CPPR Briefing Note - June 2011

The changing pattern of Scotland's economic growth since Devolution

INTRODUCTION

This Briefing Note looks at:

i) how the Scottish economy has performed since 1998[1], in particular comparing its performance with that of the UK;

ii) how this performance compares over different time periods and across industrial sub-sectors;

iii) how any such shifts in relative industrial sector performance might affect future overall economic growth and the implications of this for future government budgets.

The Note was partly inspired by a recent article in the Financial Times (11th May 2011), which disaggregated the sources of UK economic growth, by industry sector, since 2000. A similar exercise undertaken for Scotland shows that Scotland's relative performance vs the UK has changed significantly over the period studied. The note also highlights that future policy responses need to be made with a clearer understanding of these locational and sectoral differences.

PAST GROWTH

Table 1 below shows the economic growth rates, disaggregated by main industrial sectors, for both Scotland and the UK, between 1998 and 2010.

The results are split into three periods[2]:

- **1998-2003, a period where the UK outgrew Scotland;**
- **2003-2007, a period where Scotland outgrew the UK;**
- **2007-2010, the period covering the downturn so far and where both economies contracted at about the same rate.**

It highlights which industrial sectors have contributed most to Scottish growth and which have underperformed in a UK context.

[1] Detailed disaggregated data is only available for Scotland from 1998Q1.
[2] Annual rather than quarterly data is used as quarter by quarter changes can be quite dramatic and affect results unduly. Annual changes are therefore considered to be more reliable.

Table 1: GVA at basic prices (volume indices), % change

	1998-2010		1998-2003		2003-2007		2007-2010	
	Scotland	**UK**	**Scotland**	**UK**	**Scotland**	**UK**	**Scotland**	**UK**
Total	**20**	**24**	**10.3**	**15.3**	**13**	**11.4**	**-3.7**	**-3.4**
Agriculture	9	-3	4	1	5	3	0	-6
Mining	-44	-45	-10	-9	-22	-24	-21	-21
Energy	7	9	-8	13	13	0	2	-4
Manufacturing	-13	-7	-16	-1	10	4	-6	-10
Construction	26	16	7	13	19	8	-1	-6
Retail &Wholesale	48	31	29	19	12	14	2	-3
Hotels &Catering	-6	21	-1	14	3	12	-9	-6
Transport & Comms	50	44	27	33	24	16	-5	-6
Financial Services	62	60	63	34	20	24	-17	-4
Business Services	43	49	20	22	26	24	-6	-2
Public Administration	9	13	7	10	5	3	-3	-1
Education	6	7	6	6	-2	0	2	1
Health & Social Work	30	45	16	19	7	12	5	9
Other	13	8	8	11	9	2	-4	-5

Sources: Scottish Government and ONS

Note: These relative, sectoral growth rates, over the period as a whole, are similar to those identified in other work by the Fraser of Allander (FoA, Economic Commentary, Volume 34, Number 3), and the Financial Times (Financial Times, 11th May 2011). The FoA work in this area also looked at relative growth rates, in terms of GDP per person and over the longer term. CPPR will address these issues further in a forthcoming Note.

Table 2, weights these contributions according to the size of the industry in question. Hence, while decline in the Mining sector has been considerable, as it accounts for very little of the economy it does not tend to have a major impact on overall economic growth.

Table 2: GVA contribution to total, % change

	1998-2003		2003-2007		2007-2010	
	Scotland	**UK**	**Scotland**	**UK**	**Scotland**	**UK**
Total	**10.3**	**15.3**	**13**	**11.4**	**-3.7**	**-3.4**
Agriculture, Forestry & Fishing	0.1	0	0.1	0	0	0
Mining & Quarrying	-0.2	-0.4	-0.5	-0.9	-0.3	-0.5
Energy & Water	-0.2	0.2	0.3	0	0.1	-0.1
Manufacturing	-2.8	-0.1	1.3	0.5	-0.8	-1.3
Construction	0.5	0.9	1.4	0.5	-0.1	-0.4
Retail &Wholesale	2.5	2.0	1.2	1.5	0.2	-0.4
Hotels & Catering	0.0	0.4	0.1	0.4	-0.3	-0.2
Transport & Communications	1.5	1.9	1.5	1.1	-0.3	-0.4
Financial Services	3.1	2.1	1.4	1.7	-1.3	-0.3
Real Estate & Business Services	3.3	4.5	4.6	5.1	-1.1	-0.4
Public Administration	0.5	0.6	0.3	0.1	-0.2	0
Education	0.4	0.4	-0.1	0	0.1	0
Health & Social Work	1.5	1.3	0.7	0.9	0.4	0.6
Other	0.4	0.6	0.4	0.1	-0.2	-0.2

Source: Scottish Government and ONS

Over the period as a whole (1998-2010):
- very similar results are seen, in Table 1, for both Scotland and the UK in most sectors
- the positive exceptions for Scotland relate to Construction and Retail & Wholesale
- the negative exceptions relate to Hotels & Catering and Health & Social Work.

However, when this time period is broken down into the three periods outlined above, then very noticeable differences in performance emerge. In terms of each sectors contribution to overall growth, Table 2 shows that:

Over the first period (1998-2003), **when the UK outgrows Scotland**:
- Manufacturing was the greatest contributor to Scotland's slower growth rate;
- faster growth in Scottish Financial Services offset some of these negative impacts;
- amongst the smaller sectors, Hotels and Catering stands out as underperforming in Scotland, with no contribution to growth in comparison to the UK where its contribution was roughly in line with its relative size.

Over the second period (2003-2007), **when Scotland outgrows the UK**:
- once again Manufacturing was an outlier, but this time as one of the greatest relative contributors to Scotland's slightly higher overall growth rate, with Construction being the other sector that contributed substantially;
- these positive impacts were in part offset by a slightly poorer performance across a number of sectors, including Financial Services, in contrast to the first time period, and Hotels and Catering, continuing its relative underperformance.

Over the third period (2007-2010), **when Scotland and the UK perform similarly**:
- a continued relative out-performance of Scottish Manufacturing vs UK (though both decline), along with Construction and Retail & Wholesale, has been offset by poorer performances in Business Services and, in particular, Financial Services.

Explanations for all these differences are not readily apparent, though some may be easier to explain than others. For example, the Scottish decline in Manufacturing over 1998-2003 was due, in part, to the massive decline in the manufacturing of electronic components, a mobile industry that had grown sharply in the 1990s but then departed to cheaper locations as well as suffering a downturn in the industry. For most, however, it is difficult to find explanatory causes for the differential performances.

It is also important to remember that the above are general observations. Even within each time period there are specific features that are deserving of attention. This is particularly true for Scotland.

For example, with regards to Financial Services, Scotland's exceptional 1998-2003 performance was concentrated in the period 1999 to 2001. Growth in those two years is recorded as having amounted to an extraordinary 35%. Equally, the poor post-2007 performance in this sector is largely down to a, still unexplained, 12% fall in 2008. In contrast, the UK Financial sector continued to grow, by 5% that year.

In the case of Construction, Scotland's 2003-2007 out-performance of the UK, was again concentrated in a two year period, 2005-2007, when it grew by 17%.

Despite the size of these jumps there is little or no official interpretation or analysis of what happened which might explain them.

The Annex show data from an alternative source which is used as a partial check on whether the relative growth rates shown in Tables 1 and 2 are accurate.

FUTURE GROWTH

As the Financial Times pointed out in its recent analysis, a shift in industry growth patterns could be important for the future overall economic growth rate. It is also important to understand these shifts in order to assist in the development and implementation of appropriate government policy. If the fast growing sectors of the recent past (e.g. financial services) remain in abeyance, and their influence is not replaced by other sectors, then the UK's, and Scotland's, future growth rate is likely to be lower than in the past.

The fastest growing industrial sectors since 1998 have been:

- Financial Services;
- Transport, Storage & Communications;
- Real Estate and Business Services;
- Retail & Wholesale (for Scotland);
- Health & Social Work (for the UK).

The first of these sectors can safely be assumed to have poorer growth prospects for the foreseeable future compared to recent trends. The others are less certain, though, the Real Estate sector and those Business Services that helped underpin the fast growth in the Financial and Construction sectors also face diminished prospects. For Scotland there is the added worry that Construction, also with a highly uncertain future, contributed significantly to faster Scottish growth in the 2003-2007 period.

This potential lower future growth scenario could have a knock-on effect on public sector finances. If future UK economic growth is lower than has been forecast by the Office for Budget Reporting (OBR), then the pace at which government finances are rebalanced will be slower, as lower economic growth normally equates to lower growth in government revenues[3]. If further government policy cannot help stimulate growth and raise tax revenues sufficiently to fill any emerging gaps, there must be the potential for the UK government to seek further expenditure cuts, if it intends to meet its deadline for balancing the budget.

Of course there is also an alternative scenario, where government expenditure maintains or exceeds current planned levels, in order to boost the flagging economy, i.e. a return to a form of fiscal stimulus. However, at present the current UK government appears to be continuing to stake its reputation on meeting its balanced budget deadline irrespective of its impact on wider economic growth.

For Scotland, the implications of this will play out via the Barnett Formula for now, although in years to come the current Scotland Bill could change that, in which case lower Scottish economic growth would have a direct impact on available government revenues.

SUMMARY AND CONCLUSIONS

This note has highlighted key issues in relation to Scotland's recent growth rate. The need for such a note may seem odd given the strong political focus on improving Scotland's economic growth rate. However, this interest has failed to spill over into actual analysis as to how our economy has performed post devolution.

The main points emerging from this analysis of post 1998 growth in Scotland and the UK are:

- **Scotland's relative economic performance has been similar to that of the UK over the post Devolution period;**
- **however, within this overall time period Scotland's relative performance was notably poorer up to 2003, but better since then;**
- **this is because particular industrial sectors have performed erratically, e.g. Hotels & Catering, Financial Services, Construction;**
- **the causes of this are little understood, which makes it difficult to gear policy towards reversing poor performance or further encouraging good performance;**
- **the growth prospects for past high-performers is looking poor at present;**
- **this could have a knock on effect on public sector spending as budget balancing is delayed due to lower than predicted growth.**

These findings mean that the simple tale often told of Scotland's continuing underperformance of the UK economy is wrong when considered in a post devolution context. However, Scotland's improved performance is not in itself a simple story either but involves a number of changing fortunes across industrial sectors within this time frame.

[3] This gloomier outlook on future UK growth was reinforced in the Bank of England's May 2011 Inflation Report, which revised its central medium term growth forecast down from 3.1% to 2.5% based on the view that the output gap is smaller than previously believed and that recent productivity losses will not be regained.

An improved relative economic performance has been one of the key goals of the SNP-led government since 2007, and one which all other political parties in Scotland share to some degree. However, its apparent achievement has so far not been recognised. If doubts exist over the veracity of the data on this, then considerable effort should have gone into finding out whether or not it was true. That has not been the case.

Understanding economic growth is considered in detail at the UK level, by the OBR, The Treasury, the ONS, the Bank of England and many academics. A similar degree of analysis occurs in Ireland. In Scotland, the comparable work is conspicuous by its absence.

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ANNEX

A partial check of the sectoral growth results seen in Tables 1 and 2 can be made using ONS Regional Accounts data for regional GVA. This data is shown in nominal (cash) terms, rather than real (inflation adjusted) terms[4], and uses data collected from different survey source(s)[5].

The alternative growth figures are shown in Tables 3 and 4.

While the growth rates for some sectors can be considered to be consistent with the results from the data used in Tables 1 and 2, there are also some serious discrepancies, in particular in the areas of Energy, Business, Education, Health, 'Other' and Hotels & Restaurants.

For example, over the period 2003 to 2007 the Scottish Hotels & Restaurants sector outperforms the UK , as shown in Table 3, whereas in GVA terms Scotland seriously underperforms the UK, as shown in Table 1.

These discrepancies are worrying and need further investigation as they cast some doubt on what the actual growth rates of certain industrial sectors are.

Table 3: Regional Accounts, GVA at current basic prices, % change

	1998-2003		2003-2007	
	Scotland	UK	Scotland	UK
Total	**24.5**	**29.3**	**25.4**	**22.9**
Agriculture	16	6	-2	-12
Mining	-29	-24	34	40
Energy &Water	4	4	31	33
Manufacturing	-12	-5	19	7
Construction	40	50	41	36
Retail &Wholesale	28	30	15	18
Hotels & Catering	20	36	19	19
Transport & Commun's	22	23	16	15
Financial Services	69	54	37	45
Real Estate & Business	38	46	41	28
Public Admin	32	29	23	24
Education	35	40	16	25
Health & Social Work	49	45	29	27
Other	46	40	8	21

Source: ONS, Regional Accounts

[4] This means that if an industry, e.g. Manufacturing, experiences lower inflation than GDP does as a whole, then its contribution to overall growth will be larger in real terms than in nominal terms. However, as no regional industry deflators exist, this does not affect the relative growth rates for the same sector

[5] The main difference between the two sources of data is that those used in Tables 3 and 4 are based on the income method of measuring the national accounts – which adds up wages and profits i.e., the income earned by owners of the factors of production. In contrast, the data shown in Tables 1 and 2 is based mostly on ONS surveys of sectors collecting output and expenditure data on activities of producers. In theory they should give the same answer (excluding inflation) but in practice this depends on how accurate data sources are.

Table 4: Regional Accounts GVA contribution to total, % change

	1998-2003		2003-2007	
	Scotland	**UK**	**Scotland**	**UK**
Total	24.5	29.3	25.4	22.9
Agriculture	0.3	0.1	0.0	-0.1
Mining	-0.6	-0.1	0.4	0.1
Energy &Water	0.1	0.1	0.8	0.6
Manufacturing	-2.4	-0.9	2.7	1.0
Construction	2.3	2.6	2.7	2.1
Retail &Wholesale	3.0	3.6	1.7	2.1
Hotels & Catering	0.7	1.0	0.7	0.6
Transport & Commun's	1.7	1.9	1.2	1.2
Financial Services	3.5	3.3	2.6	3.2
Real Estate & Business	6.1	9.5	7.3	6.5
Public Admin	1.8	1.5	1.4	1.2
Education	2.1	2.2	1.0	1.5
Health & Social Work	3.7	2.8	2.6	1.9
Other	2.1	1.9	0.4	1.1

Source: ONS, Regional Accounts