecast horizon. The 2006 forecast is for claimant count of 84,200 (3.2 per cent) and only moving down marginally to 82,900 (3.1 per cent) by 2008. We remain convinced that Scottish unemployment will be at low and stable levels over the forecast period. Given the recent performance of the Scottish labour market we do not see any reason to change our opinions over unemployment.

Kenneth Low  
26th June 2005



## Business Forecasting Services

The Fraser of Allander Institute offers a confidential forecasting service to public and private sector clients with:

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- Access to detailed sectoral information from the influential Scottish Chambers' Business Survey

Independent research by Business am rated the Institute as the "most accurate" forecaster in 1999-2000 of the six leading groups who produce Scottish forecasts.

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# Scottish Chambers' Business Survey

## Business Performance

### Recent past and next three months

Business confidence rose in construction and tourism, remained level in wholesale and eased in logistics, manufacturing and retail. Nevertheless, business optimism rose amongst larger firms in manufacturing, logistics and retail.

Rising trends in demand were reported by small and large manufacturing firms, and amongst larger construction firms. In the service sector demand rose in wholesale and logistics. For a further quarter tourist respondents reported rising and better than anticipated trends in visitor numbers. In contrast sales remained weak in retail, although rising sales trends were reported for a net of retailers employing more than 25 staff;

Manufacturing respondents again reported a modest rise in the volume of work in progress; and whilst average capacity used remained at 79%, the percentage reporting working below optimum levels eased further to 43%. Construction firms reported a rise in average capacity used, and a slight easing in the level of work in progress, but expect rising trends to re emerge over the next six months;

In the service sector wholesale respondents reported a rising trend in sales. In retail larger firms reported rising sales trends and national retailers reported better trends than independent stores; rural respondents again reported weak sales trends. Overall 50% of retail respondents (compared to 62% in the fourth quarter) reported rising or level trends in sales. Tourism respondents reported good first quarter results, with rising business demand and rising Scottish, and rest of UK visitor numbers;

Concerns over raw material and transport costs were again widely cited by manufacturing respondents, 70% of construction firms anticipate rising material costs in 2006 and transport costs were widely cited in wholesale and retail distribution. Rising fuel costs and regulation costs were widely cited by logistics firms;

Pay increases in the first quarter ranged from 3.2% in retail to 5.2% in construction. Recruitment activity was generally lower than in the previous quarter in construction, wholesale and retail, but was higher in manufacturing and tourism.

### *Expectations for the next twelve months*

For a further quarter both manufacturing and construction respondents are more cautious in their expectations as to trends in turnover and profitability over the next twelve months, and price pressures appear stronger;

Retail respondents, excluding large retailers, are less confident as to the forthcoming year, and now expect easing trends in turnover and profitability. For the smaller retailers the pressures on margins have increased. In contrast the expectations amongst tourism respondents are strong for the second quarter.

## Manufacturing

### Optimism

Business confidence remained weak, although optimism rose for a net of small (under 50 employees) and large firms (250 plus employees).

### Orders and Sales

Rising trends in total orders were reported by a net of small and large firms, but remained depressed amongst medium sized firms. Overall respondents continue to expect a slight strengthening of trends in demand in the second quarter. Average capacity used remained at 79%, nevertheless, rising trends in the level of work and hours worked were reported for a net of firms in all size bands, Expectations for the next twelve months, are stronger than three months ago.

### Finance

For a further quarter firms downgraded their expectations as to profitability trends over the next year. Cost pressures increased as concerns as to raw material costs, transport costs and other overheads strengthened in the first quarter.

### Investment

48% reported revising investment plans for the coming year, and rising trends in investment were again reported. Investment in the current quarter was again mainly for the replacement of equipment. Investment for R & D remained weak, although investment to develop new products and processes was more evident amongst medium and larger sized firms.

### Employment

Employment rose marginally, and 53% sought to recruit staff, mainly skilled and technical employees.

**Table 1 Manufacturing – key results**

	Q1 2006		
	Up	Level	Down
Business Optimism	25.2	47.8	27.1
Trends in actual orders			
Total new orders	34.5	39.5	26.0
Scottish orders	26.4	46.5	27.1
Rest of UK orders	24.1	44.0	31.8
Export orders [42.6% = N/A]	21.0	24.6	11.9
Trends in expected orders			
Total new orders	34.0	51.2	14.9
Scottish orders	21.0	57.6	21.4
Rest of UK orders	28.9	50.0	21.1
Export orders [45.1%= N/A]	21.6	25.3	8.0
Av Capacity used	79		
Invest in plant/equip.	27.4	50.2	22.4
Cash flow past 3 moths	16.9	48.8	34.3
Turnover next 12 moths	43.3	35.2	21.4
Profitability next 12 moths	34.9	35.4	29.8
Price change next 3 moths	39.2	56.7	4.2
Pressures to raise prices from			
Pay settlements	29		
Raw material costs	72		
Finance costs	21		
Other overheads	56		
Transport costs	62		
Employment trends			
Total actual employment	16.9	68.2	14.9
Total expected next 3 months	22.8	63.2	14.0
Average pay increase	3.67		

**Construction****Optimism**

Business confidence strengthened in the first quarter, due to widespread rising confidence amongst firms employing more than 100.

**Contracts**

Larger firms reported rising trends in new contracts, whilst smaller firms (those employing under 100) reported slightly

easing trends in new contracts. Rising trends in the level of work are expected over the next six months, suggesting that seasonal factors may have been an issue affecting activity levels in the first quarter. Rising trends in work in all areas were again more evident amongst larger firms.

49% (56% in the previous quarter) reported operating at or above optimum rates in the first quarter, and average capacity used rose to 87%.

For a further quarter respondents remain confident as to rising trends in turnover over the next twelve months, but now anticipate a level trend in profitability. Smaller firms, unlike large construction firms, expect tender margins to be under more pressure over the next year.

The levels of contracts and new work and shortages of skilled labour were again seen as the two factors most likely to restrict activity over the next quarter.

**Investment**

Rising trends in investment and in the leasing of plant and equipment were reported. Investment authorised in the first quarter was mainly for the replacement of equipment.

**Employment**

The rising trend in employment continued, with more use of sub contractors anticipated over the next three months.

**Table 2 Construction – key result**

	Q1 2006		
	Up	Level	Down
Business Optimism	24.3	59.5	13.2
Trends in actual contracts			
Total new contracts	29.7	37.8	32.4
Public sector orders	13.8	62.1	24.1
Private commercial	21.2	51.5	27.3
Domestic/house build	21.9	50.0	28.1
Trends in expected contracts			
Total new orders	26.5	55.9	17.6
Public sector orders	7.7	80.8	11.5
Private commercial	18.5	70.4	11.1
Domestic/house build	10.7	71.4	17.9
Trends in work in progress			
Actual	24.3	45.9	29.7
Expected	29.4	55.9	14.7
Capacity used	87		

Invest in plant/equip.	27.8	55.6	16.7
Leasing in plant/equipment.	17.6	67.6	14.7
Employment trends			
Total actual employment	16.7	69.4	13.9
Total expected next 3 months	14.7	70.6	14.7
Average pay increase			
	5.17		
Percent recruiting staff			
	40		
Recruitment difficulties increasing			
	11.1		

## Wholesale distribution

### Optimism

Business confidence although weak was the strongest for the past 15 months.

### Sales

The outturn in sales was better than had been anticipated, and a further improvement is expected in the second quarter.

Once again the level of competition, along with business rates were seen as the factors most likely to restrict sales over the next quarter.

Expectations of price increases remained widespread but were slightly lower than in the previous three quarters. Respondents were more confident as to rising trends in turnover over the next twelve months, and concerns as to profitability, although weak, were less than in previous quarters. Pressures on margins are still evident, but less acute than in the fourth quarter.

Concerns as to transport costs together with raw material costs were again the most widely cited pressure on prices.

### Investment

Changes to investment plans were more widespread, affecting 48% of respondents.

### Finance

A rising trend in cash flow was reported.

### Employment

A level trend in employment was reported. Overall 39% sought to recruit staff, and 30% increased pay by an average of 3.23%.

**Table 3 Wholesale distribution – key result**

	Q1 2006		
	Up	Level	Down
Business Optimism	21.7	56.5	21.7
Trend in actual sales	47.8	17.4	34.8
Trend in expected sales	41.2	41.2	17.6
Investment plans	26.1	52.2	21.7
Cash flow past 3 months	30.4	60.9	8.7
Turnover next 12 months	47.8	26.1	26.1
Profitability next 12 months	28.6	28.6	42.9
Price change next 3 Months	47.8	34.8	17.4
Pressures to raise prices from			
Pay settlements	39		
Raw material costs	48		
Finance costs	17		
Other overheads	44		
Transport costs	61		
Employment trends			
Total actual employment	17.4	65.2	17.4
Expected next 3 months	14.3	76.2	9.5
Average pay increase			
	3.23		
Percent recruiting staff			
	39.1		
Recruitment difficulties			
	23.5		

## Logistics

### Optimism

Business confidence, although weak, rose amongst larger logistics firms.

### Business trends

Rising business trends across the range of logistics work were more evident amongst larger logistics firms.

Fuel and regulation costs were most widely cited cost pressures; and legislation, competition and the transport

infrastructure were the most widely cited concerns. Concerns as to the availability of drivers were less than in the previous quarter, and were more apparent amongst smaller logistics firms.

### Investment

Investment trends in vehicles and equipment remained weak.

### Finance

A rising trend in cash flow was reported by both smaller and larger logistics firms. Smaller firms anticipate more difficulties in sustaining turnover and profitability over the next year. In contrast, larger firms anticipate both rising trends in profitability and turnover.

### Employment

A level trend in employment was reported. 58% sought to recruit staff, and 26% increased pay by an average of 4.15%.

**Table 4 Logistics – key results**

	Q1 2006		
	Up	Level	Down
Business Optimism	25.0	45.0	30.0
Trend in actual business	40.0	40.0	20.0
Trend in expected business	55.6	22.2	22.2
Trend in long distance	20.0	60.0	20.0
Trend in local deliveries	26.7	53.3	20.0
Trend in storage	23.1	53.8	23.1
Trend in couriering	28.6	57.1	14.3
Trend in other work	36.4	36.4	27.3
Cash flow past 3 months	31.6	68.4	0.0
Turnover next 12 months	50.0	35.0	15.0
Profitability next 12 months	55.0	20.0	25.0
Price change next 3 Months	40.0	60.0	0.0
Pressures to raise prices from			
Pay settlements	45		
Fuel costs	95		
Finance costs	25		
Utility costs	40		
Road charging etc	20		
Regulation costs	55		

### Employment trends

Total actual employment	16.7	66.7	16.7
Expected next 3 months	11.8	88.2	0.0
Average pay increase	4.15		

### Retail distribution

#### Optimism

Overall business confidence remained weak, although rising confidence was reported by those retailers employing more than 25 staff.

#### Sales

The weak outturn in the value of sales reflected declining trends being reported by retailers employing less than 25 but rising trends by those employing more than 25 staff. National retailers reported better trends than independent stores, and rural shops reported weak sales trends.

For a further quarter competition, legislation/regulation and business rates were again identified as the three factors most likely to inhibit sales. Utility, transport and regulation costs were widely reported.

#### Investment

Changes in investment plans were limited, being reported by 25% of respondents; and a slight decrease in investment plans was noted.

#### Finance

Retailers employing 5 or less staff reported declining cash flow trends, whereas rising trend were reported by larger firms

Respondents now anticipate weaker turnover trends over the next 12 months; although firms employing more than 25 anticipate rising turnover and profitability trends over the next year.

#### Employment

The decline in employment ended, and a slight increase in full time and temporary staffs was reported. 14% increased pay by an average of 3.21%.

**Table 5 Retail – key result**

	Q1 2006		
	Level	Up	Down
Business Optimism	3.9	62.7	33.3
Trend in actual sales	11.5	38.5	50.0



Trend in expected sales	12.8	44.7	42.6
Investment plans	15.4	67.3	17.3
Cash flow past 3 months	13.7	76.5	9.8
Turnover next 12 months	13.5	50.0	36.5
Profitability next 12 months	20.0	30.0	50.0
Price change next 3 months	55.8	40.4	3.8

Pressures to raise prices from			
Pay settlements	25		
Raw material costs	44		
Finance costs	15		
Other overheads	10		
Transport costs	48		
Utility costs	58		
Regulation costs	42		

Employment trends			
Total actual employment	6.1	89.8	4.1
Expected next 3 months	5.3	92.1	2.6

Average pay increase	3.21		
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Percent recruiting staff	27		
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Recruitment difficulties inc	18.2		
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## Tourism

### Optimism

The rising trend in business confidence continued through the first quarter, reflecting a better than anticipated outturn.

### Demand

For a further quarter the outturn in demand was stronger than anticipated, and rising trends in total, rest of UK and Scottish demand were reported. Average occupancy, at 57%, was broadly the same as for the first quarter of 2005.

Overall 30% of business was local trade, 34% tourist trade and 36% business trade.

### Finance

A fifth reported discounting room rates in the first quarter and 13% anticipate some discounting of room rates in the second quarter of the year.

### Employment

Changes in employment levels were again limited, being reported by 31% of respondents, and the downward seasonal trend was the same as in the first quarter of 2005.

## Recruitment

79% sought to recruit staff, and 50% of those recruiting reported difficulties in recruiting suitable staffs, most notably in the recruitment of chefs/cooks. 36% increased pay by an average of 4.01%.

**Table 5 Tourism – key result**

	Q1 2006		
	Up	Level	Down
Business Optimism	32.6	56.5	10.9
Trends in demand/visitors			
Total demand/visitors	33.3	40.0	26.7
Demand from Scotland	33.3	45.2	21.4
Demand from Rest of UK	31.7	56.1	12.2
Demand from abroad	17.9	56.4	25.6
Business Trade	30.0	57.5	12.5
Trends in expected demand			
Total demand/visitors	39.5	55.8	4.7
Demand from Scotland	24.4	63.4	12.2
Demand from Rest of UK	39.0	53.7	7.3
Demand from abroad	35.0	50.0	15.0
Business Trade	33.3	61.5	5.1
Capacity used	57.2		
Investment	45.7	47.8	6.5
Turnover past 3 months	52.0	32.0	16.0
Average daily rate	31.8	45.5	22.7
Expected average daily rate	32.6	54.3	13.0
Employment trends			
Total actual employment	9.5	69.0	21.4
Expected next 3 months	28.6	66.7	4.8
Average pay increase	4.01		
Percent recruiting staff	79.2		
Recruitment difficulties	50.0		

# Overview of the labour market

The latest figures on the labour market<sup>1</sup> in Scotland are summarised in Table 1. Labour Force Survey (LFS) data show that in the three months to February 2006 the level of employment fell by 2 thousand, to 2,467 thousand. Over the year to February 2006, employment increased by 8 thousand. The employment rate – as a percentage of the working age population – fell to 75.4 per cent, down 0.1 percentage points on the previous quarter. Over the year to February 2006, the employment rate was up by 0.1 per cent. Figure 1 provides an account of quarterly LFS employment over a four-year period to February 2006.

The preferred International Labour Organisation (ILO) measure of unemployment rose by 4 thousand to 142 thousand during the period December 2005 to February 2006<sup>2</sup>. The ILO unemployment rate in the three months to February 2006 rose by 0.1 per cent to 5.4 per cent. This represents a fall of 0.2 per cent relative to the same period a year earlier (5.6 per cent).

The economically active workforce includes those individuals actively seeking employment and those currently in employment (i.e. self-employed, government employed, unpaid family workers and those on training programmes). Table 1 shows that the level of the economically active rose by 1 thousand over the last quarter to February 2006. There were 2,608 thousand economically active people in Scotland during December to February 2006. This comprised 2,467 thousand in employment and 142 thousand ILO unemployed. Taking account of the rise in ILO unemployment (of 4 thousand) and the fall in the number in employment (of 2 thousand), the total number of economically active people in Scotland rose by 1 thousand between December and February 2006. The corresponding level for those of working age economically inactive rose to 643 thousand, up 3 thousand on the previous quarter, and up 5 thousand on the same period a year earlier.

Scottish claimant count unemployment – a count of claimants on unemployment related benefits – is detailed in Table 2<sup>3</sup>. The most recent (seasonally adjusted) claimant count figure for April 2006 stood at 88.0 thousand, up 2.5 thousand from the previous month. The claimant count rate in April 2006 remained at 3.3 per cent, up from 86.1 thousand (3.2 per cent) compared to April 2005.

Figure 2 plots ILO and claimant count unemployment for three-month periods as an index for the period March-May 2000 to December-February 2006. Claimant count unemployment has been generally falling since March-May 2000, and continued that fall throughout 2005 before rising slightly during the start of 2006. By comparison, ILO

unemployment has fluctuated more widely, but still generally on a downward trend and most likely reflects movements between the level of employment and the number of people economically active at any one time. Hence, the difference between the ILO and claimant count definitions mirrors the distinction between those actively seeking work (but are jobless) and those who are eligible for unemployment benefit payments.

The Office for National Statistics (ONS) had deferred releasing figures for vacancies due to distortions in the data since May 2001, resulting mainly from the introduction of Employer Direct<sup>4</sup>. ONS have very recently made available a wide range of Jobcentre Plus vacancy data, which should form the basis of vacancy data in the future. At the moment, ONS have such concerns over the appropriateness of these data as a labour market indicator that they are not due to be included in the labour market statistics First Release. Our intention is to monitor these data to see if they can be used for future reports on the labour market in Scotland.

Due to discovery of an error in the Annual Population Survey (APS), release of the updated data from the Labour Force Survey has been delayed while ONS investigate possible solutions. Thus, the data in Table 3 and Table 5, and Figure 3, cannot be updated this quarter. Labour Force Survey (LFS) data provide the industrial composition of the total number of individuals in employment within Scotland. Data released through NOMIS has taken a rolling four-quarter average on this measure. Table 3 shows that for September 2002-August 2003 to March-May 2005, the percentage share of employment within manufacturing fell 0.1 per cent to 11.7 per cent. This is down from 12.2 per cent from the four quarter average beginning one year previously. The share of employment within services fell marginally to 75.2 per cent from the previous four-quarter average to the most recent one, which represents a small reduction (0.2 per cent) from the rolling four-quarter average beginning one year previously. The percentage share of employment within the Banking and Finance sector remains steady at 13.5 per cent.

The most recent figures for the number of employee jobs by industrial activity are detailed in Table 4. Employee job figures are a measure of jobs rather than people. Total seasonally adjusted employee jobs for the quarter ending June 2005 stood at 2,279 thousand, down 6 thousand from the previous quarter, and 16 thousand higher than the same period a year earlier. The number of jobs in the manufacturing industry remained constant at 235 thousand over the last quarter, down 3 thousand when compared against the same quarter one year earlier. The number of jobs in the service industry rose significantly over the last quarter to 1,071 thousand, 15 thousand higher than the same period ending a year earlier.

Table 5 and Figure 3 show the proportion and numbers of workers employed as managers and senior officials,

professionals, associated professionals, and technical occupations. These professions can be grouped together under the classification 'highly skilled jobs'<sup>5</sup>. The most recent data available (shown in Table 5) indicate that during for the most recent four-quarter average, the share of highly skilled employment within Scotland and Great Britain stood at 38.6 per cent and 41.2 per cent respectively. This is slightly higher than the previous quarter for Scotland (38.3 per cent) and higher than the previous quarter for Great Britain (41.1). Figure 3 illustrates that the proportion of employment in Scotland in highly skilled jobs has been rising steadily over recent years but continues to lag slightly behind Great Britain.

### Outlook

Scotland's labour market continues to perform strongly in light of global uncertainty. Overall UK unemployment rose slightly over the last quarter to February 2006, up to 5.1 per cent, while Scotland's unemployment rate also rose by 0.1 per cent over the same period to 5.4 per cent. Scotland's employment performance continues to improve, and the employment level and rate in Scotland remains close to its highest level since 1992 (before which consistent records are unavailable). The employment rate in Scotland remained close to historically high levels at 75.4 per cent in the three months to February 2006. The claimant count rate remained at 3.3 per cent in April 2006 while the number unemployed and claiming benefit remains relatively low, despite rising to 88.0 thousand (up in each of the last three months). The outlook for the labour market remains healthy when compared to historical standards for Scotland, with labour market sentiments expecting relatively low unemployment and high employment to continue over the next few years.

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### Endnotes:

<sup>1</sup> The Census 2001-consistent population figures at local authority level were released in February 2003. This has allowed the production of interim regional LFS estimates. The population data only cover the periods up to mid-2001. The data presented here are taken mainly from Labour Market Statistics, October 2004 and are consistent with the updated LFS data available on NOMIS from Summer 2004. This information has been release for rolling four-quarters averages, making it impossible to identify individual quarters over time. Labour Market Statistics continue to report data for Scotland at the quarterly level, so this will continue to form the basis of our analysis of movements in the labour market between quarters.

<sup>2</sup> The Labour Force Survey definition of ILO unemployment takes precedence over the claimant count measure. ILO unemployment is much less sensitive to changes in the regulations governing unemployment benefit, and conforms to a widely accepted standard to allow for more meaningful cross-country comparisons.

<sup>3</sup> All the seasonally adjusted claimant count series have been revised back three years (to January 2000), following the latest ONS annual review. The denominators used to estimate the workplace-based regional and national claimant count rates have been updated and revised back to 1996. These workplace-based denominators, which are no longer used to calculate rates for sub-regional areas, relate to the sum of claimants and workforce jobs for the corresponding mid-year (National Statistics).

<sup>4</sup> Employer Direct involves transferring the vacancy-taking process from local Jobcentres, to regional Customer Service Centres (National Statistics).

<sup>5</sup> Highly skilled jobs include sections 1-3 of the Standard Occupational Classification (SOC). Figure 4 illustrates the trend in the number of workers in highly skilled jobs between Q1 1993 and Q1 2003, as an index (1993=100). However, pre-2001 data relates to SOC 1990, and post-2001 data relates to SOC 2000, therefore, the absolute levels of highly skilled jobs over this period should be interpreted with slight caution.

Grant Allan  
8<sup>th</sup> June 2006

**Table 1: Recent developments in the Scottish labour market**

		Level (000s)	Rate (%)
Employment*	Dec-Feb 2005	2,459	75.3
	Mar-May 2006	2,457	75.2
	Jun-Aug 2006	2,465	75.5
	Sep-Nov 2006	2,469	75.5
	Dec-Feb 2006	2,467	75.4
ILO unemployment**	Dec-Feb 2005	145	5.6
	Mar-May 2006	149	5.7
	Jun-Aug 2006	132	5.1
	Sep-Nov 2006	138	5.3
	Dec-Feb 2006	142	5.4
Economically active*	Dec-Feb 2005	2,602	79.9
	Mar-May 2006	2,607	79.8
	Jun-Aug 2006	2,597	79.6
	Sep-Nov 2006	2,607	79.8
	Dec-Feb 2006	2,608	79.8
Economically inactive***	Dec-Feb 2005	638	20.2
	Mar-May 2006	638	20.2
	Jun-Aug 2006	648	20.4
	Sep-Nov 2006	640	20.2
	Dec-Feb 2006	643	20.2

**Source:** Labour Market Statistics (First Release), National Statistics.

**Notes:**

(1) Data available as of 8<sup>th</sup> June 2006.

(2) Data taken from Table 1 of Labour Market Statistics for April 2006, ONS, and are not directly comparable with previous series taken from NOMIS.

\* Levels are those aged 16 and over, rates are for those of working age (16-59/64)

\*\* Levels and rates are for those aged 16 and over. Rate is a proportion of economically active

\*\*\* Levels and rates are for those of working age

**Table 2: Claimant count unemployment\***

(000s)		Claimant count (Seasonally adjusted)		Claimant flows (seasonally adjusted)	
		Level	Rate	Off-flow	On-flow
2004	January	96,700	3.6	23,200	23,800
	February	96,200	3.6	24,500	23,700
	March	95,500	3.6	24,400	23,400
	April	94,400	3.5	24,100	22,700
	May	92,400	3.5	24,100	22,700
	June	91,600	3.4	24,400	23,200
	July	90,200	3.4	23,000	21,900
	August	90,200	3.4	22,400	22,200
	September	90,600	3.4	22,600	22,200
	October	89,800	3.4	22,700	22,100
	November	88,800	3.3	22,900	22,000
	December	87,800	3.3	23,400	22,200
2005	January	86,800	3.2	23,400	21,700
	February	85,900	3.2	22,600	21,900
	March	86,100	3.2	22,200	21,600
	April	86,100	3.2	21,300	21,400
	May	86,600	3.2	21,300	21,200
	June	86,300	3.2	21,500	20,800
	July	84,900	3.2	21,500	20,600
	August	85,500	3.2	21,300	21,600
	September	86,000	3.2	21,100	20,900
	October	85,800	3.2	20,800	20,800
	November	85,700	3.2	21,000	20,900
	December	85,400	3.2	20,600	20,300
2006	January	84,100	3.1	20,200	19,900
	February	86,000	3.2	19,600	20,700
	March	87,500	3.3	19,700	21,400
	April	88,000	3.3	19,300	19,700

**Source:** National Statistics, Nomis (Benefits Agency Administrative system)

(1) Data available as of 8<sup>th</sup> June 2006

\* Levels are those claiming unemployment benefits, rates are those claiming benefit divided by workforce jobs plus claimants.

**Table 3: Industrial composition of total in employment (LFS), percentage share**

	<i>Manufacturing</i>	<i>Banking and Finance</i>	<i>All services</i>
Dec 2002-Nov 2003	12.6	13.6	75.3
Mar 2003-Feb 2004	12.3	13.5	75.3
Jun 2003-May 2004	12.2	13.4	75.4
Sep 2003-Aug 2004	12.0	13.3	75.4
Dec 2003-Nov 2004	11.9	13.5	75.4
Mar 2004-Feb 2005	11.8	13.5	75.3
Jun 2004-May 2005	11.7	13.5	75.2

**Source:** National Statistics, Nomis (Labour Force Survey)

Notes:

- (1) Where manufacturing covers SIC section D, banking and finance covers section J and K and all services covers sections G-Q (including Banking and Finance)
- (2) LFS data taken from Nomis are rolling averages of four quarters, and are consistent with the population estimates published in February and March 2003

**Table 4 Employee jobs by industry, 000s**

	All jobs (seasonally adjusted)	All jobs	Agriculture, Forestry and Fishing	Mining, Energy and Water Supplies Industries	Manufacturing Industries	Construction	Service Industries	Public administration and other services
SIC 1992 section		A-0	A,B	C,E	D	F	G-K	L-Q
Dec 02	2,273	2,283	31	41	264	120	1,053	775
Dec 03	2,298	2,310	29	37	243	120	1,077	803
Dec 04	2,314	2,327	32	37	236	127	1,082	812
Mar 05	2,324	2,315	32	37	233	126	1,069	818
Jun 05	2,325	2,320	31	38	234	118	1,081	819
Sep 05	2,335	2,334	30	39	233	129	1,083	821
Dec 05	2,328	2,342	30	39	230	125	1,089	828

**Source:** National Statistics: Labour Market Statistics, Scotland (First Release, Table 5: Employee jobs by industry, April 2006)

**Table 5: Proportion of employment in highly skilled jobs**

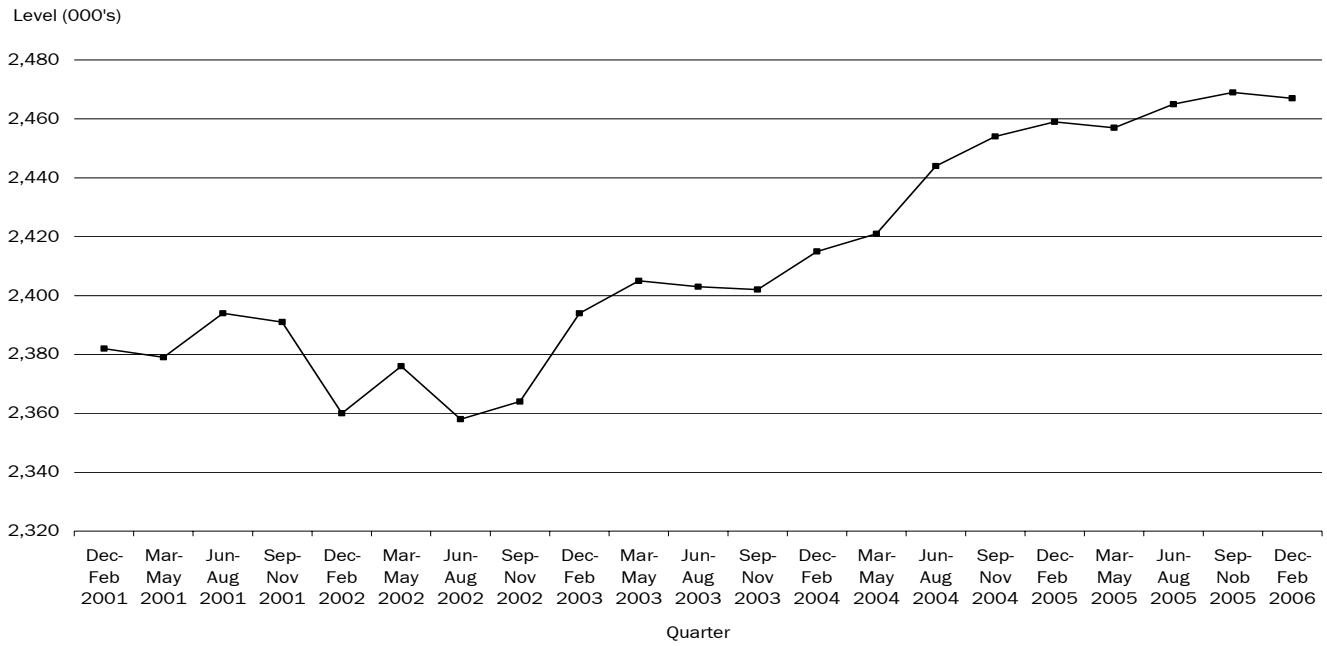
	<i>Scotland</i>		<i>Great Britain</i>	
	Level	Rate (%)	Level	Rate (%)
Sep 2002-Aug 2003	887,000	37.1	10,861,000	40.1
Dec 2002-Nov 2003	897,000	37.4	10,931,000	40.2
Mar 2003-Feb 2004	906,000	37.8	11,023,000	40.5
Jun 2003-May 2004	911,000	38.0	11,089,000	40.6
Sep 2003-Aug 2004	920,000	38.2	11,148,000	40.8
Dec 2003-Nov 2004	925,000	38.4	11,220,000	41.0
Mar 2004-Feb 2005	927,000	38.3	11,274,000	41.1
Jun 2004-May 2005	934,000	38.6	11,316,000	41.2

**Source:** National Statistics, Nomis (Labour Force Survey)

Notes:

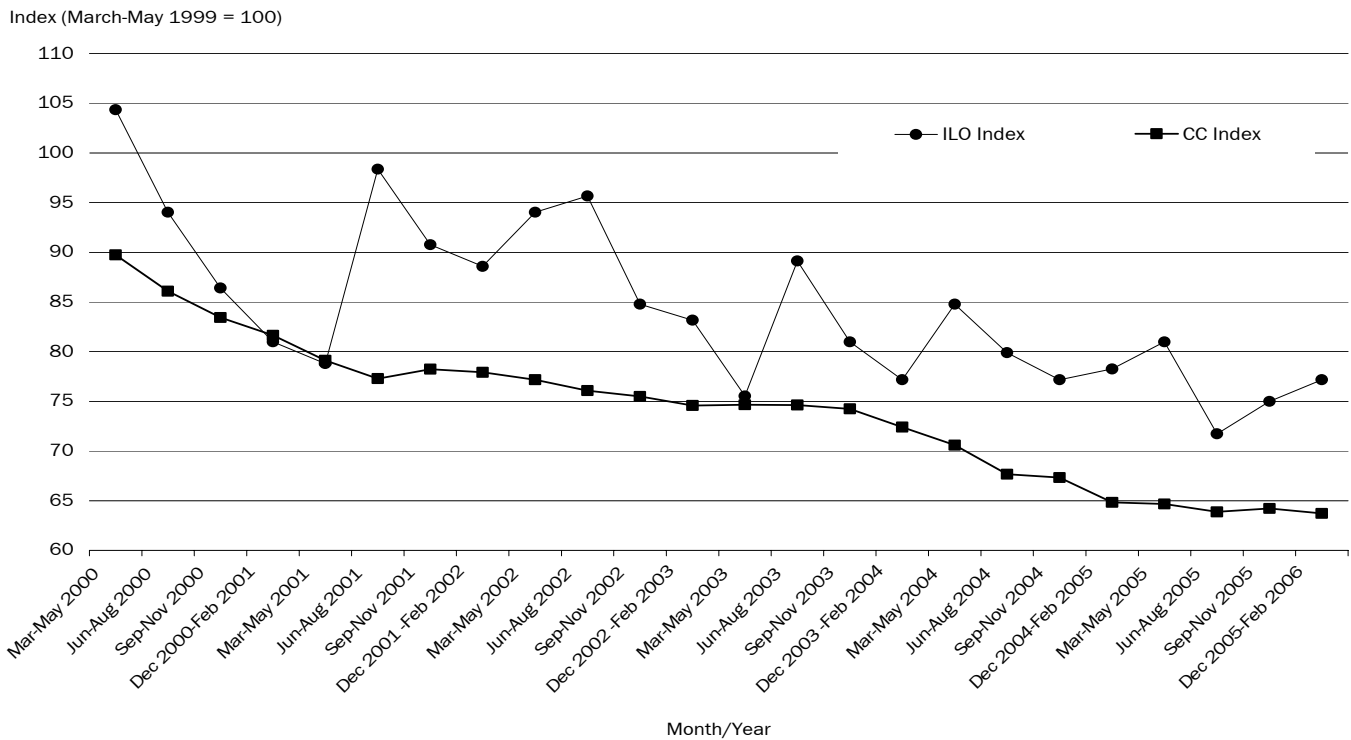
Highly skilled jobs includes sections 1-3 of the Standard Occupational Classification (SOC 2000)

**Figure 1: LFS employment in Scotland for those aged 16 and over, Dec-Feb 2001 to Dec-Feb 2006**



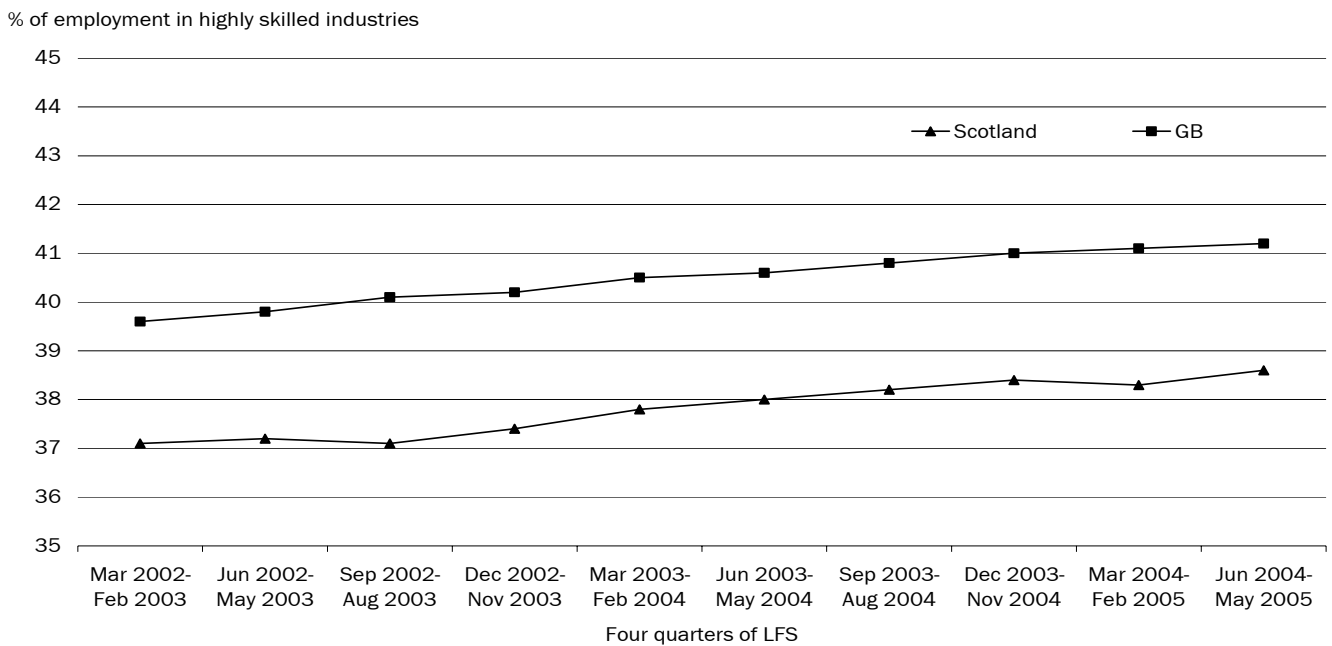
Source: National Statistics (NOMIS)

**Figure 2: Claimant Count and ILO Unemployment in Scotland, Mar-May 2000 to Jun-Aug 2005**



Source: National Statistics (Nomis)


**Figure 3 Employment in highly skilled jobs, Scotland and Great Britain, March 2002-February 2003 to June 2004-May 2005**



**Source:** National Statistics: Labour Force Survey (Nomis)

**Notes:**

\* Highly skilled jobs includes sections 1-3 of the Standard Occupational Classification (SOC).



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# Economic perspectives

# Flaws and myths in the case for Scottish fiscal autonomy

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## 1. Introduction

In May of this year Paul Hallwood and Ronnie MacDonald (H&M) published a paper under the auspices of the Policy Institute in which they argue the case for fiscal autonomy in Scotland with or without independence (Hallwood and MacDonald, 2006). They conclude that fiscal autonomy is to be preferred because it

“...offers a much sharper and clearer incentive mechanism – for both the private sector and the elected representatives in Edinburgh – than the current Barnett financial arrangement and also relative to other lesser forms of fiscal devolution, such as fiscal federalism” (page 31).

The authors claim empirical support for their view that the incentive generating effects of fiscal autonomy will result in more efficient resource allocation and faster economic growth in Scotland. Moreover, they contend that the size of this return will be more than sufficient to outweigh the risks inherent in fiscal autonomy. They argue that such risks include the loss of the block grant from Westminster of a certain and known amount, and no bail out from London in the event of a tax shortfall.

We welcome Hallwood and MacDonald's further contribution to the debate on financing devolved Scotland. The most recent paper adds to their earlier distinguished work published in the *Allander Series*, where they argued in favour of a fiscal federalist solution to the financing of Scotland's public sector (Hallwood and MacDonald, 2004; 2005). However, we contend that H&M fail to establish a case for fiscal autonomy in Scotland, and that the arguments deployed in their previous work 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. Moreover, we go further and argue 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 a form of fiscal federalism or even the present Barnett based system of financing Scottish devolution.

**Opinions expressed in economic perspectives are those of the authors and not necessarily those of the Fraser of Allander Institute**

The remainder of this paper is in four parts. We first assess some of the arguments typically used to justify greater fiscal responsibility at the sub-central government (SCG) level and highlight the principal differences between fiscal federalism/decentralisation and full fiscal autonomy. Secondly, we compare fiscal autonomy with the present Barnett-based system of funding the Scottish parliament using a standard set of criteria. Our view is that H&M either misunderstand or misrepresent the present funding system, which has many of the efficiency characteristics that they seem to uniquely associate with fiscal autonomy. The next section identifies a set of largely political and administrative problems associated with fiscal autonomy that are little considered in H&M's latest work. Finally, the paper concludes by reiterating the reasons why fiscal autonomy is not to be preferred either to the present Barnett system or to a form of fiscal federalism. We also note that some of the claimed advantages of fiscal federalism may not be as robust as asserted by its proponents and that further research is advisable before serious consideration is given to the adoption of new funding arrangements for Scotland.

## 2. Fiscal autonomy and fiscal federalism

Under fiscal autonomy the Scottish parliament would be wholly responsible for raising, and spending its tax revenues. Part of these revenues, an amount agreed to cover Scotland's share of centrally provided public goods such as defence, and foreign affairs would go to Westminster. The rest would be retained in Scotland. There would be no subvention from the rest of the UK to ensure that levels of provision of public and merit goods met a UK standard. Therefore, apart from the central provision of UK public goods, it would be as if Scotland was a separate state within the UK union.

Fiscal federalism is a more subtle concept than fiscal autonomy. It is generally agreed that if public goods and services are provided and financed in the geographical jurisdictions that embrace the benefits and costs of their provision, then there will be potential gains. These gains are to static and dynamic economic efficiency (i.e. resource allocation and growth), and to political accountability and transparency<sup>i</sup>. But, crucially, some sub-national authorities may not have sufficient taxable resources to finance the provision of appropriate services (vertical imbalances) and taxable capacity is likely to vary across jurisdictions (horizontal imbalances). In these inevitable circumstances, proponents of fiscal decentralisation and fiscal federalism argue that the unity of the state requires equalisation payments from the centre and redistribution from jurisdictions with high levels of income to those with lower taxable capacity.

Fiscal federalism therefore differs from fiscal autonomy at the SCG level in that under fiscal federalism inter-jurisdictional transfers via central government are made for equity (and also economic stabilisation) reasons. Under fiscal autonomy they are not. Further, under fiscal

federalism the degree of decentralisation to SCGs in spending and tax powers can vary considerably. On the expenditure side, jurisdictions may have complete freedom to determine the allocation, or may be allowed to spend on a basket of goods and services subject to certain centrally directed standards of provision. These standards may effectively ring fence spending on certain areas. On revenues, SCG's autonomy may vary from the very little, with no own local taxation and funding provided by a grant from the centre, through higher degrees of local taxation and the sharing/assignment of tax revenues, to a high degree of own taxation and the devolution in part or in whole of rates and bases of national taxes.

According to Ebel and Yilmaz (2001) fiscal decentralisation has the potential to improve economic efficiency through the promotion of allocative and managerial efficiencies. Better allocation results from local governments having better information than central government on the preferences of local people for specific goods and services, including the allocation of resources between present and future consumption i.e. for economic growth. In addition, competition between jurisdictions will increase as individuals migrate to those areas that best meet their preferences. It is argued that such competition will ensure the better use of public resources, limit excessive taxation and a burgeoning state (Brennan and Buchanan, 1980).<sup>ii</sup>

One thing the literature on fiscal federalism fails to make clear is the relationship between the degree of decentralisation and the postulated economic benefits. H&M assert that "fiscal autonomy is like fiscal federalism but more so!" (page 2). By which they mean that economic incentives are even clearer under the former than the latter. However, they reach this conclusion by privileging efficiency considerations whilst marginalizing equity and stabilisation concerns. This drives them to an extreme conclusion. This is actually unusual for economists who are generally keen to stress the need to focus on trading off marginal benefits and costs.

However, this would be less problematic if the theoretical arguments for the incentive promoting powers of fiscal autonomy were as strong as the rhetoric. Unfortunately they are not. We show in the next section that the present Barnett based system already exhibits many of the key characteristics required to encourage the efficient use of resources and to allow a democratically disciplined Scottish Parliament to make optimal allocation choices.

Another related difficulty with some of the literature on fiscal decentralisation is a lack of clarity on the mechanisms that link decentralisation to improved economic performance. H&M's work seems particularly prone to this problem. In addition to the benefits that flow from a better reflection of local preferences and tax competition between jurisdictions, H&M take the reasonable view that people, including politicians, will make more rational - better, superior - decisions if they have to

face the costs as well as enjoy the benefits of public expenditure (Hallwood and MacDonald, 2006, page 10). This is implicit in the tax competition argument for fiscal decentralisation, where it is assumed that people will migrate towards those jurisdictions that offer a given basket of public goods and services at a lower tax cost, or offer greater quality and choice at given cost.

H&M take this point further and argue that greater fiscal responsibility implies a harder budget constraint, which will make political decision makers spend more wisely – more efficiently – to meet local preferences than in jurisdictions with less fiscal responsibility. However, H&M appear to assume (page 11) that a fiscal imbalance at the SCG level – funded by central government - is synonymous with the budget constraint facing the SCG authorities. We suggest that this is incorrect.

Whether a budget constraint is hard or not depends on the mechanisms that set the budget. The fact that a SCG is subject, in the jargon of the literature, to a vertical imbalance, where its expenditure needs are greater than its taxable capacity, says little about the conditions that determine the level of expenditure incurred to meet those needs. Jurisdictions that have responsibility for own taxation and have ample taxable capacity might still be subject to a soft budget constraint if they are in receipt of central government grants, or are able to borrow profligately at below opportunity cost. Conversely, jurisdictions that have little responsibility for own taxation may have their expenditure limits rigorously set, which we argue below is the case in the UK Barnett system, and so are subject to a hard budget constraint.

So, from the standpoint of economic efficiency, a fiscal system will be efficient if for changes in public spending the marginal social benefits and the marginal social costs are perceived *and equated* by the political authority. There remains some doubt that increasing levels of fiscal decentralisation, up to and including fiscal autonomy, are inherently more likely to satisfy this condition. This would appear especially so in a world of increasing economic interdependence and spillovers in and between jurisdictions through trade, factor and knowledge flows. In such a world, the need for central government to apply tax and subsidy policy differentially across jurisdictions to internalise such externalities would appear to be more pressing.

**3. The Barnett system and fiscal autonomy**

H&M are particularly disparaging about the present Barnett based system for financing the Scottish Parliament. We take a much more sanguine view. Table 1 compares some of the key characteristics of the present (Barnett) mechanism with those of full fiscal autonomy. The characteristics reflect, in the context of the UK, the desired properties of an efficient and effective fiscal system at the SCG level.

**Table 1 Characteristics of Present (Barnett) System vs Full Fiscal Autonomy**

Characteristics	Present System (Barnett)	Full Fiscal Autonomy
1. Hard budget constraint	+	+
2. Composition of public spending	+	+
3. Private/Public sector split	+	+
4. Scottish growth incentive	-	+
5. Choice of tax mix	-	+
6. Westminster incentive	+	-
7. Democratic accountability	+	+
8. Automatic stabilisation	+	-
9. UK spatial distribution (equalisation)	+	-

Characteristics 1 to 6 embrace economic efficiency and growth issues, characteristics 7, 8 and 9 refer to democratic accountability, stabilisation and equalisation, respectively. A plus sign indicates that the characteristic is present while a minus sign suggests the opposite. No attempt is made in the table to indicate the degree or extent to which each characteristic is present in each system. However, this is considered in the discussion below. We deal with each characteristic in turn.

*Hard budget constraint*

H&M attach extra-ordinary importance to public sector decision makers having a “hard” budget constraint. H&M (p. 11) put it this way: “If a region knows that the size of the bloc grant it receives is [positively] related to the size of its fiscal imbalances [the difference between the local public expenditure and the local tax take], the incentive to reduce its fiscal imbalance is compromised: the region in effect faces a soft budget constraint.” The essence seems to be that where devolved decision makers know that they have to live with their mistakes, they will make better decisions. A hard budget constraint implies no *ex post* bail out from central government.

H&M believe that fiscal autonomy gives the hardest budget constraint. However, the formal system for allocating funding to the Scottish Parliament, the Barnett formula, also provides a hard budget constraint. The system of funding to the Scottish Parliament produces incremental financial allocations that are driven by a formula based upon Scotland’s population share within the UK. This is unrelated to the size of the fiscal balance. Formula bypass may still occur, as was the case with Treasury funding of

the debt write-off in the Glasgow housing stock transfer, but it is transparent and relatively rare. In addition, the Scottish Parliament and its Executive have no borrowing powers. Conversely, under fiscal autonomy while spending is limited by own taxation H&M allow scope for borrowing. There would appear to be little between the two systems in the hardness of the budget constraint.

H&M's lack of understanding of the present funding system for Scotland is revealed (page 12) when in support of their view that the budget constraint presently is soft, they suggest that poor Scottish standards of health may be used as an argument for a larger grant from Westminster. The Barnett formula does not work in this way. There is no moral hazard: Scotland does not get more funding if it has poor health. It is incorrect to suggest that the Scottish Executive is a 'Leviathan' government intent on expanding its budget with no incentive to improve the health of the Scottish people. The recent legislation banning smoking in pubs, restaurants and other public places would appear to give the lie to that contention.

#### *Composition of public spending*

H&M suggest (page 14) that a key argument in favour of fiscal federalism is that it improves the use of resources both in a static - allocative efficiency – and dynamic – growth – framework. Scottish Parliament politicians would be encouraged to better reflect the Scottish people's preferences on education, innovation, private capital and infrastructure, which could have an important influence on growth. H&M make the argument in terms of fiscal federalism, so it cannot be construed as an argument for fiscal autonomy *per se*. It should be clear that the allocation of spending has little to do with how the funding is raised or collected. The arrangements for funding the Scottish Parliament as determined by the Scotland Act (1998) allow no constraint to be placed on the composition of public spending outside the areas of defence, foreign affairs, social protection and certain regulations that are reserved to Westminster. As the Steel Commission (2006) notes:

"...the Scottish Parliament has very significant autonomy and discretion because of the fact that the block grant system does not ring-fence spending areas. In comparison with most other federal or quasi-federal systems, the extent of real power over policy and decision-making is considerable" (page 85).

And the parliament is accountable for these spending decisions through the normal democratic process, which will ensure in the long-term at least that the preferences of the Scottish people are respected.

#### *Private/public sector split*

H&M argue (page 8) that the present funding arrangements give the Scottish Executive and parliament little incentive to choose the correct balance between the size of the public and private sectors. H&M err in implying that there is some optimal size for the public sector in an absolute sense: it is

a decision that should be taken at the margin and should depend on the extent of market failure, the efficiency and effectiveness of delivery mechanisms e.g. the adoption of contestability and choice mechanisms as opposed to target setting and monopoly supply (Crafts 2005), the efficiency of regulation etc. as well as public preferences, all of which affect the social benefit from public spending.

H&M would be correct in arguing that the incentives to reduce the size, and/or increase the efficiency, of the public sector may be less under the present system than under fiscal autonomy. Under fiscal autonomy a marginal tax rule effectively operates where an extra pound of public spending has to be funded by an extra pound of taxation – in the long run if a borrowing facility is allowed. So, the optimal size of public sector provision would be determined at the point where the marginal benefits of an extra pound of public spending equal the marginal tax cost.

Yet under the present system a constrained version of the marginal tax rule is possible through variations in the tartan tax. The Scottish Parliament can increase or decrease its budget through increasing or decreasing the standard rate of income tax. H&M (p. 26) do acknowledge this but simply state that "the amount of variation is not great". However, the point is that variation at the margin is possible. H&M do not appear to have an answer to the question that if the size of the public sector is an important issue for the Scottish electorate – in whose intelligence they claim to place great faith (page 3) – then why have voters not forced the parliament to use the tartan tax one way or the other?

#### *Scottish growth incentive*

Fiscal federalism according to H&M (pages 14, 15) would provide a much stronger incentive for the Scottish executive to adopt policies to raise economic growth than the present funding arrangements where the extra tax take from improved growth flows to the UK Treasury. On the face of it this argument is correct. However, we offer some caveats. First, it is not clear that fiscal autonomy offers a much greater incentive than fiscal federal arrangements of assigned tax revenues or the ability to lower or vary tax rates and bases. Secondly, it is an assumption that the return of higher tax revenues will provide an incentive to Scottish politicians to promote growth. This is almost tantamount to assuming a 'Leviathan' government where the pursuit of higher revenues and expenditure is paramount. It is not clear that the Scottish Executive would behave in this way and the empirical evidence supporting the Leviathan hypothesis is not at all conclusive (Ebel and Yilmaz, 2001). One of the key arguments favouring fiscal decentralisation is that it enables a SCG to better reflect local preferences. The present Scottish devolution settlement also has this property and if the Scottish electorate desires higher growth it should be expected that the Scottish parliament would respond to it. Thirdly, this argument suggests that local politicians are forward looking and have low time discount rates: not a characteristic

normally associated with the practice of politics. Fourth, H&M now assert that the empirical evidence indicates that increased fiscal decentralisation is favourable to economic growth. They did not adopt such a straightforward view in their previous work. And as the Steel Commission (2006) points out “the evidence on the link between fiscal decentralisation and economic growth is ... (hard) ... to come by with relatively little research having been conducted” (page 38).

*Choice of tax mix*

The present funding arrangements severely constrain the Scottish people from choosing their preferred mix of taxes. Some scope is present through the ability to alter the tartan and council taxes, but it is clear that fiscal autonomy offers the most scope to meet such preferences. However, it is unclear how important such an issue is with the Scottish electorate and it is a moot point whether a different tax mix from the present UK would be more economically efficient.

*Westminster incentive*

The present system provides an incentive to Westminster to watch what is going on in Scotland and monitor the impact that Scottish policies may have on the UK as well as the impact of UK policies on Scotland. Spatial spillovers are important within an integrated economy (McGregor and Swales, 2005) suggesting a need for co-ordination, the incentive for which would be lacking under fiscally autonomy.

*Democratic accountability*

Under the present Scottish devolution arrangements the parliament is accountable for the allocation of public expenditure and, given the tartan tax, the absolute size of the budget to be spent at the margin. An argument cannot be sustained that Scottish politicians are less democratically accountable under the present system than would be the case under fiscal federalism or fiscal autonomy.

*Automatic stabilisation*

The adoption of fiscal autonomy would remove most of the stabilisation benefits that accrue to participation in the UK tax and benefits system: increased social protection payments, and reduced income tax and corporation tax outlays. It is true that a fiscally autonomous Scotland with borrowing rights would be able to increase its fiscal deficit in the face of an exogenous shock. However, the scope for this is likely to be severely limited since a binding borrowing constraint is likely to be imposed for UK macro-stabilisation reasons. Under fiscal autonomy the risk of greater cyclical instability would probably increase, with all the implications that would have for investment and forward planning.

*UK spatial distribution*

The adoption of fiscal autonomy would also remove from Scotland the equalisation payments that are found to be part of both unitary and most federal systems. In the

absence of greater tax revenues, current needs could only be met by higher tax rates or would fail to be met through public expenditure having to be lower. H&M recognise this (page 26) but imply that Scottish oil revenues may be sufficient to substitute – which ignores one of the rules of fiscal federalist theory that natural resource taxation should not be devolved due to price, and hence tax revenue, variability. However, if oil revenues were returned to Scotland it would be a foolhardy government that based long-term public expenditure plans on such variable revenues.

H&M contend that even if equity transfers were reduced under fiscal autonomy the faster economic growth resulting from fiscal autonomy would provide the tax revenue to fill the gap (pages 26 and 27). But as we have noted the evidence does not allow us to be so sanguine about the link between fiscal decentralisation, never mind fiscal autonomy, and economic growth.

**4. Uncertain issues for full fiscal autonomy**

In their paper, H&M stress that they are arguing for the economics of fiscal autonomy. They refer to the Steel Commission as being “largely driven by political considerations” (p.2) and assert that “[t]he politics of the Scotland Act (1998) has gotten in the way of sensible economics” (p.8). However, we believe that H&M’s argument cannot abstract economic theory from the political reality in which their proposals must operate and that the resolution of a number of issues is crucial to the functioning of any alternative fiscal system. We look in turn at issues surrounding Scotland’s resource transfer to the United Kingdom for those public or merit goods that remain UK-wide, how issues of national debt repayment and debt issue may prove awkward to resolve and whether the proposals offer any solution to the West Lothian Question.

H&M propose sufficient fiscal control to SCG that the United Kingdom government would find itself in a deficit position relative to its own revenue generation and expenditure responsibilities for Scotland (they do not comment on the economic inefficiency this would create at the United Kingdom level while they seek to solve the same concern in Scotland’s present fiscal position). They suggest that Scotland would make transfers to Westminster to pay for the services provided for the whole of the United Kingdom, presumably defence, foreign and diplomatic affairs and immigration. They do not provide any indication as to how this may be done.

There is a historical precedent within the United Kingdom of SCG being given authority to raise the majority of taxation and subsequently make transfer payments to Westminster: that of Northern Ireland between 1920 and 1972. The terms of the Government of Ireland Act 1920 envisioned the Stormont government running a budget surplus sufficient to make what was termed an “Imperial Contribution” for the services provided for its benefit by Westminster and for its share of the costs in managing the

Empire. Mitchell (2006) provides an acute analysis of the failure of the system and the quick transfer of the Imperial Contribution into an effective Imperial subsidy. While the time and circumstances may have been different many of the failures of the system remain pertinent.

Northern Ireland faced the problem of simply being unable to afford a United Kingdom standard of public expenditure given its own fiscal capacity. The Westminster government could not permit large out-migration flows and sought to subsidise Northern Ireland to prevent this. While the problem is not so acute for Scotland, the fact remains that even with all North Sea Oil receipts Scotland is reckoned to be in a persistent deficit position (Scottish Executive, various). Fiscal autonomy must concern itself not with what revenue it can raise but with what level of expenditure it can afford.<sup>iii</sup>

An Imperial Exchequer Board was established to determine the level of contribution expected of Northern Ireland on the basis of its revenues and the services it received. A similar body would be required to regulate the financial relations between a fiscally autonomous Scotland and the United Kingdom. This would need to consist of representatives of both governments and have terms of reference in case of disputes, such as may occur over the increased, and probably unforeseen, defence requirements that the United Kingdom government may be required to undertake. An issue in such cases is likely to be whether the new body would have first call on financial resources. Mechanisms can be established to resolve these issues, but they are part of the fiscal package and cannot be dismissed as political considerations.

H&M envisage Scotland being granted borrowing powers. This raises the problem of how to treat existing as opposed to future national debt. Again Ireland provides an example. The constitution of the Irish Free State stipulated that it was required to service the debt of the United Kingdom. In fact this did not happen and when the Republic of Ireland was established it did not inherit any share of the existing United Kingdom debt. It is unlikely Scotland would be permitted such an outcome. Instead, a division would require to be made between that debt incurred for the benefit of the United Kingdom prior to fiscal autonomy and subsequently that debt incurred by the Scottish government for Scotland's benefit and that incurred for the United Kingdom on those services provided for the whole of the United Kingdom (including Scotland). This is no easy task.

At present the United Kingdom does not borrow for specific purposes – it has a general borrowing requirement that it meets through lending markets and a large part of borrowing is recycled as debt is repaid and re-issued. Another body would need to be established to address these issues and to determine what share of whole United Kingdom existing debt servicing Scotland should incur and

subsequently what share of post-fiscal autonomy whole United Kingdom debt servicing is due to Scotland.

A final issue is whether fiscal autonomy offers any potential solution to the West Lothian Question. Put simply, this is the anomaly that Scottish MPs may vote on all matters affecting England while English MPs at Westminster can vote only on those matters affecting Scotland that are not devolved to the Scottish Parliament. H&M propose the devolution of almost all taxation to Edinburgh. If additional responsibilities currently held at Westminster do not follow the change in fiscal responsibility to Edinburgh, then there will remain a large vertical fiscal imbalance: Scotland's taxation receipts in 2003-04 were estimated at £34bns while total government expenditure in Scotland is estimated at £45.3bns. Of that, spending by the Executive amounted to £23.5bns with the remaining £20bns being spent by the United Kingdom government between reserved matters in Scotland and Scotland's share of expenditure incurred for the benefit of the whole of the United Kingdom. An outcome without further devolution of powers from London to Edinburgh would put great pressure on inter-governmental transfers and the body required to oversee them.

If anything H&M's proposals are likely to increase the pressure on Scottish MPs at Westminster. Should greater devolution of powers than currently granted under the Scotland Act be considered as a part of the plans for fiscal autonomy laid out by H&M, then the scope for Scotland's MPs to vote on matters affecting Scotland would be reduced to the limited remnants of whole-UK functions. However, there is no method at present to restrict those issues on which Scottish MPs may vote and without a radical change in the procedures of the House of Commons Westminster could have less influence on the lives of those living in Scotland while the role of its representatives is unchanged. Sufficient changes in fiscal structure can demand institutional alteration and there can be little doubt that fiscal autonomy would require a radical recasting of the role of Scotland's representatives at Westminster, with the impacts we have discussed above as the 'Westminster incentive'.

## 5. Conclusions

In this paper we have argued that Hallwood and MacDonald (2006) while purporting to establish a case for fiscal autonomy in Scotland have signally failed to do so. The arguments deployed in their previous work 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. They do not appear to appreciate fully the problems that would arise from the adoption of such a system, nor do they appear to be fully aware of the properties of the present form of funding devolution under the Barnett based system.

We contend 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 a form of fiscal federalism or the present Barnett system. It is, therefore, not surprising that Hallwood and MacDonald (2004 and 2005) in their earlier work 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. But, in view of this, it is surprising that H&M now cease to reject full fiscal autonomy for Scotland and embrace it with enthusiasm. The Steel Commission (2006) concludes that

“... full fiscal autonomy is not in the interests of Scotland – in fact it would be extremely damaging to Scotland. It also ignores the considerable benefits, both to Scotland and the rest of Britain, of being part of the United Kingdom. It exists in no other industrialised country in the world and it is clear that such a system effectively negates any meaningful role for a wider UK state” (page 91).

Our analysis supports that conclusion.

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## Endnotes:

<sup>i</sup>It is assumed that central government can only provide public goods and services uniformly across jurisdictions (Ebel and Yilmaz (2001)).

<sup>ii</sup> Although the degree of competition under the limited and asymmetrically devolved UK system is small.

<sup>iii</sup> This raises the question of whether H&M see fiscal autonomy as a general financing mechanism for all the devolved administrations and what the response would be for fiscal autonomy for London, for example.

# Risk and profit: unanswered questions about the strategic review of water charges 2006-10

Jim Cuthbert and Margaret Cuthbert

*“Public sector companies can often support much lower levels of interest cover than private concerns because of the lower risks.”: (OFWAT-International Comparisons of Water and Sewerage Services)*

## 1. Introduction

1.1 In a paper in the January 2006 issue of this Commentary, [Cuthbert and Cuthbert, 2006], we identified a number of errors in the financial control of the water industry in Scotland. These errors had resulted in serious overcharging in the strategic review 2002-06, with, we argued, knock on effects to the 2006-10 period. A meeting with the Chairman of the Water Industry Commission, Sir Ian Byatt, was held on 22<sup>nd</sup> February at the Scottish Parliament to discuss one particular symptom of this, the high levels of new capital expenditure funded out of revenue in the water industry in Scotland.

To illustrate the latter point, on the basis of outturn figures in Scottish Water's published accounts, [Scottish Water, annual] and the projections in the Final Determination of Charges 2006-10, [Water Industry Commission for Scotland, 2005], the amount of net new capital expenditure, (that is the formation of capital assets over and above depreciation), funded from revenue will be at least £600 million in 2002-06, and is projected to be over £400 million in 2006-10. The amount of net new capital formation funded out of revenue over the period 2002-10 will therefore be over £1 billion: over the same period, the total amount of net new capital formation will be around £2.1 billion. Given the normal principle that net new capital formation should be funded from borrowing, the high proportion of net new capital formation being funded from revenue represents a strong prima facie case that there will have been very substantial overcharging of water customers in Scotland over the period.

1.2 At the meeting, Sir Ian refused to discuss the strategic review 2002-06, arguing that this was not the legal responsibility of the Water Industry Commission, which was formally constituted only in July 2005. However, Sir Ian was prepared to discuss the 2006-10 period, and argued that the revenue caps set in strategic review 2006-10 were justified in terms of the need to meet targets for certain key financial ratios: these ratios, and the targets set for them, were the same as used by OFWAT in its review of charges for the water industry in England and Wales: [OFWAT, 2004]. Sir Ian justified the use of the same ratios, and indeed the same targets for these ratios as in England and Wales, by the need to avoid risk. Our initial response at the meeting was that the use of the same ratios and targets for private companies like the English water and sewage companies, and a public body like Scottish Water, was unjustifiable, given that public and private bodies face very different risk profiles. We undertook at the meeting to develop more fully our thoughts on the differences in risk for public and private bodies: this forms the primary subject of this paper. Our conclusion is that the straight application of OFWAT targets is indeed unjustifiable: this will inevitably result in overcharging, and the funding of too much capital expenditure out of revenue. We look to Sir Ian to justify his position that it is appropriate to apply the OFWAT ratios and targets to Scottish Water without modification.

1.3 The above discussion on appropriate financial ratios and targets forms the main subject matter of this paper. However, in carrying out this research, we observed an apparent difference in the calculation of current cost profit between that used in strategic review 2006-10 in Scotland, and the definition used by OFWAT in their Regulatory Accounts: [OFWAT, 2003]. This is described in the penultimate section of the paper. The effect is that profits in Scotland are significantly understated, compared to what they would be if OFWAT conventions were used. On the basis of OFWAT definitions, it appears that strategic review 2006-10 is projecting pre-tax profits of almost £900 million, and post-tax profits of over £500 million, over the period 2006-10. These high profit levels are again consistent with the view that substantial overcharging of customers has continued in strategic review 2006-10.

## 2. How appropriate are the OFWAT financial ratios and targets for the purpose of controlling risk in Scotland

2.1 Chapter 26 of the Final Determination of Charge for 2006-10 sets out the key financial assumptions that were used in the determination of the charge caps. An important part of this process was the use of financial ratios and targets to assess the financial strength of Scottish Water. The ratios chosen, and their target values, were the same as five out of the six ratios used in OFWAT's 2004 price review for England and Wales. The relevant ratios and targets are set out in the following table.



**Financial ratios**

Financial Ratio	Target Value
Cash Interest Cover	Around 3 times
Adjusted cash interest cover	Around 1.6 times
Funds from operations: Debt	Greater than 13%
Retained cash flow: Debt	Greater than 7%
Gearing	Less than 65%

The definitions of these ratios, given on page 273 of the Final Determination, are as follows:

**Cash Interest Cover**

= (Net Operating Cash Flow - Tax)/ Interest,  
*where net operating cash flow = Turnover - Operating Expenditure.*

**Adjusted Cash Interest Cover**

= (Net Operating Cash Flow - Depreciation - Infrastructure Renewals -Tax)/ Interest

**Ratio of Funds from Operations : Debt**

= (Net Operating Cash Flow - Tax -Interest)/ Net Debt

**Ratio of Retained Cash Flow : Debt**

= (Net Operating Cash Flow - Tax - Interest - Dividends)/ Net Debt

**Gearing =Net Debt / RCV,**

*where RCV is the Regulatory Capital Value, which represents the value of the regulated business on which Scottish Water can earn a return: this is essentially a proxy for the market value of the business.*

Note that since Scottish Water, as a public company, does not pay dividends, retained cash flow will equal funds from operations: so the value of the fourth ratio will always equal the third ratio.

2.2 In our meeting with Sir Ian Byatt, he stressed that the key ratio and target, which more than any other had determined the revenue caps, was the third ratio, namely, "funds from operations:debt".

Chapter 26 of the Final Determination justifies the application of the OFWAT ratios and targets as follows:

"We have also noted that these financial ratios were developed in consultation with the water companies, the City, and the credit rating agencies. We believe that these ratios are therefore likely to represent a fair market assessment of the appropriate split between current and future financing needs. We can see no reason why Scottish Water should not seek to match the financial strength of the companies in England and Wales".

On the face of it, this is a surprising statement, given the quotation from OFWAT reproduced at the start of this paper. In this section, we argue in greater detail a) why indicators of the OFWAT type cannot be relied upon as the primary method of assessing or controlling a company like Scottish Water: and

b) why in any event, the OFWAT targets have to be modified before being applied to Scottish Water, because of the different circumstances facing Scottish Water as compared to the English and Welsh Water and Sewerage Companies, (WASCs).

2.4 As the quotation in the paragraph above makes clear, the OFWAT ratios have been primarily modelled on the kind of indicator used by the markets to assess the risks associated with a company. Two of the classic traps, and therefore risks, into which a company can fall are:-

*Runaway cycle of borrowing*

This is the risk that a company gets itself into a position where it is borrowing to cover current costs like operating expenses, depreciation, and interest. This could lead to an exponential growth in debt unbacked by productive capital assets, with ultimate danger of financial collapse.

*Collapse of customer base through over-charging*

This is the risk that, because customer charges are set too high, the revenue generating base of customers may grow more slowly than the requirement for revenue, leading to a vicious circle of further increases in charges, and so on. In a competitive market, this could be followed by rapid collapse: in a monopoly market, collapse is unlikely to be rapid, but may nevertheless ensue in the longer term. Note that, because there is a substantial fixed cost element in water company operations, (in terms of a largely fixed capital base, depreciation, and interest charges), once the customer base starts to shrink, the rise in unit fixed costs poses a real danger of a self-perpetuating cycle becoming established. There are a number of ways in which a company might fall into this particular trap - for example, it might come about through failure to achieve required operating cost efficiencies, or through attempting to finance too high a proportion of capital expenditure out of revenue.

2.5 The first of the above two risks will be associated with high levels of borrowing throughout, while at least in its initial stage, the second risk may well be associated with low borrowing. The OFWAT ratios, with their stress on debt and interest costs, are weighted towards detecting the emergence of the first of these risks. For a private company operating in a competitive market, this is probably fair enough, since the second risk, over-charging, will normally be penalised anyway by the operation of competition, leading to an easily detectable decline in profits and in market share. There is thus little need for the market to have developed special indicators to detect the problem of over-charging.

2.6 For a company operating in a market where there is limited competition, however, (like a water company), then the normal competitive checks against over-charging will not apply. In these circumstances, the asymmetry in the OFWAT financial ratios does matter: if too much reliance were placed on the OFWAT ratios alone, then while this would avoid the danger of over-borrowing, (because the OFWAT ratios guard against this), there would be a very real risk of falling into the opposite trap of over-charging. Of course, for a water company or similar utility, the place of the market check on over-charging is supposed to be taken by the role of the regulator, one of whose primary responsibilities is to guard against over-charging. Thus, in England and Wales, Severn Trent Water Company was recently fined by the regulator for over-charging. The important point we wish to make here, however, is that for companies in the position of Scottish Water or the WASCs, it is not enough to set revenue caps purely or primarily by reference to the types of financial ratios listed above: it is also necessary to consider carefully and directly whether there is evidence of over-charging, which could show up, for example, in the form of excess profits. We shall argue later that there is indeed evidence, as regards the strategic review 2006-10, of over-charging being overlooked, or of being given insufficient weight.

2.7 We now show that, in any event, there are strong arguments for saying that the OFWAT ratios have not been calculated appropriately for Scotland, but either need to be modified, or in one case, (the gearing ratio), should not be calculated at all. The reasons are as follows.

#### *Gearing ratio*

2.8 The gearing ratio, as noted above, is the ratio of debt to RCV. We argue that this ratio is meaningless for Scotland, given the way RCV is currently calculated in Scotland. As the discussion on page 270-1 of the Final Determination makes clear, the RCV for Scottish Water was not based on any absolute method of determination, but was calculated so that, in 2009-10, "the cash allowed return on the RCV and the allowance for embedded debt was equal to the difference between the required level of revenue and the allowed level of costs." In other words, the RCV for Scotland is an imputed figure, calculated so that the product of RCV times the assumed rate of return gives a required amount of cash: this means that the value of the RCV is a relative concept, which varies in inverse proportion to the assumed rate of return. A problem arises when such a relative concept as the RCV is compared with an absolute concept, namely, debt, as is done in calculating the gearing ratio. It is difficult to see how the concept of gearing for Scotland can have any meaning, unless some more objective and absolute way of calculating Scottish RCV can be determined. Note that this problem does not arise in England, since RCV there is based upon rolling forward the market value from the time of privatisation.

Another problem with the Scottish method of calculating RCV arises because of the error acknowledged on page 295 of the Final Determination in double counting inflation in rolling forward RCV. This error apparently has a very large effect on assessed RCV values: the following quotation, from page 296, indicates the effects of correcting for this error- "If we changed our model so that it implied an initial RCV using a real rate of return, the initial RCV would become around £11 billion. This is around double the upper end of the range suggested by the Commissioner's analysis. In our view, such a large RCV could not be justified."

What we take from this quotation is that there must be a further huge element of uncertainty about the particular RCV values attributed to Scottish Water in the Final Determination. Given the relative and uncertain nature of the Scottish RCV figure, calculation of a gearing ratio based on the Scottish RCV is meaningless.

#### *The difficulty of comparing debt between Scottish Water and the WASCs.*

2.9 The remaining four OFWAT ratios all depend in some way or other on debt, (or the related quantity, interest). There is, however, a fundamental difference between a public body like Scottish Water, and the private WASCs in England, in that the former only has access to two main sources of finance, (debt, and retained profits), while the latter have access to three, (debt, retained profits, and equity). To restrain Scottish Water and the English companies to the same level of debt, therefore, would be to throw a greater burden on retained profits for Scottish Water, since, unlike the English companies, it does not have the option of accessing equity finance.

This point is acknowledged on page 345 of the Final Determination, where there is the following discussion about the possibility of relaxing the OFWAT "funds from operations divided by debt" target, (the key third ratio), for Scottish Water: "The rationale for allowing this ratio to be breached would be that Scottish Water is funded entirely by customer charges and debt, and there is no indication that the Scottish Executive will seek to require Scottish Water to pay a dividend on any retained earnings. From this standpoint, complying with this ratio could reasonably be regarded as challenging."

In the event, the Final Determination did not go down the road of relaxing the third ratio constraint, because the resulting reductions in charges would have breached the Ministerial Guidance on charges, and because of public expenditure constraints. However, the important point for present purposes is that the sentiment expressed in the above quotation is one with which we absolutely agree: setting the same targets in respect to debt ratios for Scottish Water as for the English companies is much tougher for Scottish Water.

2.10 To get round this problem, we really need to consider the following question: "If the equity finance of the WASCs were replaced by conventional debt, how much conventional debt could they take on without experiencing any additional risk?"

If one regards the equity finance raised by the WASCs as a form of proxy debt, then

(a) it is much more expensive than conventional debt: as can be seen from the information in tables 1 and 7 of [OFWAT, 2005a,], the WASCs have recently been paying annual dividends equivalent to over 18% of the equity capital actually raised: and this is after tax.

But

(b) a private company, in any given year, does not have to pay a dividend: so equity finance provides a greater cushion against imminent failure in times of financial stringency. An element of equity finance gives a company a less brittle financial structure.

If, therefore, one was seeking an appropriate conversion factor from equity finance to conventional debt, the above two arguments would point in different directions: since equity finance is more costly than conventional debt, a given amount of equity finance would cost the same as a significantly larger amount of conventional debt: so in this sense equity finance would convert to conventional debt at a factor greater than one. But equity finance leads to a less brittle financial structure than conventional debt: so in this sense, equity finance should convert to conventional debt at a factor less than one. To balance up these two conflicting effects, we take a factor of 1 as a reasonable conversion factor from equity finance to conventional debt. Given the very high cost of equity finance to the WASCs, this is probably a conservative assumption: in other words, the WASCs could probably replace their equity finance with a larger amount of conventional debt without incurring any additional risk.

2.11 Another factor that must be taken into account in determining equivalent levels of debt between Scottish Water and the WASCs is the fact that Scottish Water can borrow more cheaply than a typical WASC, since the former is borrowing from the Scottish Consolidated Fund at public sector rates, rather than market rates. In setting water and sewerage charges for England and Wales for the period 2005-2010, OFWAT assumed that the real pre-tax cost of debt for the WASCs, (that is, the cost over the entire debt base of the companies), would be 4.3%, [OFWAT, 2004, page 219]: this would be equivalent to about 6.8% in nominal terms. From pages 121 and 122 of Appendix 9 to the Final Determination of water charges in Scotland, it can be seen that the projected average interest rate to be paid by Scottish Water on government loans varies between 5.8% and 5.3% over the period 2006 to 2010. Given these figures, it seems safe to assume, on a

conservative basis, that the cost of debt for the WASCs over the foreseeable future is likely to be at least 20% more than that for Scottish Water.

2.12 Given the above, therefore, it follows that the equivalent to the ratio of

$$\frac{\text{funds from operations}}{\text{debt}}$$

for Scottish Water would be the ratio

$$\frac{\text{funds from operations}}{1.2(\text{debt} + \text{equity finance})}$$

for the WASCs.

We therefore need to establish what value of the latter ratio would be equivalent to a target value of 13% for (funds from operations)/(debt) for the WASCs. The calculation is as follows.

First, from Table 7 in [OFWAT, 2005a], it can be seen that, in 2004, the debt of the WASCs was £24525 million, and their called up share capital plus share premium, (equivalent to the capital raised by means of equity), was £6596 million, implying that

$$\frac{\text{debt} + \text{equity finance}}{\text{debt}} = 1.27$$

Hence, for the WASCs, if

$$\frac{\text{funds from operations}}{\text{debt}} = 0.13,$$

then

$$\frac{\text{funds from operations}}{(\text{debt} + \text{equity finance})} = \frac{0.13}{1.27} = 0.102$$

and

$$\frac{\text{funds from operations}}{1.2 * (\text{debt} + \text{equity finance})} = \frac{0.102}{1.2} = 0.085$$

The equivalent target for the ratio of funds from operations to debt for Scottish Water should thus be around 8.5%, rather than 13%.

2.13 Clearly, the specific assumptions we have used in the above calculations are subject to fine tuning. Nevertheless, the basic principle remains, that if allowance were made for the more limited sources of finance available to Scottish Water, then the OFWAT targets would

need to be significantly adjusted. While we have worked through the arithmetic for the key third ratio, similar principles would apply to the other ratios involving debt or interest.

### 3. What light does the profit and loss account throw on how reasonable the revenue caps are, and what are the implications?

3.1 We have argued in the previous section that revenue caps set for Scotland using a straight application of the OFWAT targets for the financial ratios are likely to give a distorted outcome - being unduly cautious as regards risks associated with over-borrowing, and failing to give adequate warning about the risk of overcharging. If so, we could expect this to show up in the projected profit and loss account for Scottish Water, with the company having an unduly large profit after allowing for operating expenses, depreciation, interest, and other relevant charges. Comparison of the projected income and expenditure accounts for Scottish Water on page 358 of the Final Determination with, for example, outturn profit and loss accounts for the WASCs, (in OFWAT, 2005a), suggests some support for this hypothesis. For example, the outturn current cost post-tax profit for the water industry in England and Wales was £123 million in 2003-04, and £213 million in 2004-05. In comparison, the projected current cost post-tax surplus for Scottish Water in the final determination is £85.9 million in 2006-07 and totals £260.9 million over the five years 2006 to 2010, (and over £500 million pre-tax). Thus it is indeed the case that the projected surpluses of Scottish Water are larger, on a proportional basis, than the outturn profits had been for the WASCs. It could be argued that some or all of this difference represents the need to include some contingency allowance in the planned figures for Scottish Water: nevertheless, a cumulative pre-tax surplus of over £500 million does on the face of it appear somewhat excessive.

3.2 However, a detailed examination of the projected accounts for Scottish Water as compared with the OFWAT accounts shows that there appears to be a very significant difference in the way in which the two sets of accounts are compiled. This relates to the term “financing adjustment”, which appears in both sets of accounts. In the OFWAT accounts, which are compiled in accordance with the Regulatory Accounting principles set out in [OFWAT 2003], the “financing adjustment” represents a significant income element in the profit and loss account, (ranging from £345 million to £667 million over the period 2000-01 to 2004-05.) For OFWAT, the financing adjustment “is equivalent to the effect that RPI inflation has in eroding the level of net debt that exists at the start of the financial year.” In a profit and loss account which includes depreciation of fixed assets adjusted for inflation on a current cost basis, as the OFWAT accounts do, then the logic of also including the benefit experienced through the erosion of outstanding debt by inflation appears unimpeachable.

3.3 In the final determination current cost accounts for Scottish Water, while there is a term for “financing adjustment”, the values included under this term are trivial, ranging from £4 million to £8 million per annum. On the other hand, if a financing adjustment had been calculated using the OFWAT methodology, representing the eroding effect of retail price inflation at 2.5% on Scottish Water’s debt, then, on the basis of the debt projections in Table 35.15 of the final determination, this would have amounted to the values set out in the following table,

**Financing adjustment for Scottish Water on OFWAT basis:  
£ million**

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2006/07	65.0
2007/08	69.0
2008/09	74.1
2009/10	80.7
Total	288.8

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Given that the projected accounts for Scottish Water, like the OFWAT accounts, include depreciation calculated on a current cost basis, there appears to be no good reason why the financing adjustment, as calculated in this table, should be excluded from the accounts of Scottish Water in the final determination. Inclusion of this financing adjustment would mean that cumulative pre-tax profits over the period 2006-10, calculated on the same current cost basis as used by OFWAT, would be over £800million, and post-tax profits would be £550 million. This appears grossly excessive. We argue that this is compelling evidence that the use of the straight OFWAT financial ratios and unadjusted OFWAT targets in determining revenue caps for the period 2006-10 has indeed been inappropriate, and has resulted in serious overcharging. This in turn is likely to expose Scottish Water to serious risk of erosion of the customer base, as the excess burden of water charges makes Scottish business less competitive.

3.4 In setting revenue caps for Scottish Water, therefore, we argue that not merely should the target on the key financial ratio have been significantly relaxed, (probably to around 8.5%), but that more account should have been taken of other dangers, like overcharging. This would have involved looking, among other things, at projected retained profits, (calculated using the OFWAT Regulatory Accounting conventions, to give a proper assessment of the likely impact of inflation). In addition, there should have been direct consideration of the amount of net new capital formation which it was planned to fund from revenue. If this had been done, then the twin indicators implicit in the Final Determination of:

a) retained pre tax profits of over £800 million, and post tax profits of £550 million, (on the OFWAT conventions), over the four years 2006-10, and

b) no less than £437 million net new capital creation funded out of revenue over the same period,

should surely have rung danger bells.

3.5 It might be argued that the Water Industry Commission, (WIC), could not in the event have departed significantly from the revenue caps set out in the final determination, because the Ministerial Guidance, and available public expenditure provision, were over-riding constraints. Over the period 2006-10, the final determination plans project that £30 million more public expenditure provision will actually be used than is being made available over the period: this implies that the available margin of unused public expenditure, which was projected to be £256 million at the start of 2006, would reduce to £222.6 million at the end of 2010- (Final Determination Table 34.10). It is clear that the revenue caps could not have been set significantly lower without eroding the safety margin of unused public expenditure provision to a dangerously low level- or even using it up altogether.

3.6 This argument, however, raises some deep issues about the proper role of the WIC. It seems to us that it would be perfectly reasonable for the WIC to raise with Ministers the implications of ministerial decisions, if these decisions were resulting in a situation where:

a) excess retained profits are projected, implying the continuation of substantial overcharging throughout the final determination period;

b) where normal principles of inter-generational equity are being breached, as regards the funding of capital expenditure, with today's customers paying out of charges for the creation of substantial amounts of net new capital assets for the benefit of future generations;

c) where, as a result of past and current overcharging, Scotland's industrial base, and potential for development, is being damaged.

3.7 In addition, it appears to us that there is another, longer term danger. This is the risk that the industry might be moving into a position where the public's clearly expressed preference for Scottish Water to continue in public ownership will be frustrated.

Because overcharging in strategic review 2002-06 reduced the need to borrow, the Scottish Executive was able to transfer significant amounts of public expenditure provision out of the water budget: the exact amounts are unclear, but probably around £500 million was transferred out in total. The reduced amounts of provision remaining in the water

budget are very likely to cause real problems in the longer term- as the projections in the Final Determination itself illustrate. For example, projections on page 345 of the Final Determination show that, if investment continues over the period 2010-14 at the same level as now in real terms, then revenue will have to rise by 4.4% per annum over the period, (implying price rises significantly above inflation), and borrowing over the period will be some £150 million more than the public expenditure currently being made available: as a result, by the end of the period the safety margin of unused public expenditure provision would be almost exhausted. This would be an unsustainable position, unless prices rose even more steeply - or the Executive could find resources elsewhere within its budget to restore the provision it has transferred away from the water budget. It does not seem likely that the Executive would easily be able to find the required provision, given the other budgetary pressures it will be facing, and the fact that the privatised water industry in England does not generate any Barnett consequential for Scotland. In these circumstances, the Executive will feel strong pressure to privatise Scottish Water: this would be extremely unfortunate given that, as we have noted above, the clear preference of the Scottish public is for water to remain in public ownership.

#### 4. Conclusion: The unanswered questions

4.1 In this paper we have shown that the straightforward application of the OFWAT financial ratios and targets to Scottish water is unjustifiable, given the different financing options open to Scottish Water, and the resulting different capital structures, compared to the English WASCs. But this is not just our view: the same conclusion is implicit in the OFWAT quotation given at the beginning of this paper- and, indeed, is also implicit in the quotation from the Final Determination given in para 2.9 above.

The first question which the Water Industry Commission requires to answer is: why, then, were the unadjusted OFWAT ratios and targets applied in strategic review 2006-10?

4.2 In section 3, we have identified what appears to be a critical difference in the methodology for calculating current cost profit, as between the regulatory accounts specified by OFWAT, and the WIC's strategic review 2006-10. The OFWAT approach includes as an income element in the current cost profit and loss account the benefit arising from the eroding effect of inflation on outstanding debt: this term is apparently omitted from the corresponding Scottish accounts in strategic review 2006-10. This results in profits in Scotland apparently being understated. On the OFWAT convention, (which clearly appears to be the correct approach), cumulative current cost pre-tax profits for Scottish Water are projected to be over £800 million over the period 2006-10: this appears to be a grossly excessive level.

Questions which require to be answered are:

Why was a different convention used in this part of the calculation, (particularly when, as regards the financial ratios employed, the Final Determination makes a supposed virtue of slavishly following the OFWAT conventions)?

What can possibly justify such high levels of retained profit?

4.3 Overall, the findings presented in this paper confirm that the overcharging in strategic review 2002-06, which we identified in our earlier papers, does extend, via different mechanisms, into the 2006-10 period. This means that:

- a) there is a real risk of erosion of the customer base, because of the depressing effect that continuing high charges will have on Scottish industry, and hence on the important industrial component of the customer base;
- b) the principles of inter-generational equity are being breached, because today's customers are being forced to fund unjustifiably high amounts of the creation of net new capital assets out of current revenue.
- c) More generally, because there is a real danger of Scottish Water being privatised, this would mean that Scotland would never receive the potential benefits which might legitimately have been expected from a publicly owned water company. Rather than paying what (on English experience) are likely to be excessive dividends to a private owner, public ownership gives the opportunity to return these dividends to customers in a variety of ways. These include lower charges, the pursuit of social justice objectives, and targeted support of industrial development. For example, it would be possible, by selective targeting of appropriate industrial uses, (as opposed to the present ill-judged blanket harmonisation of business charges), to pro-actively attract water intensive industry to Scotland - so exploiting what should be a natural comparative advantage. It should also not be forgotten that such a policy on water charges would be one of the few ways in which Scotland could legitimately, and cost effectively, circumvent the restrictions on selective aid to industry implicit in the EU's anti-competitiveness Directives. If, in a climate of increasing global water shortage, the choice for Scotland lies between exporting water, and exporting virtual water, (that is, products whose manufacture involves high water usage), then we should be seeking to adopt the latter strategy - since that way, the value added in the manufacturing process remains in Scotland. It would be tragic if the opportunity of pursuing such a strategy were lost through privatisation.

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