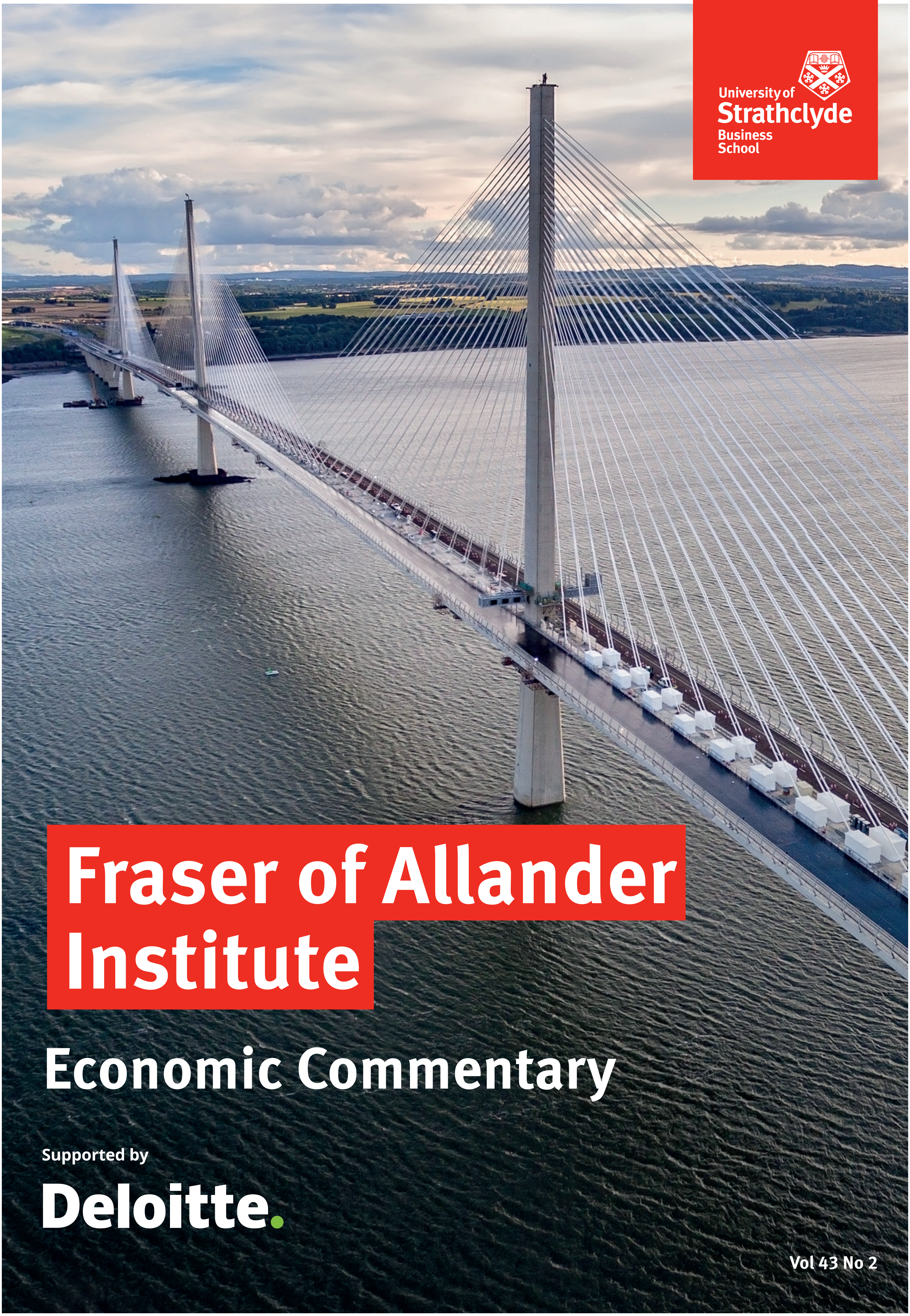

University of Strathclyde Business School

Fraser of Allander Institute

Economic Commentary

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Vol 43 No 2

Foreword

As it is 20 years since the Scottish Parliament was established, it is an opportune moment to reflect on what has changed in our economy over that period and to look forward to what may change in the next 20 years.

In many respects, the past 20 years has been a game of two halves, with the first half seeing the economy performing strongly and the second seeing a major downturn, starting with the global financial crisis in 2008 and followed by further negative impacts such as the downturn in the oil price.

While Scotland's economy has recovered, it has been a very gradual recovery. There have been strong points, for example, with employment exceeding expectations and reaching record levels. However, we should all hope that the next 20 years are more akin to the first half of the last 20 than the second.

When we look forward to the next 20 years, the challenges ahead may seem quite daunting when we consider issues such as Brexit, the possibility of Indyref2, the 4th industrial revolution, climate change, an ageing population, and the rise in geo-political tension, trade wars and tariffs.

What will pan out is obviously uncertain however there is every likelihood of much more and much faster change. As Justin Trudeau, Canada's prime minister, told the World Economic Forum in 2018: "The pace of change has never been this fast, yet it will never be this slow again."

While we will continue to face an environment of ongoing uncertainty, it is important that we do not lose sight of the longer-term trends that should provide a boost to the economy. Change creates opportunities and it is imperative that we seek to identify those future opportunities that will allow the country to continue to grow and ensure its future prosperity.

Scotland needs to be able to adapt to the challenges it faces at pace and be to bolder. Trends such as the 4th industrial revolution and climate change will be disruptive but they will also encourage investment and innovation.

In Scotland, Fintech is one sector that is leading the way. Changes in consumer demand, evolving technologies and regulatory developments have seen the financial services (FS) sector embrace new technologies and ensure it possesses a socially aware culture underpinned by financial inclusion and education. Scotland in many ways is unique in containing all of the elements in close proximity to fuel the growth of this sector and champion a vibrant ecosystem. As a firm, we have been incredibly proud to support Fintech Scotland on leading the charge to seize this opportunity.

Over the next 10 to 15 years, our FS sector will evolve and adapt to support the next generation of skills required to embrace this opportunity. Recognising that an alchemy of technical skills with social understanding will be key. The rounded FS professional of the future will blend the data scientist and the anthropologist – a critical mix to not only understand how to design and build new services, but also importantly understand the social surroundings and context in which they sit.

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While climate change concerns mean that there is rightly a real focus on energy transition, we cannot lose sight of the fact the UK will still be dependent on oil and gas as the country moves towards a zero-carbon future.

Anchoring experienced leaders with new talent who will use technology, such as digital and artificial intelligence, to ensure the energy industry is fit for the future is crucial. Similarly, ensuring the supply chain is able to survive and thrive is vital as we develop future energy resources.

For most businesses, whatever the sector, the projected decline in the working age population will be another challenge. Increasing opportunities for agile working and encouraging older people to remain in the workforce will be fundamental.

By way of example, in 2015, Deloitte established an industry-first Return to Work programme for people returning from a career break of at least two years. It was specifically designed to refresh knowledge and skills to help candidates transition back to the workplace with confidence and has resulted in almost 50 people successfully joining the firm. More, similar, initiatives are likely to be required to meet our labour needs.

The scale of change we will likely experience over the next 20 years will undoubtedly create significant opportunities and Scotland needs to position itself to take advantage of these. However, as the Commentary notes, if Scotland is to do this, everyone will need to be bolder than in the past 20 years.

John Macintosh
Tax Partner
Deloitte
June 2019

Fraser of Allander Institute

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Economic Commentary

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

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UNIVERSITY of STRATHCLYDE
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Summary

Brexit uncertainty continues to cast a shadow over the UK and Scottish economies.

Three years on from the referendum and there is little clarity surrounding the nature or timing of the UK's withdrawal from the EU.

This has had two consequences.

Firstly, there is mounting evidence that the uncertainty is impacting upon investment. Business investment in the UK declined throughout 2018, with recent surveys here in Scotland suggesting the start of 2019 has been just as challenging.

Secondly, activity in the overall economy has been noticeably more volatile than usual. During Q1, and as businesses implemented contingency plans, growth in the Scottish economy picked-up to 0.5%. This was the fastest rate of growth in 2 years.

But the boost is likely to be temporary. Indeed, we have already seen the UK economy shrink in both March and April as the effects of stockpiling are unwound.

One bright spot has been in international exports with the latest data showing strong growth in 2018. Scotland's labour market also continues to perform strongly – at least on headline measures of activity – with a record number of people in work. However, lying behind these data are more subtle trends such as weak long-term productivity, squeezed household incomes and earnings lagging the UK.

The need for frankness about what the data is telling us is all the more crucial given the policy challenges – and opportunities – that now face the Scottish Government.

Last month's announcement from the Scottish Fiscal Commission of the potential for 'income tax reconciliations' totalling over £1bn laid bare the risks now embedded in Scotland's new Fiscal Framework.

The lack of analysis so far from the government to explain the causes of the gap or how they will respond has been surprising.

As in our last Commentary, we have developed a series of scenarios to illustrate how the Scottish economy may fare over the next three years. As with all such scenarios, the exact decimal point estimates are less important than the overall scale and direction of travel.

In our central forecast, we continue to assume an orderly departure from the EU, although uncertainty continues to impact on growth for the foreseeable future. We have revised up slightly our forecast for 2019 to 1.2% but kept 2020 and 2021 unchanged at 1.4% and 1.5%.

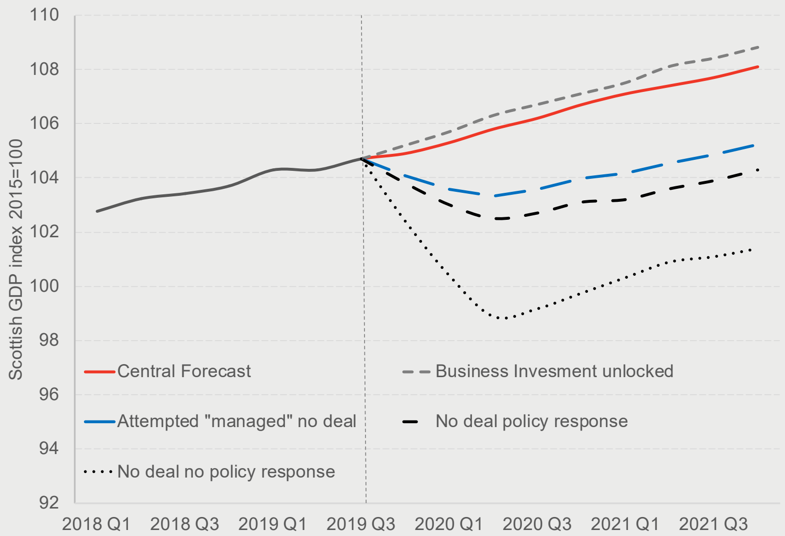
A positive scenario, where some form of deal is reached and uncertainty is reduced, could see growth surprisingly on the upside. 'No deal' outcomes – even where there is some coordinate policy response – will have a negative impact on Scotland's growth prospects.

All of this comes at a time when we mark the 20th anniversary of devolution. In this commentary, we look at how the Scottish economy has changed over that period.

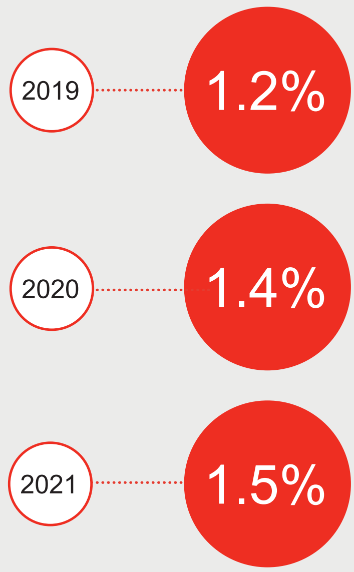
With Brexit, the potential for IndyRef2, not to mention an ageing population, climate change and the 4th industrial revolution all on the cards, the next 20 years are likely to require a boldness in policy making far beyond what we have seen so far in the devolution era.

Fraser of Allander Institute
June 2019

Scottish growth scenarios



Central forecast



Due to uncertainty around possible Brexit outcomes, we have developed a range of different scenarios. More information can be found in the 'Our forecasts' section.

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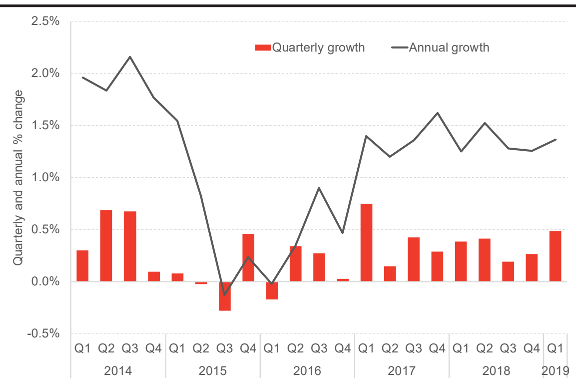
At a glance

Scottish growth (since 2014) – year and quarter %



Employment & unemployment rates, Feb - Apr 2019

	Employment (16-64)		Unemployment (16+)	
	Rate (%)	**Year Change**	**Rate (%)**	**Year Change**
Scotland	75.9	▲	3.3	▼
England	76.3	▲	4.0	▼
Wales	75.5	▲	4.5	▲
N. Ireland	71.3	▲	3.2	▼
UK	76.1	-	3.8	▼

FAI forecast Scottish labour market indicators - central forecast based on orderly departure

	2019	2020	2021
Employment rate (%)	75.3	75.1	74.7
Unemployment Rate (%)	3.7	4.0	4.2

FAI forecast Scottish economic growth (%), 2019 – 2021, central forecast based on orderly departure

	2019	2020	2021
GDP	**1.2%**	**1.4%**	**1.5%**
Production	1.2%	1.5%	1.4%
Construction	0.9%	1.0%	1.0%
Services	1.3%	1.5%	1.6%

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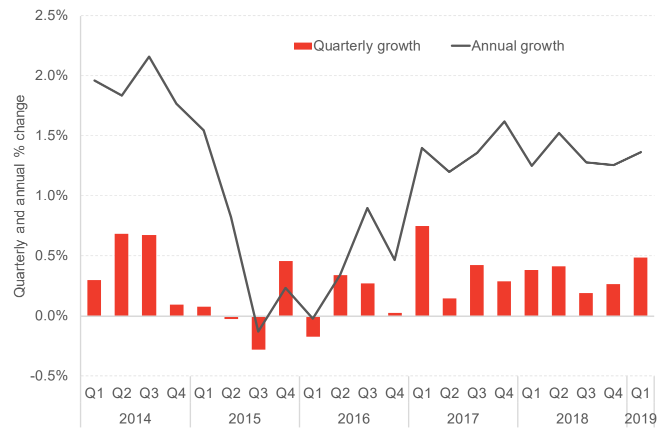
Outlook and Appraisal

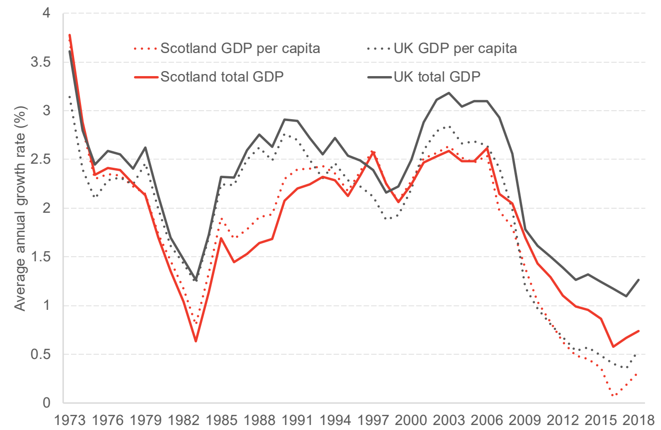
The Scottish economy remains relatively resilient despite the ongoing Brexit uncertainty. But recent data has been skewed by firms implementing Brexit contingency plans. The risks to the outlook remain high.

Chart 1: Scottish growth (since 2014) – year and quarter %



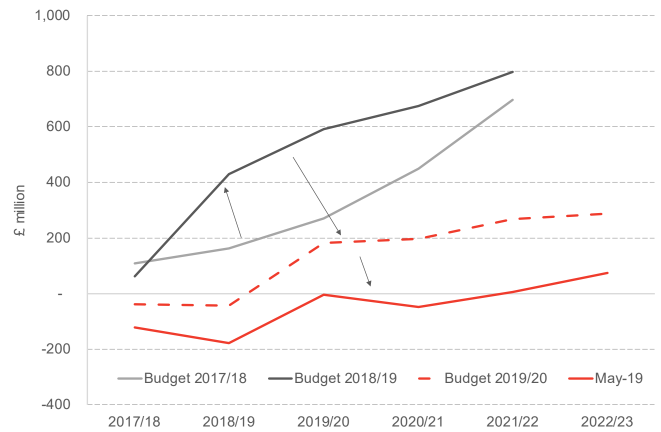
Source: *Scottish Government*

Chart 2: GDP average annual growth rate (over 10 years)



Source: *Scottish Government*

Chart 3: Income tax 'net tax' position at successful fiscal events



Source: *FAI*

Introduction

We still await clarity over the UK's departure from the EU, 3 years since the referendum.

Despite this, growth in the first 3 months of 2019 was +0.5% - the fastest growth in 2 years. Chart 1.

But much of this appears to stem from businesses stockpiling for a potential 'no deal'. As more up-to-date UK data has shown, this is likely to unwind in time.

Growth in the services sector – less likely to be impacted by stockpiling – slowed to just 0.1%.

International exports have performed strongly over the last year, with strong growth in a number of sectors.

Much of the Brexit debate has focussed upon the possible impacts on trade patterns.

But arguably a bigger challenge is what it might mean for Scotland's population. A significant proportion of Scotland's long-term growth gap with the rUK can be explained by population growth. Should Brexit make in-migration more difficult – or less attractive – then this could have implications for key sectors and the economy at large. Chart 2.

That being said, not all of the current risks facing Scotland relate to population. The latest information from the SFC and the OBR suggests a gap is opening up between Scottish and rUK earnings requiring an 'income tax reconciliation' of around £1bn.

Whilst Scottish income taxpayers are paying some £500m more in income tax than they would pay under UK policy, this has been completely offset by weaker performance in the Scottish tax base. Chart 3.

To call this a 'black hole' is an over-dramatization. But the Scottish Government will have to find money to pay for these reconciliations.

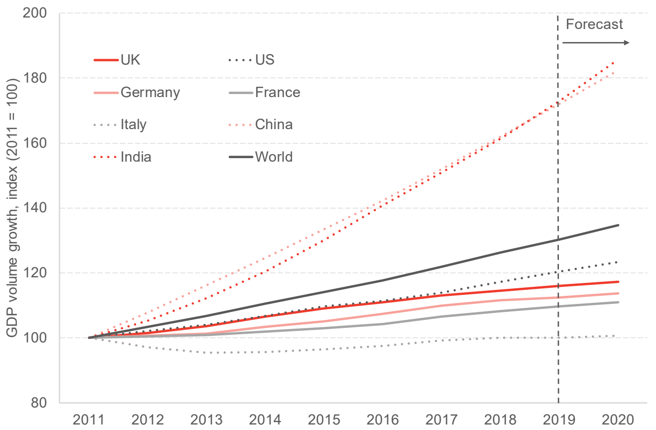
There are serious issues here and they shouldn't be overly political. MSPs need to work through these challenges and better scrutinise government policy.

Table 1: OECD growth rates (%), 2017 & 2018 (outturn) to 2020

	2017	2018	2019	2020
UK	1.8	1.4	1.2	1.0
US	2.2	2.9	2.8	2.3
Japan	1.9	0.8	0.7	0.6
Canada	3.0	1.8	1.3	2.0
Germany	2.5	1.5	0.7	1.2
France	2.3	1.6	1.3	1.3
Italy	1.8	0.7	0.0	0.6
Euro Area	2.5	1.8	1.2	1.4
World Growth	3.7	3.5	3.2	3.4

Source: *OECD Economic Outlook*

Chart 4: World economic growth, 2011 - 2020



Source: *OECD Economic Outlook*

The global economy

In the past few commentaries, we have highlighted a general weakening in global economic prospects following over two years of robust growth.

It is now clear that the policy uncertainties that have built over the past year are finally starting to impact on real indicators. Table 1

The latest assessments of both the IMF and OECD suggest that growth will slow to around 3.2% this year before edging up to 3.4% in 2020 - below the growth rates seen over the past three decades and in 2017-18. Chart 4.

A slowdown was always on the cards. The global economy had been growing above trend for a number of years, and for the first time since the financial crisis. At the same time, a number of countries – most notably the US – had been adding further stimulus through increased government spending and tax cuts.

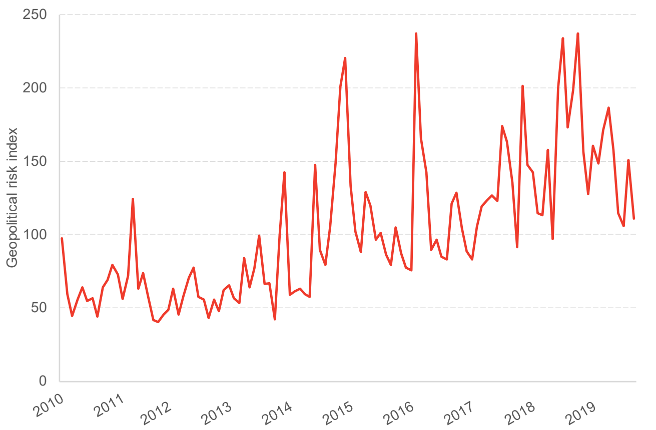
But the easing to a more balanced growth trend has been accompanied by more worrying signs.

Rising geo-political tensions (in the Middle East) and heightened domestic policy uncertainties – of which Brexit is one – have not helped. Chart 5.

The series of new tariffs and retaliatory counter-measures introduced in 2018 by a number of countries are having a negative effect on output.

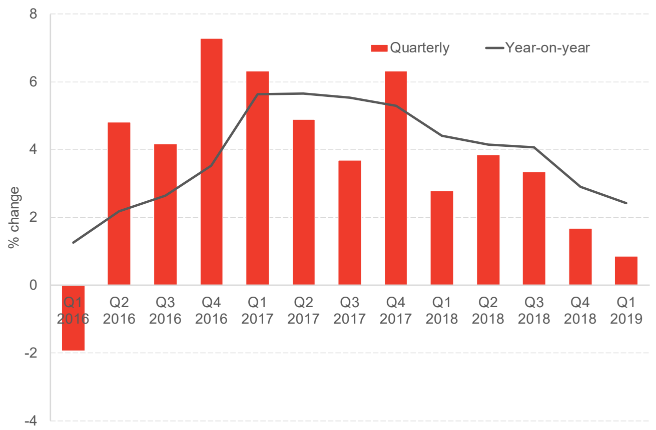
Trade has slowed sharply. With Europe particularly impacted. Chart 6 and 7.

Chart 5: Geopolitical Risk Index, 2010 - 2019



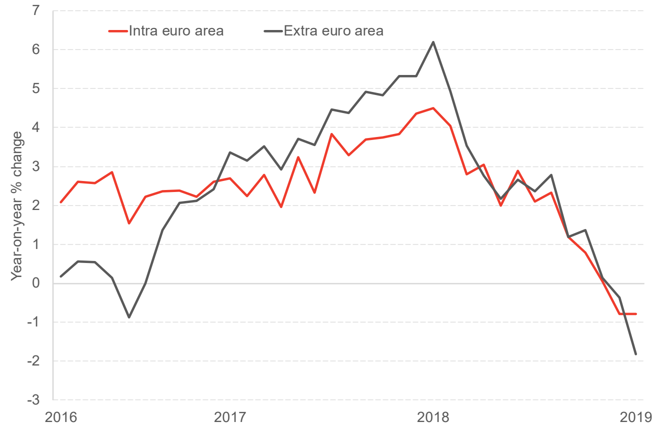
Source: *Caldara & Iacoviello*

Chart 6: World trade growth, Q1 2016 - Q1 2019



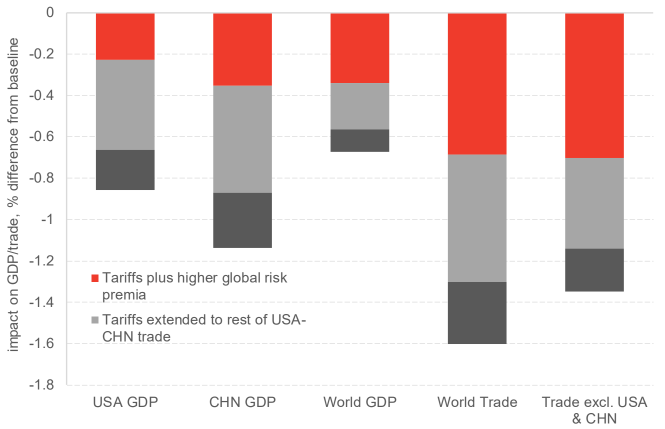
Source: *OECD Economic Outlook*

Chart 7: Euro area export volume growth, Jan 2016 - Jan 2019



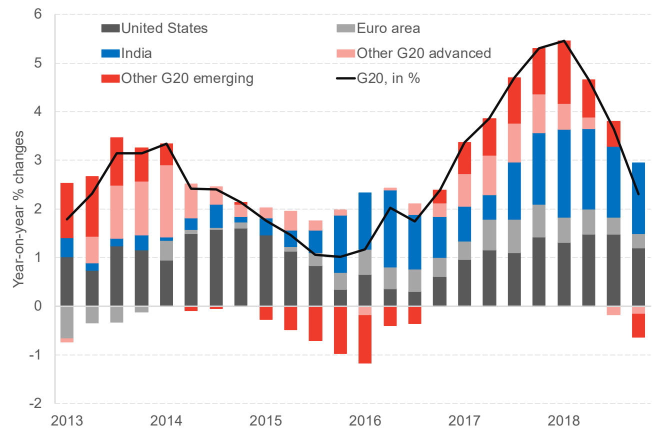
Source: *OECD Economic Outlook*

Chart 8: Impact of higher US-China tariffs on the level of GDP & trade by 2021-22



Source: *OECD Economic Outlook*

Chart 9: Contribution to G20 fixed investment growth, 2013 - 2018



Source: *OECD Economic Outlook*

Of course, a key driver of this outcome has been the escalation of trade tensions between the US and China.

The announcement in May of a further round of tariffs by the Trump administration on Chinese goods worth around $200bn – on top of those announced last year – led to swift retaliatory action.

The OECD estimates that such measures could reduce US and Chinese GDP by up to 0.3% by 2022 (on top of a similar reduction for the 2018 restrictions).

The bigger risk is for such actions to lead to a wider weakening in sentiment and further 'beggar-thy-neighbour' policies. Chart 8.

Talk of a recession remains wide of the mark, but it is clear that the risks are high.

As with any period of uncertainty, investment is the first element to take a hit.

Investment growth in the G20 has halved, from around 5% in 2017 to 2½ per cent in 2018. Chart 9.

In such a climate it is no surprise that oil prices have been volatile. Chart 10.

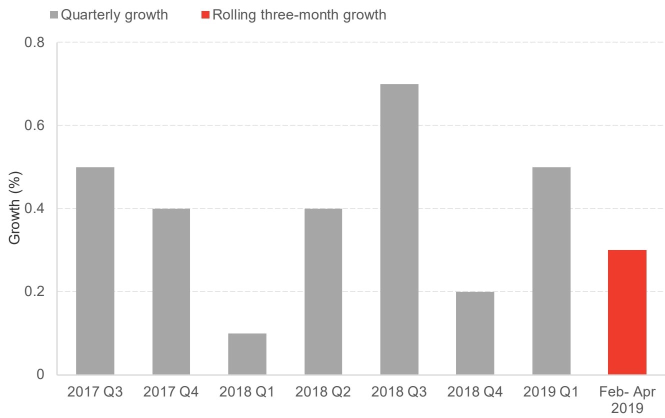
Despite this, confidence in Scotland's oil and gas industry remains relatively healthy.

Our latest survey of the sector continues to show high levels of optimism. Whilst there has been a slight easing in the number of firms reporting an uplift in expected activity in the months ahead, most were reporting steady growth. Investment remains on the rise.

Chart 10: Price of oil, Jan 2013 - Jun 2019, US $/BBL

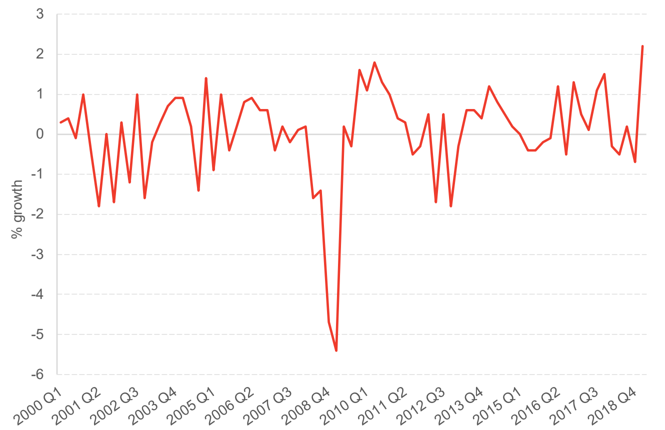
Source: *Thomson Reuters Datastream*

Chart 11: UK GDP growth, Q3 2017 - Q1 2019



Source: *ONS*

Chart 12: IoM quarter-on-quarter growth, seasonally adjusted, UK, Q1 2000 - Q1 2019



Source: *ONS*

Table 2: UK economic Growth, 2017 - 2019

	2017	2018	2019
GDP	0.2%	-0.1%	-0.4%
Services	0.2%	-0.1%	0.0%
Production	0.6%	0.7%	-2.7%
Manufacturing	1.0%	0.9%	-3.9%
Construction	0.5%	-1.9%	-0.4%
Agriculture	-0.6%	-0.1%	0.0%

Source: *ONS*

The UK economy

We remain in uncharted territory, with each and every data release – both official and unofficial – poured over to try to better understand both the possible impacts of Brexit and the underlying health of the UK economy.

As we highlighted shortly after the EU Referendum in 2016, the economic data was likely to be volatile until further clarity in the UK's position post-Brexit was forthcoming.

Three years on, this remains as true today as back then.

The most recent calendar quarter we have data for – the period January to March 2019 – shows robust growth of 0.5%. Chart 11.

However, much of this growth appears to have been due to firms stockpiling in case of a 'no deal' Brexit on 29th March. Chart 12.

This boost was only ever going to be temporary, and indeed recent monthly data shows that the UK economy actually shrank in both March and April of this year.

Stockpiling is most obvious in manufacturing. Manufacturing output increased by 1.0% in February and by a further 0.9% in March; before falling back by nearly 4% in April. Table 2.

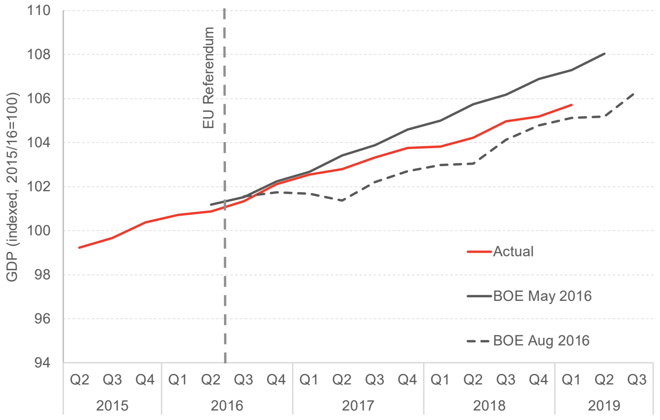
This volatility harms businesses in a number of ways. Firstly, it has an impact upon cash flow and company balances. Secondly, it diverts attention and resources from more productive practices, such as seeking opportunities for business expansion and investment.

In such times, it is more important to focus upon longer-term trends to get a broader picture of performance.

There is no doubting that the UK economy is weaker than many people thought it would be by this time back in 2016. Chart 13. Compared to the Bank of England forecast back then, output is currently more than £30bn less than predicted.

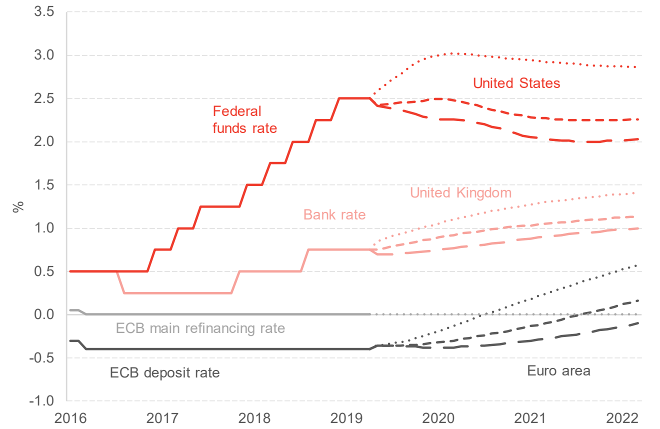
With this uncertainty and weaker outlook, expectations for how long monetary policy will remain at its highly expansive state have been extended. Chart 14.

Chart 13: Post-referendum performance relative to pre- and post-referendum growth forecasts, Q2 2015 - Q3 2019



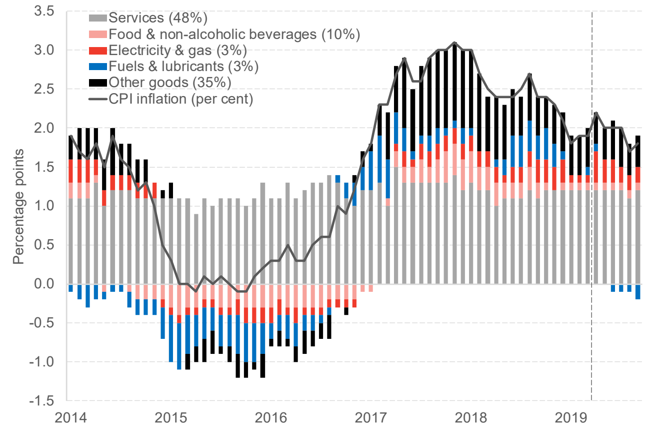
Source: *Bank of England & ONS*

Chart 14: International forward interest rates, 2016 - 2022



Source: *Bank of England*

Chart 15: Contributions to CPI inflation, UK, 2014 - 2019



Source: *Bank of England*

Even so, inflation in the UK continues to fall – albeit there has been a modest rise in recent months. CPI inflation is expected to come in below target through the remainder of 2019. Chart 15.

One clear cost of the impasse over Brexit has been the impact upon investment in the UK economy.

The UK had the slowest growth in Gross Fixed Capital Formation of any G7 country in 2018. Chart 16

A key driver of this has been weak business investment.

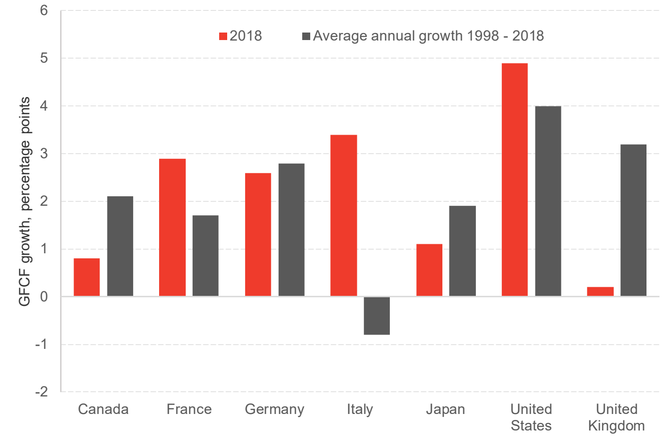
Business investment fell by 0.9% in the final three months of 2018 - the fourth consecutive quarter-on-quarter fall. This is the first time business investment has fallen for such a sustained period of time since the 2008-09 financial crisis.

Overall, the decline in investment by business sector has been relatively broad based. Chart 17.

Such a decline is a concern given that we know that a key reason why the UK's productivity lags behind the best performing countries in the world is because of low levels of investment – by both the private and public sectors.

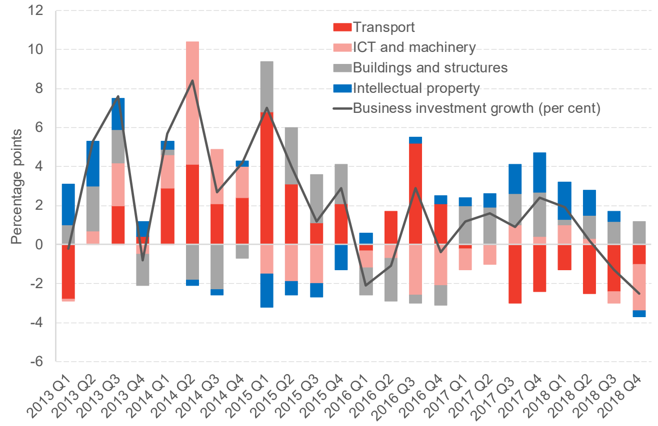
This comes at a time when many of the determinants of business investment have remained supportive. The cost of finance is low relative to historical norms, rates of return on capital are robust, the labour market remains tight and survey measures suggest that firms are operating with limited spare capacity.

Chart 16: Gross fixed capital formation growth, UK, Q1 2018 - Q4 2018



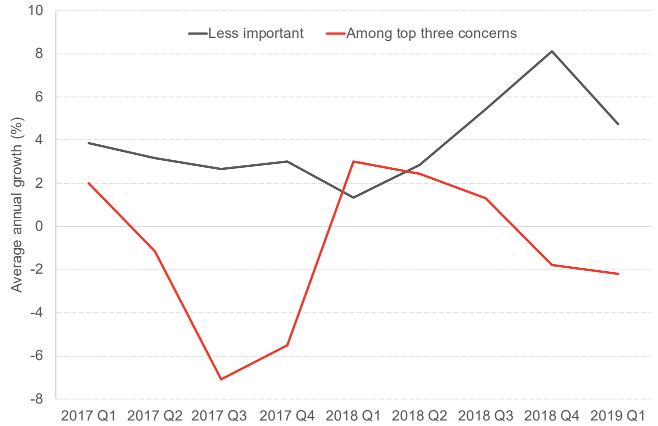
Source: *ONS*

Chart 17: Contributions to four-quarter growth in business investment by asset, UK, Q1 2013 - Q4 2018



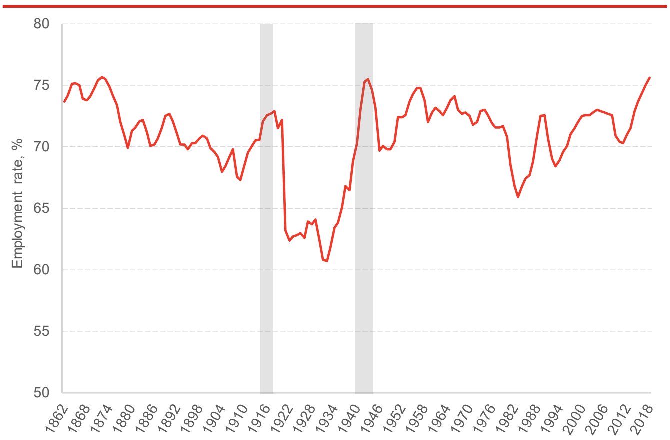
Source: *Bank of England*

Chart 18: Average annual growth in capital expenditure by degree of concern about Brexit, Q1 2017 - Q1 2019



Source: *DMP Survey & Bank of England*

Chart 19: Employment rate, UK, 1861 - 2018



Source: *Bank of England*

But uncertainty is clearly having an impact.

According to the latest Deloitte CFO Survey, 54% of CFOs rate the level of uncertainty as high or very high, compared to just 25% in 2018 Q2.

The Bank of England's own research estimates that investment may be between 6%–14% lower than it would have been in the absence of Brexit uncertainties.

At first glance, the one bright spot in the UK economy remains the labour market.

The UK employment rate was estimated at 76.1%, higher than for a year earlier (75.6%) and the joint-highest figure on record.

The UK unemployment rate is now just 3.8%; it has not been lower since October to December 1974.

This 'tight' labour market has – at long-last – started to lead to improvements in real take-home earnings for many workers. Over the year to March 2019, regular pay was estimated to have increased by 3.3% in nominal terms and by 1.5% in real terms

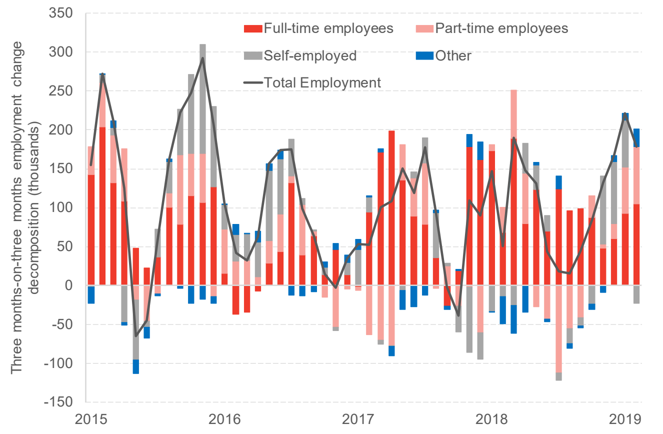
It is possible to go even further back and put today's labour market figures in context.

A new project by the Bank of England - The Millennium of Macroeconomic Data – aims to put together various datasets to provide an illustrative measure of economic variables going back to the mid-19th century. Whilst exact point estimates have to be used with caution – and clearly the economies of 2018 and 1918 differ significantly from each other in so many ways. Chart 19.

One of the key drivers for higher employment and participation rates has been changes in female participation.

Industrial changes, incremental improvements in legislation and shifting social attitudes have all contributed to a significant increase in female participation in the labour market. Over the 10 year period, 1951 to 1960 there were an estimated 6.91 million women 'economically active'. Between 2011 and 2018 the figure was 15.25 million.

Chart 20: Decomposition of the change in employment, UK, Jan 2015 - Feb 2019

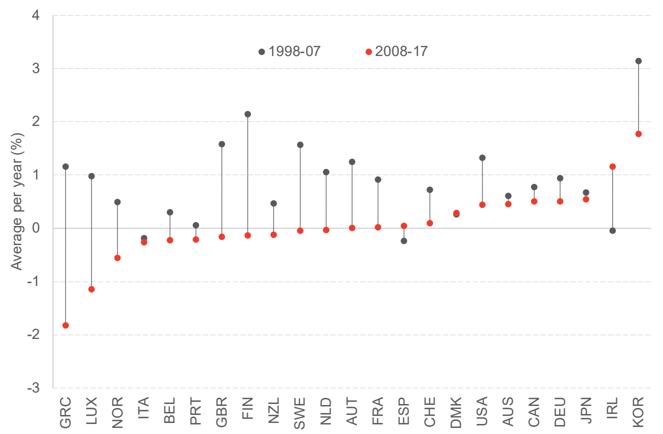


Source: *Bank of England*

Chart 21: Labour productivity growth, 1998 - 2017

Source: *OECD*

Chart 22: Multi-factor productivity growth, 1998 - 2017



Source: *OECD*

Immediately after the financial crisis there were fears that much of the 'robustness' in the labour market data might be camouflaging a rise in involuntary part-time work and self-employment.

But in recent times, whilst these two elements continue to grow, much of the growth in the headline employment figures is stemming from full-time jobs. Chart 20.

Alongside the rise in employment, the participation rate has been increasing in recent times. Much of this increase was accounted for by those aged 50 and over.

Of course, the strength in employment growth alongside soft demand growth has therefore – once again - been associated with sluggish productivity growth.

Whilst weak productivity growth has been a feature of most advanced economies since the financial crisis, it appears to be particularly pronounced in the UK (with only Greece, Luxembourg, Mexico and Italy) having weaker productivity performance this last decade. Charts 21 and 22.

UK economic outlook

Most near-term indicators continue to point to weak growth in the overall UK economy.

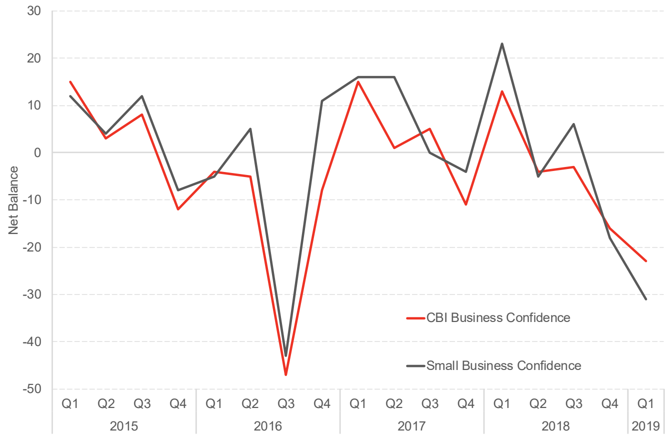
As highlighted above, growth figures – and other metrics of economic activity – are likely to be volatile.

Following the strong growth of 0.5% in Q1 2019, most economists are predicting much weaker growth of 0.2% in Q2 2019. Early indications are not great, with a huge reduction in vehicle production in April helping the UK economy to contract in that month.

Away from the official data, most measures of confidence and current activity levels remain – at best – subdued, and in most cases, negative.

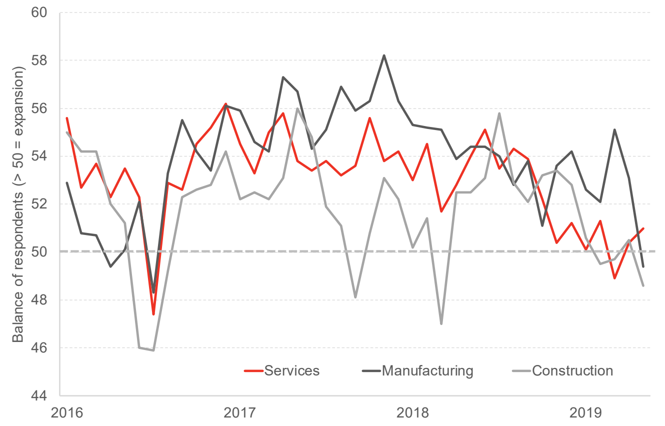
The CBI's Business Optimism Indicator was -13 in Q2 2019. Chart 23. This was the 5th month in a row that the indicator was negative. The proportion of firms citing political/economic conditions abroad as a factor likely to limit export orders in the next three months was at its highest since January 1983.

Chart 23: CBI measures of confidence, Q1 2015 - Q1 2019



Source: *CBI*

Chart 24: Purchasing Manager's Index (PMI) for the UK, Jan 2016 - May 2019



Source: *IHS Markit*

The most recent purchasing managers' surveys for manufacturing, construction and services also point to activity being fairly stagnant. Chart 24.

Two of them, for manufacturing and construction, showed a drop below the key 50 level, pointing to falling output. The other, for services picked up marginally to 51, but this is consistent with barely any growth.

As we highlighted in our last commentary however, we need to be slightly careful when interpreting surveys at the current time.

It is possible that in times of uncertainty, the link between surveys – particularly around measure of 'confidence' – and actual day-to-day activity is not perfect.

However, it would be wrong to completely dismiss them, particularly when there is such consistency across the board. What we can definitely conclude is that uncertainty is high. Chart 25.

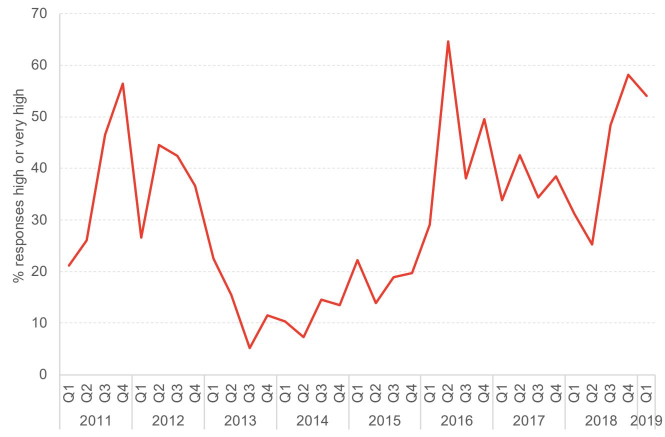
Households seem to be particularly pessimistic about the near-term outlook. Chart 26.

According to the Bank of England, household expectations about the economic outlook are at their lowest since just after the financial crisis.

The question is where do we go from here.

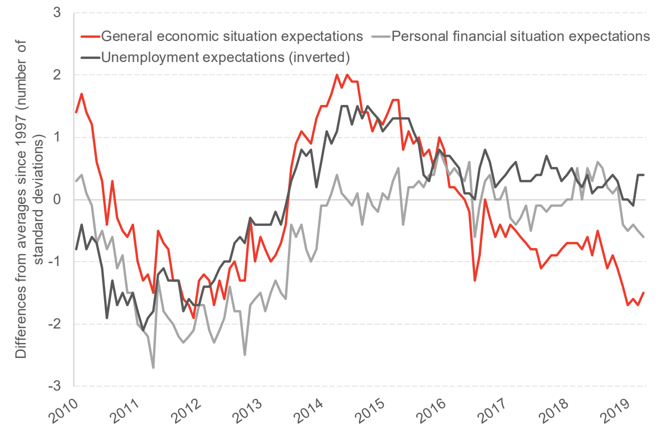
The Bank of England and Office for Budget Responsibility have attached considerably large error bands around their projections for the UK economy over the next few years. Chart 27.

Chart 25: Deloitte CFO survey -v % of CFOs who rate external uncertainty facing their business as high or very high



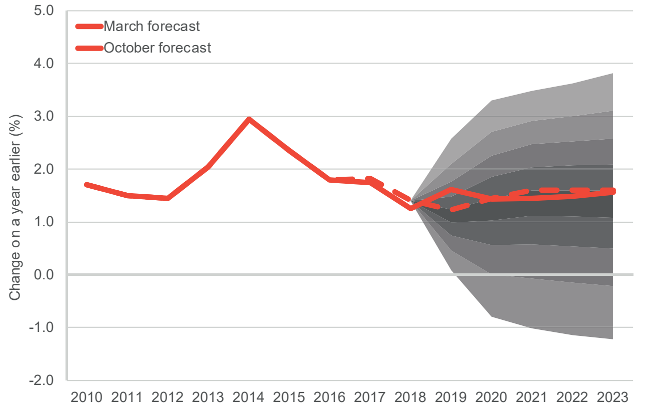
Source: *Deloitte*

Chart 26: Indicators of consumer confidence, UK, Jan 2010 - Apr 2019



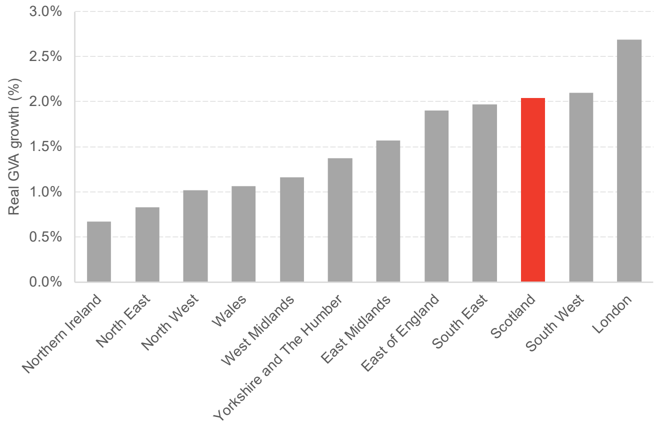
Source: *Bank of England*

Chart 27: GDP growth, 2010 - 2023



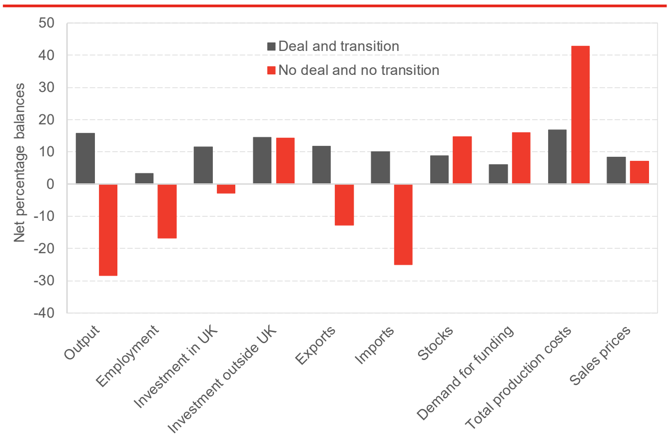
Source: *OBR*

Chart 28: Nowcasts of UK regional growth, year to Q1 2019



Source: *ESCoE*

Chart 29: Expectations for the impact on business of Brexit



Source: *Bank of England*

Variations across the UK are likely to continue. Scotland is projected to be one of the better performing parts of the UK - once again - in a sluggish UK economy. Chart 28.

Most forecasters predict that the UK economy will continue to grow this year, but to remain subdued.

Of course, crucial to this will be what happens politically over the summer months, following the election of a new Prime Minister.

Many of the businesses that we work with breathed a huge sigh of a relief when the prospect of a 'no deal' Brexit in March was lifted.

But it did not come without cost. Many companies are now running under higher cash-flow and resource constraints as they try to adjust their business models to cope with additional stock-piling and contingency planning.

The prospects of a 'no deal' Brexit remains a risk.

As we have argued on many occasions, a no-deal Brexit would represent a significant shock to the UK economy.

A 'managed' no-deal may seem attractive to some – and depending upon the nature of how it is managed, some of the worst impacts may be reduced. But it would still act as a serious hit to growth and prospects on the short term.

Amongst the business community, there appears however, to be an increase in investment to prepare for a 'no deal' scenario. In a recent survey for the Bank of England, three quarters of respondents reported that they had done some form of contingency planning, with two thirds of respondents feeling that they were ready for a 'no deal, no transition' Brexit.

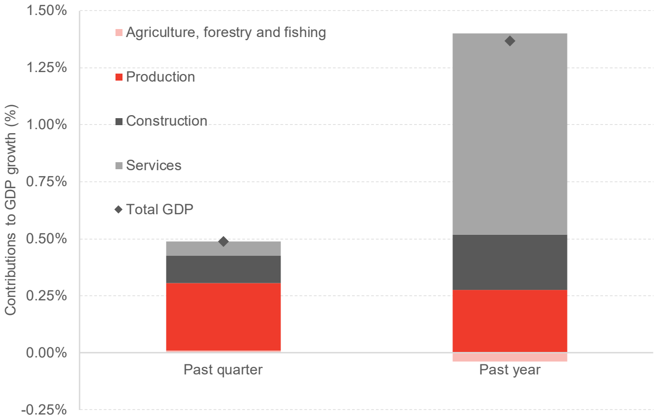
As in previous surveys, even those respondents who reported being 'ready' thought on average that output and employment would fall substantially over the next year in a 'no deal, no transition' scenario.

In the most recent survey conducted in April, a net percentage balance of -28% of firms expected output to fall and -17% of firms expected employment to shrink if there was no deal and no transition. Chart 29.

Scottish Economy Dashboard

	% of Economy	Growth 2018	Growth Q1 2019	Key issues/trends
Production	**17.2%**	**2.8%**	**1.8%**	
Manufacturing	10.6%	3.2%	2.6%	The main contributor to growth for Q1 2019 was the manufacturing sector. Within this, two sectors combined contribute 0.3% to total GDP growth (0.5%). This was likely due to companies 'stockpiling' in preparation for Brexit.
Food and drink	2.9%	5.4%	6.2%	The food and drink sector started 2019 strongly, continuing to rise on previous years. Much of this growth appears once again to stem from greater exports. Scotland's exports increasingly look set to develop strengths not only in whisky, but other exports of Scottish food and drink.
Electricity & Gas supply	3.5%	3.7%	-0.4%	Electricity and gas supply decreased by 0.4%. This was a smaller drop than last quarter (2018 Q4 is -4.3%).
Services	**75.7%**	**1.2%**	**0.1%**	
Retail and wholesale	10.4%	1.6%	0.3%	The retail and wholesale sector started 2019 better than many expected - particularly given the fragile state of household confidence. The persistent troubles for traditional retailers are still present however.
Accommodation & food services	3.3%	3.6%	-1.1%	Accommodation & food services was up on the year however, down over 1% during the first quarter of this year. Other sectors with falling output were Professional Services and Administration & Support.
Financial & insurance	6.1%	0.9%	1.2%	Steady growth continued into 2019 Q1, creating a strong platform for the finance and insurance sector to build upon into the remaining 3 quarters. This sector has grown by over 2% over the last year, taking it close to pre-crisis levels of output.
Construction	**5.9%**	**-0.6%**	**2.0%**	This quarter shows relatively strong growth following on from three previous quarters of sustained positive growth.
Agriculture	**1.2%**	**-2.1%**	**0.9%**	Weak performance during 2018. This is the first positive percentage change since 2017 Q4.

Chart 30: Composition of economic growth in Scotland over the quarter and over the year

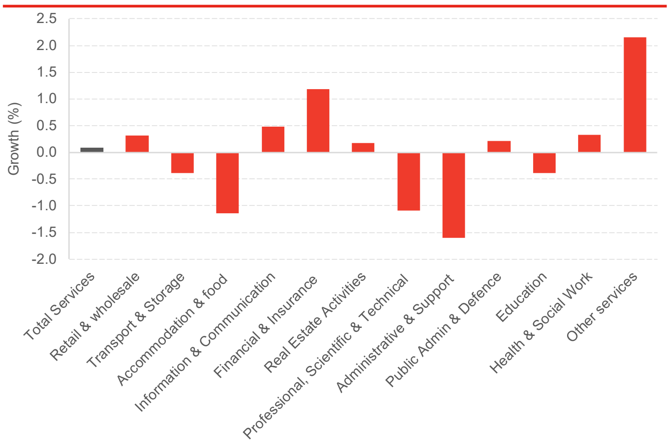


Source: *Scottish Government*

Chart 31: Manufacturing growth by key sub-sector

Source: *Scottish Government*

Chart 32: GDP quarterly growth, services, Q1 2019



Source: *Scottish Government*

The Scottish economy

The latest data shows that the Scottish economy grew by 0.5% during the first three months of 2019 – the fastest growth in two years.

Despite this, growth over the year remains relatively constant at 1.4% (still below Scotland's long-term average growth rate) and marginally behind the UK rate.

Underlying the most recent quarterly statistics are some interesting trends.

Annual Growth – as to be expected – driven by the performance of the services sector (which makes up around 75% of the Scottish economy). Chart 30.

But over the most recent quarter, however, growth was driven by the production sector, and in particular, manufacturing.

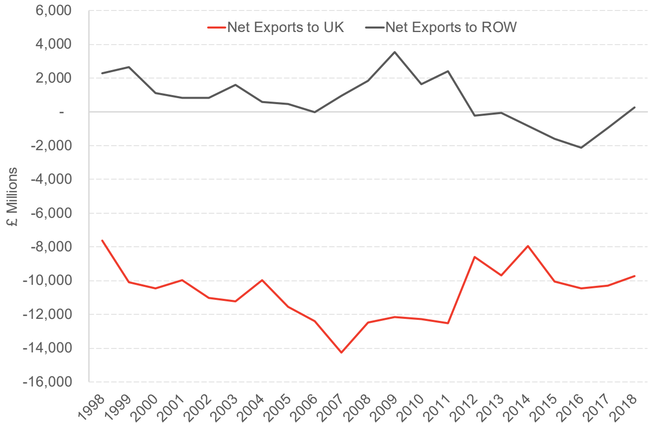
Manufacturing activity was up 2.6% over the quarter. The largest contributions come from the food & beverages sector and the refined petroleum & pharmaceuticals sector. These two sectors make up less than 5% of the economy but generated over half of Scotland's Q1 GDP growth. Chart 31.

The effect of stockpiling on GDP is to boost activity in the short-run, but for it to then slip back as firms run down their stocks later. We have seen this already happen at the UK level. Manufacturing output increased by 1.0% in February and by a further 0.9% in March. But it fell back by 3.9% in April.

Of concern was the very weak performance of the services sector which only grew by 0.1%. Key sectors such as those tied to accommodation and food, transport and wider professional and administrative services all slipped back over the three month period. Chart 32.

Financial services remained relatively resilient, and have been a key strong point for the Scottish economy over the last year. Output was up 4.5% on the same period in 2018. Growth in food and drink manufacturing was also very strong – up 6.2% over the quarter. Whilst a large element of this is likely to be the effects of stockpiling, there is wider evidence to suggest that this sector continues to be one of Scotland's growth markets.

Chart 33: Scottish exports to UK & RoW, 1998 - 2018



***Source:** Scottish Government*

One strong area for growth in Scotland in recent times has been in net exports to international markets.

Scotland has traditionally run a positive trade balance with the rest of the world, primarily because of the strong performance of the whisky sector and industries to oil and gas. In recent years, Scotland had moved into deficit. But this was turned around in 2018, with a trade surplus of £265 million. The key driver of this was an 8% growth in international exports, double the growth rate of international imports. This trend appears to have continued into Q1, with the latest HMRC data. Chart 33.

As we discuss below, our more recent business survey data suggests that this strong export growth may be starting to ease a little.

Table 3: UK labour market, February - April 2019

	Employment (16-64)	Unemployment (16+)	Inactivity (16-64)
Scotland	75.9	3.3	21.5
Quarterly change	0.6	-0.1	-0.5
Annual change	0.8	-1.0	0.0
UK	76.1	3.8	20.8
Quarterly change	0.0	-0.1	0.1
Annual change	0.5	-0.4	-0.3

***Source:** ONS, Labour Force Survey (LFS)*

Scottish labour market

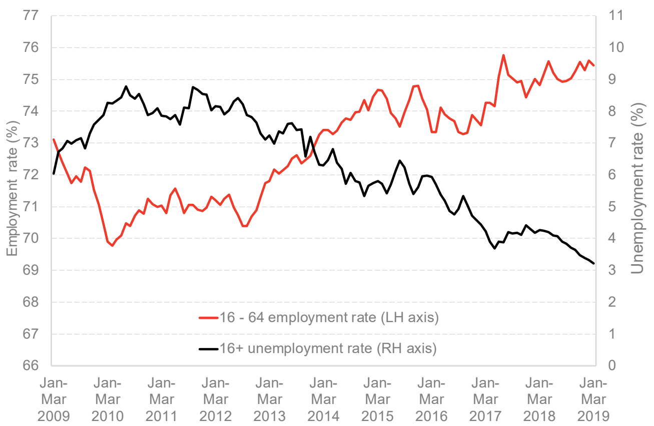
Scotland's unemployment rate currently sits at 3.3%. This is a full percentage point lower than it was this time last year, and fractionally above its record low set last month. Table 3.

The UK saw its unemployment rate drop to 3.8%, falling by 0.4%-points over the past year, and now recording its joint lowest rate since 1974.

There have been a number of changes in the Scottish and UK labour markets since the global financial crisis. Chart 34.

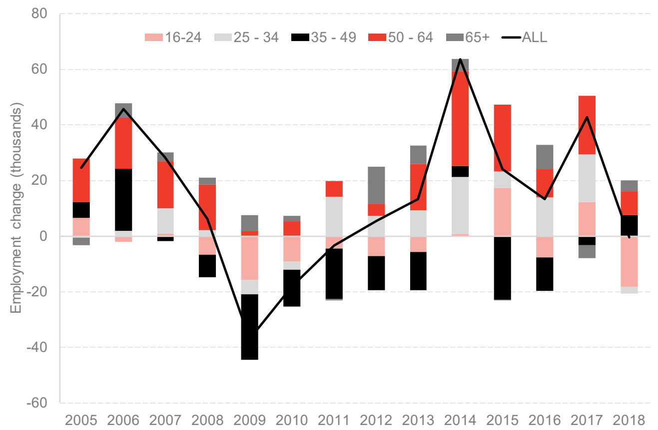
One area where we have seen some notable changes is in the age composition of those in employment. Chart 35.

Chart 34: Scottish employment & unemployment rate 2009 - Jan/March 2019



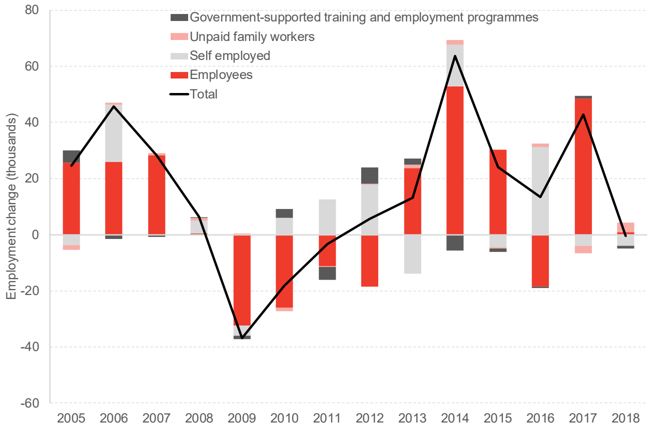
***Source:** ONS, LFS*

Chart 35: Employment changes by age up to January - December 2018



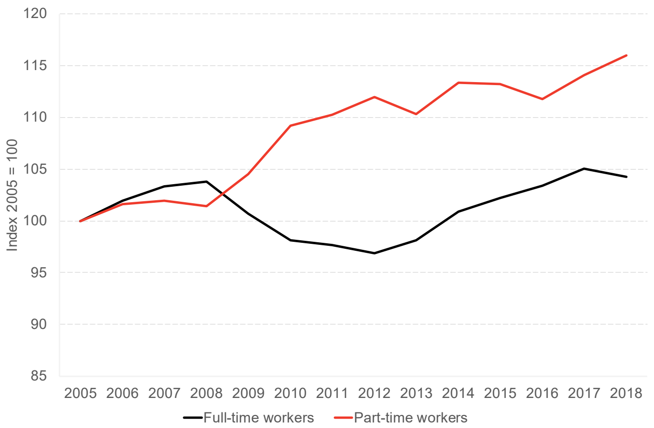
***Source:** ONS, APS*

Chart 36: Employment changes by type of employment up to January - December 2018



Source: *ONS, APS*

Chart 37: Changes in full-time and part-time employment to January - December 2018



Source: *ONS, APS*

Older workers are much more likely to be in employment now than they were earlier in the 2000s.

Most of the job growth since 2005 has been in employee jobs, with the exception of the increase in self-employment in the aftermath of the financial crisis and the larger increase in 2016. Chart 36.

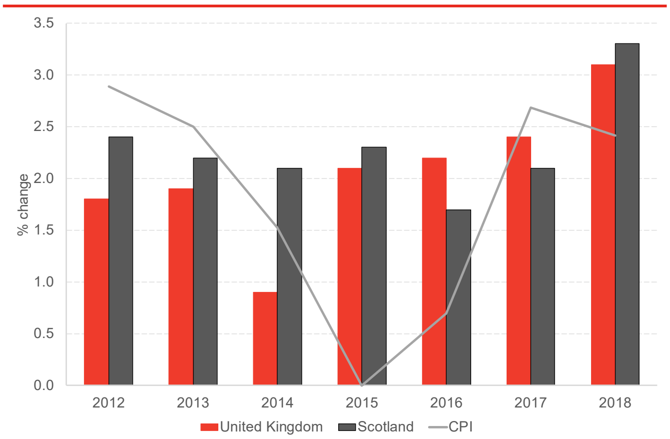
Another way to look at changes in the labour market in Scotland is by looking at changes in the nature of work, for example by part-time and full-time working. Chart 37.

There is a clear rising trend in the number of workers in part-time employment, up over 15% since 2005, with a smaller increase in full-time employment of nearly 5%.

For obvious reasons, many people view growth in full-time work as a better indicator of labour market health than part-time work, however part-time work can represent greater labour market flexibility for workers and can be valued by workers for that reason.

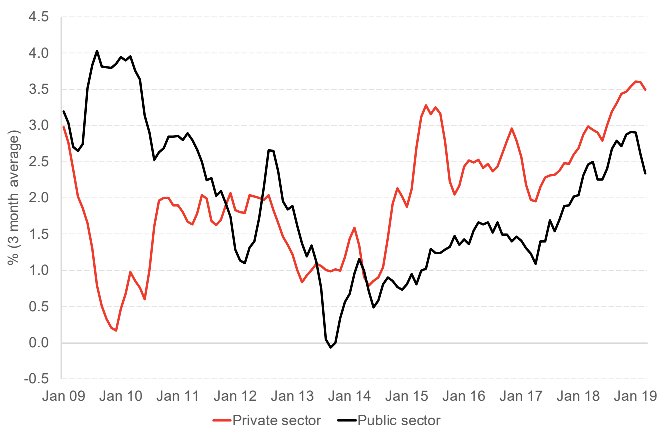
Chart 38 shows growth in median pay in Scotland and the UK since 2012. Overlaid on Chart 38 is the headline consumer price index measure of inflation. Where the red or black bar is above the grey line, this indicates that median earnings are growing more quickly than inflation, and therefore these workers should on average be seeing their purchasing power increase.

Chart 38: Growth in median pay, 2012 - 2018 and Consumer Price Index



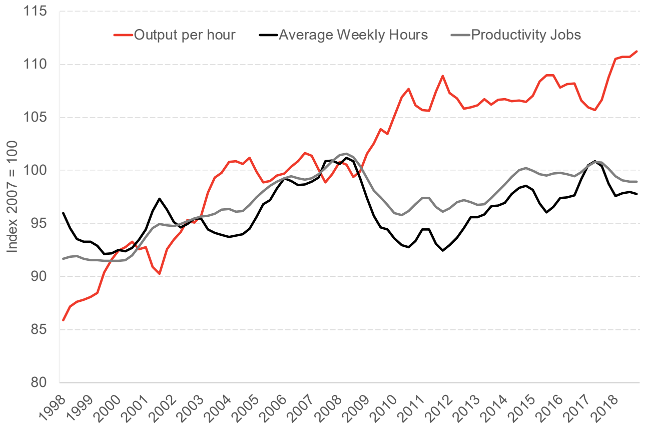
Source: *ONS, APS*

Chart 39: UK average weekly earnings growth, by public and private sector, to March 2019



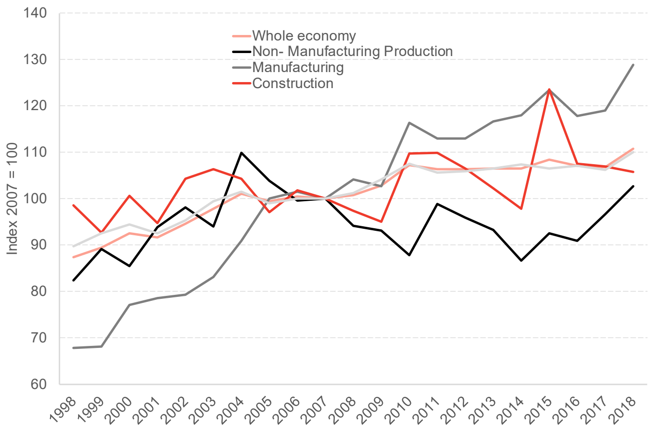
Source: *ONS, AWE*

Chart 40: Productivity growth (output per hour) to Q4 2018, Scotland



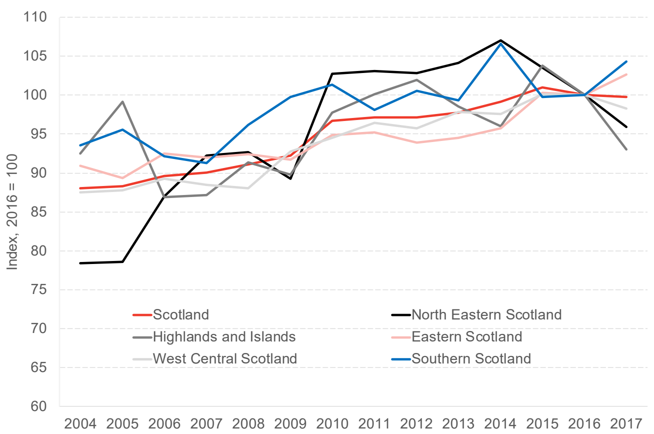
Source: *Scottish Government*

Chart 41: Productivity growth (output per hour) by sector to 2018, Scotland



Source: *Scottish Government*

Chart 42: Productivity growth (output per hour) by region of Scotland



Source: *ONS, Regional and Sub Regional Productivity Feb 2019*

More recent data on earnings growth for the UK as a whole can be found in the ONS's Average Weekly Earnings survey data. These are shown in Chart 39. We can see that pay, in cash terms, grew through 2018, in line with the ASHE data above, but that in more recent times pay growth has started to weaken – particularly in the public sector.

Productivity

Productivity and earnings have a close relationship. It is through increases in productivity, how much output a worker is able to produce in a given period of time (typically per hour), that firms are able to afford increases in pay.

Chart 40 shows the path of productivity growth in Scotland since 1998. We can see that labour productivity growth (output per hour worked) grew rapidly at the start of this period, and much more slowly after the global financial crisis. This reflects the UK-wide 'productivity puzzle'.

In more recent times, Scottish productivity has improved, but this is typically because of a fall in hours worked, not because workers are producing more output.

Chart 41 shows similar data, but broken down by sector. We can see that manufacturing industries have seen rapid productivity growth, both before and after the global financial crisis. Other sectors, for instance services are barely more productive now than a decade ago.

Within Scotland the location of activity in each sector will have implications for local productivity growth, and in turn wages. Chart 42 shows data on local labour productivity.

We can see that the North Eastern Scotland economy saw rapid rises in productivity through to the oil-price collapse in late 2014.

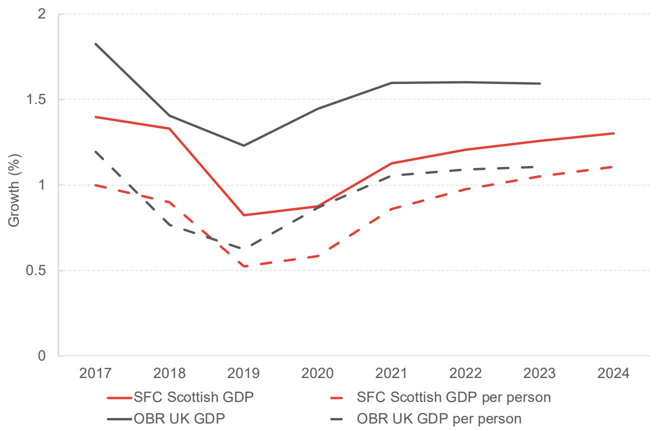
Since then labour productivity has dropped markedly. Elsewhere most areas have tracked Scotland's relatively muted average productivity growth.

Table 4: Scottish economic Growth, % growth rates, 2018 - 2024

GDP	2018	2019	2020	2021	2022	2023	2024
Dec 2018	1.4	1.2	1.0	1.0	1.1	1.2	
May 2019	1.3	0.8	0.9	1.1	1.2	1.3	1.3

Source: *Scottish Fiscal Commission (SFC)*

Chart 43: Forecast comparison, SFC May 2019 Scotland with OBR March 2019 UK, GDP and GDP per person growth



Source: *SFC, OBR (2019) Economic & Fiscal Outlook*

Table 5: Income tax reconciliations

Budget year	Outturn data	Budget affected	Forecast reconciliation (£m)
2017-18	Summer 2019	2020-21	-229
2018-19	Summer 2020	2021-22	-608
2019-20	Summer 2021	2022-23	-188

Source: *SFC*

Scottish Fiscal Commission

Last month, we had an update from the Scottish Fiscal Commission setting out their forecasts for the economy and Scotland's devolved public finances.

The SFC remains more pessimistic about the outlook than we are – with growth of just 0.8% predicted for 2019. Table 4.

The SFC's forecasts are also weaker than the OBR forecasts for the UK, although the growth forecasts for GDP per head are not too dissimilar. Chart 43.

The big story was the substantial reconciliations in income tax of around £1bn. Table 5.

Interestingly, this gap appears to stem, not from Scottish tax receipts performing weaker than forecast, but from rUK receipts doing better. With a gap in earnings opening up. Chart 38.

The Smith Commission brought more autonomy and accountability to Holyrood with new responsibilities over tax and social security.

But it also brought risks. Parliament was happy to trade off these risks for 'more powers'.

These risks include -

- the risk that the Scottish Budget bears the cost of any divergence between Scottish and rUK tax growth no matter the source, or ability of Holyrood to respond;
- the risk that Scotland has to match rUK tax performance with London included in the rUK tax take;
- the risk that the borrowing and reserve powers to manage volatility in forecasting may be restrictive;
- the risk that assigning VAT based on a sample of a few hundred households might not be robust; and
- the risk that the devolution of social security powers may be more complex and costly than envisaged.

Whilst the Parliament has spent a lot of time debating how to use its new powers, it cannot ignore the risks.

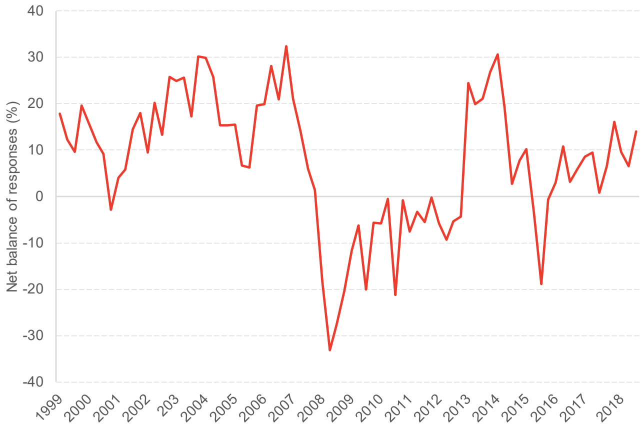
The quality of recent debates – and in particular the scrutiny of the medium term outlook for the Scottish Budget – suggests that many MSPs are yet to appreciate the scale of the risks now embedded in the new budget process.

Table 6: FAI Business Monitor Key Indicators, Q2 2019

	Q2 2019	Quarter change	Year change
FAI Business Activity Index (net % balance)	+14%	+8	+7
Business activity (net % balance)			
New business	+11%	+4	+2
Repeat business	+5%	+1	+5
Business concerns (%)			
Weakening demand - important	78%	-3	-1
Exchange rates - important	52%	-2	0
Investment (net balance)			
Capital investment	-7%	0	0
Leasing	-21%	-4	+2

Source: *FAI Business Monitor*

Chart 44: Business Monitor Activity Index, Q2 1999 - Q2 2019



Source: *FAI Business Monitor*

Latest Scottish indicators

The most recent indicators of conditions in the Scottish economy continue to paint a relatively mixed picture.

Our latest FAI Scottish Business Monitor shows that businesses appear to remain relatively resilient to the ongoing uncertainty. Table 6.

The net balance for new business was, once again positive (+14) jumping by eight points on the previous quarter. Chart 44.

However, the net balance for exports slumped to its lowest level in 3 years with only 1 in 5 firms indicating a rise in export activity. Almost 3 in 10 reported a fall with half of firms reporting no change to export levels.

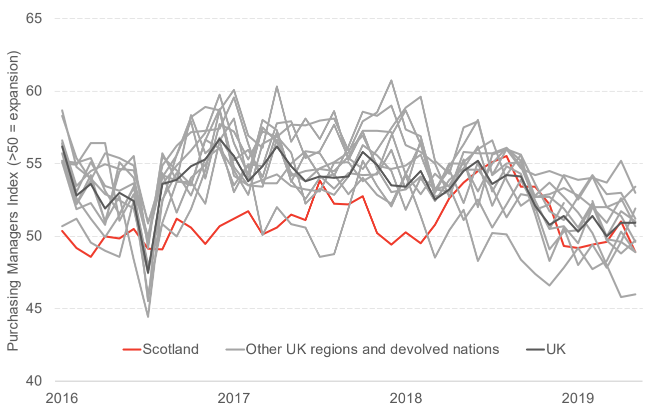
The outlook for investment also remains highly negative – and continues to flat-line well below its long-run average.

A more downbeat assessment was provided in the latest IHS Markit PMI indicator. According to this indicator, private sector output in Scotland declined in May for the 5th time in 6 months.

Scotland does not seem to be that different to the picture for the UK as a whole. Chart 45.

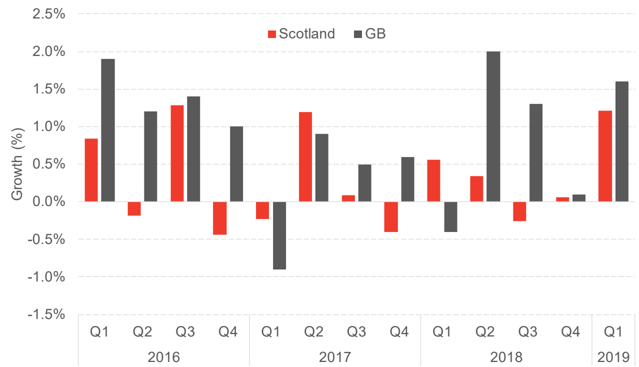
Retail sales picked-up in the first quarter of 2019 after a weak end to 2018. Chart 46. However, wider measures of consumer confidence continue to paint a bleaker picture.

Chart 45: Purchasing Manager's Index, Scotland & UK, Jan 2016 - May 2019



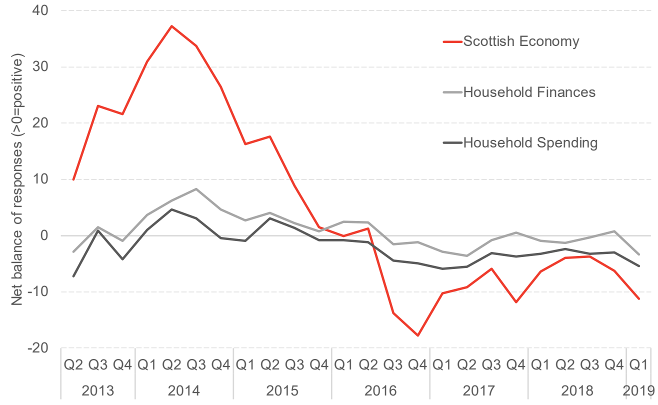
Source: *IHS Markit*

Chart 46: Quarterly retail sales growth in Scotland & GB since 2016



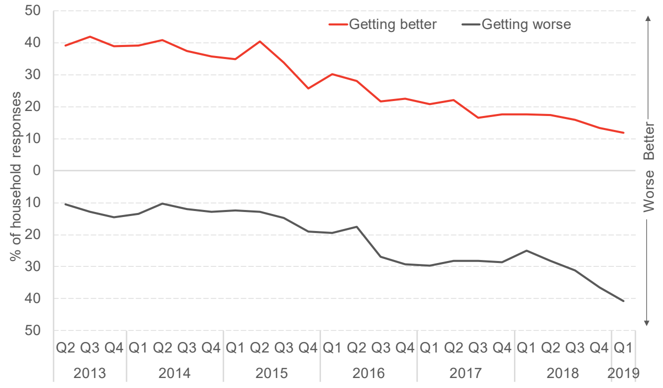
Source: *Scottish Government*

Chart 47: Scottish Government Consumer Sentiment Index, current conditions, Q2 2013 - Q1 2019



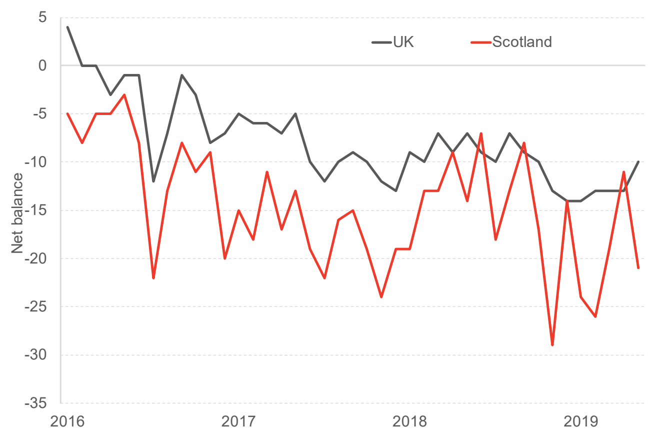
Source: *Scottish Government*

Chart 48: Scottish Government Consumer Sentiment Index expectations of the Scottish economy, Q2 2013 - Q1 2019



Source: *Scottish Government*

Chart 49: GfK consumer confidence index, Jan 2016 - May 2019



Source: *GfK*

The latest Scottish Government Consumer Sentiment indicator slumped to -9.6. Compared to Q4 2018, the indicator decreased by 3.8 points, implying that sentiment weakened over the quarter. It was also the lowest value recorded since the indicator began in 2013. Chart 47.

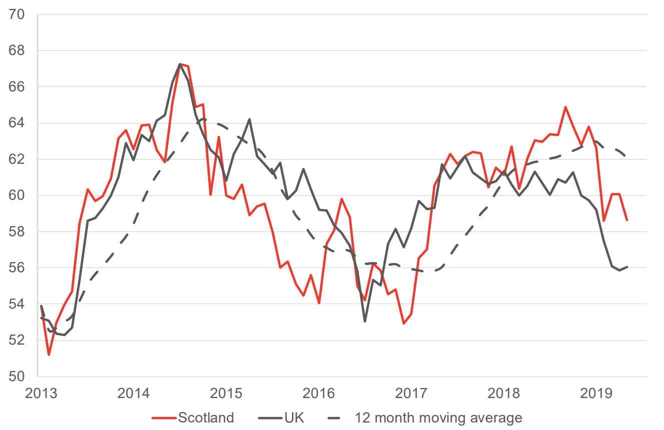
Dragging down the indicator is a particularly strong negative sentiment amongst households about the outlook for the economy. Chart 48.

A similar picture is evident in the GfK measure of consumer confidence. Overall, the series for Scotland is more volatile for the UK – which is to be expected given that it is based upon a smaller sample. But over time, it shows a negative picture, and one that appears to be weakening over time. Chart 49.

Like the official statistics, the one bright spot remains the jobs market. Indicators on activity remain positive, suggesting that recruitment continues and demand for new employees is on the rise. That being said, the outlook does appear to have slipped back a little in recent times to levels consistent with activity back in 2017. Chart 50.

With inflation falling, the tight labour market should start to put upward pressure on wage rates which in turn should help boost consumer confidence and household spending.

Chart 50: Employment barometer, March 2007 - May 2019



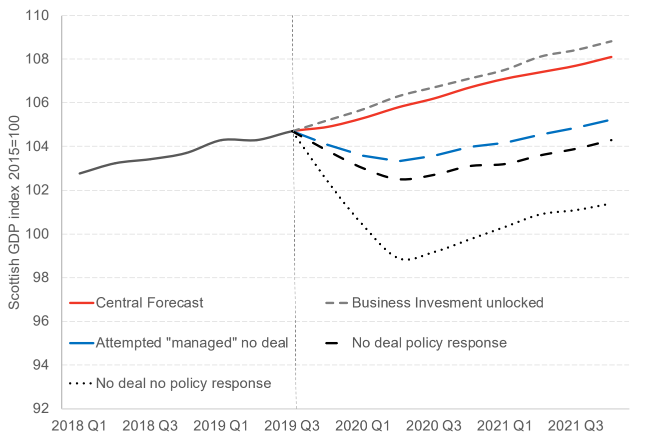
Source: *IHS Markit*

Table 7: Latest growth forecasts for the UK economy

	2019	2020	2021
Bank of England	1.3%	1.5%	1.8%
OBR	1.2%	1.4%	1.6%
NIESR	1.4%	1.6%	1.7%
European Commission	1.3%	1.3%	-
IMF	1.2%	2.0%	1.6%
Oxford Economics	1.3%	1.6%	-
ITEM Club	1.4%	1.5%	-
CBI	1.4%	1.6%	-

Source: *HM Treasury, Bank of England, OBR*

Chart 51: FAI central forecast and scenarios



Source: *Fraser of Allander Institute*

Table 8: FAI central forecast and scenarios, %, 2019 to 2021

	2019	2020	2021
Business Investment unlocked	1.3%	1.8%	1.7%
Central Forecast	1.2%	1.4%	1.5%
Attempted “managed” no deal	1.0%	-0.7%	1.0%
No deal policy response	1.0%	-1.4%	0.9%
No deal no policy response	0.6%	-4.2%	1.4%

Source: *Fraser of Allander Institute*

NB: These are annual growth rates. Each scenario has a contraction between Q4 2019 and the middle of 2020. From peak to trough these contractions are -1.3% for ‘attempted “managed” no deal’, -2.1% for ‘no deal policy response’, and -5.6% for ‘no deal no policy response’.

Our forecasts

Economic forecasting in the midst of this current uncertainty continues to be fraught with difficulties.

As a result, all economic forecasts need to be viewed with caution. We simply do not know how decisions in Westminster or Brussels will pan out. Nor do we have any precedent to fall back on to give guidance on what the economic impacts might be.

Moreover, the smoothness, or otherwise, of the UK’s withdrawal from the EU is but one step in the process. Negotiations on the terms of the UK’s future relationship with the EU have yet to begin in earnest.

In the light of all this, we present a series of scenarios for how the Scottish economy may evolve over the next three years. Chart 51.

These are not forecasts rather they are different potential pathways for consumption, investment and trade based on different possible outcomes, which we have tried to badge with the different labels that are being used in the current debate.

With this in mind - as with any such scenarios - the exact point estimates are less important than the overall scale and direction of travel.

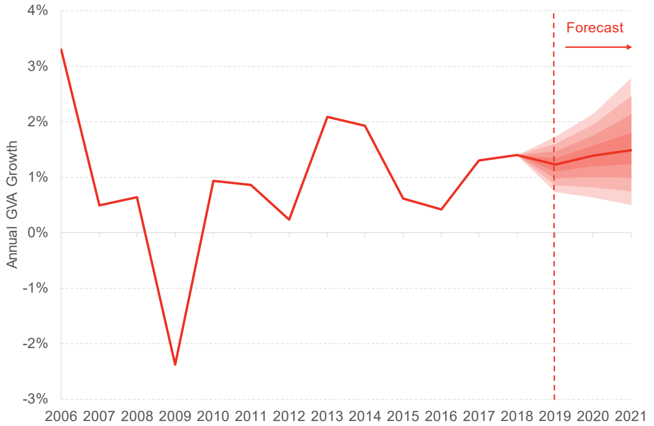
In our central forecast, we assume that the UK now makes an orderly departure from the EU at the end of October 2019, although uncertainty continues to impact on investment and private sector spending decisions for some time yet.

We have left our forecasts for the next 3 years broadly unchanged at 1.2% for 2019, and 1.4% and 1.5% for 2020 and 2021.

For our other scenarios, we take the impact point as Q4 2019, given the new scheduled departure date. The date any impacts may occur is still uncertain, however. Starting at Q4 is simply for illustrative purposes to show the range of outcomes.

Whilst the risk of a ‘no-deal’ outcome has been pushed back, it remains a possibility. There is huge uncertainty over how this might look, the timing of when this might happen, and how the economy might respond.

Chart 52: FAI forecast Scottish economic growth range



Source: *Fraser of Allander Institute*

* Actual data to 2018. Central forecast with forecast uncertainty for 2019 – 2021. Uncertainty bands sourced from accuracy of past forecasts at different forecast horizons.

Table 9: FAI central forecast Scottish GDP growth 2019 to 2021

	2019	2020	2021
GDP	**1.2%**	**1.4%**	**1.5%**
Production	1.2%	1.5%	1.4%
Construction	0.9%	1.0%	1.0%
Services	1.3%	1.5%	1.6%

Source: *Fraser of Allander Institute*

Table 10: FAI Labour Market forecasts to 2021

	2019	2020	2021
Employment rate (%)[1]	75.3%	75.1%	74.7%
Unemployment Rate (%)[2]	3.7%	4.0%	4.2%

Source: *Fraser of Allander Institute*

[1] Rate calculated as total employment divided by total of economically active population aged 16-64. [2] Rate calculated as total unemployment divided by total of economically active population aged 16 and over.

What any policy response to a 'no deal' Brexit might look like is still very uncertain. It is likely to involve a significant monetary stimulus through a cut in interest rates and possibly further Quantitative Easing.

A fiscal stimulus is also likely, with an uplift in spending – possibly on infrastructure – and, as in 2008, a temporary reduction in certain tax rates to support domestic spending.

Even then, and assuming a policy stimulus relatively comparable to that in 2008/2009, the economy is still likely to take a negative hit, but on a much smaller scale.

Of course, should the policy stimulus be bigger or smaller, then the exact number would change. On any reasonable assumption however, the scale of the 'hit' to the economy is likely to be much less than some of the 'worst' case scenarios have suggested. This is illustrated through the attempted "managed" no-deal scenario, where further policy initiatives e.g. in order to temporarily reduce the impact on trade could be put into place.

Of course, there is a 'best' case scenario, where the recent uncertainty is reduced and confidence returns to the economy. In such a situation, we are likely to see a significant spike in new investment and in wider spending in the economy.

This could reflect for example, clarity on the UK's future relationship with the EU, including a commitment to close economic ties in some form or another.

In such an instance, we think that growth could surprise on the upside and be much closer to trend by 2020 and 2021.

Based on our central scenario, our latest nowcasts suggest that growth will be 0.30% in Q2 2019. However, given the high degree of stockpiling we have seen in Q1, it is likely that the actual growth in Q2 will be lower than this.

Our central forecast scenario is driven by solid growth in production and services, and a forecast pick up in construction activity after zero growth in 2018.

Policy context

20 years of Devolution

It is 20 years since the devolved Scottish Parliament was established.

In many ways, the Scottish economy has been greatly transformed over that period.

What the next 20 years will hold is obviously uncertain. But with Brexit, the possibility of IndyRef2 and major structural shifts in our economy guaranteed, it is clearly going to be a period of further upheaval.

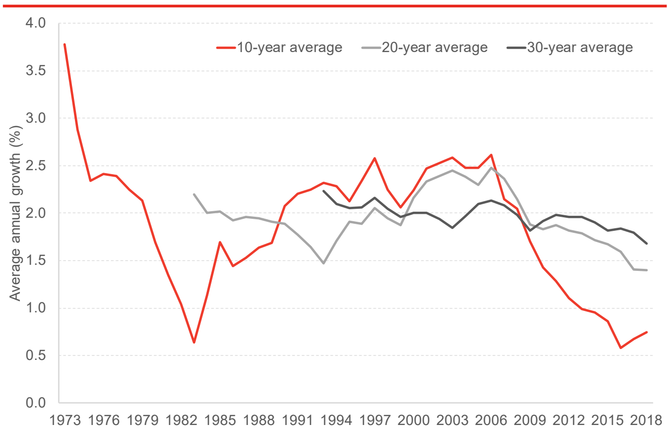
Economic and fiscal performance over the past 20 years

The first eight years of the parliament, from 1999 to 2007, were characterised by a strongly performing economy (in Scotland and the UK), and a growing Holyrood budget.

But in 2008, the global financial crisis tipped Scotland into a sharp and damaging recession.

In the end, the scale of the downturn – at least in terms of output and jobs lost – turned out to be smaller than perhaps many had feared at the onset of the meltdown in the global financial system.

Chart 53: Average GDP growth rates, Scotland, 1973 - 2018



Source: *Scottish Government*

But what has been particularly challenging has been the fragility of the subsequent recovery – not just in Scotland but across advanced economies.

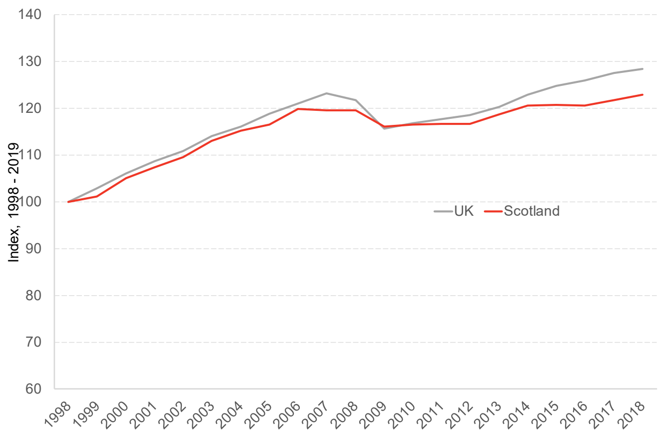
On top of this, the oil price shock of 2015 had a particularly negative effect on Scotland by dampening growth just when confidence was returning. A year later, in June 2016, the EU Referendum ushered in a renewed period of uncertainty.

Scotland's long-term growth rate is now well below trend. Chart 53.

Real terms household income per head, after having grown strongly through the early 2000s, remains lower today than in 2007.

By the end of 2018, output per head was only 3% above its pre-crisis level – about 1/10 of the growth in previous ten years. Chart 54.

Chart 54: GDP per head, Scotland & UK, 1998 - 2018



Source: *Scottish Government*

The one bright spot has been the labour market, with employment at near record levels.

But unpicking the data reveals some concerns.

Whilst participation rates have risen sharply, a combination of weak wage growth, cuts to in-work benefits and fewer hours worked means that for many households, employment is no longer the route into a secure economic future it once was.

The number of people in an in-work poverty household has risen by over 100,000 since 1999. Nearly 2/3 of children now living in poverty in Scotland are in a household with at least one adult in work.

On the public finances, after a period of unprecedented growth in spending in the early years of devolution – with growth in resource budgets of almost 50% in real terms between 1999 and 2007 – over a decade of consolidation (or ‘austerity’) has followed.

Since 2010-11, the Scottish Government’s resource budget has shrunk by 7% (in real terms).

At the same time, this fiscal squeeze has taken place at a time of a growing population and rising demand for many public services, most notably health.

The cuts to ‘non-protected’ areas therefore have been particularly tough. There is little evidence that austerity will be over anytime soon for many parts of Scotland’s public sector.

Throughout all of this, the Parliament has taken on significant new responsibilities. Most notable are the new powers around income tax and other devolved taxes, with major new powers over social security coming on stream over the next few years.

The arrangements for funding the Scottish Budget are now much more complicated than before, with the relative performance of the Scottish economy now having a major bearing on the revenues available to the Scottish Government.

How has the Scottish Economy and Labour Market changed?

A striking thing about the last 20 years has been the structural changes in our economy.

Many of these changes go unnoticed. But they highlight the consistently evolving nature of our economy to technology, global factors and policy priorities.

The offshore economy continues to be an important part of the Scottish Economy, but less than it was. Chart 55.

Indeed there has been a more general trend in our energy mix. Renewables contributed just 16% to our total electricity consumption back in 2005; now they contribute 75%.

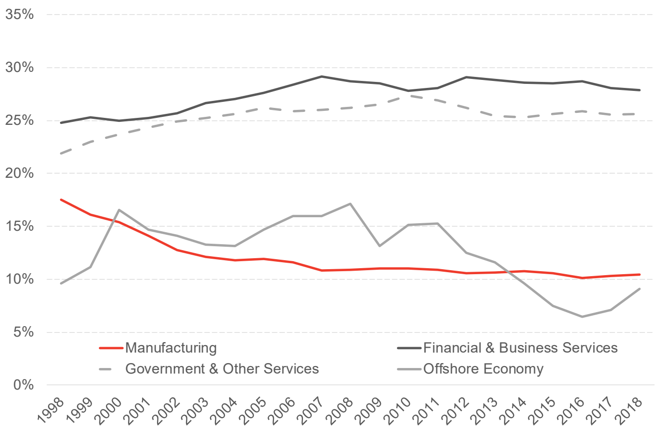
Over the period – and despite the financial crisis - business services and finance have grown to be an ever larger share of our economy.

Government (and related sectors such as universities) has also grown in its share of Scottish economic output.

But contrary to some perceptions however, job growth in Scotland has been largely driven by the private rather than the public sector. Whilst public sector employment has risen by around 16,000 since 1999, private sector employment has risen by over 410,000.

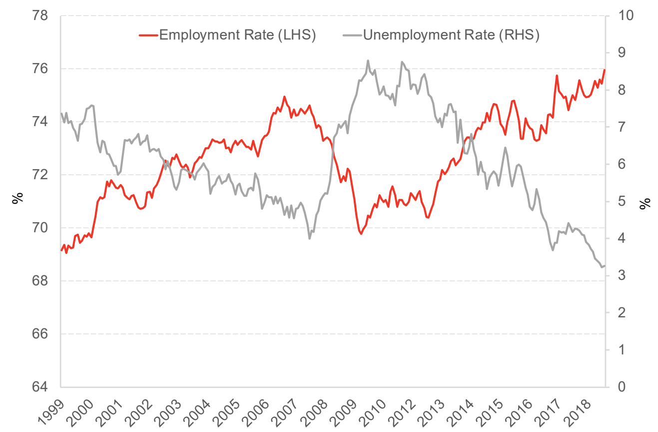
Going in the opposite direction from business services & finance and government (and related sectors) has been manufacturing. We see clearly the decline of Silicon Glen, with computers and electronic equipment alone declining from 3% of the economy in 1999 to only 0.5% in the latest year.

Chart 55: Industry shares of the Scottish economy



***Source:** Scottish Government*

Chart 56: Employment & unemployment, Scotland, 1999 - 2018



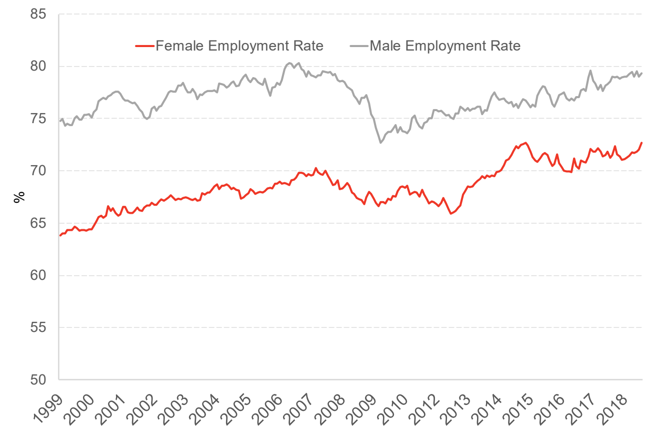
***Source:** ONS*

This has had a number of implications, including helping to explain Scotland's weaker productivity and export performance.

The Scottish labour market has also gone through significant changes. Chart 56.

Much of this long-term improvement in Scotland's employment, unemployment and inactivity rates has been as a result of a sustained and significant uplift in female labour market participation. Chart 57.

Chart 57: Employment rates by gender, Scotland, 1999 - 2018



Source: *ONS*

The employment rate for women was 64% in 1999, now it is 73%.

Our labour market is also getting older – with a 40% increase in the number of people employed who are over 50 in the last 15 years.

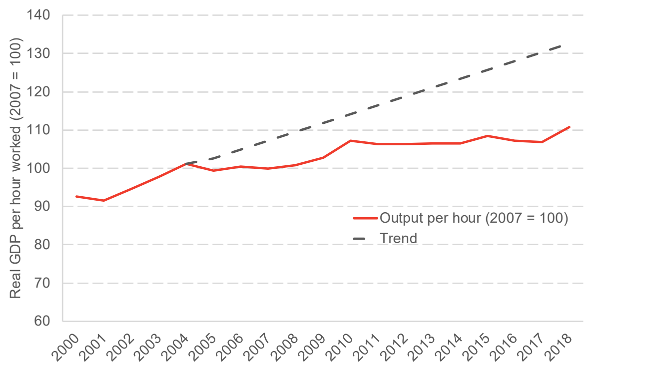
It is also becoming more flexible in the way people access employment opportunities, with a rise in part-time work and self-employment. Whether or not all of this greater flexibility is a good thing remains unclear.

With relatively weak growth in the wider economy, but a strongly performing labour market, this has had consequences for Scotland's productivity performance. Chart 58.

Like many advanced economies, productivity growth has slowed markedly since the financial crisis and compared to the initial period of devolution.

Scotland's productivity remains some 20% below the best performing OECD countries (although this gap does narrow if different measurement techniques are used).

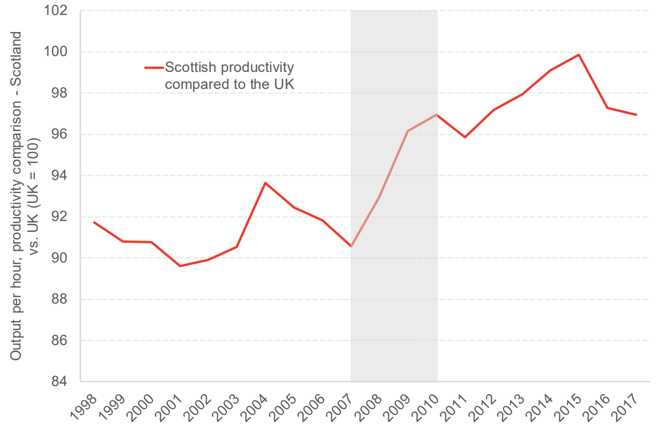
Chart 58: Scottish labour productivity & trend, 2000 - 2018



Source: *Scottish Government*

Scotland has however, 'caught-up' with the UK. Back in 1999, Scotland's labour productivity was 91% of the UK's. In 2017 it was 97%. Chart 59.

Chart 59: Scottish vs. UK labour productivity, 1998 - 2017



Source: *Scottish Government, FAI calculations*

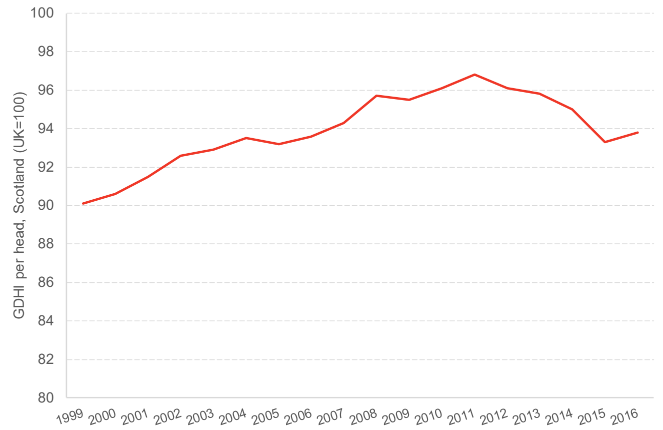
Again, unpicking this reveals some interesting trends that unfortunately increasingly get ignored. In particular, Scotland's relative improvement in productivity vis-à-vis the UK as a whole can largely be explained by changes in hours worked rather than a sustained uplift in relative economic efficiency.

As a result, people in Scotland might be relatively 'more productive' but this has been eroded by other means, including weaker growth in working hours.

This is somewhat reflected in the weakening of Scotland's relative position on Gross Disposable Household Income compared to the UK since 2010. Chart 60.

People in Scotland may be more productive but wider labour market outcomes squeeze their prosperity.

Chart 60: Gross Disposable Household Income, Scotland (UK = 100), 1999 - 2016

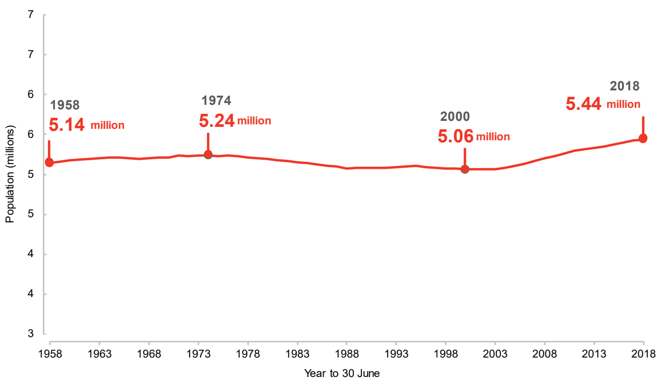


Source: *ONS*

A key driver of the growth in the number of people in work in Scotland has been the turnaround in Scotland's population.

The population of Scotland has increased significantly since the turn of the century, reversing the decline since the 1970s to be at the highest level ever. Chart 61.

Chart 61: Population in Scotland, 1958 - 2018



Source: *National Records of Scotland*

This increase has been driven by migration, both from the EU Accession countries and the rest of the UK. In general, natural change (i.e. births minus deaths) is negative, and therefore any population growth comes from migration.

So how much has devolution changed Scotland's economic fortunes?

Answering such a question easily is clearly fraught with difficulties, given the lack of a counterfactual and the significant wider structural change that has taken place over this time.

Scotland continues to remain the wealthiest part of the UK outside of London and has had notable successes in areas such as renewable energy and attracting international investment.

On a number of key macroeconomic indicators, Scotland has improved its relative position within the UK – both in terms of comparisons to the UK as a whole and to the other devolved nations and English regions. This includes on productivity and most labour market measures. Table 11.

Economic policy has departed from the rest of the UK in a number of areas, most notably in higher education, the retention of Scotland's enterprise agencies and – in recent times – on tax.

But in many other areas, the economic challenges that Scotland faced 20 years ago remain today.

Overall, aspects of our private sector economy appear to be less dynamic than elsewhere.

Our export base is smaller than that of our competitors. On business R&D, almost 40% of such expenditure is attributable to just five companies with Scotland ranking 9th out of the 12 devolved nations and English regions of the UK.

On new business start-ups, Scotland ranks 10th, and also lags behind the UK average in terms of levels of entrepreneurship and innovation.

Inequality remains a huge challenge.

For all the efforts on 'inclusive growth', nearly 1 million people – including nearly 1 in 4 children - live in relative poverty.

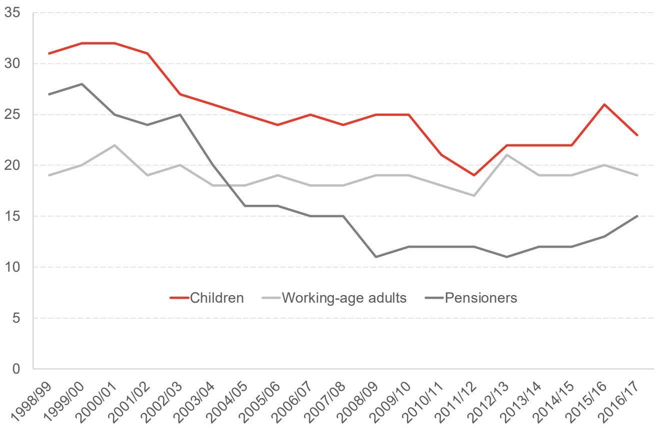
UK Social Security changes over the past decade have changed the make-up of households in poverty significantly, with the burden of poverty falling less on pensioners and more on working age households and those with children. Chart 62.

Table 11: Economic indicators, 1999 - today

Indicator	Value in 1999	Performance relative to UK	Rank (12 UK countries/ regions) in 1999	Most recent value	Most recent performance relative to UK	Current rank (12 UK countries/ regions)
GVA per head	£13,865	90%	4th	£25,485	92%	3rd
Productivity (output per hour worked)	N/A	91%	7th	N/A	97%	3rd
Employment rate (16-64)	69%	-2.6 p.p	8th	76%	-0.2 p.p	5th
Unemployment rate (16+)	7%	+1.1 p.p	9th (lowest)	3%	-0.5 p.p	5th (lowest)
Inactivity rate (16-64)	25%	+1.9 p.p	8th (lowest)	22%	+0.7 p.p	6th (lowest)
GDHI	£10,400	90%	9th	£18,100	93%	5th
Full-time gross median weekly pay	£330	95%	5th	£565	99%	4th

***Source:** ONS*

Chart 62: Percentage of households in relative poverty (after housing costs)



***Source:** Scottish Government, HBAI*

Scotland's health inequalities continue to act as a significant drag on long-term growth potential. In 2017, the premature mortality rate in the most deprived areas was 4 times higher than the rate in the least deprived areas.

Our economy also remains unbalanced geographically. The 16-64 employment rate is greater than 80% in Aberdeenshire, but as low as 64% in Glasgow.

Future economic and fiscal challenges

What is the next 20 years likely to hold?

Of course, the immediate change on the horizon is Brexit. And for policymakers at Holyrood this will mean not only dealing with the implications for the economy and society, but handling potentially significant legislative and fiscal changes.

In the relatively short-term, there will also be a number of issues to resolve in relation to the way in which the Scottish Budget is funded.

We have seen in recent weeks the potential serious implications for the Scottish Budget from tax 'reconciliations' (the reckoning between tax forecasts that were made when budgets were set with the outturn data) that underpin the new Fiscal Framework.

A decision will also be required on whether current plans to assign VAT revenues should go ahead given the significant uncertainties in the estimation of these revenues and the consequent budgetary risks.

These issues will lie at the heart of the renegotiation of the Fiscal Framework in 2021.

Beyond these relatively concrete issues, the parliament is likely to face a range of wider economic challenges, some of which we can be relatively certain about and others over which there is more uncertainty.

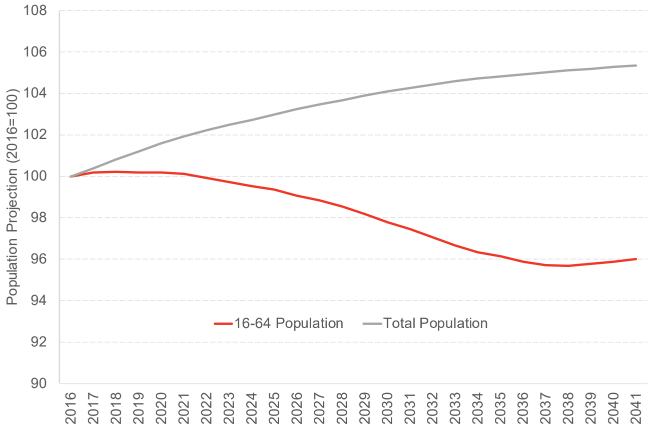
The fallout from the 'Great Recession' and fiscal austerity have illustrated that – in many key areas – the major macroeconomic and fiscal policy levers remain at Westminster. But many of Scotland's long-term challenges lie within devolved powers.

We highlight three here – demographic change; climate change; inequalities and well-being.

The major 'known' long-term economic shift over the next 20 years which will have a profound effect both on the Scottish economy and public finances is demographic change, colloquially referred to as 'population ageing'. Chart 63.

The number of people aged over 75 is expected to increase by 79% over the next 25 years.

Chart 63: Population projections, Scotland, total & working age, 2016 - 2041



Source: *Nationals Records of Scotland*

This process of population ageing will continue to have profound implications for Scotland's economy and public finances.

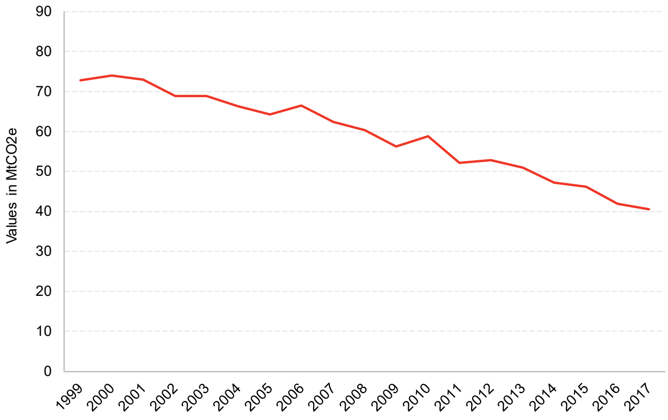
Scottish Government spending on health has risen from 37% of day-to-day devolved spending in 1999/00 to 48% in 2019/20. Spending on social care for older aged adults is similarly absorbing a larger and larger share of local government spending.

Keeping up with such demand pressures, whilst trying to tackle Scotland's stubbornly high levels of health inequalities, will not be easy.

A key policy challenge will, of course, be climate change.

Scotland should be well placed to take advantage of a concentration of industries that can support the transition to a low carbon economy. But the scale of the transformation required – and the trade-offs that may be required in the short-term - will not be easy to manage. Many of the decisions required will be politically unpopular. Current patterns of economic activity are likely to require significant disruption.

Chart 64: Greenhouse Gas emissions in Scotland, 1997 - 2017



Source: *Scottish Government*

Tackling Scotland's unequal economy arguably remains the biggest challenge.

Whilst significant policy shifts have been made in many areas, Scotland remains a highly unequal society.

Some of this reflects the long-term nature of many of the interventions that we know will make a difference (e.g. in education).

But there is also a question about how bold and truly transformational the proposals being put forward are – by all political parties – particularly if Scotland is to meet its objectives in areas such as reducing child poverty.

For example, despite it being nearly five years since the Scottish Government launched 'inclusive growth' as its key policy agenda, the Poverty and Inequality Commission have raised concerns that the Scottish Government has not been sufficiently clear about what it means by inclusive growth, concluding that "inclusive growth appears to be more of a concept than something which results in a tangible outcome".

Other economic trends are associated with more uncertainty.

Will Scotland be more or less impacted by Brexit than the rest of the UK? How will Scotland's economy cope with the long-term decline in the North Sea? And what are the risks and opportunities for Scotland's economy from the 4th industrial revolution and the rise of the digital economy?

Conclusion

In the 20 years since the Scottish Parliament was established, the Scottish economy and labour market has changed greatly. However, many of the challenges remain the same.

The Parliament has been responsible for notable and bold social policy initiatives, like the smoking ban and minimum unit pricing. It is possible to argue that in the area of economic policy, there has been a more timid approach.

The next 20 years are likely to see economic change at least as significant as the past 20 years, as well as further change to the constitutional settlement.

If Scotland is to meet the challenges of the next decade and beyond – and take advantage of the undoubted opportunities that will arise – it is likely to require a much bolder economic policy agenda.

Fraser of Allander Institute

June 2019

University of Strathclyde Business School

Scotland's Budget 2019

Tuesday 12th November

We are delighted to announce the Fraser of Allander's 4th Scotland's Budget event will take place on Thursday 12th November in the National Museum of Scotland in Edinburgh.

This annual briefing event analyses the state of the economy, the public finances and the options open to the Scottish Cabinet Secretary for Finance, Economy and Fair Work as the Scottish Government prepares for its Budget later in the year.

Alongside the event, we'll be publishing our annual report of Scotland's devolved public finances and the choices, opportunities and risks facing the Scottish Government as it prepares to set its Budget for 2020/21.

We're delighted that Paul Johnson – Director of the Institute for Fiscal Studies – will once again be joining us to provide his take on the outlook for the UK public finances.

Keynote speakers include:

- Paul Johnson, Director, Institute for Fiscal Studies
- Graeme Roy, Director, Fraser of Allander Institute
- David Eiser, Head of Fiscal & Budget Analysis, Fraser of Allander Institute
- Mairi Spowage, Head of Economic Analysis, Fraser of Allander Institute

Date: Tuesday 12th November
Time: 9am-11.30am (registration & refreshments from 8am)

Sign up details will be available closer to the time of the event.

www.strath.ac.uk/fraser

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