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Scottish economy remains resilient, but Brexit uncertainty continues to erode long-term growth prospects

Risks from new Fiscal Framework likely to hit Scottish Budget in years ahead

The Scottish economy may have grown by its fastest rate in two years in the first quarter of 2019, but the risks to Scotland's growth prospects have not gone away, says the University of Strathclyde-based Fraser of Allander Institute.

In its latest Economic Commentary, supported by Deloitte, the research institute highlights how much of the recent up-pick in growth is likely to have stemmed from firms implementing 'no deal' contingency plans. Underlying growth – particularly in key sectors of the economy – remains fragile.

Professor Graeme Roy, Director of the Fraser of Allander Institute, said: "Three years on from the Brexit Referendum, we still have little clarity over the timing or format of the UK's departure from the EU.

"Given the scale of the challenges that a no deal Brexit might bring, it is no surprise that businesses are taking matters into their own hands by rolling-out contingency plans.

"Much of the Brexit debate has focussed upon the potential dislocation of trade patterns. But arguably an even greater challenge, particularly over the longer-term, are the implications for Scotland's population.

"Our analysis shows that a significant amount of the long-term growth gap between Scotland and the rest of the UK can be explained by differences in population growth.

"Should Brexit make migration to Scotland more difficult, or less attractive, then this could have serious implications for key sectors and the economy at large."

John Macintosh, tax partner at Deloitte said: "Events over the past few weeks have increased the likelihood of no deal. Theresa May was committed to leaving the EU with a deal but the new Conservative leader may not be. The default position is still that the UK leaves the EU on 31 October 2019 with or without a deal, unless either the EU agrees another extension or Article 50 is revoked.

"Business should take this time over the next few weeks and months to reset and re-engage with their 'no deal' planning, bearing in mind that more strategic options that were impossible to complete by 29 March have now become viable again. Firms have been afforded some time, and businesses that do not prepare sufficiently could be at a disadvantage if a new Conservative leader does pursue a 'no deal' strategy."

The Institute also discusses the recent debates on Scotland's Budget with the possibility emerging of £1bn in income tax reconciliations likely to reduce the resources available to the government in future budgets.

Professor Roy continued: "As we mark the 20th anniversary of devolution, Holyrood is currently taking on board a major expansion of its tax and spending powers. The Smith Commission was designed to bring autonomy and accountability to Holyrood with new responsibilities including over income tax and social security. But it also brought risks, risks that MSPs were happy to trade-off for the goal of 'more powers'.

"Much of the debate so far has centred upon how to use these new powers. But the risks inherent in the Fiscal Framework are now surfacing – demonstrated most visibly through the £1bn of 'income tax reconciliations' the Scottish Government must now tackle."

David Eiser, Head of Fiscal Analysis, said: "To call this a 'black hole' is an over-dramatisation. But the reconciliations will reduce the resources available to the Scottish Government in the future, and by a significant amount in 2021/22, the last budget of this parliamentary session."

However, whilst media and political scrutiny is focussed on the £1bn of potential income tax reconciliations resulting from forecast error, there is a potentially more serious underlying risk to the long-term health of the Scottish budget. This is the risk that Scottish earnings continue to grow more slowly than those in the rest of the UK.

The Institute's latest analysis highlights that whilst Scottish income taxpayers are paying some £500m more in income tax than they would pay under the UK policy, this has been completely offset by the relatively weaker performance of the Scottish tax base.

Graeme Roy added: "At the heart of the framework is a risk that – with the exception of population – the Scottish Budget bears the full cost of *any* divergence between Scottish and UK income tax performance, no matter its source or the ability of Holyrood to mitigate its impact.

"Whether or not the framework is sufficiently flexible to manage these and other risks is open to debate. At the very least, it deserves much more effective scrutiny than we have seen from Parliament in recent weeks. "

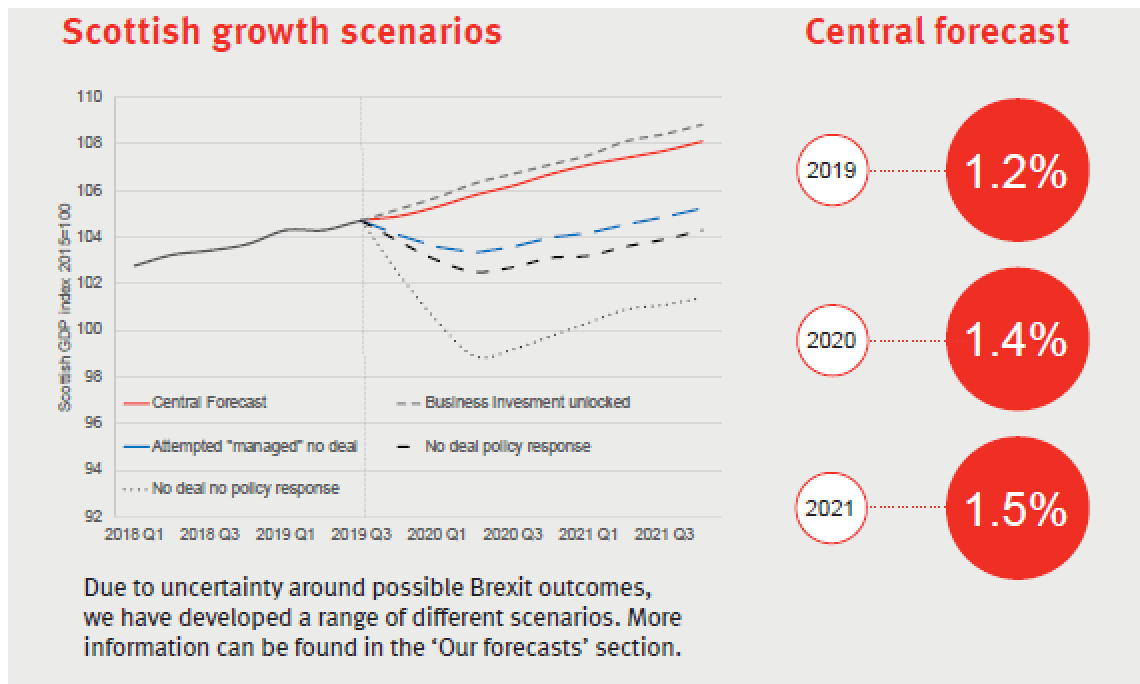
The Commentary also reviews Scotland's economic performance over the first two decades of devolution, tracking key successes in areas such as renewables and the labour market but

also highlighting areas – such as Scotland's long-term health inequalities – which have seen little change.

Today's report lays out different scenarios for growth in Scotland over the next few years.

These include scenarios ranging from a disorderly exit from the EU, to a scenario where confidence returns, unlocking business investment and boosting the economy to nearer trend growth.

The Institute's central forecast, based on an orderly departure at some point in 2019, predicts growth of 1.2% in 2019 and 1.4% and 1.5% for 2020 and 2021.



Read the full commentary here:
https://www.sbs.strath.ac.uk/download/fraser/201906/20190626-Commentary.pdf