Scottish v. UK growth forecasts: how big a difference is there, and does it matter?

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The Scottish Fiscal Commission’s forecasts for economic growth in Scotland over the next five years, published in December, raised some eyebrows. Growth in GDP per capita will average just half a percent a year over the period to 2022 according to the forecasts. This is about half the average growth rate seen during the noughties. It is also slower than the 0.7% average growth rate that the OBR is forecasting for the UK.

The latest GDP statistics for Scotland, published last week, included a downward revision to recent rates of GDP per capita growth. Prior to the revision, recent growth of Scottish GDP per capita had already been looking weak, with growth of just over half a percent between Q1 2015 and Q2 2017. But following the data revision this positioned has worsened, with GDP per capita actually shrinking fractionally over that same period, according to the revised figures. In contrast, UK GDP per capita grew 2.7% over the same period, opening up a marked gap in relative performance (see Chart).
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In this context, it’s difficult to argue that the SFC’s forecasts are too pessimistic. The SFC is effectively arguing that future growth will be more rapid than we’ve seen during the past 2.5 years, and on a par with average growth rates over the past decade (see Chart). (Scottish GDP per capita has grown barely 1% since Q1 2007).

True, the SFC forecasts do imply that the gap that recently opened up between Scottish and UK growth rates will continue to widen slightly going forward – but equally, the future differential performance between Scotland and the UK is not forecast to be as great as the one we have seen in the past three years.

Nonetheless, the SFC is forecasting that GDP per capita in Scotland will grow slightly slower than the OBR forecasts for the UK. It might be expected that slower growth in GDP per capita would translate into slower forecast growth in income tax revenues per capita in Scotland than in the UK. If it did, under the new fiscal framework for Scotland, the implication would be that Scottish income tax revenues would be smaller than the block grant adjustment for income tax. In other words, the Scottish budget would be worse off as
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A result of income tax devolution than it would have been without, under the Fiscal Framework arrangements.

But in fact, the SFC forecasts imply that Scottish income tax revenues will grow more quickly than the block grant adjustment. How can we reconcile these positions? (GDP per capita growing more slowly in Scotland than UK, but income tax revenues per capita growing more quickly?)

According to the SFC’s forecasting model, the main determinants of income tax revenues are employment and earnings. What are the SFC’s judgements about how these two factors will evolve?

- The SFC’s forecasts imply that the employment rate in Scotland will grow at the same rate as the OBR forecasts for the UK (strictly speaking, the 16+ employment rate is forecast to fall by around 0.15% per annum by both forecasters). The fact that the employment rate follows the same trend in Scotland and UK despite slower growth in Scottish GDP per capita is explained by the SFC’s judgement that productivity (the amount of output per job) will grow more slowly in Scotland than the OBR forecasts for the UK.
- The SFC’s forecasts imply that average earnings will grow at the same rate in Scotland as the OBR forecasts for the UK. The fact that Scottish earnings are forecast to grow at the same rate as UK earnings, despite lower productivity growth in Scotland might appear a bit of a puzzle; at national level a common assumption is that earnings growth should broadly track productivity growth over the long run. But this relationship might be much weaker at sub-national levels or over shorter time periods (for example, earnings in Scotland might be more closely tied to UK productivity and UK wage settlements than they are to Scottish specific productivity).
- With the SFC forecasting that earnings and employment will trend in Scotland similarly to the UK, growth in Scottish income tax revenues would broadly match the UK in the absence of policy change. But combined with income tax changes in Scotland announced this year and last, Scottish income tax revenues are forecast to grow more quickly than they are in the UK – providing a boost to the Scottish budget.

What should we take from all this?

On balance, the SFC’s GDP forecasts are not out of kilter with the recent past. And the SFC assumes that there will be no ‘bounce-back’ in Scottish growth to recapture weak growth relative to the UK over the past 2.5 years.
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But whilst we often obsess about fairly marginal differences in economic data between Scotland and the rest of the UK, we should remember here that, given the necessarily wide confidence interval around any economic forecast, the differences between the SFC and OBR forecasts for growth in GDP and revenues are actually small. (The forecasts do not imply we will see anything like the divergence in fortunes that has been observed in the last 2.5 years).

True, there does remain an interesting empirical question about the extent to which Scottish earnings and employment growth will be linked to rates of per capita output growth in Scotland in future. But the big difference is between the forecasts for GDP and earnings growth over the next few years – at Scottish and UK levels – compared to what we became used to prior to 2008. It is this difference that has big implications for the public sector finances, at both Scottish and UK levels.