Quarterly
ECONOMIC
Commentary

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EDITORS .... Brian Ashcroft, Eleanor Malloy and Sarah Le Tissier
GRAPHICS .... Eleanor Malloy
PRODUCTION .... Linda Kerr and Isobel Sheppard

OUTLOOK *and* APPRAISAL

The effect of the Chancellor's Budget measures is to produce a broadly neutral fiscal stance in the UK over the next three years. A slight stimulus to aggregate demand this year is counterbalanced by a tightening of demand in the following two years. The implications for the growth of demand in the Scottish economy are much more difficult to assess. The effect of the tax changes in Scotland should broadly parallel their impact in the UK, although given the strong redistributive elements in the Budget it might be expected that the stimulus to demand would be somewhat greater here. This follows because incomes are lower in Scotland, while the importance of social security payments to incomes is higher. In addition, the abolition of mortgage interest tax relief in 2000 will have less effect here because of the appreciably lower rate of home ownership. On the other hand, the increased duty on cigarettes and fuel will take proportionately more tax from Scotland than the rest of the UK due to the greater incidence of smoking and the importance of private transport to rural areas.

On the expenditure side, the picture is a little clearer but it must be admitted not by much. The expenditure projections contained in the Budget were largely set in the Comprehensive Spending Review (CSR) last year. However, last year's Budget announced a change to the presentation and control of public expenditure, which was implemented in the CSR and continued in the recent Budget. Departmental Expenditure Limits (DELs) were set for three years ahead and a distinction made between capital and current expenditures. Targets for Annual Managed Expenditure (AME) were set covering expenditures which are more difficult to fix and predict such as social security payments. The CSR included no published estimates of AME for Scotland and this is continued in the recent Budget. We therefore have data for Scotland on the Scottish Office DEL but not AME, plus data on the old Scottish Office Control Total (CT) to 1998-99. After 1998-99, the CT is superseded by DEL, AME. We are aware of no published attempt by the Treasury or the Scottish Office to reconcile the new and old presentation. This makes it difficult to provide an overview of recent movements of public expenditure in Scotland under the control of the Secretary of State and the coming Scottish Parliament.

Figure 1 graphs estimates of the Scottish Office expenditure control total for 1993-94 to 1998-99 and the Departmental Expenditure Limit from 1993-4 to 2001-02, while Figure 2 charts the percentage change in the Scottish Office DEL and the UK DEL for the period 1994-95 to 2001-02. The last three years of the DEL reflect the plans in the recent Budget. The series in both figures are expressed in real terms at constant 1997-98 prices. The graphs allow us to draw the following conclusions:

- In 1998-99 Scottish Office expenditure was lower in real terms than in the years from 1993-94 to 1997-98.
- The Comprehensive Spending review and the March 1999 Budget plan to raise Scottish Office (and Scottish Parliament) expenditure in real terms by 2.43% in 1999-00, by 1.85% in 2000-01, and by 2.10% in 2001-02. By 2001-02 real expenditure is expected to be 7% higher than the estimated outturn in 1998-99.
- Planned expenditure in 2001-02 will, at £13.7bn in real terms, be 0.72% lower than the last expenditure peak of £13.8bn in 1994-95.
- The planned percentage increase in Scottish Office/Scottish Parliament expenditure is less in real terms than the planned increase for UK government departments. The planned UK increase is estimated to be 3.48% in 1999-00, 3.48% in 2000-01, and 2.79% in 2001-02.

The slower rate of real growth of Scottish Office/Scottish Parliament expenditure compared to the UK is presumably a reflection of the application of the Barnett formula. As Professor Gavin McCrone notes in his historical analysis of Scotland's public finances in this **Commentary** and as Professor Neil Kay noted in his article in the previous **Commentary**, the formula seeks to realise convergence in public expenditure per head in Scotland and the rest of the UK. The strict application of the formula therefore results in smaller percentage increases in public expenditure in Scotland than in England, which, given the weight of English expenditure in the UK total, means lower percentage growth than in the UK.

The notion, implicit in the strict application of the Barnett formula, that public expenditure per head of population should be broadly the same in Scotland, Wales, Northern Ireland and England is difficult to justify. As Professor McCrone observes in his paper, the special features of Scotland, including large sparsely populated rural areas, a poor health record and the number of students from outside Scotland at its universities and medical schools, are some of the factors that would appear to justify higher public expenditure per head of population. No doubt similar justifications could be offered for Wales, Northern Ireland and some of the English regions. It is therefore difficult to disagree with Professor McCrone's conclusion that what is required is a new assessment of need covering all the constituent parts of the UK, which would be best undertaken by a body of the highest authority and impartiality. The most obvious vehicle fulfilling such criteria would be a Royal Commission.

Outlook

The latest Scottish Office data on production in Scotland refer to the third quarter of 1998. Compared to the second quarter, the output of Scotland's production industries (excluding oil and gas) fell by 0.8% while the same industries in the UK exhibited no change. In manufacturing, which constitutes 83% of the output of the production sector, output in Scotland fell by 1% compared to a slight fall of 0.1% in the UK.

When longer periods are taken, Scotland still outperforms the UK in production and manufacturing. In the year to the third quarter 1998, Scottish manufacturing output rose by 3% compared to a UK increase of 0.5%. Production output rose by 2.6% here compared to 0.5% in the UK. Over the four and a half years between the first quarter of 1994 and the third quarter 1998, the output of the production industries in Scotland rose by 12.3% compared to 7% in the UK. Manufacturing output rose by 12.8% over the period in Scotland compared to 5.7% in the UK. However, within this total, the non-electronics component of manufacturing *contracted* by nearly 8% while its UK counterpart increased its output by 3%.

The recent relative deterioration in Scottish manufacturing performance reflects in large part the weak performance of the Scottish electronics industry, which contributes more than a quarter (about 27%) of total manufacturing output. The electronics sector contracted by 3% in the second quarter of last year and this was followed by a further contraction of 0.8% in the third quarter. In the UK, the sector did better, with output *rising* by 0.9% in the second quarter and by 1.8% in the third quarter. Other sectors exhibiting recent weak performance include chemicals, which contracted by 3% in the third quarter (compared to1% growth in the UK), transport equipment, which contracted by 11% (3.5% growth in the UK) and other manufacturing, which contracted by more than 3% (1% growth in the UK). In contrast, and somewhat surprisingly, the textiles sector grew by 1% in Scotland while contracting by 2% in the UK. The drinks industry recovered from the marked reverses earlier in the year to grow by more than 3%, while its UK counterpart contracted by 0.3%. Finally, the metals sector grew by just under 3% in the third quarter while the same industry in the UK contracted by 2%.

Another sector of the economy causing considerable concern is the oil & gas industry where the average oil price for 1998 was $13.14 compared to $19.13 in 1997. Investment was only £1.5bn (down two thirds on planned investment) with a significant reduction in exploration activity. Despite this, production in 1998 rose by 1.1% to 2.54mbpd (the fourth highest level since the 1970s) with a record 109 in production but revenues decreased by 33% in cash terms and 20% in real terms according to the Royal Bank of Scotland Oil & Gas Index. In the past year there has been considerable job losses principally due to the oil price collapse therefore accelerating the cost reduction initiative.

Recent Scottish business surveys confirm that growth is continuing to slow. The Deloitte & Touche Scottish Chambers' Business Survey for the fourth quarter of 1998 revealed that confidence continued to fall in all sectors. Total orders fell in manufacturing, wholesale distribution, retail distribution and tourism and a balance of respondents in all sectors expected that demand would fall further in the first quarter of 1999. On the more positive side, there was some evidence that the decline might be "bottoming out" in manufacturing. This may in part be a reflection of a slight improvement in conditions in export markets. The rate of decline in manufacturing export orders and sales eased, although the deterioration in tourist demand from abroad continued.

The latest Aberdeen Chamber of Commerce and Deloitte & Touche Oil & Gas Survey shows 76% of firms in the oil & gas related sector reporting a drop in confidence, 77% reported reduced exploration work and more than 70% expect to reduce exploration over the next six months. 61% of respondents reported reduced volumes of work in the production and service sector with 88% citing demand as a constraint on activity. 42% reported reducing investment plans and 40% of respondents cut employment.

Against this background, we have revised down our forecasts for the growth of aggregate demand in the Scottish economy. Consumer demand in Scotland is now forecast to grow by 1.3%, 1.5% and 1.9% in the years 1999, 2000, and 2001. This compares with our previous forecast of 1.9%, 2.1% and 2.4%, respectively. The growth of investment demand is also expected to be lower, at 2%, 4% and 3.9% over the next three years. The other principal revisions are to the forecasts of tourism and export demand. Tourism demand is now expected to grow by 2.3% this year, 3.6% in 2000 and 5.3% in 2001. Export demand from the rest of the world has been cut from 3% to 1% this year, with expected growth of 3.5% and 5.4% in 2000 and 2001 respectively.

Table 1. GDP and Jobs Forecast 1999 to 2001

		1999	2000	2001
GDP Growth	%	0.89	1.88	2.57
Jobs Growth	Nos	-15,318	9,980	19,925
	%	-0.81	0.48	0.98

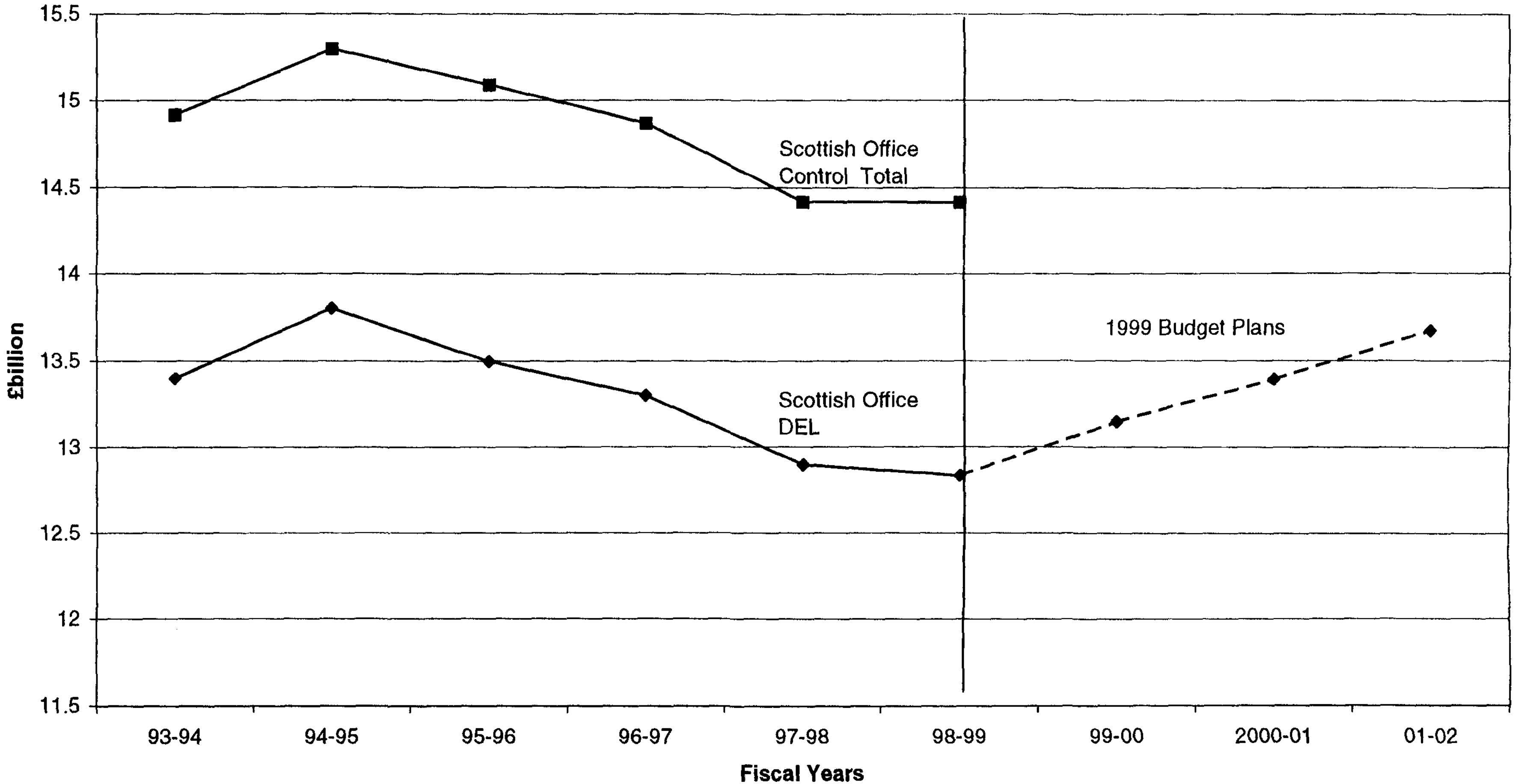
Table 1 presents the forecasts for GDP and jobs growth, which result from the incorporation of the forecasts of the components of aggregate demand into the Institute's Medium Term Model (MTM) of the Scottish economy.

We now expect that GDP will grow by 0.89% this year, which is lower than our benchmark forecast of the UK economy of about 1%. In 2000, GDP growth is expected to rise to 1.88%, which is below our expectation for the UK of around 2.5% but is compatible with a 'soft landing' in both the Scottish and UK economies. In 2002, we anticipate a further increase in growth to 2.57%, which is broadly in line with our expectation for the UK.

The outturn in the labour market is more difficult to predict. Productivity growth has slowed in the UK as firms have to some extent hoarded labour in anticipation of an upturn. In the absence of data for Scotland, we have adjusted our forecasts of productivity growth downward to reflect the UK position. On this basis, we anticipate that just over 15,000 jobs will be lost overall this year. However, next year we expect that the upturn in the economy will lead to net job creation of just under 10,000 jobs. This is expected to be followed in 2001 by an additional 20,000 jobs as the economy displays strong growth above trend.

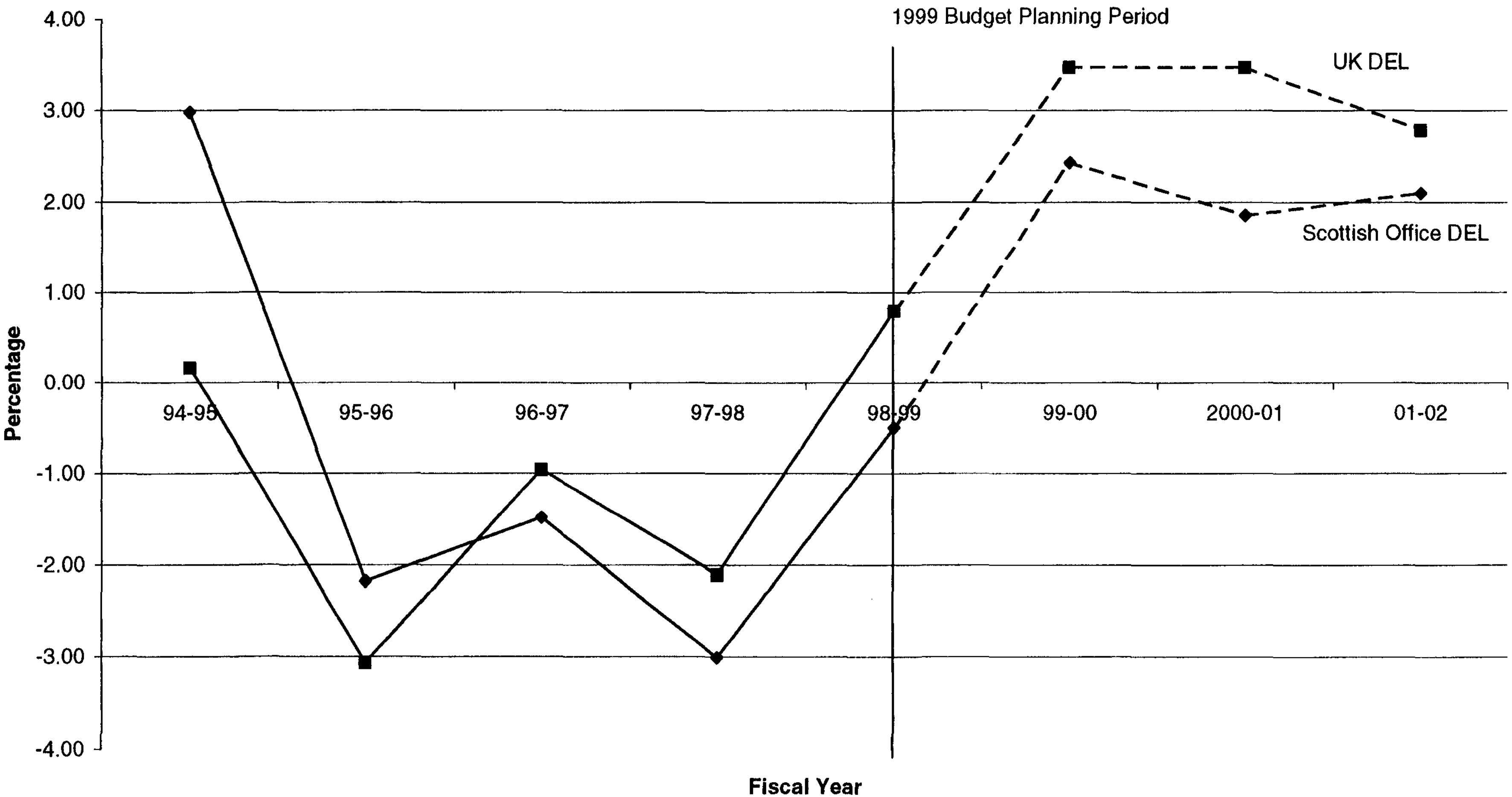
16 March 1999

Figure 1: Scottish Office Expenditure Control Total and Departmental Expenditure Limit 1993/4 to 2001/2 at 1997-98 contant prices.



Source: 'Public Expenditure Statistical Analysis 1998-99' Cmnd 3901, April 1998. 'Financial Statement and Budget Report', March 1999. 'Comprehensive Spending Review', July 1998. FAI calculations.

Figure 2: Percentage Change in Scottish Office Department Expenditure Limit (DEL) and UK DEL 1994-95 to 2001-02



Source: 'Comprehensive Spending Review', July 1998. 'Financial Statement and Budget Report', March 1999. FAI calculations.