



University of
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Business
School

Fraser of Allander Institute

Economic Commentary

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Foreword

The past 12 months have provided both good news and bad for Scotland's economy – economic growth has picked up during 2018, but overall growth remains low. One reason for the low growth is a lack of productivity growth.

This mix of fortunes is also evident in the latest of Deloitte's Power Up reports, Power Up: UK-Wide Growth. It showed that Scotland's economy has only grown at around half the UK average rate and while the country has outperformed the UK average in productivity growth over the last 10 years, productivity growth remains low.

The latest Power-Up report looked at many years of employment and productivity data to help identify where Scotland can maximise opportunities by learning from the past, before combining this with the very real experiences and views of current business leaders, educators, local government officials and other stakeholders.

One of the findings is that Scotland's businesses need to collaborate further with educators and policymakers to develop the vital skills required to harness productivity for regional growth. Another key finding is that Scotland's business leaders will need to remain open and agile to transformational opportunities, as digital strategies and technology innovation continue to influence productivity gains in the short term.

Our report also highlighted that Scotland needs more businesses of scale that are competitively positioned across international markets.

Scotland can grow these businesses. Innovation and entrepreneurialism are embedded in Scotland's roots, standing businesses in good stead to respond to the challenges ahead. This was reflected in the recent Summit Entrepreneurship Awards which Deloitte was proud to sponsor once again.

Like many before them, this year's finalists demonstrated exceptional leadership skills. Their vision and commitment, combined with ongoing investment in their people, technology and other assets, has ensured they continue to run strong, sustainable businesses which can adapt to ever-changing marketplaces.

As we face the challenges ahead including the continuing uncertainty around Brexit, it is important that business leaders in Scotland continue to plan for the future. Similarly, it is important not to lose sight of the importance of announcements such as the upcoming Scottish Budget, detailing the Scottish Government's spending and tax plans for the year ahead.

The Scottish Government's use of income tax powers has certainly been the main focus of recent Scottish Budgets, and with the announcement in October's UK Budget that the Chancellor intends to raise the higher rate threshold to £50,000, from April next year, it is likely to dominate once again.

Scotland's Finance Secretary, Derek Mackay, has indicated he does not intend to match this for Scottish income tax bands, which apply to earnings and pensions for Scottish residents, and that will result in a noticeable difference in the tax paid between Scotland's higher rate tax payers and those in the rest of the UK.

What impact this will have on investment and growth in Scotland is the subject of much debate. However, it is important that Scotland is seen as an attractive place for people and businesses. We have an ageing population, a shrinking working age population and it is vital for our future that we do not deter people from choosing to come to Scotland.

There are no easy answers to how to improve Scotland's productivity growth, our economic growth or how to balance the nation's books. As the country's business landscape continues to evolve, it will be important for all leaders to think innovatively and plan differently, to identify solutions from which everyone can benefit.

John Macintosh
Tax Partner
Deloitte
December 2018

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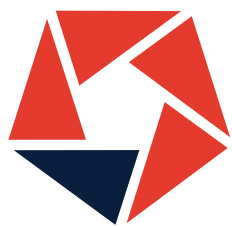
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Policy context

For regular analysis on the Scottish economy and public finances please see our blog

www.fraserofallander.org



Summary

The vote on the UK's EU Withdrawal Agreement will be one of the most significant in a generation. It has the potential to shape the future of the UK and Scottish economies for decades to come.

Whatever happens, it will not mark the end of the uncertainty. A vote in favour will see the UK enter a near two-year transition process. But the most challenging issue – a future UK-EU trade deal – has yet to be agreed.

Some will argue that a vote against will increase the likelihood of 'no-deal'. Others argue that it provides a last opportunity to secure a softer Brexit.

In such times, any economic forecasts must come with major health warnings.

What we can say with some confidence however, is that 'no deal' would be a substantial (negative) economic shock. The Bank of England have set out a 'worst-case' scenario which could see the UK economy shrink by around 8% from 2019.

To put that in context, that is around double the size of the recession Scotland witnessed during the financial crisis. Whilst some people have questioned this analysis, even under a less disruptive 'no deal', the Bank's analysis suggests that the slowdown could still be significant.

All this comes at a time when the Scottish economy had been showing signs of picking-up. Growth in Scotland for the first six months of 2018 had outperformed the UK as a whole.

In the event of a 'smooth' Brexit with a full transition period, we expect growth to pick up. We have kept our forecasts broadly unchanged on September at 1.4% for 2019, followed by 1.5% for 2020 and 1.4% for 2021.

Given the Brexit debate, the Scottish Government's upcoming Budget has received little attention.

But the government faces a number of decisions that will shape the direction of Scotland's public finances for years to come.

Will Mr Mackay choose to follow – at least in part – the decision by the Chancellor to raise the Higher Rate threshold on income tax? Or will he take a further decisive shift to differentiate Scottish and rUK income tax policy?

As a minority administration, what might be offered to secure parliamentary support? Will Scottish Green Party backing lead to a more fundamental look at the funding of local government?

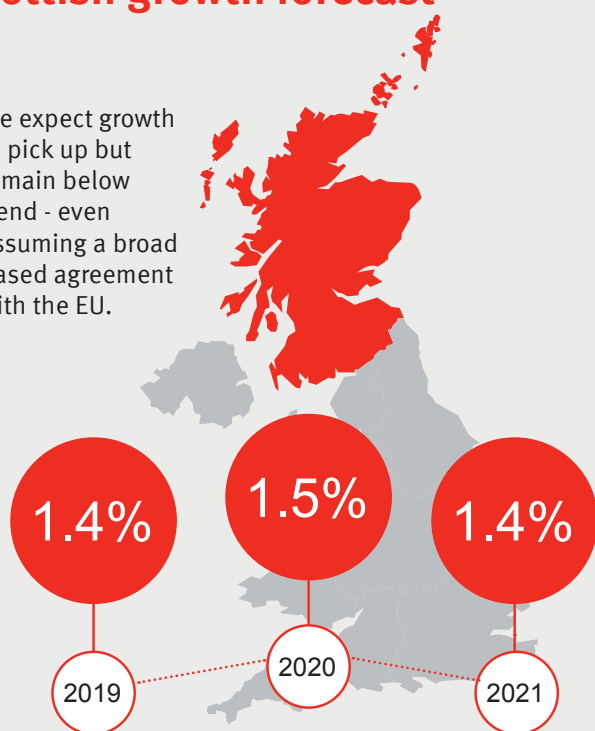
And what is the long-term strategy for public services? With the NHS on track to soon account for around £1 of every £2 spent by the Scottish Government, pressures on other budgets continue to increase. We have heard a lot about plans for priority areas of spend, but what about other areas?

During the coming months of debate and negotiations, the Scottish budget will no doubt play second fiddle to Brexit. But we should not forget the importance of the budget, not only because it determines how much income and council tax we all pay, but because of what it will tell us about the long term outlook for public spending and tax competitiveness in Scotland.

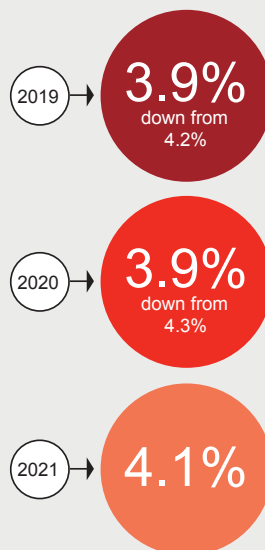
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December 2018

Scottish growth forecast

We expect growth to pick up but remain below trend - even assuming a broad based agreement with the EU.



Unemployment forecast



Fraser of Allander Institute

At a glance

Chart: Scottish growth (since 2013) – year and quarter

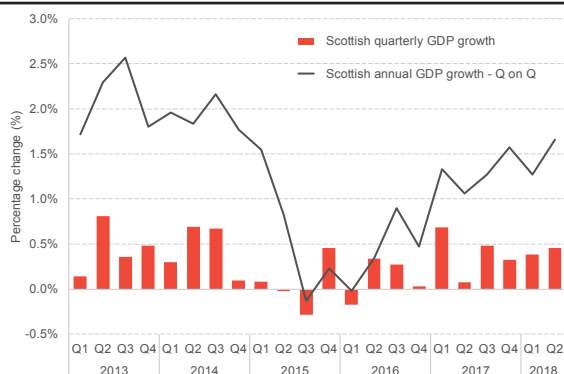


Table: Employment & unemployment rates, July - Sep 2018

	Employment (16-64)		Unemployment (16+)	
	Rate (%)	Year Change	Rate (%)	Year Change
Scotland	75.0%	▼	3.8%	▼
England	75.8%	▲	4.1%	▼
Wales	75.0%	▲	3.9%	▼
N. Ireland	68.5%	▲	4.1%	-
UK	75.5%	▲	4.1%	▼

Chart: FAI forecast Scottish economic growth range

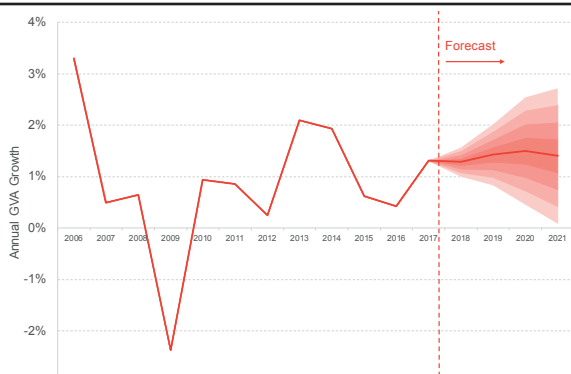


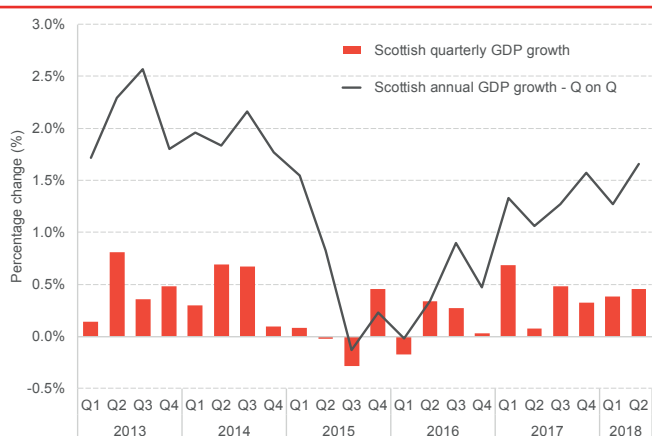
Table: FAI forecast Scottish economic growth (%), 2019 – 2021

	2019	2020	2021
GDP	1.4%	1.5%	1.4%
Production	1.6%	1.7%	1.6%
Construction	1.1%	1.1%	1.1%
Services	1.4%	1.4%	1.4%

Outlook and Appraisal

Whilst economic growth in Scotland remains below trend, it has picked-up in 2018 to its fastest pace since 2014. However, businesses are increasingly nervous about the prospects for the UK and Scottish economies in the light of the looming Brexit impasse and the potential political crisis it could usher in.

Chart 1: Scottish growth since 2013, year and quarter



Source: Scottish Government

Table 1: UK labour market, Jul - Sep 2018

	Employment (16-64)	Unemployment (16+)	Inactivity (16-64)
Scotland	75.0%	3.8%	22.0%
England	75.8%	4.1%	20.8%
Wales	75.0%	3.9%	21.9%
N. Ireland	68.5%	4.1%	28.5%
UK	75.5%	4.1%	21.2%

Source: ONS, LFS

Table 2: Change in Scottish GDP relative to baseline of full EU membership after 15 years

	EEA	FTA	WTO
UK (2018)*	-2.5%	-6.7%	-9.3%
SG (2018)	-2.7%	-6.1%	-8.5%
FAI (2017)	-	-4.9%	-7.5%

* Figures for the UK economy

Source: Fraser of Allander Institute

Introduction

As we outlined in our last Commentary, growth in the Scottish economy has picked up in recent times – consistent with the forecast we set out this time last year. Chart 1.

Whilst activity remains below trend, it has certainly been more positive than in recent times and has helped unemployment to remain at a near historical low. Table 1.

But the outlook is dominated by one issue: Brexit.

There remains a sense that no one knows where the ongoing political process will end: indeed, the range of outcomes seems as wide as ever.

Forecasting any economic outlook in such times is fraught with difficulties. We make no excuses for saying that we can offer little certainty to where the economy might go in the months ahead.

Whatever the outcome, it is far from apparent that the fog enveloping the near term outlook will roll away to reveal a clarity that has been starkly absent thus far.

Indeed, many critical elements may simply be fudged, or more openly deferred, leaving uncertainty for many more months, if not years.

In such times, building resilience into plans for 2019 and beyond is perhaps the most effective strategy that can be undertaken at the current time by businesses.

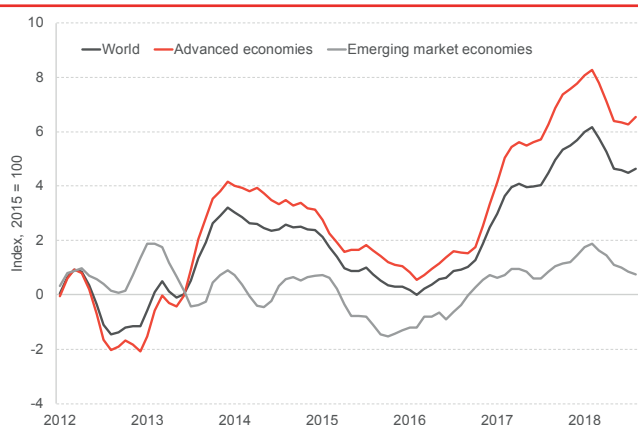
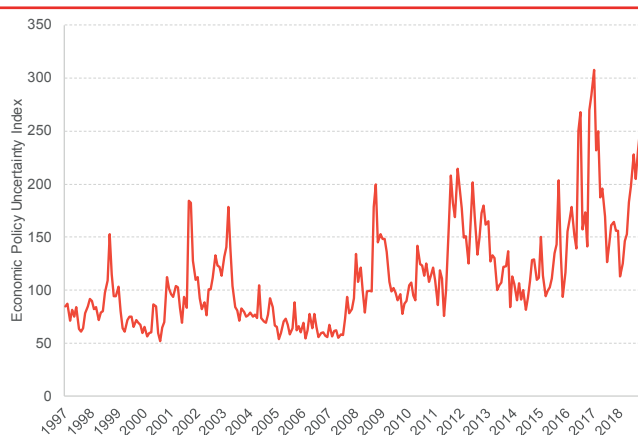
One of the most frustrating things about the Brexit debate – whether you agree or disagree with the decision – is that many important issues, such as this month's Scottish Budget, are being side-lined.

But the decisions that Mr Mackay will take on tax, public spending and economic policy, will shape the economic and fiscal outlook for years to come.

It is therefore important that we continue to debate and critique the choices that will be made.

Table 3: OECD & EU quarterly growth rates: 2017 to 2018

	2017				2018		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
UK	0.4	0.3	0.4	0.4	0.1	0.4	0.6
US	0.4	0.7	0.7	0.6	0.5	1.0	0.9
Japan	0.7	0.5	0.6	0.2	-0.2	0.7	-0.3
Canada	1.0	1.1	0.4	0.4	0.4	0.7	0.5
Euro Area	0.7	0.7	0.7	0.7	0.4	0.4	0.2
Germany	1.1	0.5	0.6	0.5	0.4	0.5	-0.2
France	0.8	0.6	0.6	0.7	0.2	0.2	0.4
Italy	0.5	0.4	0.4	0.3	0.3	0.2	0.0

*Source: OECD***Chart 2:** Global manufacturing PMI's: falling back in recent months*Source: Thomson Reuters Datastream***Chart 3:** Global Economic Policy Uncertainty Index, 1997 - Oct 2018*Source: Economic Policy Uncertainty*

The global economy

The global economy has been in robust health for over two years now.

World GDP is estimated to have risen by 3.7 per cent in 2017, up from 3.2 per cent in 2016. The IMF forecast that it will remain at this – above trend – level in 2018.

However, as we highlighted in our last commentary, most economists believe that growth has peaked (at least in advanced economies).

Indeed, there is growing evidence of a slowdown in many of Scotland's key trading partners. Table 3. In particular, output in the Euro Area rose by just 0.2% – a four year low – over the summer.

Significantly, the German economy contracted for the first time since 2015, driven in part by ongoing challenges in car manufacturing, but also wider fragility in investment and household spending.

Indicators of activity across the global economy have eased back. Chart 2. Some of this reflects a natural change in the economic cycle. However, there are concerns that heightened political uncertainty could turn a 'soft-landing' into something altogether more challenging. Chart 3.

Chief amongst these are the potential impacts of rising trade tensions, led by the increasing protectionist policies of the Trump administration.

World trade accelerated sharply in 2017 – to grow at its fastest rate since 2011 – but there are signs that this momentum is fading with recent trade disputes taking their toll.

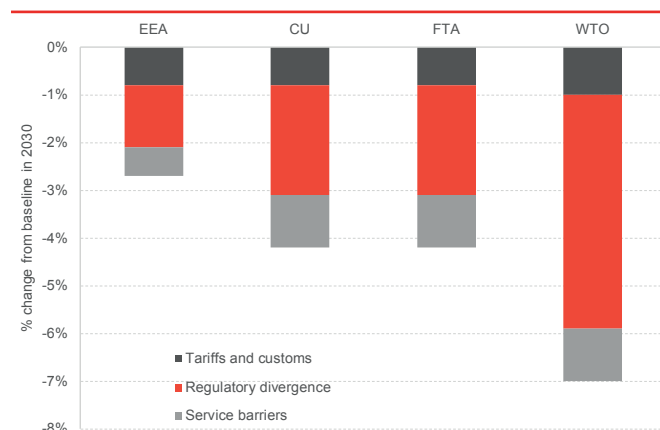
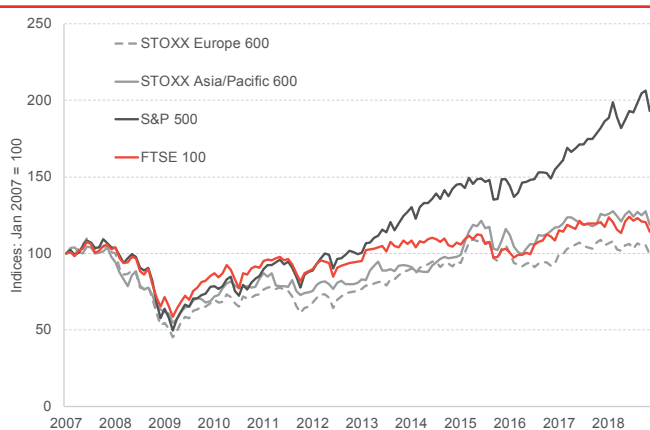
Chart 4: Long-term impact of Brexit on Ireland's GDP*Source: The Department of Business, Enterprise & Innovation (DBEI), Irish Government*

Chart 5: Stock market performance to Nov 2018, 2007 = 100



Source: Thomson Reuters Datastream

Of course, Europe faces its own challenges from Brexit – nowhere more so than Ireland. Chart 4.

The heightened risk around that global outlook has spilled over into renewed volatility in stock markets. Most major indices have seen falls in recent weeks.

The FTSE 100 is down around 10% on its May 2018 peak. Chart 5. Such volatility has some investors speculating that the world's major central banks may put off plans to tighten monetary policy.

Closer to home, Sterling continues to trade at a discount, driven by concerns over the UK's long-run prospects post-Brexit. Chart 6.

The FT reported in November that investors have withdrawn more than \$1tn from UK-focused equity funds since the referendum – the highest outflows since the financial crisis.

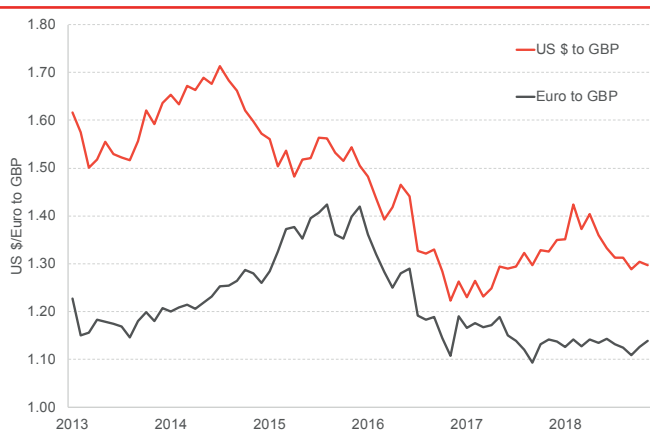
And in October, the UK market was rated the least popular of 22 asset classes among fund managers in a Bank of America Merrill Lynch survey.

The price of oil has entered 'bear market' territory. In just over a month, Brent has plunged by around 30% to below \$60. Chart 7. Whilst fears of a global slowdown have not helped, it is an oversupply that has had the greatest impact.

This of course matters here in Scotland. The oil and gas sector had just come through a difficult period, with confidence returning. Chart 8.

Whilst the low oil price will come as a blow to many, the mood in the sector remains confident with most contractors and operators better prepared for a lower break-even price.

Chart 6: Exchange rates, \$/€ to £, 2013 - Nov 2018



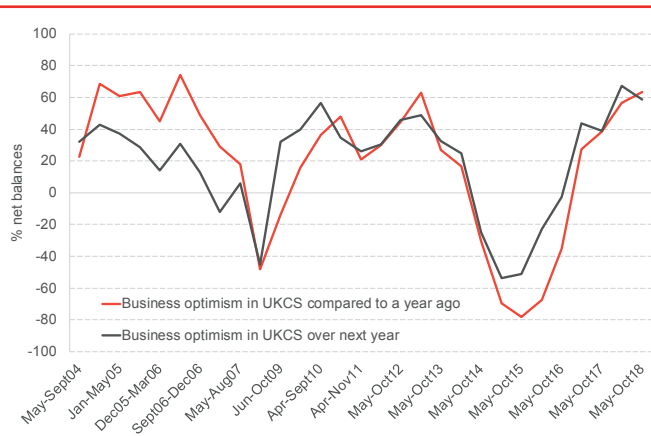
Source: Thomson Reuters Datastream

Chart 7: Price of oil, 2013 - Nov 2018, US \$/BBL



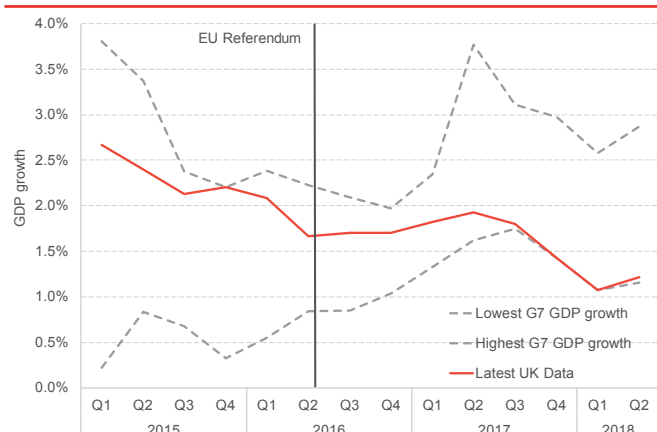
Source: Thomson Reuters Datastream

Chart 8: Optimism in North Sea , 2004 - May-Oct 2018



Source: FAI / AGCC

Chart 9: UK economic growth compared to (best & worst) G7 economies



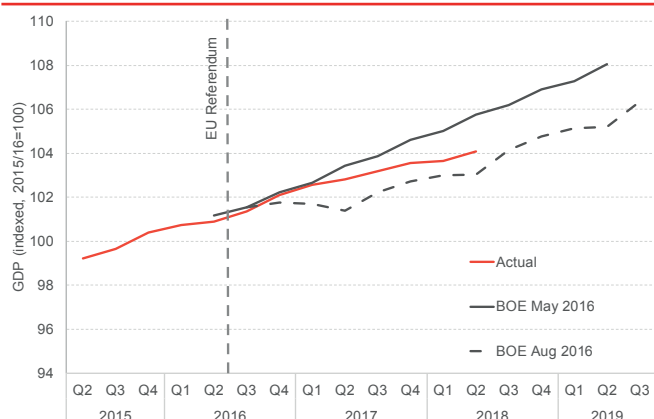
Source: ONS & OECD

Chart 10: UK economic performance, 2008 - Q3 2018



Source: ONS

Chart 11: Post-referendum performance relative to pre- and post-referendum growth forecasts



Source: Bank of England & ONS

The UK economy

Following a period of relatively strong growth in 2014 through 2016, the UK economy has slowed significantly over the last couple of years. Chart 9.

In late October, the OBR revised down their forecasts for GDP growth in 2018 to just 1.3%. Since then, figures have shown that growth picked-up over the summer (+0.6%), boosted in part by good weather, the World Cup and recovery in sectors which had experienced a challenging start to 2018.

This recovery was particularly pronounced in construction, where output grew by over 2%.

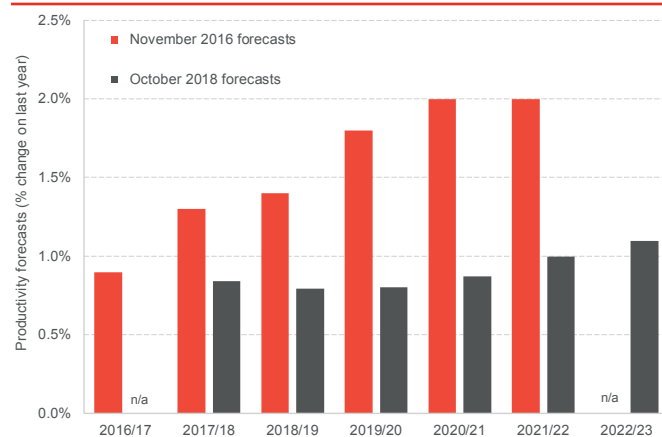
It is over a longer time horizon that a clearer picture of the true health of an economy can be assessed. This shows that even with these recent positive figures, UK growth remains below trend with annual growth of 1.5%. Chart 10.

It is therefore hard not to conclude that the ongoing Brexit uncertainty has had an impact. The fall in the pound has squeezed household incomes. Business investment has arguably taken the biggest hit and has contracted now for three consecutive quarters.

Of course, predicting where the economy 'would have been' had a referendum not been called is fraught with difficulty. Chart 11.

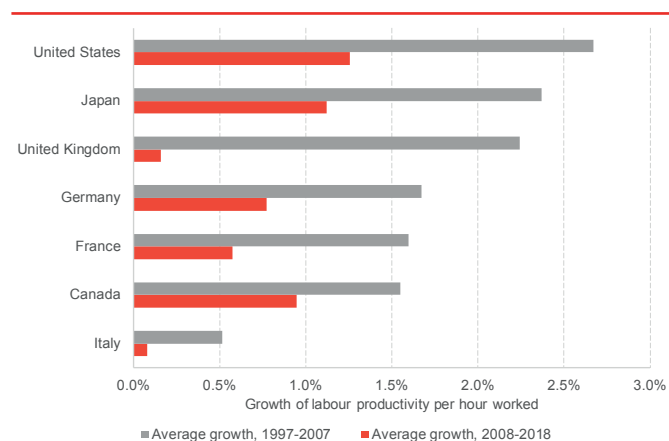
What we can at least conclude is that those who predicted a sharp recession immediately after June 2016 were wrong, but so too were those who suggested that leaving the EU would have no negative impact. Chart 12.

Chart 12: Weaker productivity forecasts for UK for next 5 years



Source: Office for Budget Responsibility

Chart 13: Productivity performance pre and post financial crisis in G7



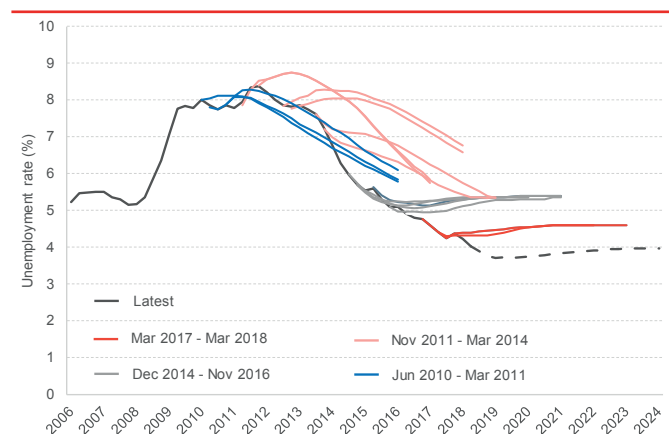
Source: ONS & OECD

Interestingly, much of the explanation why both the Bank of England and the Office for Budget Responsibility remain relatively pessimistic about the outlook for the UK economy is not driven by short-term factors, such as Brexit uncertainty or even a more fragile and volatile global policy environment.

Instead, it is driven by continued weak productivity. It is this, more than anything else that is holding back growth forecasts.

It is easy to see why the government's official forecasters continue to take a much more pessimistic outlook for productivity given recent performance. Productivity across developed economies is much lower than pre-crisis but the drop off in the UK is particularly pronounced. Chart 13.

Chart 14: OBR forecasts for the UK unemployment rate: currently overly pessimistic



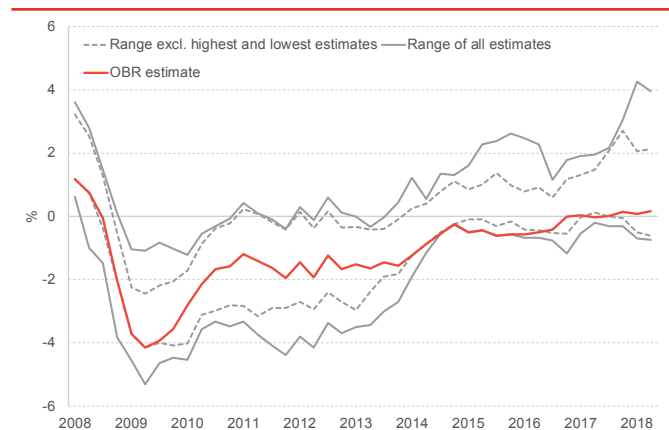
Source: Office for Budget Responsibility

At the same time however, the labour market continues to perform much better than expected, with unemployment consistently beating forecasts – Chart 14. Indeed, there are increasing signs of skills shortages and rising vacancies across sectors.

Taken together, the outlook for productivity and the labour market, means that there seems to be little spare capacity to help growth pick-up beyond current levels – Chart 15. Most forecasts predict that the UK is operating at close to its potential or sustainable level (the 'output gap').

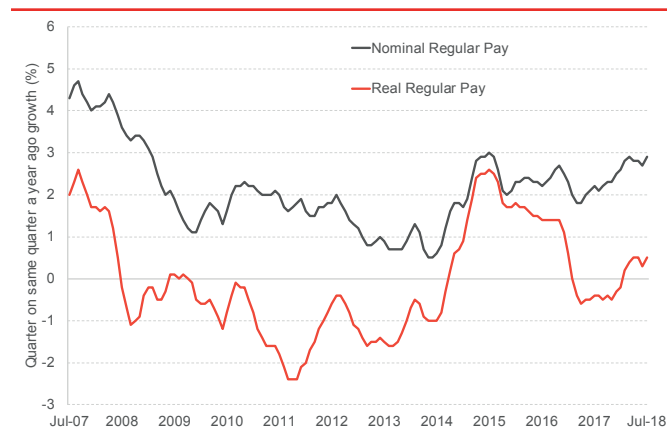
It also means that whilst real earnings have started to rise once again, the prospects for a substantial pick-up in take-home pay appear remote. For many households, the feeling of 'austerity' is likely to continue for some time to come. Chart 16.

Chart 15: Output gap estimates, Q1 2008 - Q2 2018



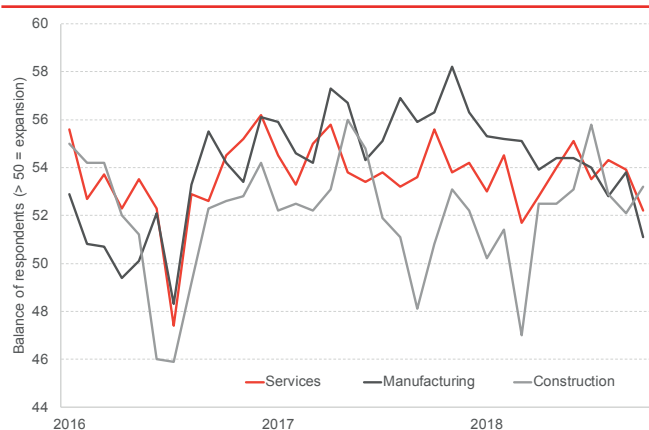
Source: Office for Budget Responsibility

Chart 16: UK real and nominal pay growth since 2007



Source: ONS

Chart 17: UK Services, Construction and Manufacturing PMI



Source: RBS, IHS Markit

Faced with an ongoing squeeze, it is no surprise that borrowing amongst households is on the rise once again. At the same time, the UK savings ratio continues to remain close to record lows.

Most up to date business surveys point to growth continuing, but at a slow pace.

The UK manufacturing PMI fell to just 51.1 in October (well below market expectations and well above 50 marks expansion). UK services PMI also fell to 52.2. Chart 17.

The CBI's Business Optimism indicator decreased to -16 for Q4 2018, the lowest reading since immediately after the EU referendum.

At the heart of the slowdown in business activity is a fall-off in investment.

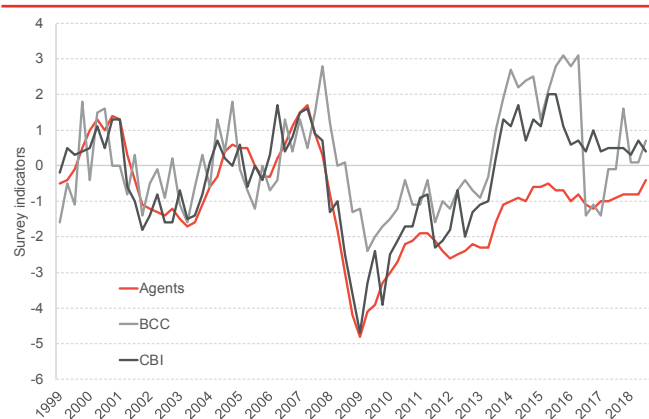
November's Bank of England Inflation Report found that, for Q3 2018, Brexit uncertainty was the single largest factor weighting on investment plans. Chart 18. Other measures, such as Deloitte's CFO survey, have also found evidence of rising uncertainty. Chart 19.

Of course how this affects different parts of the UK will vary.

New work by researchers at the University of Strathclyde – as part of the Economics Statistics Centre of Excellence (ESCoE) – shows that the economic gap between the south and north of England has widened since the referendum. Chart 20.

After adjusting for inflation, London's economy is roughly 5% bigger than it was in June 2016 compared to growth of only 1.3% in the North East.

Chart 18: Surveys of capacity pressures



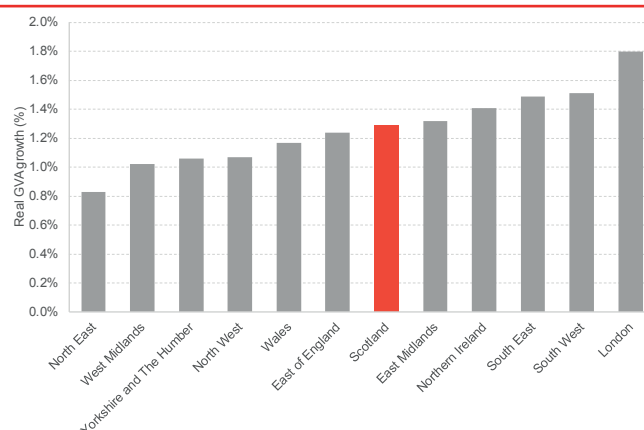
Source: Bank of England

Chart 19: CFO Business Uncertainty since 2013



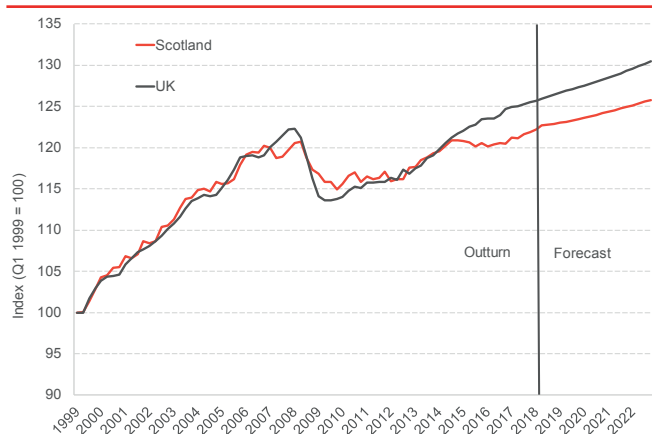
Source: Deloitte

Chart 20: Nowcasts of UK regional growth, year to Q3 2018



Source: ESCoE

Chart 21: GDP per capita in Scotland and the UK, Q1 1999 = 100



Source: Scottish Government, SFC and OBR

The Scottish economy

After a sustained period of weak growth, the Scottish economy has been showing signs of strengthening.

Growth has picked up and employment remains at relatively high levels. This has been a positive turnaround on twelve months ago.

Growth over the year to June 2018 was the fastest since late 2014/ early 2015, with the Scottish economy outpacing the UK for the last two quarters.

That being said, annual growth of 1.7% (quarter-to-quarter) and 1.4% (4Q-on-4Q), still lags Scotland's long-term historical growth rates.

At the same time, much of the pick-up in recent times arguably reflects a degree of 'catch-up' after a challenging period for the Scottish economy.

As Chart 21 highlights, since late 2014 the Scottish economy has been lagging behind the rest of the UK. The last six months have at least helped to stop this trend.

Overall, the upturn has been relatively broad-based.

Over Q2, there was growth of 0.3% in production activities, 1.9% in construction and 0.5% in services.

With services making up over 75% of activity – it is no surprise that Scotland's overall rate of growth has been shaped by services. Chart 22.

The pick-up in Scottish exports continues, with international exports increasing by almost 10% over the last year.

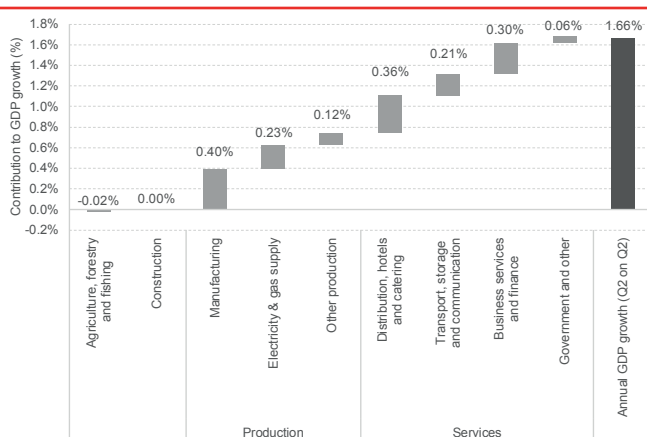
With imports growing only 3% in value, this has contributed significantly to nominal GDP growth over the last year. Chart 23.

This currently means that, in the latest quarter, Scotland has a positive trade balance with the rest of the world, off-setting a large deficit with the rest of the UK.

In our report, [Scotland 2050](#), we discuss Scotland's wider long-term export challenge and our gap in performance with the best performing countries.

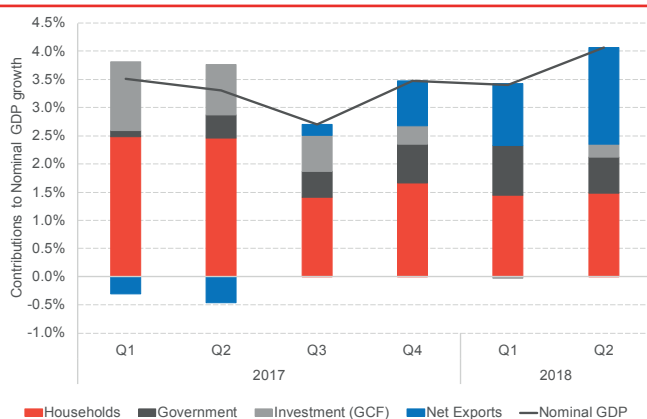
We highlight the importance in taking advantage of the significant global opportunities that are open to the Scottish firms.

Chart 22: Sector contributions to annual GDP growth, %, Q2 2018 on Q2 2017



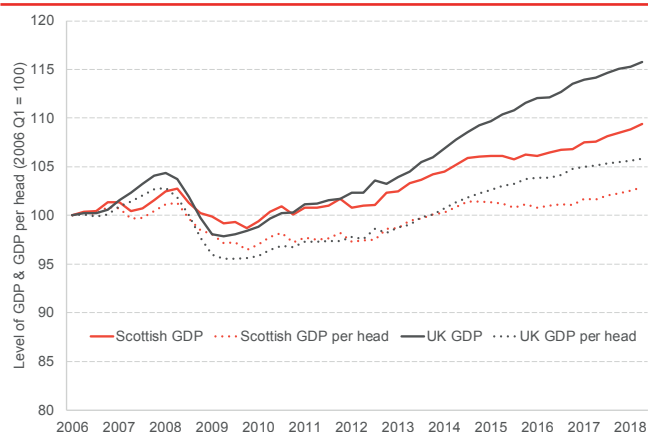
Source: Scottish Government & FAI analysis

Chart 23: Contribution of expenditure components to nominal GDP, Q1 2017 - Q2 2018



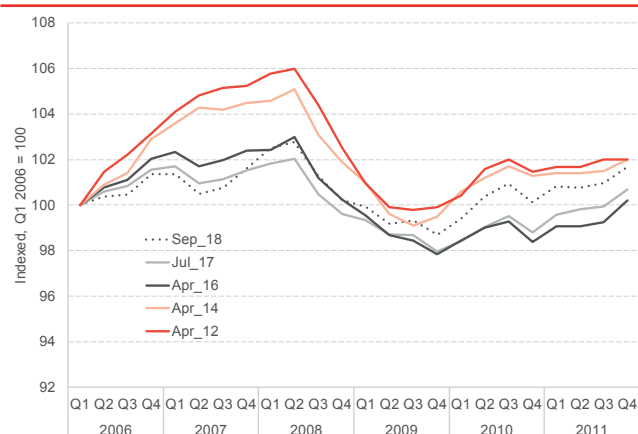
Source: Scottish Government & FAI analysis

Chart 24: Scottish and UK economic performance since the financial crisis



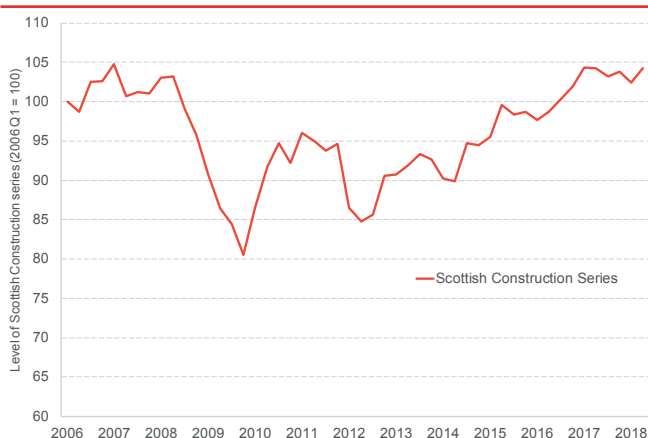
Source: Scottish Government

Chart 25: Scottish recession during the financial crisis - the impact of data revisions (date estimates were published)



Source: Scottish Government

Chart 26: Scotland's construction sector since financial crisis



Source: Scottish Government

The Scottish economy ten years after the financial crisis

It is 10 years since Scotland – like many other parts of the world – slipped into recession as the global financial system ground to a halt.

A decade later, how have we fared?

The financial crisis wiped around 4% of output from the Scottish economy. UK output fell by over 6%. Chart 24. Interestingly however, the scale of the downturn is now believed to have been much less – around 50% smaller – than first measured at the time at the height of the crisis. Chart 25.

Instead, what has been particularly challenging for Scotland has been the weak recovery. It took around five years for output to return to its pre-crisis level in Scotland.

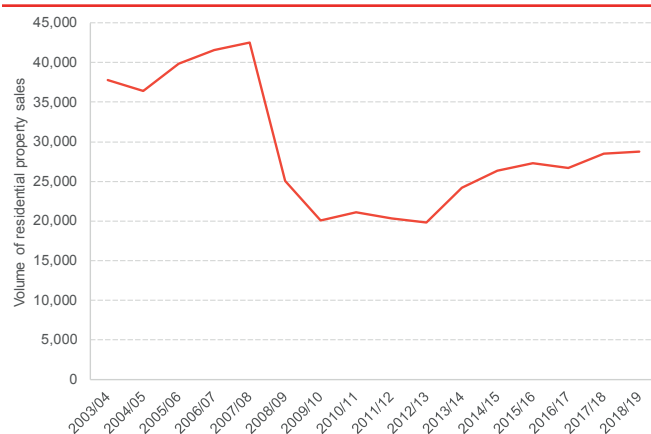
Chart 24 also shows that whilst the UK economy suffered a deeper recession than Scotland (driven by a sharper fall in services), it performed better in the recovery period.

Today, GDP per head in Scotland is 1.7 per cent greater than it was 10 years ago. To put that in context, average annual growth in the preceding 10 years was 1.9% *per annum*.

The impact of the crisis varied by sector.

Unsurprisingly, construction bore the brunt of the downturn – contracting by over 20%. According to the newly revised data from the Scottish Government, the sector in Scotland around the same level as it was 10 years ago. Chart 26.

Chart 27: Volume of residential property sales in Scotland per year, Q2 2003 - Q2 2018



Source: National Records of Scotland

Scottish Economy Dashboard





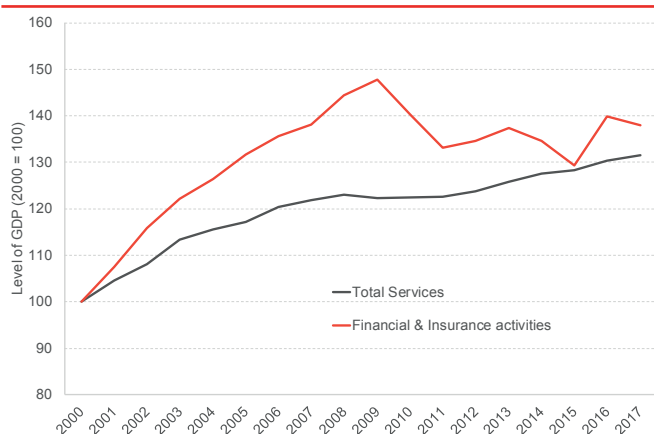
		% of Economy	Growth		Key issues/trends
			2017	Q2 2018	
	Production	17%	2.0%	0.3%	
	Manufacturing	11%	1.6%	0.8%	<ul style="list-style-type: none"> Confidence and growth has returned recently. In particular, growth in computer products, food and drink, and textiles Exporters continue to benefit from weak pound. But fall in oil price, and slow down in export markets is a challenge. At risk from dislocation of UK-EU trade
	Food and drink	3%	-0.8%	3.8%	<ul style="list-style-type: none"> Sector continues to grow strongly – and is now at its highest ever level Growth potential is high, although boosting productivity in sector will be key for sustainability Future post-Brexit challenges could include ‘just-in-time’ deliveries and access to migrant workers
	Services	76%	1.0%	0.5%	
	Retail and wholesale	10%	1.6%	1.2%	<ul style="list-style-type: none"> The most recent data suggests a modest upturn in retail and wholesale combined after a challenging start to 2018 But retail data suggests tough trading conditions, with many high-profile names on the high street struggling Rising wages could give some respite to a sector going through significant structural change
	Accommodation & food services	3%	0.2%	-0.4%	<ul style="list-style-type: none"> Modest growth over the year, but some fall-back in the most recent quarter Like retail, many eating establishments are facing challenges. Changes in how households consume entertainment is impacting many business models Tourist facing elements of sector continue to do well
	Financial & insurance	6%	-0.9%	2.5%	<ul style="list-style-type: none"> Sector has seen strong growth recently after a tough 2017 Unlike other sectors directly exposed to the financial crisis – such as professional services and real estate – financial services has taken much longer to get back on its feet and remains below pre-crisis highs
	Construction	6%	4.4%	1.9%	<ul style="list-style-type: none"> Uplift in public sector capital investment should help support infrastructure, but wider measures of activity – including commercial property and house-building – remain relatively subdued
	Agriculture	1%	4.6%	-1.4%	<ul style="list-style-type: none"> Grew strongly in 2017 but performance in the last four quarters has been relatively poor Sector is arguably most exposed to any hit to migration post-Brexit Sector will need clarity on support, opportunities and regulation post-Brexit to ensure growth can continue

Chart 28: Services and financial services since the 2008 financial crisis, 2000 = 100



Source: Scottish Government

The housing market has also yet to fully recover to pre-financial crisis levels of activity. Chart 27.

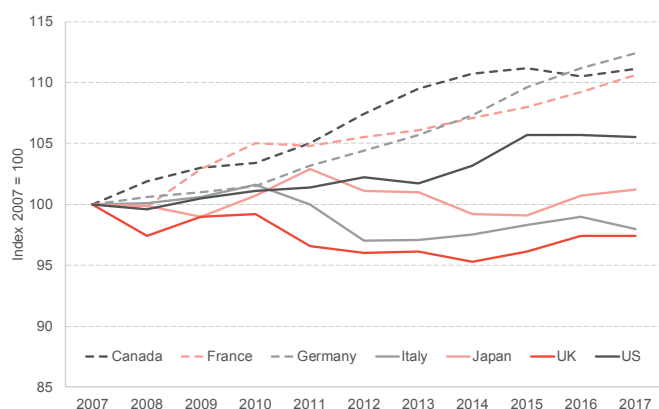
Overall, services fared better. Output only fell by 1.6 per cent. Unsurprisingly, financial services output fell sharply (by around 12%). It is still over 7% smaller than its pre-crisis level. Chart 28.

Interestingly however, it has adjusted to a more 'normal' size which perhaps reflects how unsustainable the 'good' times were but also the underlying resilience of the (non-banking) sector since.

A key concern from past recessions was that unemployment could rise significantly. However, whilst unemployment did rise (peaking at 8.9% in 2010), it has since fallen back.

But earnings have lagged behind for much of the decade. Indeed, earnings growth in the UK has been the weakest in the G7 since the financial crisis. Chart 29.

Chart 29: Performance of average real wages across the G7 since the financial crisis, 2007 = 100



Source: ONS & OECD

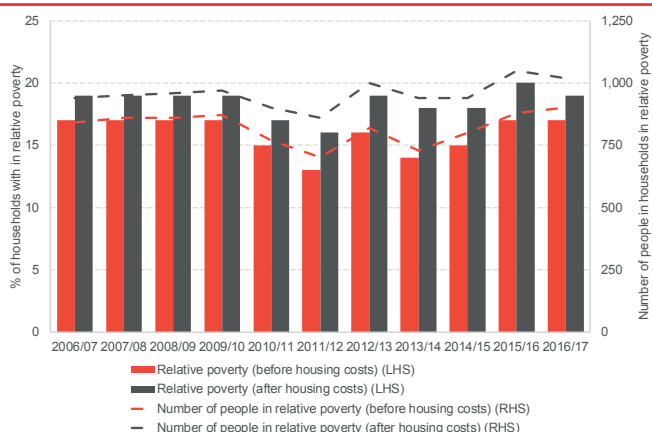
According to the Scottish Fiscal Commission, real household incomes per head are on track to remain below their pre-financial crisis levels even by 2023.

Poverty levels in Scotland have, as a result, remained stubbornly high. Chart 30. around 1 million people are estimated to be living in households classified as 'relative poverty' – including 1 in 4 children.

The key reason for weak earnings growth has undoubtedly been the poor performance of productivity.

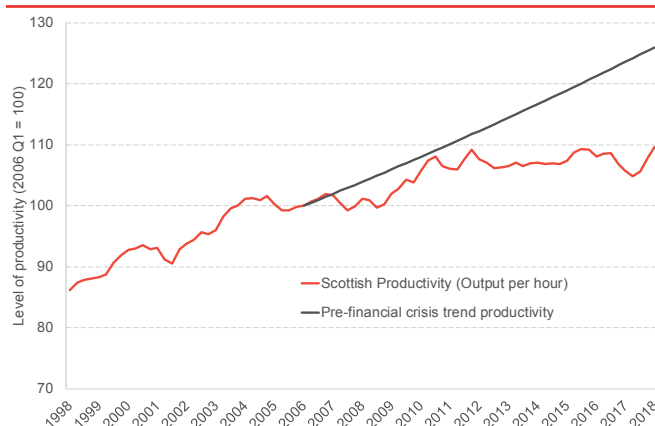
Had the pre-2006 trend continued, productivity in Scotland would be around 15% higher than it is today. Chart 31.

Chart 30: Relative poverty in Scotland (before and after housing costs)



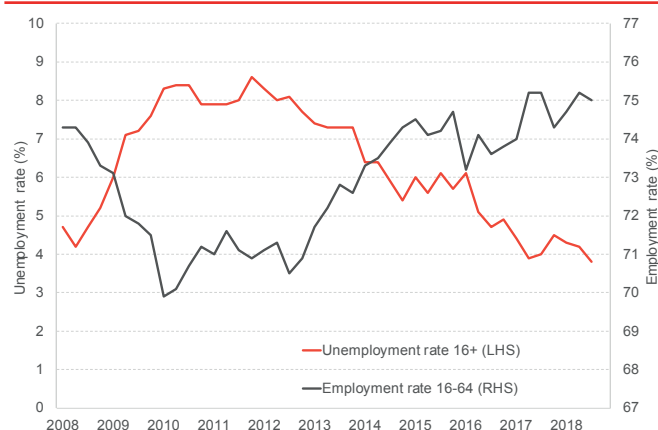
Source: Scottish Government

Chart 31: Scotland's long-term productivity performance



Source: Scottish Government & FAI analysis

Chart 32: Scottish employment & unemployment rate



Source: ONS, LFS

Scottish labour market

Scotland's labour market continues to experience a period of historically low unemployment and high employment.

Scotland's headline unemployment rate is now 3.8%, its lowest recorded rate, with an employment rate of 75%. Chart 32.

Overall, Scotland's unemployment rate is one of the lowest in the UK. Chart 33. However, unlike in the rest of the UK, inactivity has risen in Scotland over the last year – up 0.4% points compared to a fall of 0.4% points in the UK.

This might not all be bad news however, as the largest increase has been amongst those aged 16–24, with some of this likely to reflect increased student numbers.

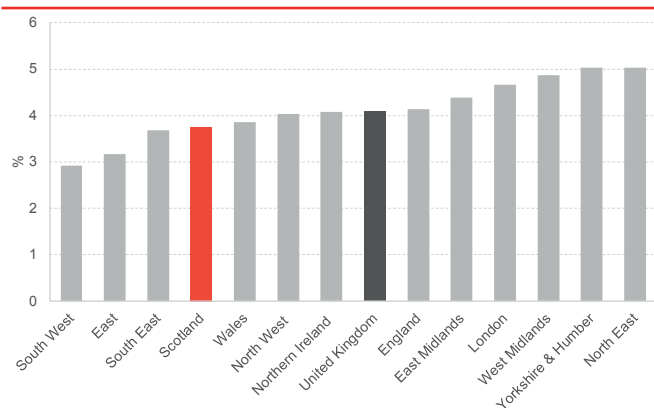
In contrast to the past couple of years, the balance of employment in Scotland between self-employment and employee jobs appears to be shifting back towards employees.

This suggests that the substantial rises in self-employment witnessed since the Great Recession may have eased somewhat. Chart 34.

At the same time, the number of people in part-time work who are seeking – but cannot find – full-time work continues to fall. Chart 35.

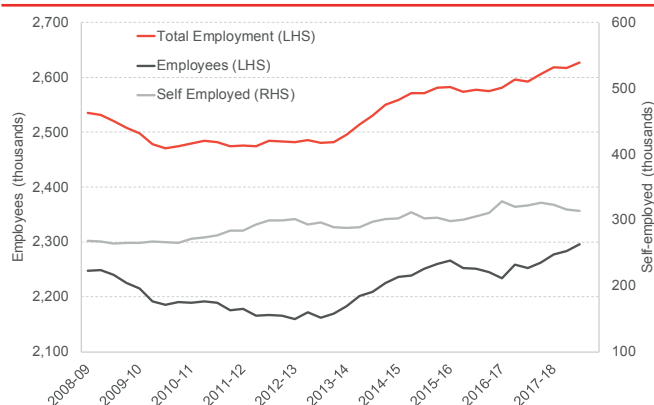
The ageing of Scotland's labour force continues apace.

Chart 33: Unemployment rate by different part of the UK



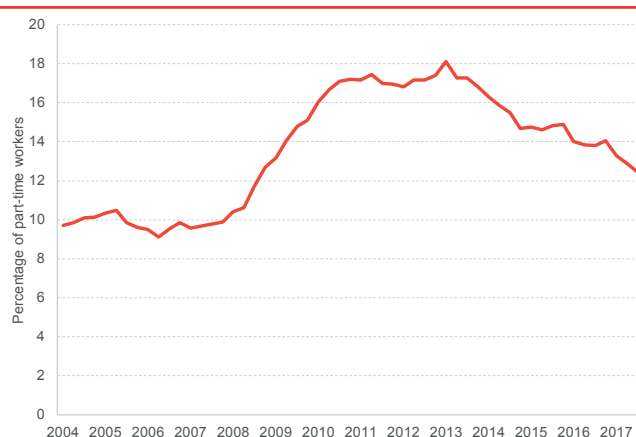
Source: ONS, LFS

Chart 34: Scottish employment & self-employment



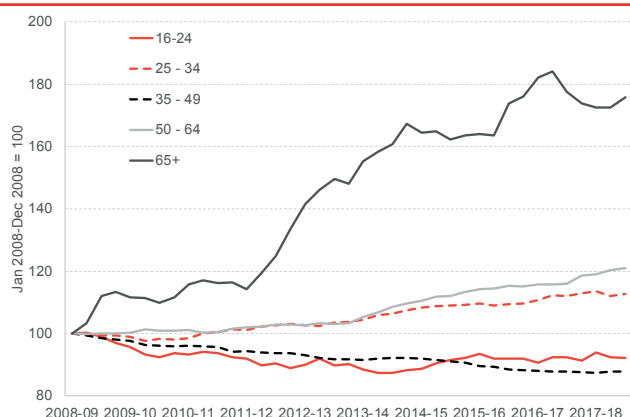
Source: ONS, LFS

Chart 35: Percentage of part-time workers who cannot find full-time work, Jan-Dec 2004 up to Jul 2017 - Jun 2018



Source: ONS, LFS

Chart 36: Employment levels by age in Scotland since 2008-09



Source: ONS, LFS

Employment amongst those aged 65+ continues to rise. In contrast, there are fewer young people employed now than 10 years ago.

Some of this reflects fewer young people in the general population, but it also reflects a lower youth employment rate. Chart 36.

Whilst the headline measures of labour market performance might appear robust, challenges remain. In particular, real earnings growth (i.e. after adjusting for inflation) in Scotland has been – at best – barely positive over the last few years. Chart 38.

Much has been written about productivity since the financial crisis. Many hypothesis have been formulated, yet little appears to be changing in the headline data. Chart 39.

Chart 37: Youth (16-24) employment and unemployment in Scotland since 2008-09



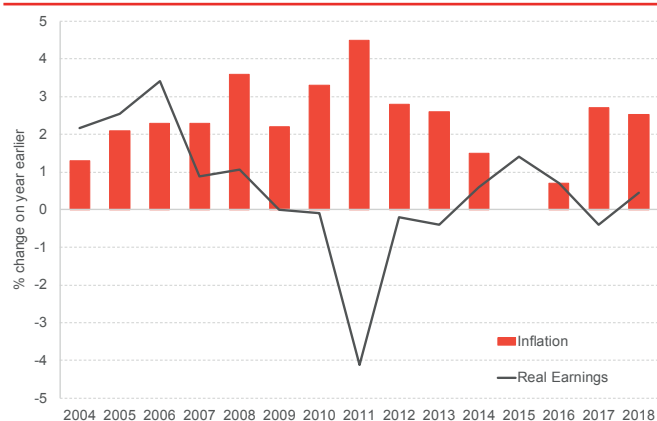
Source: ONS, APS

In Scotland, while there has been some improvement in ‘catching up’ with the UK over the last decade, this reflects more the failure of UK productivity than any particularly turnaround in Scotland.

The last few quarters have produced better rates of productivity growth, but overall, productivity has barely moved since 2010/11.

A [recent report from Deloitte UK](#) on productivity in UK’s Nations and Regions concludes that Scotland needs more businesses of scale that are competitively positioned across international markets as well as support in the development of leadership skills and confidence to enter and succeed in export.

Chart 38: Median real earnings in Scotland and UK CPI inflation



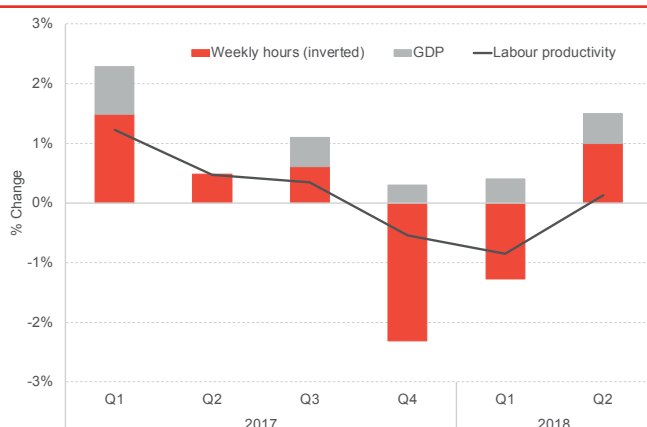
Source: ONS, ASHE

Chart 39: Scottish GVA per hour



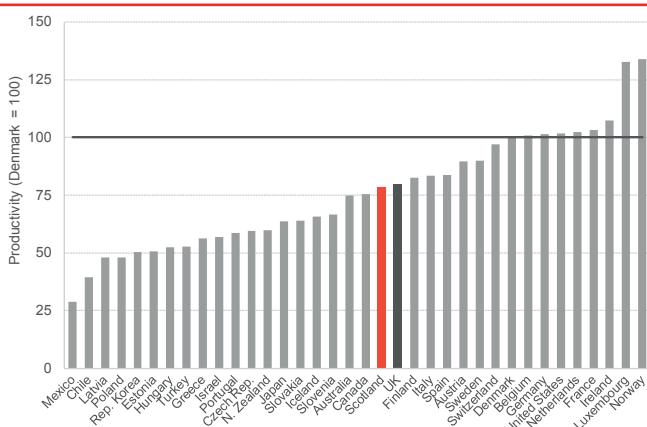
Source: ONS, Scottish Government

Chart 40: Scottish hours worked, GDP and labour productivity



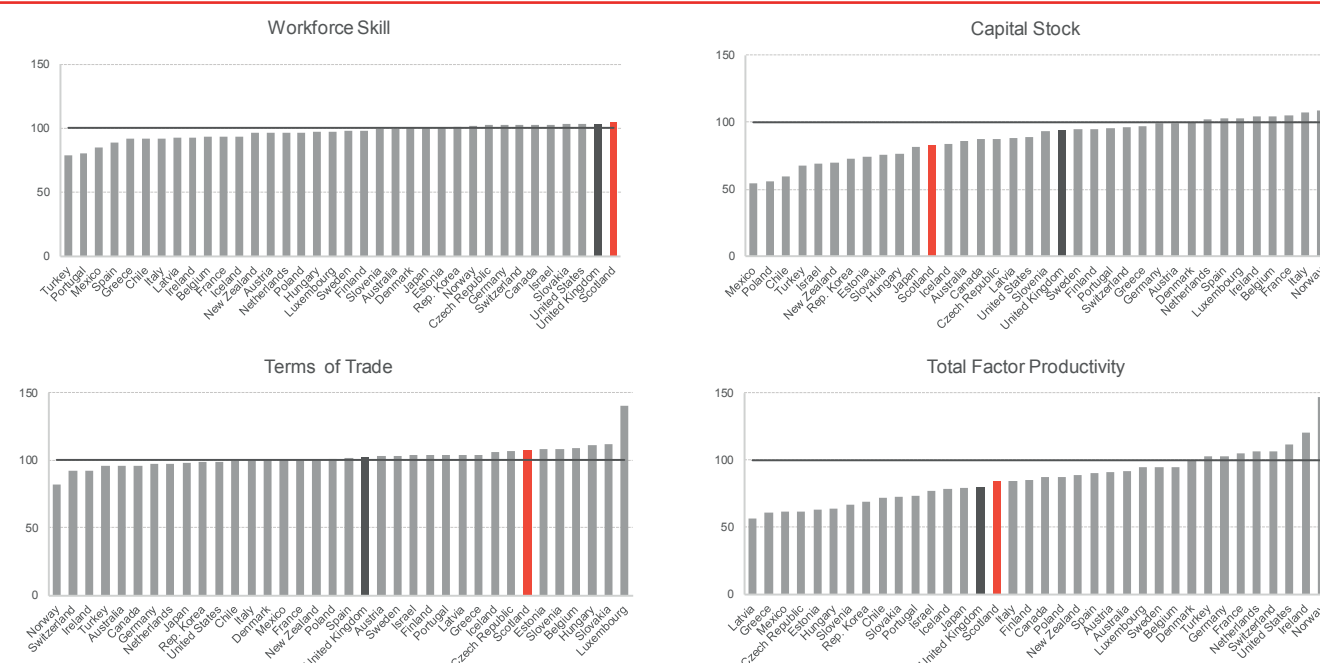
Source: ONS, APS

Chart 41: Productivity across countries, Denmark = 100, purchasing power adjusted GDP per hour, 2014



Source: Mitchell and Zymek (2018)

Chart 42: Scotland's relative productivity performance, by key driver, Denmark = 100, 2014



Source: Mitchell and Zymek (2018)

The pre-financial crisis trend of sustained productivity growth is no longer a given – temporary periods of growth have been eroded by stronger growth in the number of hours worked. Chart 40.

New research by Edinburgh University academics Robert Zymek and Mark Mitchell offers new insights on Scotland's recent productivity performance. Chart 41.

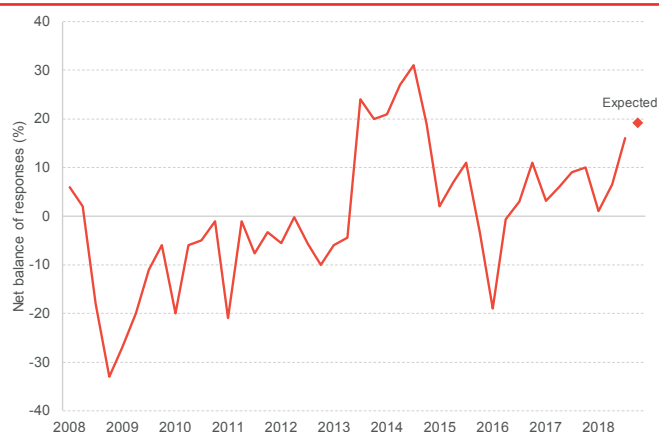
Using novel methods, they show that the productivity gap with the OECD's top performers can be attributed to a low capital stock per worker, and low "Total Factor Productivity". Chart 42.

The former refers to the level of investment in machinery, equipment and infrastructure. The latter to the efficiency with which an economy combines its productive resources to grow its economy.

Whilst Scotland benefits from relatively high workforce skills and relatively terms of trade, this is insufficient to offset this weaker performance elsewhere.

This suggests that solutions for Scotland should focus upon boosting investment – both public and private – and focussing upon the quality of management within firms, the need to tackle the prevalence of small and less efficient firms and demographic factors (such as population age) which may be possible culprits for Scotland's low TFP.

Chart 43: FAI/RBS Business Activity Index, 2008 - Expected Q4 2018



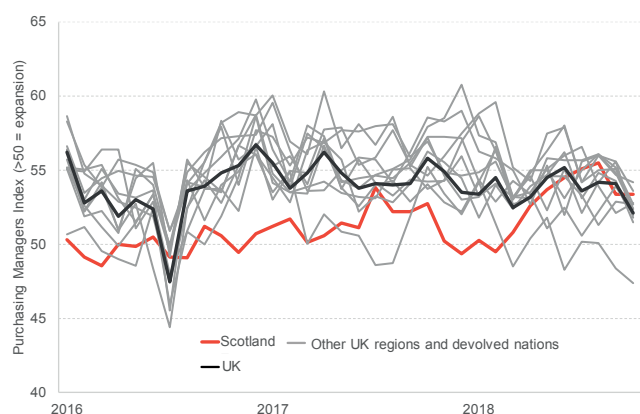
Source: FAI - RBS Business Monitor

Table 4: FAI/RBS Business Monitor key indicators, Q3 2018

	Q3 2018	Quarterly change	12 month change	3 year average
Business volume (net balance)				
New business	+16%	+7	+4	+17
Repeat business	+10%	+10	+9	+2
Business concerns (%)				
Weakening demand - important	77%	-5	-1	-4
Exchange rates - important	53%	+1	-3	+3
Investment (net balance)				
Capital investment	-11%	-5	-3	-8
Leasing	-24%	0	0	-20

Source: FAI-RBS Business Monitor

Chart 44: RBS UK regional PMI, Jan 2016 - Oct 2018



Source: RBS

Latest Scottish indicators

Business Sentiment indicators for Scotland continue to show a generally positive picture.

Our FAI/RBS Business Activity Index shows the expectations for Q4 to be fairly buoyant, following a strong Q3 – Chart 43. The main areas of concern remain around investment, as decisions are delayed due to wider economic uncertainty. Table 4.

The RBS regional PMI shows that the sentiment in Scotland is in positive territory, on a par with the UK as a whole. Chart 44.

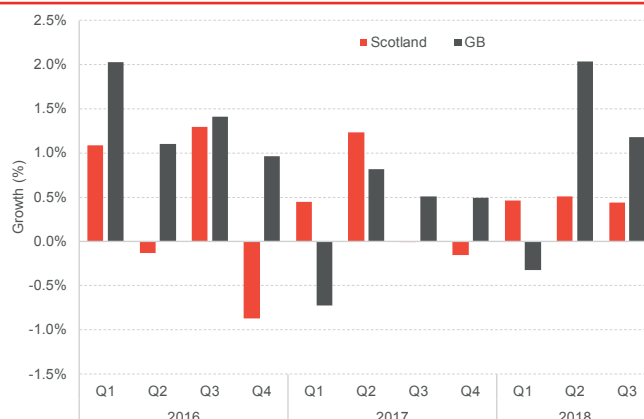
The retail sector in Scotland has had a difficult period over the last year or so, with quarterly growth lagging the UK. Chart 45.

Indeed, the volume of retail activity over the last year in Scotland has grown by 1.3%, compared to 3.4% in the UK.

It is large retailers (those with 250+ employees) in Scotland that seem to be suffering the most. Volume of business in retail has remained flat over the last year for these larger retailers, and has in fact contracted in the latest quarter.

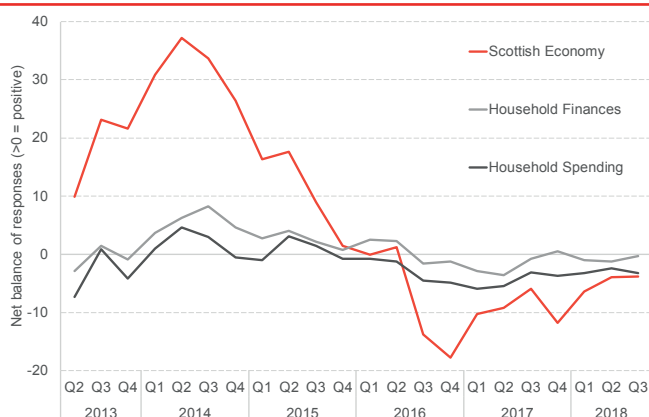
This compares with healthy growth for smaller retailers that is more similar to the overall UK picture.

Chart 45: Quarterly retail sales growth in Scotland and GB since 2016



Source: Scottish Government

Chart 46: Scottish Government Consumer Sentiment Index current conditions, Q2 2013 - Q3 2018



Source: Scottish Government

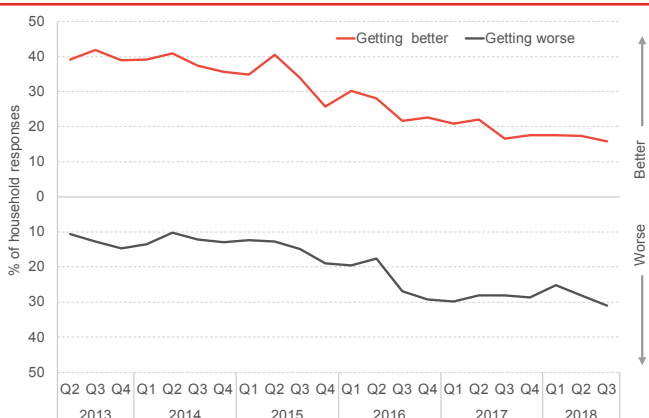
In contrast to business sentiment, the confidence of consumers is much more subdued. The outlook for the Scottish Economy, household spending and finances are all in negative territory. Chart 46.

Looking in detail at consumer expectations for the Scottish economy, the trend since 2015 has been that fewer people think the economy is getting better, and more people think the economy is getting worse overall. Chart 47.

This would chime with the official data on the Scottish economy, insofar as the gap between Scottish and UK GDP per head has widened and then persisted over recent years.

The UK Consumer Confidence Barometer is conducted by GfK on behalf of the EU, with similar surveys being conducted in each European country.

Chart 47: Scottish Government Consumer Sentiment Index expectations of the Scottish economy, Q2 2013 - Q3 2018



Source: Scottish Government

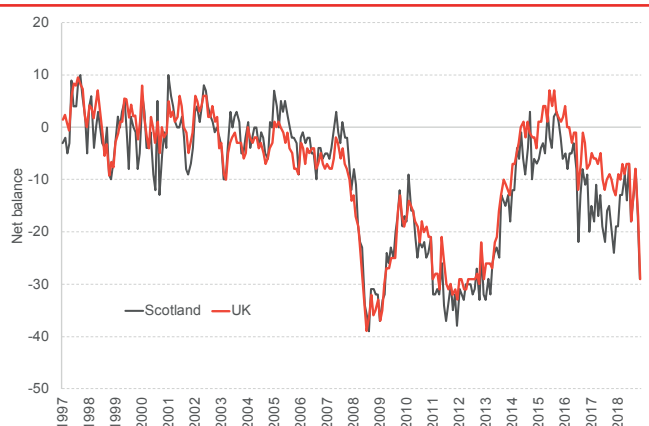
The current survey was carried out in early November 2018. This collects views on personal finances, general economic conditions, views on major purchases and how good a time it is to save.

The most recent figure for Scotland is both low in historical terms and compared to the UK. Indeed, this is the lowest value in over 4 years. Chart 48.

The outlook for the labour market remains positive.

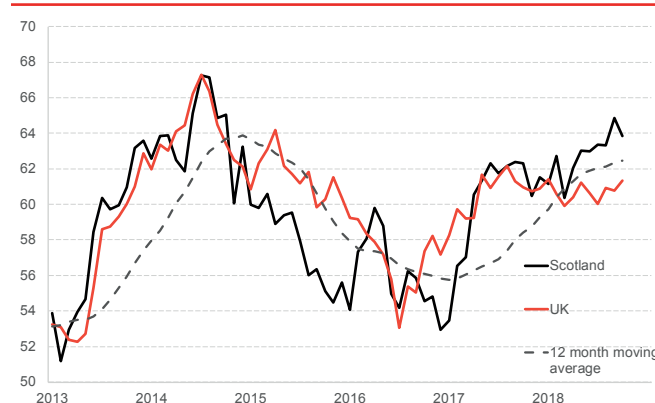
Most indicators - such as the RBS Jobs Barometer - all point to the labour market in Scotland operating at near capacity. Chart 49.

Chart 48: GfK Scottish Consumer Confidence Index, Jan 1997 - Nov 2018



Source: GfK

Chart 49: RBS Scottish Jobs Barometer index: continued high demand for jobs

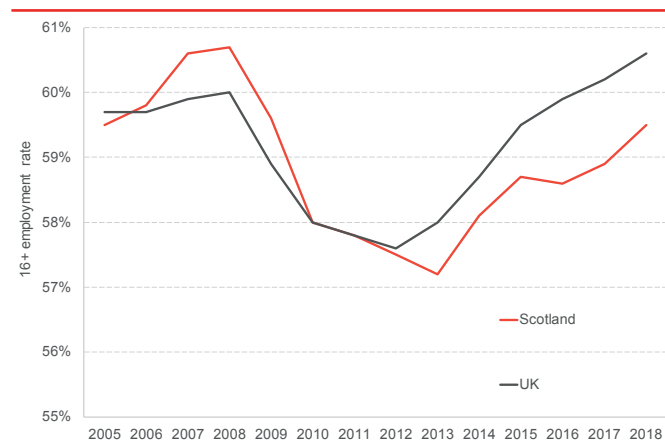


Source: RBS and IHS Markit

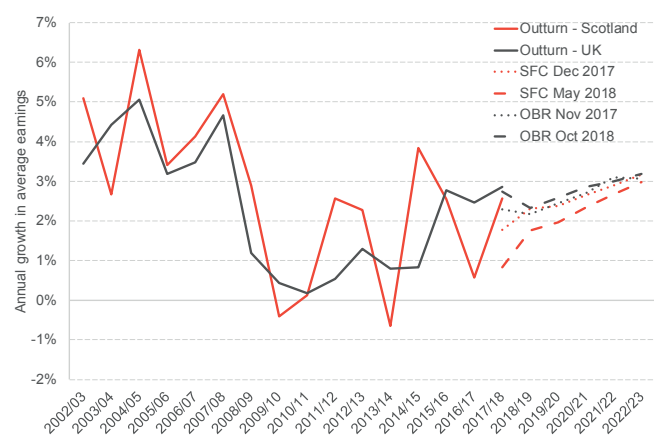
Table 5: Latest GDP growth forecasts and outturn

	2017/18	2018/19	2019/20	2020/21
SFC (Dec 2017)	0.7%	0.8%	0.9%	0.6%
SFC (May 2018)	0.7%	0.8%	0.8%	0.9%
SG (Sep 2018)	1.3%	-	-	-
	2017	2018	2019	2020
FAI (Sept 2017)	1.2%	1.4%	1.7%	-
FAI (Sept 2018)	-	1.3%	1.4%	1.4%

Source: Scottish Fiscal Commission, Scottish Government & FAI analysis

Chart 50: Employment rate (16+) in Scotland and the UK

Source: ONS APS

Chart 51: Annual growth in earnings (outturn) and SFC & OBR forecasts

Source: ASHE, SFC & OBR

Scottish Fiscal Commission's forecasts

Alongside the Scottish Government's Draft Budget, the Scottish Fiscal Commission (SFC) will publish their revised forecasts for the Scottish economy.

We discuss the wider budget context in the Policy section of the Commentary.

The SFC forecast a number of variables around their now twice yearly reports. This is all underpinned by an 'overall' view of how they think the Scottish economy is faring and the outlook.

The SFC have been cautious, forecasting growth of less than 1% until 2022. Table 5.

So what is worth watching out for?

The first thing that the SFC will have to do is reflect upon how their forecasts compare with the most recent data on Scottish GDP (in particular, the major revisions to the Scottish construction series).

It is highly likely that the SFC will revise up their growth forecasts. However, we see little evidence that they will take a much more positive outlook than in their first two sets of forecasts.

The second key element that they will have to consider is how 'tax rich' this growth is likely to be.

For income tax, the most significant devolved revenue by far, the two most important elements are employment and earnings.

Mirroring the trend in economic performance, Scotland's employment rate fell in 2016. Since then, employment in Scotland is now growing at the same rate as in the UK. Chart 50.

What about earnings?

Chart 51 compares outturn data on average annual earnings in Scotland and the UK, alongside two recent forecasts of earnings growth from the SFC and OBR.

The latest data has confirmed somewhat slower growth in Scotland, consistent with the SFC's assessment in May. However, the good news is that the gap between Scotland and the UK may not be as large as perhaps thought. However, it seems likely that the SFC will continue to forecast weaker earnings growth in Scotland relative to the UK as a whole.

Table 6: Latest growth forecasts for the UK economy

	2018	2019	2020
Bank of England	1.5%	1.8%	1.7%
OBR	1.3%	1.6%	1.4%
NIESR	1.4%	1.9%	1.6%
European Commission	1.3%	1.2%	-
IMF	1.4%	1.5%	1.5%
Oxford Economics	1.3%	1.7%	2.0%
ITEM Club	1.3%	1.5%	1.7%
CBI	1.4%	1.3%	-

Source: HM Treasury, Bank of England, OBR

Table 7: Bank of England projections - what could they mean for Scotland? (compared to the financial crisis)

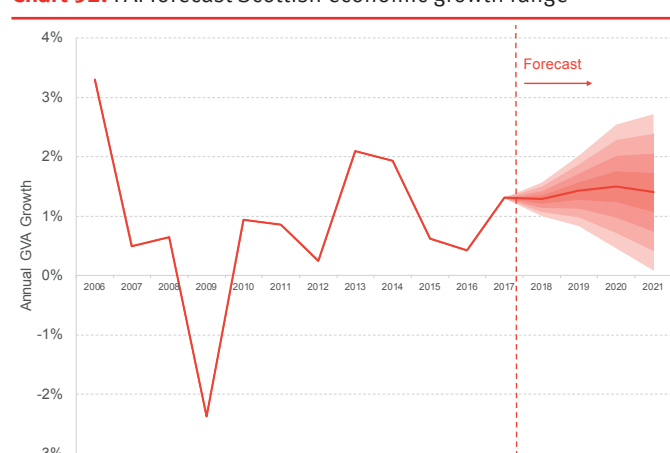
	GDP	Unemployment	House prices
2008-09 Financial Crisis	-4%	+131,000	-16%
Disorderly	-8%	+100,000	-30%
Disruptive	-3%	+52,000	-14%
Economic partnership	-0.75% to +1.75%	+/- 2,000	N/A

Source: Bank of England, Fraser of Allander Institute

Table 8: FAI Nowcasts for Scotland's GDP in Q3 and Q4 2018

	Q3	Q4
Quarterly Growth	0.35%	0.39%
Annualised Growth	1.42%	1.57%

Source: Fraser of Allander Institute

Chart 52: FAI forecast Scottish economic growth range

Source: Fraser of Allander Institute

* Actual data to Q2 2018. Central forecast with forecast uncertainty for 2018 – 2020. Uncertainty bands sourced from accuracy of past forecasts at different forecast horizons.

Our forecasts

Economic forecasting in the current climate is fraught with difficulty.

Even in 'normal' times, forecasting is not an exact science. An economy – particularly a small open one like Scotland – is constantly subject to events out with its control. This is why we are clear about the sensitivities of our forecasts and encourage readers to focus on the range of estimates.

The unpredictability of short-term outcomes, also highlights why it is important – particularly from a policy perspective – to focus upon the long-term drivers of growth and prosperity.

But the debate in Scotland on such questions remains weak. We have through the year pointed to the weaknesses in strategy and economic thinking within policymaking. We see little evidence of things having changed for the better.

In terms of immediate prospects, Brexit remains the key risk factor.

Firstly, no-one can predict with confidence what might happen next – particularly if Parliament votes against the proposed withdrawal agreement.

Secondly, there is simply no precedent for a 'no deal' outcome to use as a benchmark for forecasting. In Box 1 we discuss the channels through which the economy could be impacted.

So without any hard evidence about what might happen next politically, we have based our analysis upon a smooth transition deal. This is the approach taken by most other forecasters. Table 6.

The Bank of England has provided some thoughts. In November, they set out a series of scenarios covering how the UK economy may evolve in the event of a no deal. Table 7.

In this 'worst case' scenario – one of a disorderly Brexit – the Bank believe that the UK economy could shrink by 8%.

To put this in context, the Scottish economy contracted by just under 4% during the financial crisis.

Table 8 shows our latest nowcasts.

Table 9: FAI forecast Scottish GDP growth (%) 2018 to 2021

	2018	2019	2020	2021
GDP	1.3%	1.4%	1.5%	1.4%
Production	1.5%	1.6%	1.7%	1.6%
Construction	1.0%	1.1%	1.1%	1.1%
Services	1.2%	1.4%	1.4%	1.4%

Source: Fraser of Allander Institute

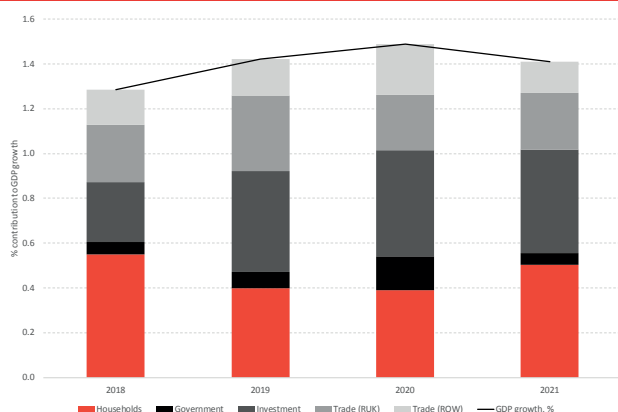
Table 10: FAI Labour Market forecasts to 2021

	2018	2019	2020	2021
Employee jobs	2,495,250	2,521,800	2,550,400	2,577,700
% employee job growth over year	1.0%	1.1%	1.1%	1.1%
ILO unemployment	98,000	103,500	104,400	112,500
Rate (%) ¹	3.7%	3.9%	3.9%	4.1%

Source: Fraser of Allander Institute

Absolute numbers are rounded to the nearest 50.

¹ Rate calculated as total ILO unemployment divided by total of economically active population aged 16 and over.

Chart 53: FAI GDP forecasts by sector, 2018 – 2021

Source: Fraser of Allander Institute

The results are consistent with our expectations for growth in 2018 first made in 2017. On balance, we believe that – setting aside any risks from the Brexit negotiations going awry – Scotland should be on track to grow at a broadly similar rate to last year (if not slightly faster). Table 9.

Turning to our forecasts for the next three years, as in the past, we report a central forecast but also uncertainty bands that set out a likely range within which we predict Scottish economic growth will lie.

It is important to note that such bands are based upon historical variations in our ‘normal’ forecasting performance. The potential for a ‘no deal’ Brexit outcome is clearly not a ‘normal’ event and would significantly lower our outlook for growth. We do think that the worst case scenario put forward by the Bank is highly unlikely, though accept growth will slow sharply.

A technical recession – i.e. two or more consecutive quarters of falling output – whilst by no means a certainty, cannot be ruled out.

With nominal earnings growth expected to pick-up, and provided that this outpaces inflation, household spending should see some modest gains.

Investment activity is likely to remain under pressure as Brexit-uncertainty continues to cast a shadow over growth ambition. But it could also be the element that bounces back most strongly in the event of a positive outcome (from the perspective of maintaining close ties to the EU).

Net exports and tourism are on track to continue to benefit from the low value of Sterling. However, the softening in global growth might mean that 2019 is not as healthy as 2018. As in recent years, services should make the greatest contribution to growth. There is a renewed risk in manufacturing however, with the downturn in the price of oil likely to test the resilience of the oil and gas supply chain. Most indications are that the sector is better prepared than four years ago. Chart 53.

With major new public investment in the pipeline, the construction sector should continue to see a more sustained outlook.

We expect unemployment to rise slightly toward a level consistent with more medium-term trends. Table 10.

Box 1. 'No deal'

Clearly the greatest risk to our forecast is the possibility of 'no deal'.

Our own estimates suggest that – over the long-run – such an outcome would act as a significant drag on Scotland's long-term growth potential.

These estimates were obtained from what is known as a general equilibrium model of the Scottish economy. This however tells us little about the short-term impact of 'no deal'.

The challenge with forecasting what a 'no deal' might mean is the lack of any precedent to fall back on.

So whilst we can be confident that a breakdown of the UK's economic relationship with the EU will have significant economic implications, it is difficult to attach an exact number.

The OBR and most independent forecasters have stuck to assuming that the UK and the EU will secure some form of deal, with a transition period. We follow that approach.

The Bank of England in contrast, has set out a series of scenarios for what 'might' happen, with the aim of stress-testing the banking system.

Up to March 2019, if a 'no deal' increases in probability, there are likely to be two forces at work.

Firstly, there is a series of factors that may slow the economy even further. Sterling is likely to fall, pushing up inflation and reducing real wages.

Financial markets are likely to be volatile. Some have suggested that the UK's Credit Rating may be downgraded. All of this could lead to a further fall in business and consumer confidence, reducing investment and spending.

Secondly, however, there are some forces that could boost growth. In particular, businesses and government may start to prepare – e.g. stockpiling and contingency planning – and this will help boost spending in the short-term.

One thing that can be guaranteed is that economic activity is likely to be choppy.

Post-March 2019, the outlook in the case of a 'no deal' outcome is likely to be more negative.

Firstly, any boost from stockpiling and contingency will gradually be eroded: items stockpiled prior to 'no deal' cannot be used more than once.

Secondly, uncertainty over how long a 'no deal' outcome could last might further dampen investment and spending.

Thirdly, and of course most significantly, the actual barriers that a 'no deal' outcome would create – in terms of tariffs, customs controls and regulations – would come into immediate effect. The disruption to export markets and supply chains – for some – could be significant.

Whilst it is important to remember that most UK businesses are one-step removed from international markets, the knock-on effects from weaker growth through supply chains is likely to be the key avenue through which growth slows. Analysis by the Fraser of Allander Institute showed that around 130,000 jobs are supported by EU export demand in Scotland.

Much will depend upon how the government and Bank of England respond. It is also possible that the UK and EU authorities (at least in the short run) would try to mitigate some of the most disruptive consequences of a disorderly Brexit.

Box 1. 'No deal' - continued

Over the next year, there are a number of planned (regular) statistical releases which will cover activity in the Scottish economy. These will be likely watched carefully by commentators for evidence of an impact of the short-term impacts of Brexit.

In the table below, we note these, and the period of time to which these relate.

	Date	Data	Period covered	Geography
1	December 2018	GDP	2018 Q3	Scotland
2	January 2019	Retail Sales Index	2018 Q4	Scotland
3	February 2019	GDP first estimate	2018 Q4	UK
4	March 2019	GDP	2018 Q4	Scotland
5	May 2019	Retail Sales Index	2019 Q1	Scotland
6	May 2019	GDP first estimate	2019 Q1	UK
7	June 2019	GDP	2019 Q1	Scotland
8	August 2019	Retail Sales Index	2019 Q2	Scotland
9	August 2019	GDP first estimate	2019 Q2	UK
10	September 2019	GDP	2019 Q2	Scotland
11	November 2019	GDP first estimate	2019 Q3	UK
12	November 2019	Retail Sales Index	2019 Q3	Scotland
13	December 2019	GDP	2019 Q3	Scotland

It is worth noting that official data on the period that Brexit actually occurs will not be available until August/September; and that data released in March will be referring to the period we are currently in now.

With the departure of the UK from the EU set at the 29th of March 2019, this equates to the end of the first quarter.

This means that the first release of economic statistics covering the period when the UK is no longer in the EU will be in August 2019 – with the first estimate of UK GDP for the 2nd quarter of the year, and the Retail Sales Index for Scotland.

The data for Scotland in 2019 Q2 will be available the following month. Only at that point will we have 'hard' statistical measures of the impact on short term economic variables.

This distance between the time period and the data relating to that period means that all eyes will focus upon regular business surveys – such as our FAI Scottish Business Monitor – as well as “flash” estimates of economic activity, such as our monthly nowcasts.

Policy context

Budget 2019/20

The Scottish budget 2019/20, which Derek MacKay will present to Holyrood on 12th December, will be the third budget of this parliamentary session.

The ‘story’ of the previous two budgets has been the use by the Scottish Government of its new income tax powers to raise additional revenues from those with higher than average incomes. Income tax policy has also been the conduit through which the minority SNP government has leveraged political support for its budget from the Scottish Greens – with the Greens securing additional revenue raising measures in each of the past two budgets compared to those the government had initially proposed.

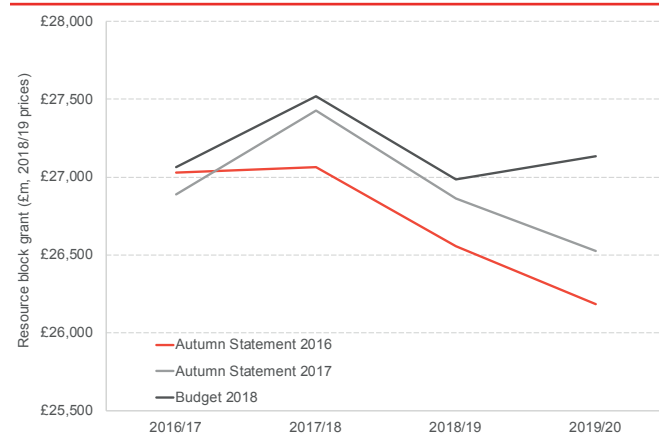
Back at the start of the current parliamentary session, 2019/20 looked like it would be a particularly tough budget year. At the time, the resource block grant was due to decline by 1.4% in real terms, having fallen by 1.6% the previous year.

Since then, additional spending by the UK Government as a result of both better than forecast revenues and some relaxation of fiscal policy, means that the outlook for the block grant has improved. The block grant will now in fact increase very slightly in 2019/20, and be marginally higher than it was at the end of the last parliament (2016/17). Chart 54.

But the block grant is now only one part of the picture when it comes to the Scottish budget. The government’s exact spending envelope in 2019/20 will also hinge on the tax forecasts of the Scottish Fiscal Commission (SFC) which will be published on budget day (most importantly for income tax, but also for LBTT, Landfill Tax and Non-Domestic Rates).

Critically, what matters is the difference between the revenue forecasts and the forecasts of the so-called ‘block grant adjustments’ – the counterfactual estimates of the revenues that the UK Government has foregone as a result of transferring each revenue stream to Scotland. Where Scottish revenues are forecast to be higher than the corresponding BGAs (perhaps because of a higher tax rate in Scotland, or faster growth in determinants of the Scottish tax base, such as wages), then the Scottish budget is better off to the extent of this difference.

Chart 54: Scotland’s resource block grant, 2016/17 - 2019/20



Source: HM Treasury

In the 2018/19 budget this gap between revenues and BGAs was £428m in the Scottish Government’s favour, largely because of the decisions taken on income tax. How different might this number be in 2019/20?

On the one hand, the income tax gap might be less significantly in Scotland’s favour this year, given that the SFC now appears to be taking a slightly dimmer view about the prospects for Scottish wage growth than it had done last December (as indicated by its mid-year forecasts published in May).

On the other hand, this somewhat less optimistic outlook could be offset by Phillip Hammond’s 2018 Budget announcement of a significant increase in the Higher Rate Threshold in rUK. This tax cut for higher rate taxpayers will reduce the size of the income tax BGA, the counterfactual estimate that is deducted from the Scottish Government’s block grant. Assuming the Scottish Government chooses not to increase the Scottish higher rate threshold to the same extent, it may be able to retain the gap between Scottish income tax revenues and the BGA at a similar level as last year.

Depending on which of these scenarios plays out, the Scottish budget could end up being about the same in 19/20 compared to last year, or increase slightly - perhaps by around 1% in real terms.

Tax policy and the budget deal

As well as the SFC's assessment about the future growth of the Scottish economy and the factors determining Scottish revenues (such as wages, employment, house prices, and so on), the Scottish budget will be influenced by tax policy choices.

On income tax, Derek Mackay has indicated that the current five-band tax structure will remain in place, but has not ruled out changes to rates or thresholds within this structure. Theoretically this still leaves a wide range of policy options (Table 11), depending on how the government seeks to balance its desire to raise additional revenues with a preference for avoiding too many negative headlines about the size of tax liability differential between Scotland and rUK.

These choices are likely to be most acute in relation to the higher rate threshold. Compared to a policy of increasing the threshold by inflation:

- Matching the UK threshold of £50,000 would cost around £280 million;
- Increasing the threshold by the same percentage as the rUK increase in 2019/20 would take the threshold to £46,850 and cost around £130 million;
- Freezing the threshold in cash terms at £43,430 would raise an additional £60 million for spending on public services, but mean that some Scottish income taxpayers would face an average tax rate of 1.5% higher than rUK counterparts.

Table 11: Summary of income tax policy options

	Static effect	Dynamic effect (including behavioural response)
1p on Basic Rate (BR)	£174m	£167m
1p on Intermediate Rate (IR)	£133m	£128m
1p on Higher Rate (HR)	£83m	£64m
1p on Additional Rate (AR)	£22m	£2m
Freeze IR threshold rather than increasing in line with inflation	£7m	£6m
Freeze HR threshold rather than increase in line with inflation	£70m	£64m
Increase HR threshold to £46,850	-£145m	-£132m
Increase HR threshold to £50,000	-£306m	-£280m

Source: FAI income tax model

As in the previous two years, parliamentary arithmetic means that the government will need to do a deal with another party to ensure it can pass the budget bill. If, as in the previous two years, the Scottish Greens are budget kingmakers, large increases in the higher rate threshold seem unlikely in practice. One hypothesis is that the draft budget will propose a moderate real terms increase in the threshold, in anticipation of it being negotiated back towards the existing level as part of the budget deal.

Alternatively, perhaps 2019/20 will be the year that the higher rate threshold ceases to be the cornerstone of the budget deal. Earlier this year the leader of the Scottish Greens Patrick Harvie wrote to Nicola Sturgeon to point out that progress on local tax reform would be the party's next area of 'constructive challenge' when it came to negotiating a budget deal in 2019/20.

In this context, 'progress on local tax reform' could be seen to encompass a range of possibilities, including moves toward reform of council tax and non-domestic rates, and allowing local authorities to have greater fiscal autonomy in a range of existing and new areas, potentially including through the enabling of new taxes at local level – such as visitor taxes or environmental levies.

Spending choices

So whilst there remains some uncertainty around the size of the budget and the Scottish Government's tax policies, there is perhaps a little more certainty on the broad direction of the spending choices that the government is likely to take.

We know for example that the Scottish Government will 'pass on' recently announced health consequentials from UK Government spending increases in England into the Scottish health budget. We know that the police budget will be protected in real terms. And we know the broad size of funding allocations for some of the government's key spending commitments on educational attainment, early learning and childcare, and higher education.

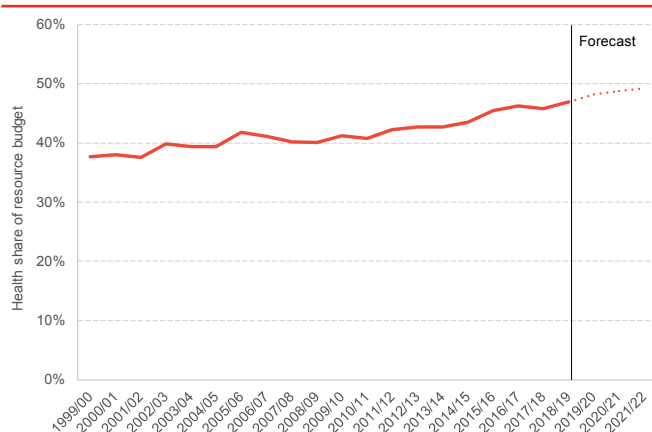
These commitments on their own account for almost 60% of the government's resource budget. Real terms increases in health spending, which are likely to be around 2.4% in 2019/20, constrain other parts of the budget given the dominance of health

spending as a share of the budget. Even if the total budget increases by one or even two per cent, most other portfolios that account for the remaining 40% of spending are likely to see declining real terms settlements.

Even during the course of the first two budgets of this parliament, substantial variation in the financial fortunes of different public bodies can be observed. The core local government settlement has fallen by almost 3% between 2016/17 (the last budget set by the previous parliament) and 2018/19. The budget allocation to higher education has fallen by almost 4%, despite it being one of the government's spending 'commitments'. Environmental organisations such as SEPA, SNH and Zero Waste Scotland have seen budget reductions between 2016/17 and 2018/19 of 6.7%, 8%, and 3.6% respectively.

Over time, the Scottish budget is undergoing a radical change in its make-up. The prioritisation of the health budget in particular represents the continuation of a longer term trend. Spending on health, which was 38% as a share of the Scottish budget in 1999 had reached 47% by 2018/19, and could feasibly account for half of government resource spending by the time Holyrood debates the final budget of this parliamentary session. Chart 55.

Chart 55: Health spending in Scotland

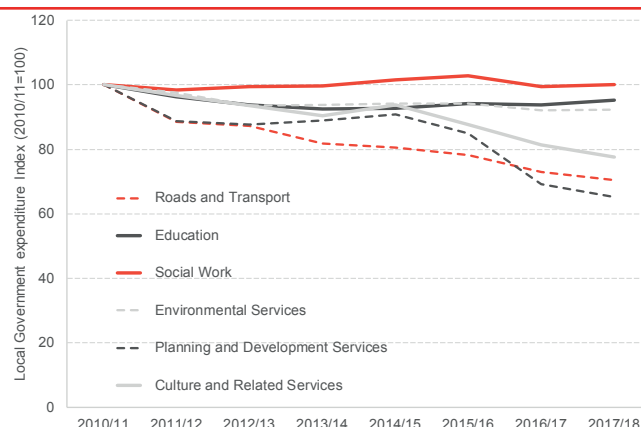


Source: Fraser of Allander analysis

Local government has seen its core resource settlement from government fall by around 8% in real terms between 2010/11 and 2018/19. Its response has been to prioritise spending on statutory areas of social work and education. As a consequence, spending on these areas has fallen

only slightly, whilst spending on some non-statutory areas including cultural and recreational services, and planning and economic development, has fallen by over 20%. Chart 56.

Chart 56: Index of real terms changes in local government outturn expenditure by service area, 2010/11 – 2017/18



Source: Provisional Outturn and Budget Estimate Statistics,

As ever, it remains unclear to what extent these spending changes might affect outcomes, whether economic, environmental or social. But the long-term concentration of public sector spending towards health, social care and (to a lesser extent) education – at the expense of many areas of cultural, economic and environmental areas - is clear.

Looking beyond 2019/20

It is worth briefly looking beyond 2019/20 to consider the challenges lurking ahead for the final two budgets of the parliament.

Budget 2020/21 looks ominously complicated compared to budget 2019/20. In principal, 2020/21 will see assigned VAT start to contribute to the Scottish budget, and around £1bn of social security spending will be added to the budget. At the same time, 2020/21 will be the first year of income tax 'reconciliation' – where the budget will be adjusted to account for any forecast error in relation to the 2017/18 income tax forecast.

Budget 2021/22 will be the last budget set in this parliament before the Holyrood elections in May 2021. A further £2bn of social security spending will come on stream.

Parliamentary debates on this budget will potentially straddle the period during which the UK exits its transitional arrangement with the EU.

In some ways therefore, compared to the likely backdrop to the next two years' budgets, the 2019/20 budget looks relatively unexciting; arguably a typical backdrop to a mid-term budget.

But the 2019/20 budget could yet be blown off course. Westminster is expected to have its 'meaningful vote' on the Withdrawal Agreement on the 11th December, the day before the Scottish budget is presented.

If MPs back the Agreement, the UK will in principle slide smoothly out of the EU at the end of March 2019 straight into a transitional period. In principle this should leave Mr Mackay's spending plans (and the SFC forecasts) relatively unscathed, and lay the way for the UK Government to go forward with its planned spending review later in 2019.

If however parliament rejects the proposed Withdrawal Agreement – which is arguably the more likely outcome as things stand – then the possible scenarios range from the UK exiting the EU with no agreement in March next year, through to some combination of Article 50 extension, renegotiation of the Withdrawal Agreement, a general election and/or a second EU referendum.

Quite how the 2019/20 budget might be affected by such events is unclear, but there could be implications for the UK fiscal plans (influencing the Scottish budget via the Barnett formula), and potentially substantial changes in tax forecasts.

One thing that is clear is that, during the next two months of budget debate and negotiations, the Scottish budget will no doubt play second fiddle to Brexit as a news story.

But we should not forget the importance of the budget statement, not only because it determines how much income and council tax we pay next year, but more fundamentally because of what it will tell us about the long term trends of public spending in different spheres of public policy intervention in Scotland.

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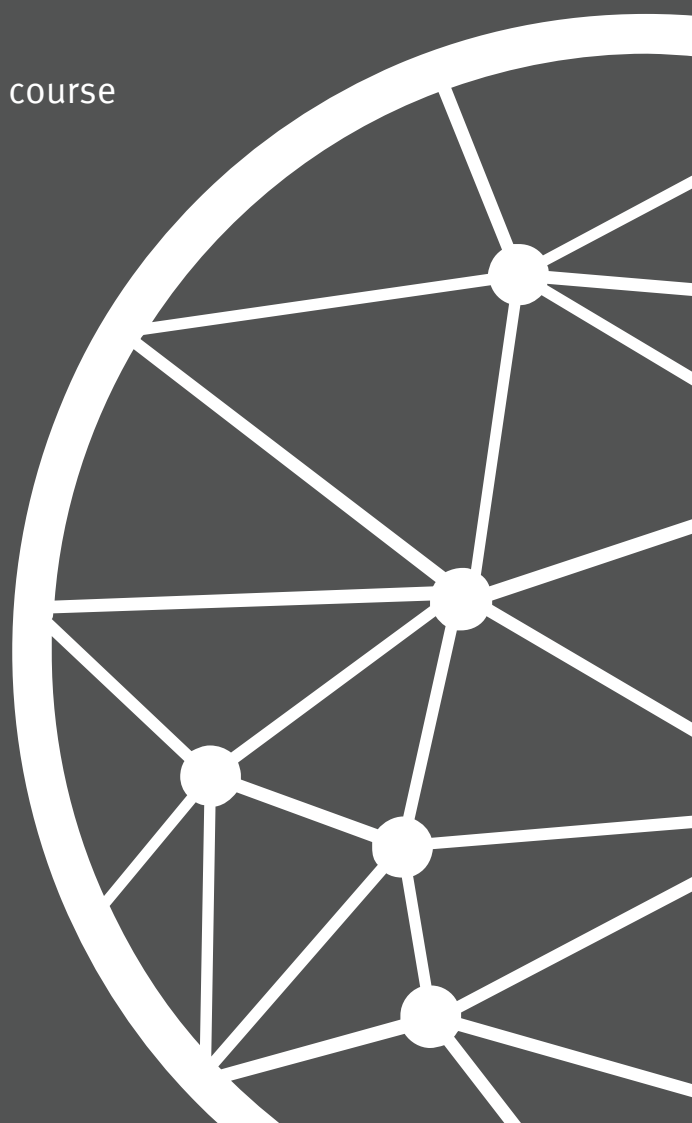
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