University of Strathclyde Glasgow

Fraser of Allander Institute

Economic Commentary

Vol 47 No 3

Deloitte.

Foreword

We enter the final months of 2023 amid a thoroughly mixed outlook for our economy and, accordingly, for business and consumers. As this quarter's Commentary outlines, we have seen economic growth this year, but that growth has been at its weakest rate since the 1950s; and although inflation is falling it remains uncomfortably high.

The Commentary highlights that from a consumer standpoint, that doesn't mean a drop in prices, just that prices are increasing less quickly. It's no surprise, then, that consumer confidence – despite having risen for two consecutive quarters – remains historically weak.

The outlook for businesses is equally challenging, with Deloitte's latest CFO Survey showing that finance chiefs are regarding debt finance with a remarkable level of caution, as they foresee an extended period of high interest rates and stubbornly high inflation. The survey found 84% of CFOs expect their operating costs will continue to increase, either somewhat or significantly, in the next year, and that their focus has very much shifted to prioritising debt reduction.

That chimes with the conclusions of the Fraser of Allander Institute's latest Scottish Business Monitor, which found a third of businesses expect to only be able to absorb costs for another year. It also showed notably high rates of delays and cancellations to business investment, though half of businesses do anticipate initiating investment in 2023 or 2024, suggesting that hesitation may be temporary.

Undeniably, businesses that are truly committed to a transition to net zero will need to invest substantially, and 58% of CFOs we surveyed believe their organisation will see significant or wholesale change in the move to a low carbon economy in the next 10 years. The survey also found that, in the year since ChatGPT was launched, CFOs have become markedly more optimistic about the prospect of generative AI delivering material improvements to their business' performance, which could be key to freeing up such investment.

UK economic activity is expected to stagnate and possibly contract in the second half of the year before picking up gradually next year. Indeed, the continued subdued growth in most advanced economies is a symptom of Central Bank efforts to contain inflation through rate rises. We know poorer households are disproportionately impacted by price inflation, so growth for growth's sake cannot be our sole objective. Any growth we pursue must be sustainable, and cannot risk leaving anyone behind.

The Commentary also points out the very real risk of 'greedflation', though it acknowledges there is little evidence of this happening to date. Profitability will always be a key driver for businesses, but there is a growing acceptance today that businesses have a serious obligation to act responsibly, and to ensure their operations are making a positive contribution to society. Business leaders are increasingly embracing that responsibility, thanks in no small part to new regulations, as well as swathes of the workforce applying pressure on their employers – and prospective employers – to truly walk the walk on ESG.

This quarter's Commentary includes a focused look at Scotland's hospitality sector, which faces a unique triple threat of challenges around recruitment, pay, and training and development. Employers in the sector have expressed the need for constructive engagement with government to enable them to devise sustainable solutions to these challenges.

That engagement needs to happen across all sectors of our economy, and that is something Deloitte has championed with our Shaping Scotland's Future Economic Landscape events over the last year. These events have involved representatives from business, policy and academia gathering to discuss what truly sustainable growth for Scotland could look like, and agreeing on realistic actions to make that sustainable growth a reality. To its credit, the Scottish Government has been engaging more with businesses in recent months, which is hugely welcome.

Every government must strive to provide services that deliver the best outcomes for all. Having robust public services in place isn't just important for people at a personal level, though: it's essential to enable vital sectors of our economy to flourish.

The Fraser of Allander Institute's research uncovered a critical need among hospitality workers for better access to affordable childcare and transport outside traditional working hours. The importance of co-production between industry and government in enacting this kind of systemic change cannot be overstated.

Early in 2023, we predicted that the effects of the economic challenges that defined 2022 would very much continue to be felt this year. As we publish our Foreword to the final Commentary of the year, this has unfortunately proved to be true, as the drawn-out cost of living crisis looks far from over for both businesses and consumers.

Ahead of the UK Government's Autumn Statement in November, which will be followed closely by the Scottish Budget in December, that meaningful dialogue with businesses is vital to ensure both governments are making public spending decisions from an informed position, aimed at addressing the most urgent needs of our people and businesses.

Angela Mitchell

Senior Partner for Scotland at Deloitte

October 2023

Deloitte.

Deloitte supports the production of the Fraser Economic Commentary. It has no control over its editorial content, including in particular the Institute's economic forecasts.

CONTENTS

ECONOMIC COMMENTARY

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

www.fraserofallander.org

ISSN 2046-5378

UNIVERSITY of STRATHCLYDE
FRASER OF ALLANDER INSTITUTE

Summary

Growth in the economy has been faltering and pretty muted over 2023, with a high interest rate environment and wider economic uncertainty leading to many businesses choosing to delay or cancel investments.

Whilst not in the recession that many economists were predicting at the end of 2022, monthly economic figures have been very mixed, which means growth overall for 2023 is likely to be pretty poor.

The most recent data on inflation, which held steady at 6.7% in September, shows that the high inflationary and interest rate environment is likely to persist for longer than previously thought – therefore it is likely that there are more risks to the downside for our forecasts numbers than in the previous quarter.

We are now forecasting growth of 0.2% in 2023, 0.7% in 2024 and 1.2% in 2025. For 2023, this is a revision down from our previous set of forecasts in June, as data for 2023 to date has been much weaker than expected. The forecasts for 2024 and 2025 have not changed since June.

Analysis in the Commentary this quarter includes a detailed look at the hospitality sector in Scotland. This sector, one of the hardest hit over the period of the pandemic, is a large employer in Scotland and the institute has been carrying out research with employers and employees into how pay and conditions in the sector can be improved.

The Commentary also looks ahead to the Autumn Statement, which will be presented by the UK Chancellor on 22nd November. This will be important to set the scene – and indeed broadly the spending envelope - for the Scottish Budget on 19th December.

The outlook for the public finances continues to be challenging, with slow growth translating into weak tax revenue forecasts. Despite recent positive revisions to UK growth, this is unlikely to translate into more fiscal headroom for the Chancellor.

This will mean that the spending envelope remains tight, which will put further pressure on the Scottish Government's finances in the run-up to the Scottish Budget. There have been a number of spending commitments made by the Scottish Government in recent weeks that are likely to make the situation more challenging.

Fraser of Allander Institute
October 2023

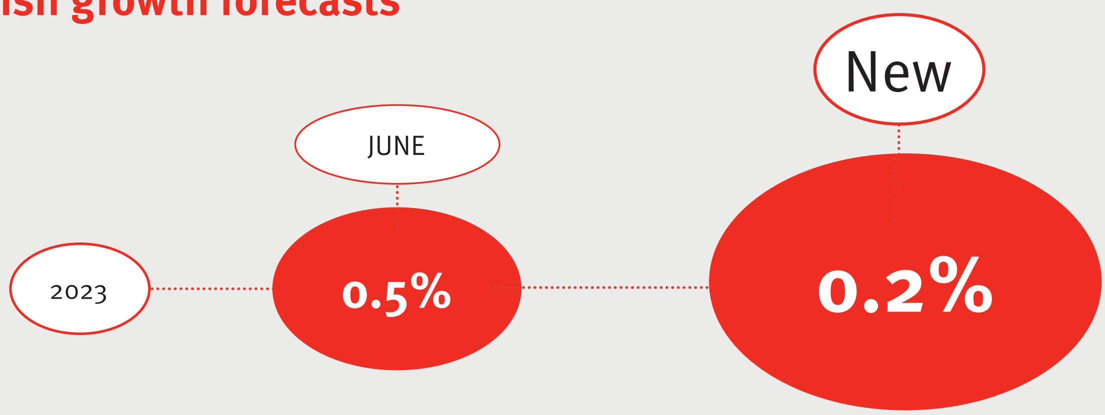
Fraser of Allander Institute

State of the economy

Indicator	% of 2019 Q4	Change on previous quarter	Performance	Latest data
Scottish GDP	99.8%	-0.3%	▼	August 2023
Production	93.3%	-2.1%	▼	
Construction	105.6%	-0.1%	▼	
Services	100.7%	0.0%	-	

Indicator	Level	Change on previous year, same month/ quarter	Trend	Latest data
Inflation (CPI)	--	6.7%		September 2023
Employment rate	75.1%	-0.1pp	▼	
Unemp. rate	4.3%	+1.3pp	▲	
Inactivity rate	21.4%	-0.9pp	▼	

Scottish growth forecasts



	2023	2024	2025
FAI *October 2023*	0.2%	0.7%	1.2%
FAI *June 2023*	0.5%	0.7%	1.2%
FAI *March 2023*	-0.7%	0.9%	1.7%

Outlook and Appraisal

Where are we now?

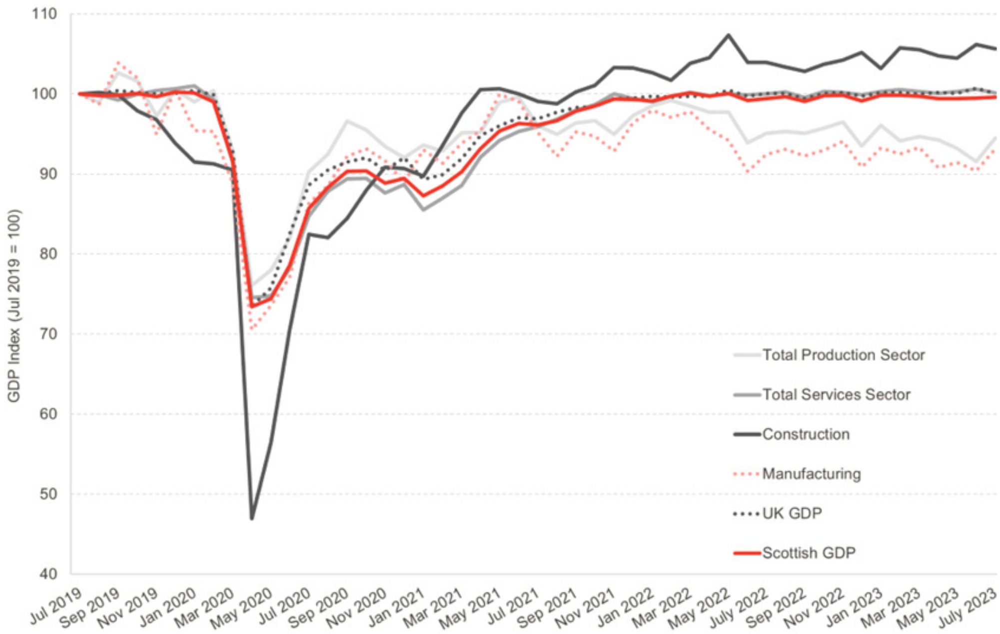
Scotland's GDP increased by 0.1% in July, epitomising the relatively flat growth we have observed across most of the economy since the start of the year.

Although GDP in Scotland is still down relative to 3 months prior, output in the production sector grew by 2.8% in July, largely driven by growth in the manufacturing sector. Meanwhile, in the services sector, aggregate output contracted by 0.4%.

In the 3 months to August, the UK economy as a whole grew by 0.3 percentage points, stronger than the flat growth many had anticipated.

However, the big picture is that the UK economy grew by just 0.4% from the start of 2022 to June – the weakest 18 months of growth since the 1950s.

Chart 1: Scottish and UK GDP growth indices with selected Scottish sectors, July 2019 – July 2023



Source: *Scottish Government, ONS*

In the 12 months to September, consumer price inflation (CPI) rose by 6.7%, down from 6.8% in July – after falling for three consecutive months, it is now holding steady.

Many, however, had anticipated an uptick in inflation after a global surge in energy prices.

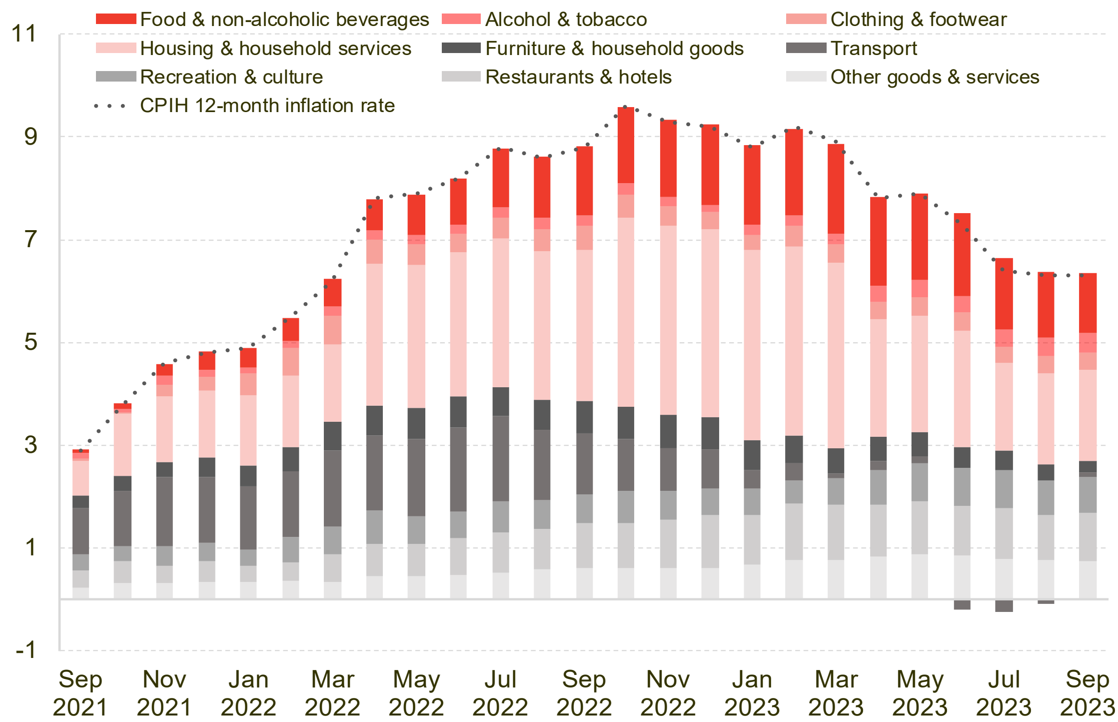
Since June, oil prices have risen by 35% and are on track to reach $100 a barrel for the first time in more than a year, following a series of global production cuts.

The RAC motoring group reported that the increasing cost of oil caused prices of petrol and diesel to shoot up by 7p and 8p, respectively, in August – the fifth and sixth largest monthly rises in 23 years.

While higher prices at the pump have added to inflationary pressures, they were offset by a slowdown in rising food prices and a monthly decline in accommodation costs. In the year to September, food prices increased by 12.2%, down from 13.6% in August and a recent 45-year high of 19.2% in March.

The largest upward contributions to the UK annual CPIH inflation rate continued to come from housing and household services, and food and non-alcoholic beverages, similar to recent months. See Chart 2.

Chart 2: Contributions to the annual CPIH inflation rate, UK, September 2021 – September 2023



Source: *ONS*

It is important to note, however, that a falling inflation rate does not mean prices are coming down, they are simply rising less quickly.

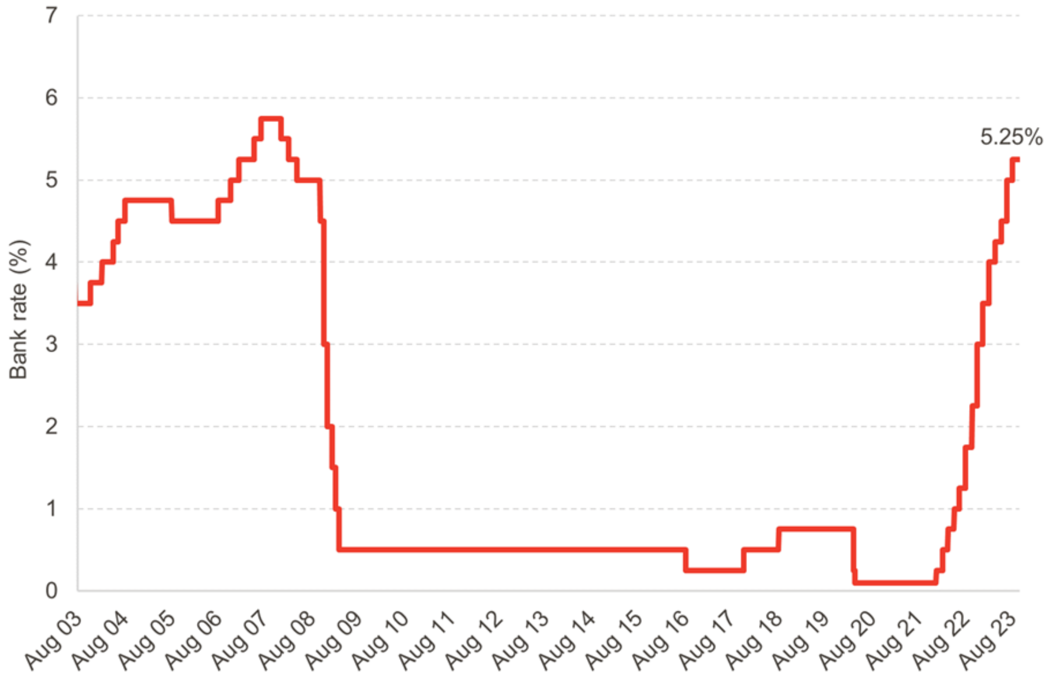
For the Bank of England, bringing persistently high inflation down has been a long battle.

Back in December 2021, the Bank's Monetary Policy Committee started the tightening cycle with 14 consecutive rate rises until September this year when it decided to leave rates unchanged at 5.25%. See Chart 3.

Despite the current pause in rises, the bank rate remains at its highest level in 15 years.

The Committee indicated it wanted to keep rates at the current level for some time to ensure inflation returns to its target of 2%. However, should inflation prove to be more stubborn than the Bank's forecasts, its next move could be upwards.

Chart 3: Bank of England Bank Rate, August 2003 – August 2023



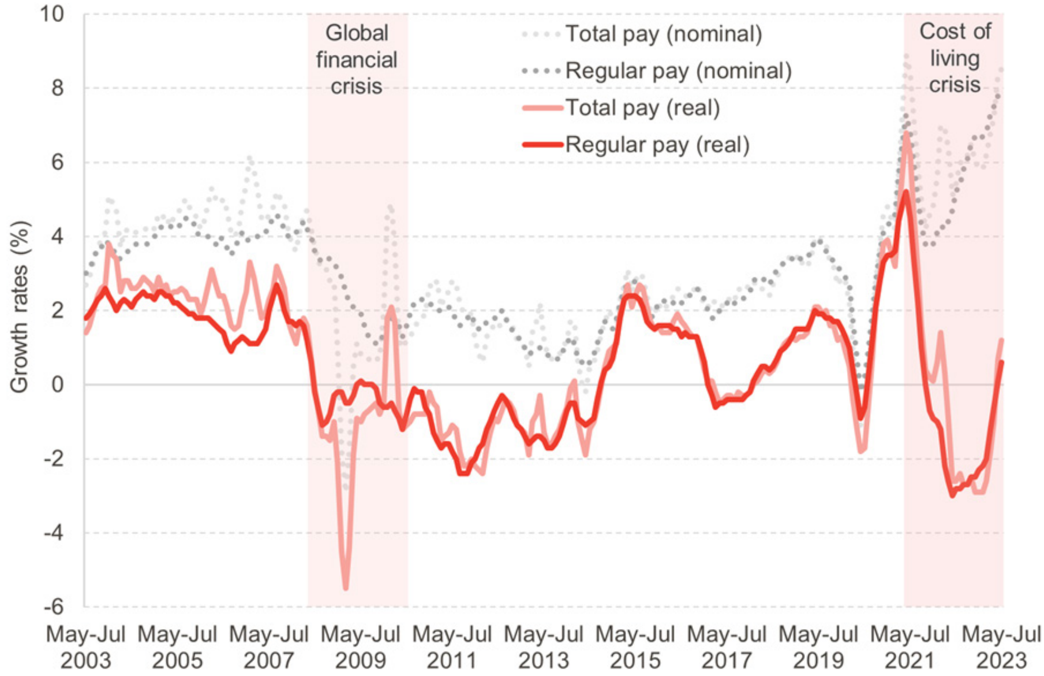
Source: *Bank of England*

In the labour market, despite an increase in unemployment and general slowdown in hiring, wages grew at the fastest pace on record, increasing by 7.8% in the three months to July. See Chart 4.

This means that, for the first time in almost two years, wage growth has caught up with rising prices and the real pay of workers is no longer falling – a development that will relieve households but is likely to reinforce the Bank of England's concerns over inflation.

This is because, for many firms, wage growth accounts for a large proportion of costs, some of which is likely to be passed on to consumers in the form of higher prices.

Chart 4: Average weekly earnings annual growth rates in Great Britain, seasonally adjusted, May to July 2003 – May to July 2023



Source: ONS

Findings from our latest Scottish Business Monitor highlight this as a pressing concern for firms.

When asked to consider key future cost drivers, Scottish firms expect all cost pressures to lessen, with the exception of wages; just under two thirds of firms expect wages to push costs upward over the next six months. See Chart 5.

Moreover, more than 8 in 10 businesses have seen their costs increase in the past year, with over two thirds of firms absorbing these costs to avoid passing them on to consumers.

This quarter, however, many firms reported that absorbing costs is unsustainable: 1 in 2 businesses surveyed are either unsure how much longer or simply no longer able to absorb costs, while just over a third expect to only be able to absorb costs for another year.

Under pressure to preserve margins but fearing customers will flee, some businesses have turned to sneaky strategies such as “shrinkflation” where manufacturers reduce pack sizes rather than raise prices; the logic being that consumers are less likely to notice it than its alternative, higher prices.

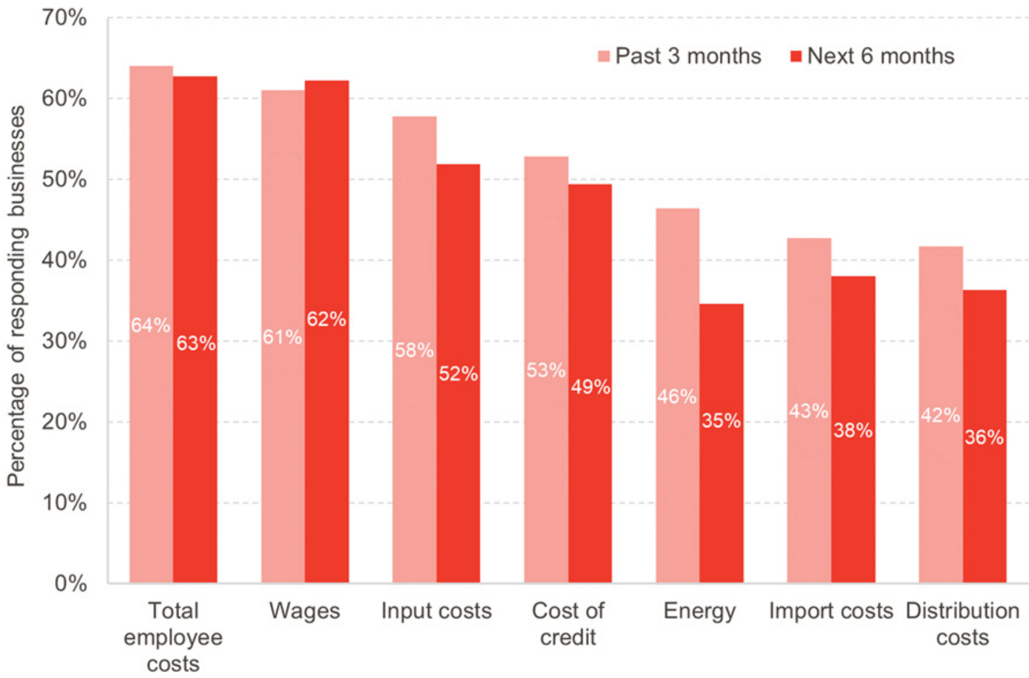
The phenomenon does not start and stop with packaged goods, however. Firms in the hospitality sector who were hit the hardest during the pandemic are also practising cost-shifting strategies by providing less for the same price or tacking on new fees.

During the pandemic, insolvency numbers were kept low as financial support from government and temporary legal restrictions on credit action alleviated pressure on businesses, helping them to restructure and avoid entering administration.

Over the past year, however, as costs soared, pandemic-related support came to an end and the economic recovery lost momentum, insolvencies have surged.

Between Q2 of 2022 and 2023, corporate insolvencies in England and Wales increased by 13% while Scotland saw insolvencies rise by almost a fifth.

Chart 5: Main cost drivers for Scottish businesses over the past quarter and the next six months, Q2 2023



Source: *FAI Scottish Business Monitor*

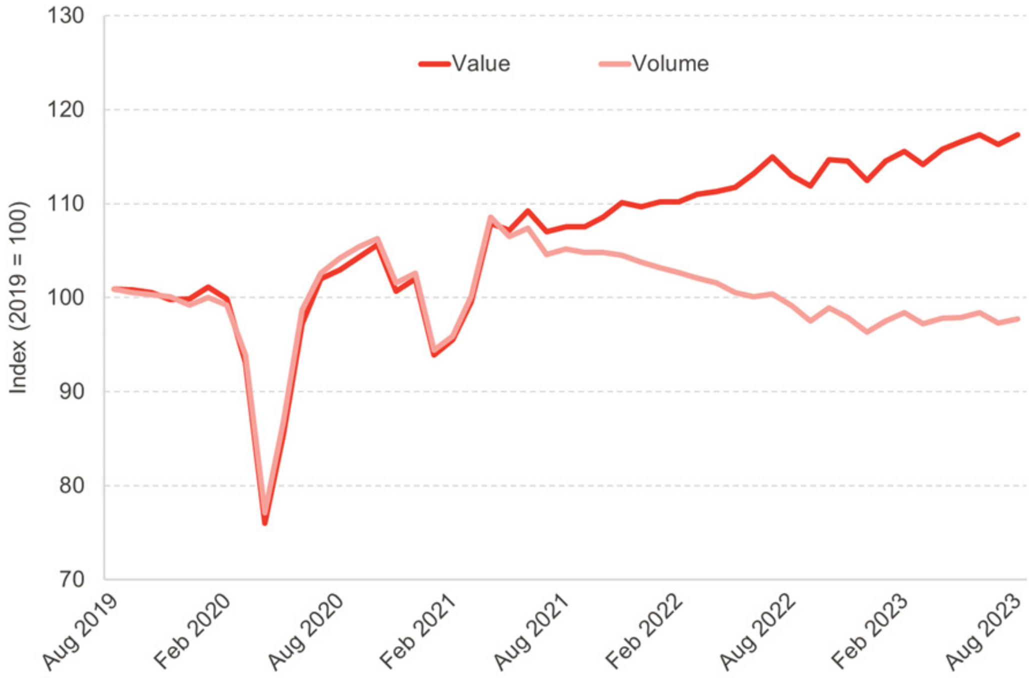
A further concern is that as debt comes due, firms still in need of cash will need to refinance into a higher-rate environment, which in turn, could cause bankruptcies and defaults to accelerate.

In August, the retailer Wilko was announced as the latest casualty, with all 400-plus of its stores set to close and more than 12,000 jobs at risk across the UK; its demise will deal a further blow to the hollowed-out high streets.

When compared with pre-pandemic levels in February 2020, the volume of retail sales was down 1.5 percentage points in August, despite the fact shoppers spent 17.3% more.

The growing divergence between value and volume of sales reflects the significant erosion of consumer purchasing power. See Chart 6.

Chart 6: Volume and value of retail sales, seasonally adjusted, Great Britain, August 2019 – August 2023



Source: *ONS*

Feeling the pressure from all angles, the drawn-out cost of living crisis looks far from over for businesses and consumers.

In Scotland, despite consumer sentiment increasing for the second consecutive quarter, it remains weaker than any point prior to the pandemic. See Chart 7.

All indicators remain negative, with the exception of expectations for the Scottish economy. However, after rising sharply over the first three months of 2023, it was the only indicator not to increase over the latest quarter, falling by 0.3 percentage points.

Expectations for household finances remained negative for the 5th consecutive quarter but had improved 5.2-p.p. on the previous quarter.

The current high interest rate environment has exacerbated the debt vulnerability of households across the UK.

Since 2011, fixed rate mortgages have become the lion's share of total mortgages in the UK.

More than 6.7 million homeowners are currently on fixed-rate deals – most commonly for two or five years – and protected from rising rates. As contracts expire, however, these households will likely face significantly steeper repayment costs.

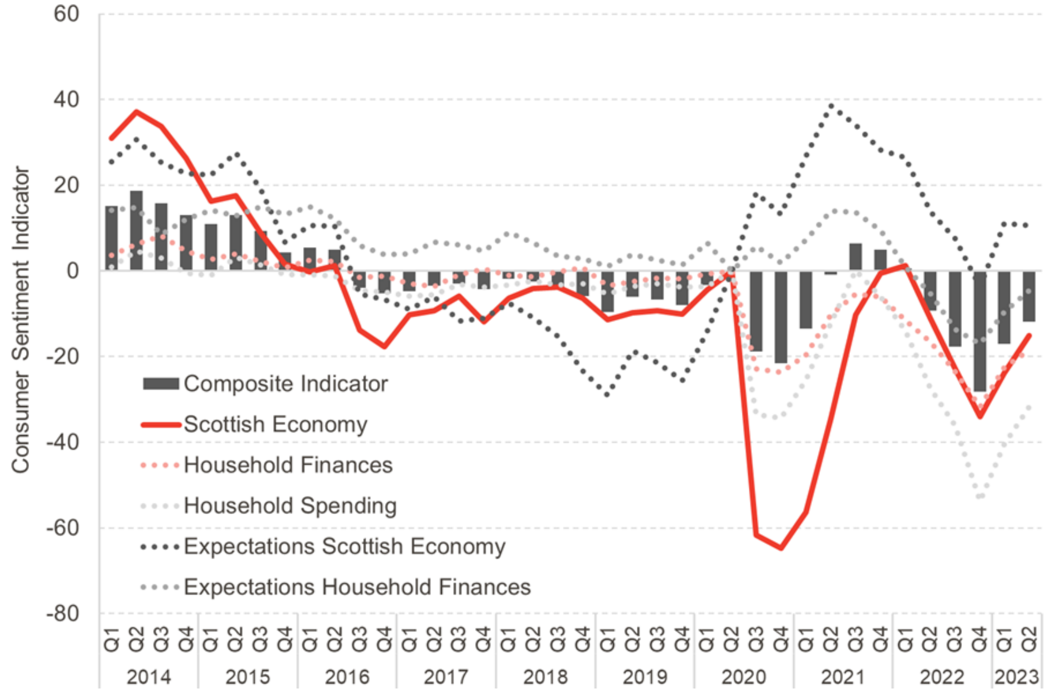
By the end of 2023, around 3 million households will face immediate increases. The Bank of England reports that for these households, average mortgage interest costs have soared from 2% last year to around 6.5% at present as a consequence of recent interest rate hikes.

Therefore, as an example, a household borrowing £300,000 on a 25-year mortgage would now face a 50% rise in monthly repayments, from £1,200 to £1,800.

The challenge is that monetary policy operates with long lags, meaning that the full effect of higher borrowing costs will unlikely be seen for quite some time. This can be seen in Chart 8.

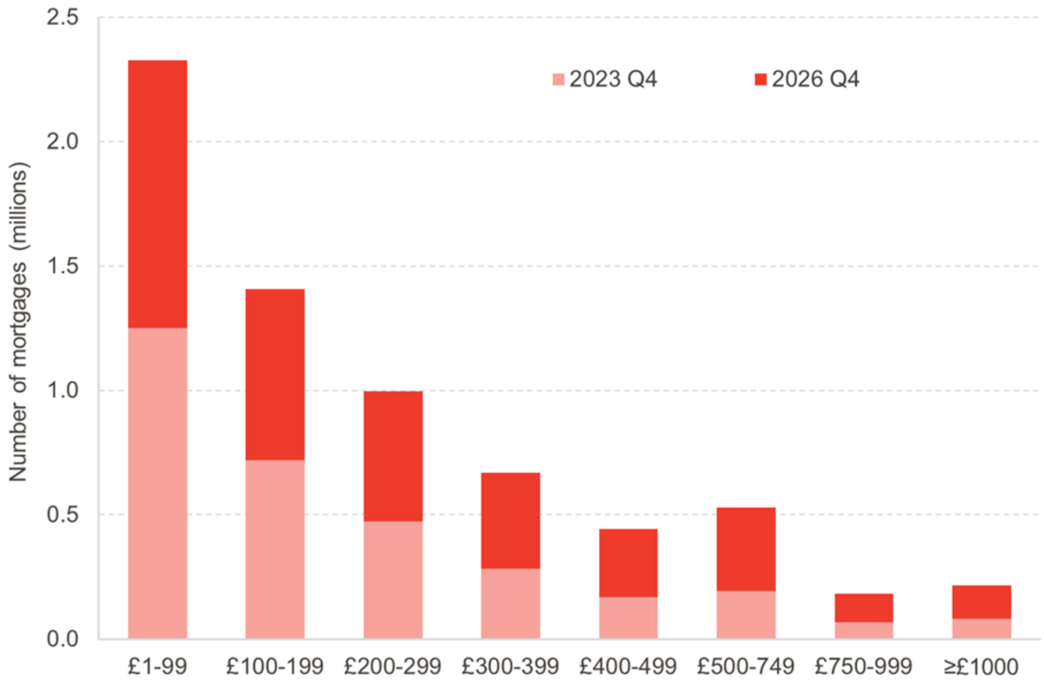
Over the next 3 years, the payments of more than 2 million borrowers are likely to rise by over £300 a month. The longer interest rates remain elevated, the deeper the stresses are likely to become.

Chart 7: Scottish Consumer Sentiment Indicator, Q1 2014 – Q2 2023



Source: *Scottish Government*

Chart 8: Number of owner-occupier mortgages which will experience increases in monthly mortgage costs, by amount of monthly increase, Q4 2023 and Q4 2026



Source: *Bank of England*

Global economy

Following recent upward revisions to UK GDP data by the ONS, the economic recovery of the UK from the pandemic was stronger than previously thought.

In the three months to June this year, UK GDP was 1.8% higher – up 0.2 percentage points following revisions – compared to the pre-pandemic level of Q4 2019.

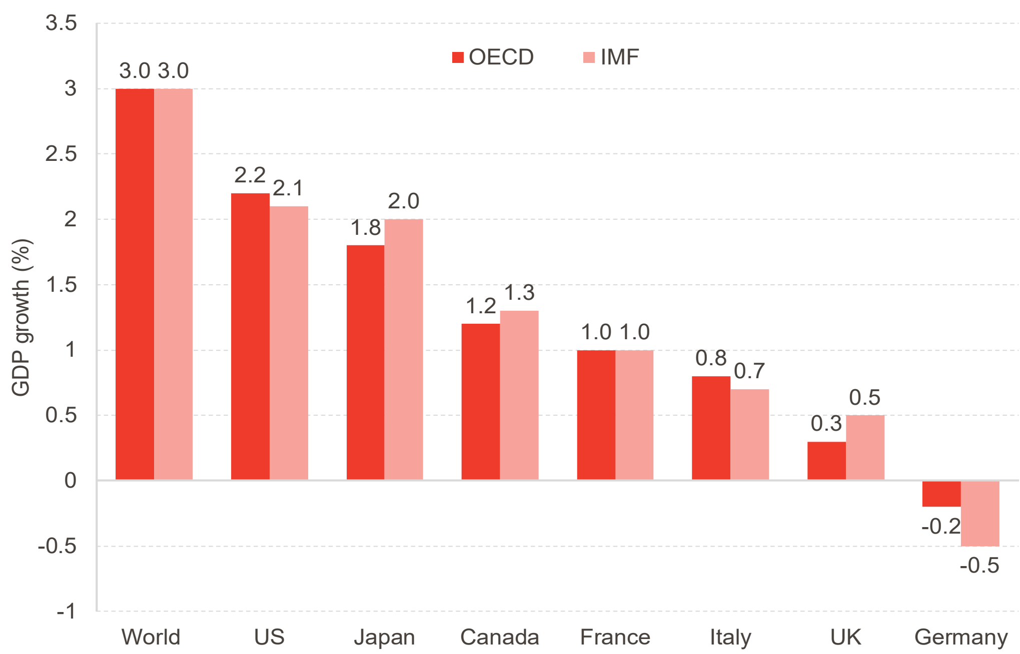
As a result, when compared to other G7 economies, the UK is no longer at the back of the pack; GDP in France was up by 1.7%, while Germany was only 0.2% higher.

Forecasts for the world economy from the OECD and IMF show that while global growth in the first half of this year was more resilient than anticipated, the recovery remains weak by historical standards.

Of advanced economies, both forecast that only Germany will see a contraction in 2023, with all countries returning to growth in 2024.

Meanwhile in the UK, growth is expected to remain low, between 0.3 and 0.4 per cent; however, low growth is still growth and better than a recession. See Chart 9.

Chart 9: OECD and IMF real GDP growth 2023 forecasts, G7 and the Eurozone



Source: *OECD and IMF*

Growth in most advanced economies will continue to be held back as the efforts of Central Banks to tackle inflation through policy rate rises are taking effect.

Despite this, inflation remains high across the majority of Europe and the US.

OECD forecasts, however, show the UK rate of inflation falling below that of the Euro Area and the OECD average rate at the start of 2024 for the first time since 2021.

Global inflation rates in most G20 economies have fallen faster than expected, with the exception of Japan.

For 2023 and 2024, average G20 inflation is now projected at 6% and 4.8%, down from 7.8% in 2022 – but still above central bank targets in most countries.

While headline inflation is declining, persistent core inflation remains in many economies.

For the G20 advanced economies, annual average core inflation in 2023 is expected to be 4.3%, slightly higher than in 2022. However, it is projected to recede to 2.8% in 2024 as cost pressures subside and profit margins stabilise.

How are businesses faring?

Businesses continue to face a difficult environment, although there are some positive signs.

Although the cost of inputs for manufacturing is up 35% from two years ago, it has fallen slightly in the latest data. If that continues, inflationary pressures on the manufacturing sector might ease.

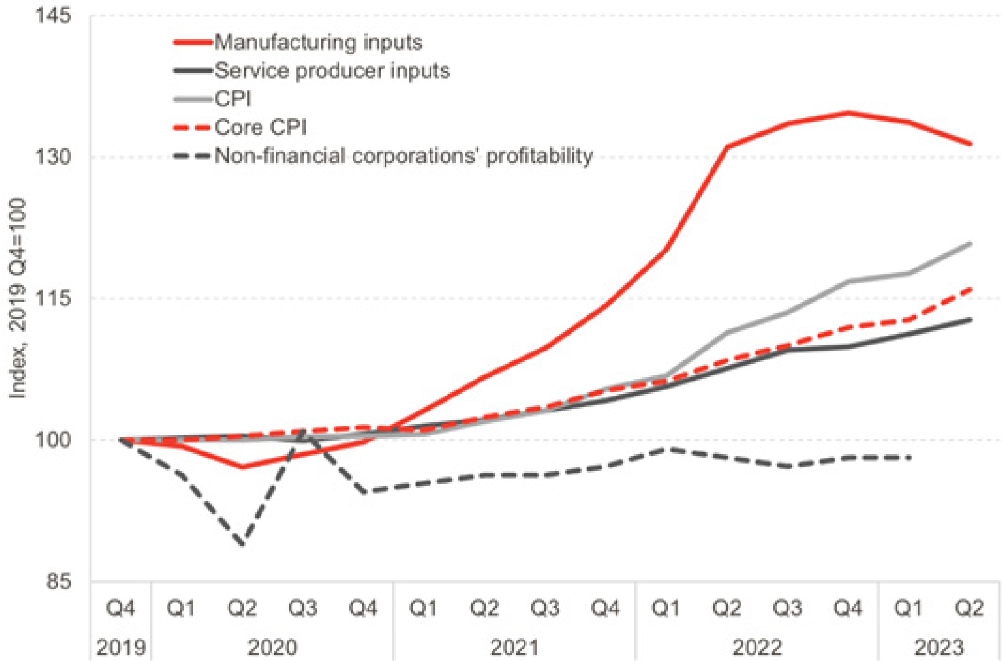
Private sector pay growth — one of the main indicators of inflationary pressures in the services sector — continues to be strong according to average weekly earnings data, although the Bank of England noted recently that it sees other indicators as pointing to a more stable path.

With inflation still running over 6%, there continues to be some focus on whether the increases in prices faced by consumers reflect genuine increases in input costs, or whether firms are increasing prices over and above them to increase their profitability – a process that has been termed as 'greedflation' in the media.

But, how would we be able to tell if that were the case?

If firms really are increasing prices by more than they have to in order to keep rates of return, and are therefore profiting from the inflationary pressures, two things should come through in the data: consumer prices should be increasing by more than input prices, and their profitability should be increasing.

Chart 10: Inputs, Consumer Price and Profitability Indexes, Q4 2019 – Q2 2023



***Source:** ONS, FAI calculations*

There does not appear to be strong evidence in the latest data of prices increasing consistently ahead of inputs. Manufacturing input prices increased much stronger than general consumer prices. Services producer input prices, for their part, have increased pretty much in line with core inflation (which excludes the more volatile energy and food categories).

This is also reflected in the data available so far from the ONS on profitability, although this is more lagged than other indicators. The average rate of return for non-financial corporations has recovered slightly from the depths of the pandemic but was little changed since pre-Covid times until Q1 of 2023.

This is consistent with research published by the Bank of England, which finds little evidence of excess profits at an aggregate level for the UK in response to the 2021-22 energy price shock. In fact, the Bank's researchers found a decline in earnings above all production costs throughout 2022, which is consistent with the ONS data plotted above.

Despite this, there have been differences in responses across sectors and across types of firms: more concentrated sectors have seen profits increase relative to the average, whereas more competitive ones have seen margins fall. This is not particularly surprising and reflects market power more than any other factors.

The latest consumer price inflation shows a deceleration in price increases and the Bank of England has decided to hold interest rates steady. With manufacturing input prices falling in recent quarters – largely reflecting falls in energy prices – it seems likely that we will continue to see CPI inflation falling as firms no longer need to increase prices by as much to cover rises in their inputs.

The main question mark is on the services side, as different indicators of wage growth – one of the most important determinants of services inflation – currently provide an inconsistent picture of whether there is a lot of pressure on the labour market.

The Scottish Hospitality Sector

Hospitality is an integral part of Scotland's economy, but recent events such as Covid, Brexit and the cost-of-living crisis have challenged the sustainability of the sector.

The Fraser of Allander Institute has been working with employers and employees in the hospitality sector since 2022 as part of a three-year project called Serving the Future. The goal of this research is to unpick the complexities of the industry to improve sustainability for both business owners and workers.

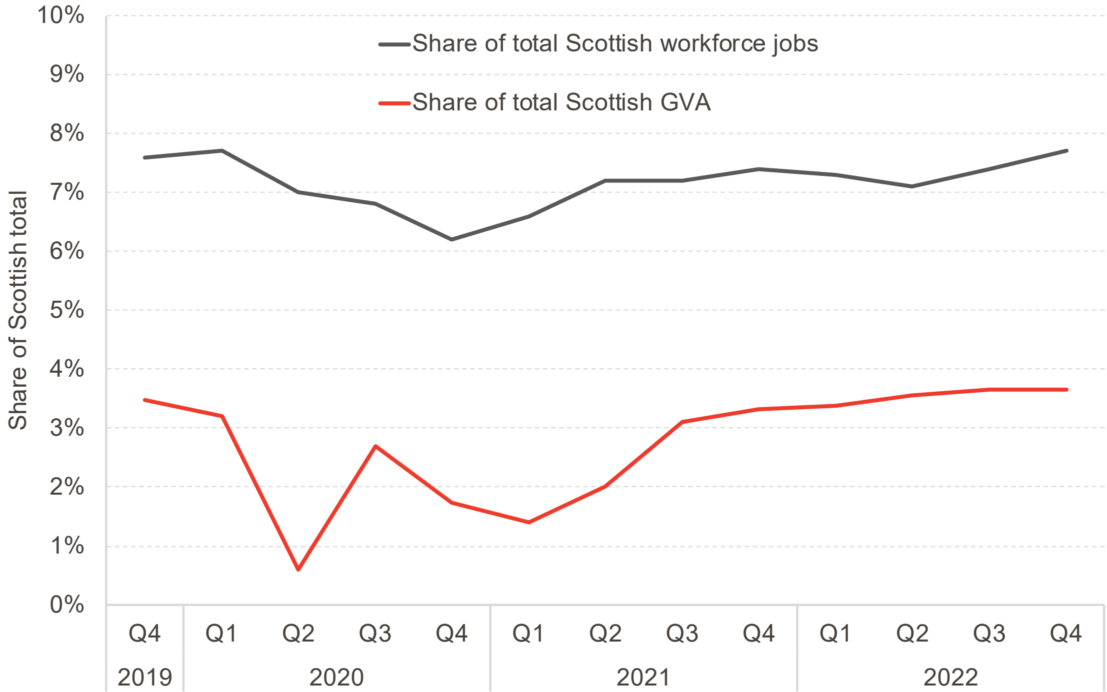
In this section, we share some of our findings alongside national statistics to provide an overview of the sector's economic outlook, and the critical issues identified so far.

Industry Overview

Hospitality and the visitor experience industry are important sectors of Scotland's economy, especially in rural areas where tourism is a large source of income. Pre-pandemic, food and accommodation services accounted for approximately 4% of Scotland's GVA and 8% of Scotland's jobs. In 2022, the sector rebounded to these pre-pandemic figures.

The hospitality sector suffered significantly and was hit disproportionately harder than the rest of the economy by the Covid-19 pandemic. While the sector's contribution to the economy largely recovered to pre-pandemic levels in Spring 2022, employment levels have been slower to recover.

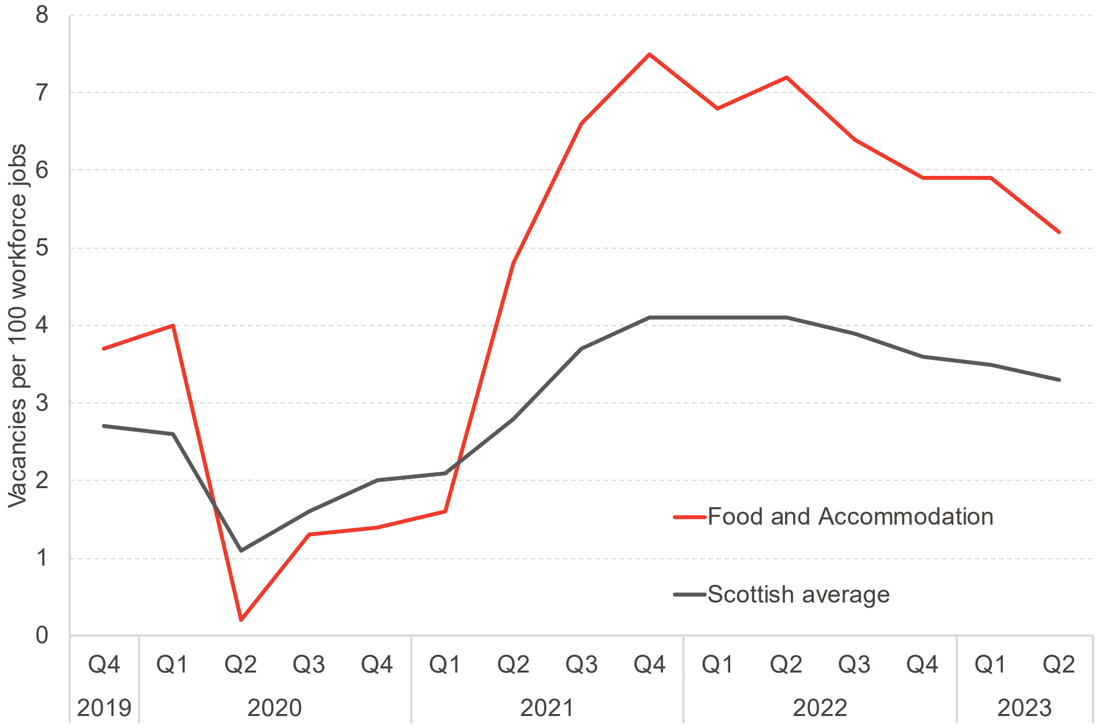
Chart 11: GVA and workforce jobs in the Food and Accommodation Services sector, share of Scottish total, Q4 2019 - Q4 2022



Source: *Scottish Government, ONS*

Across the UK, vacancies in the hospitality industry spiked during 2021 to roughly twice their pre-pandemic rate. The number of vacancies has since fallen but remains above pre-pandemic levels. Pay in this sector is around a third lower than the Scottish average, although recent pay growth has kept pace with other jobs across the Scottish economy. There is no sign that low pay is becoming less of an issue, despite labour shortages.

Chart 12: Vacancies per 100 workforce jobs, Q4 2019 - Q2 2023



Source: ONS

The Outlook for Hospitality Businesses and their Workforce

Hospitality employers in our research described the post-Brexit, post-Covid, and cost-of-living crisis business environment as the most challenging time they have ever faced.

These economic challenges have compounded ongoing problems with recruitment, pay and training, leading to difficulties for both employers and workers.

This finding seems to be consistent with wider trends in the industry, with the latest Employer Survey from the Scottish Tourism Alliance reporting that 50% of businesses are still in 'survival' or 'consolidation' mode.

1. Recruitment

While GVA in the Hospitality sector has now recovered to pre-Covid levels, vacancies are still high. Employers in our research highlighted that recruitment remains highly competitive, compounded by increased restrictions on recruiting staff from the EU. Some employers also reported that competitive recruitment has also contributed to issues with retention and turnover for some employers.

As high vacancy rates persist, the consequences for those we spoke to already working in the sector have become more pronounced. Unfilled vacancies mean short-staffed workplaces, which can lead to busier shifts, burnout and stress, as well as a worsening work life balance for staff, especially for parents trying to balance work with their caring roles. The latest data suggests that 45,000 households with children in Scotland had at least one adult working in hospitality.

2. Pay

Despite high vacancy rates, pay in the sector has not risen relative to other industries. In 2022, the sector had the highest percentage of workers earning below the real living wage. Employers spoke to us about constraints such as unpredictable cash flow, large increases in prices for other inputs and competition as factors that prevent movement on pay.

The employees we spoke to continue to be negatively impacted by low pay. Precarious hours, last-minute shift changes, and unreliable income from tips also contributed to financial insecurity among those interviewed. Employees felt that wage and contract security were critical to improving working conditions.

3. Training and Devleopment

Training and development are an ongoing struggle for the hospitality industry, where skills gaps tend to be higher than in any other industries. With high stress, high employee turnover, and high vacancy rates common in the hospitality industry, managers find it difficult to allocate enough time to training and developing staff. Hospitality workers, surprisingly, have higher levels of post-secondary education compared to workers in similar occupations across other industries, indicating a mismatch between education levels and required skills for these workers. While relevant training exists, it can be difficult for workers and employers alike to navigate the education system, and difficult to access for many workers, especially in rural areas.

Employees in the hospitality industry discussed their struggles with a lack of consistency in management or clear lines of progression. These struggles were especially pronounced for women with caring responsibilities, who may not be able to manage longer and fluctuating hours that come with progression opportunities. Employees we spoke to also felt that limited increases in pay for more senior positions in the sector made progression less attractive.

What Next?

Our research underscores that there are employers committed to enhancing conditions for their workers, but factors outside of their control require action from the government. We heard that public services are not adequate for hospitality workers. In particular, access to affordable childcare and transport outside traditional working hours would greatly improve the experience of low-paid employees.

Employers voiced the need for meaningful dialogue between business and government to create sustainable solutions to the problems of recruitment, pay and training.

Business Investment

Since the Great Recession, the UK's productivity performance has been poor, both when we compare our rates of growth to pre-crisis levels and when we compare ourselves to similar countries on the international stage.

Scotland performs worse than the UK on a number of productivity measures, including business investment, business R&D, and exports as a percentage of GDP. The 2022-2023 Scottish Productivity Index showed that Scotland lags behind the UK and comparable countries in 8 of the 13 productivity indicators for which comparable data is available. However, it is worth noting that London and the South East typically prop up the UK's estimates on several productivity measures.

Over the past 20 years, business investment has typically made up the majority of total domestic investment therefore, this analysis focuses on the challenges surrounding the contribution of businesses to Scotland's productivity through investment, drawing on findings from our Scottish Business Monitor (SBM).

It is worth mentioning that business investment is not the silver bullet needed to change the trajectory of Scotland's productivity performance.

As outlined in the annual Scottish Productivity Index, there are a number of wider measures of productivity. The health of our workforce, our infrastructure and digital connectivity, all contribute to Scotland's productive capacity. Scotland has outperformed the rest of the UK and many comparable countries internationally on education measures for a number of years, yet our productivity puzzle remains unsolved. Therefore, we must not lose sight of the mixed bag of productivity drivers that need attention.

Nevertheless, investment plays an important role in driving Scotland's productivity therefore, this analysis evaluates the outlook for capital and broader business investment in Scotland over the next couple of years, highlighting some challenges in an already difficult landscape.

Business Investment in Scotland

Since 2014, we have asked Scottish firms in our SBM about their capital investment intentions, and over the past 9 or so years, sentiment around investment has been poor. See Chart 13.

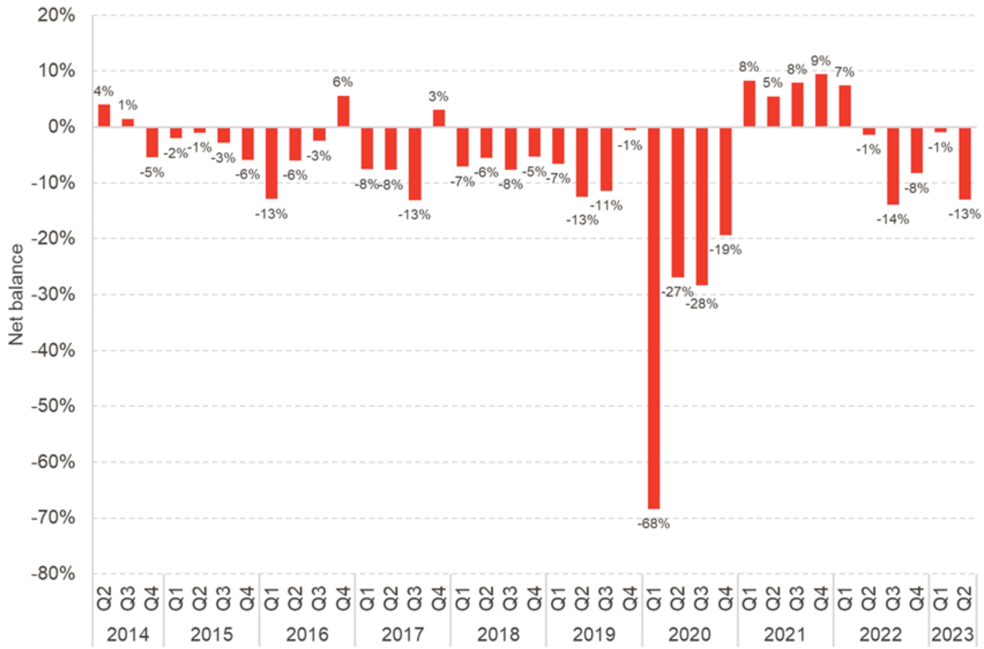
Although there was a short period of optimism following the height of the pandemic, this has since been dampened by the ongoing cost-of-doing-business crisis.

In the latest quarter, the net balance[1] of firms reporting an expected increase in new capital investment over the next 6 months stood at -13%.

This is particularly concerning when we look at the performance of Scotland relative to the UK and international comparators because Scotland has been lagging behind for quite some time, and it looks like this is set to continue.

1 Net balance in this context is defined as the share of firms reporting higher expected capital investment minus the share of firms reporting lower expected capital investment.

Chart 13: Net balance of firms expecting an increase in new capital investment over the next 6 months, Q2 2014 – Q2 2023



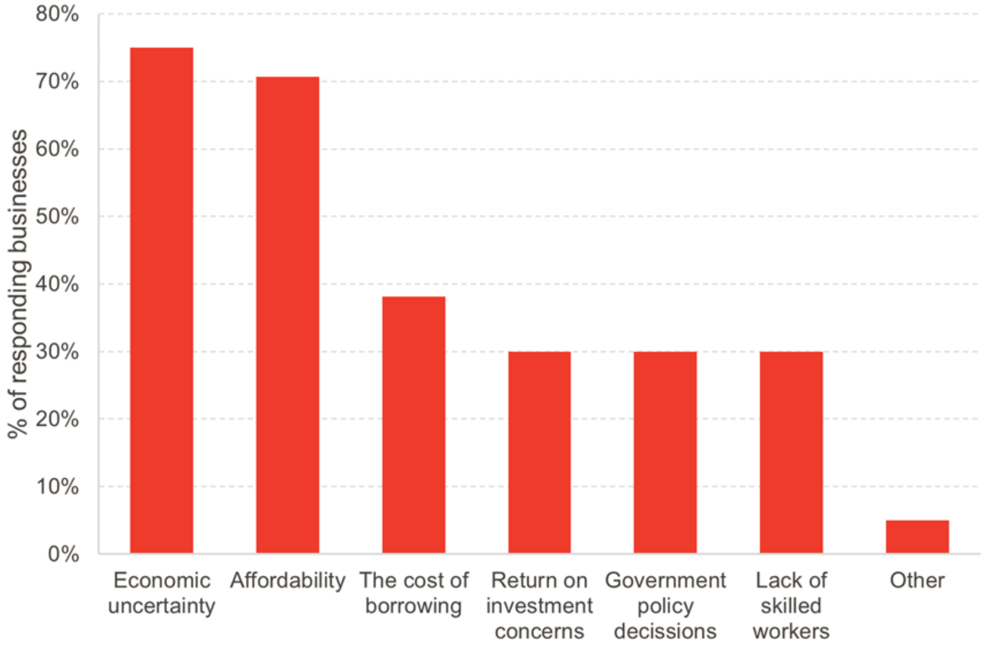
Source: *Scottish Business Monitor*

Our latest SBM for Q2 2023 has provided further insight into Scottish firms' planned business investment, including concerningly high rates of investment delays and cancellations.

2 in 5 businesses surveyed have reported cancelled or delayed investments over the past 12 months, with 14% reporting cancellations and 25% reporting delays. Most delayed or cancelled investments were in physical assets (73%), followed by workforce (36%) and environmental initiatives (26%).

Chart 14 highlights the reasons businesses cited for cancellation or delay of investment. The most common were economic uncertainty (75%), affordability (71%), and the cost of borrowing (38%). Of those businesses delaying investment, 13% of firms anticipate initiating investment in 2023, 37% in 2024, 27% in 2025 or beyond, and 22% are unsure.

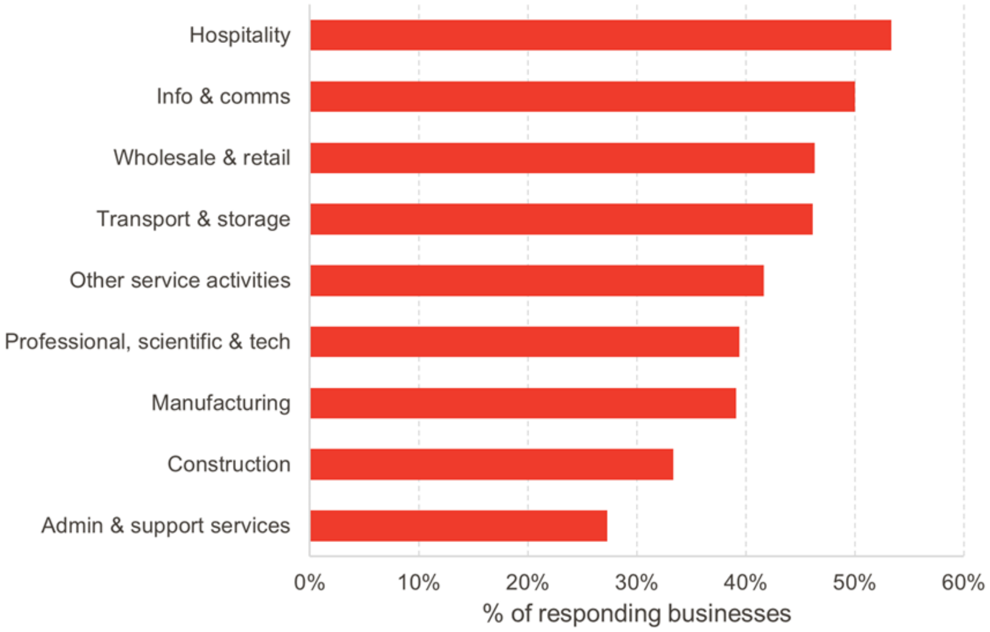
Chart 14: Decisons for business delays or cancellations, Q2 2023



Source: *Scottish Business Monitor*

We also examined business investment decisions by sector (Chart 15). While firms across all sectors reported cancelling or delaying planned business investment, more than half of firms surveyed in the hospitality sector reported cancelling or delaying investment (53%). Firms in the info and comms and wholesale and retail sector also had high rates of cancelled or delayed investment; 50% and 46%, respectively.

Chart 15: Business investment delays and cancellations by sector, Q2 2023



Note: The sample size is low (N<15) for the transport and storage and other service activities sectors, so caution should be taken when interpreting these results.

Source: *Scottish Business Monitor*

Across the majority of sectors, most delayed or cancelled investments were in physical assets. This was highest for the hospitality sector (88%) and wholesale and retail sector (84%).

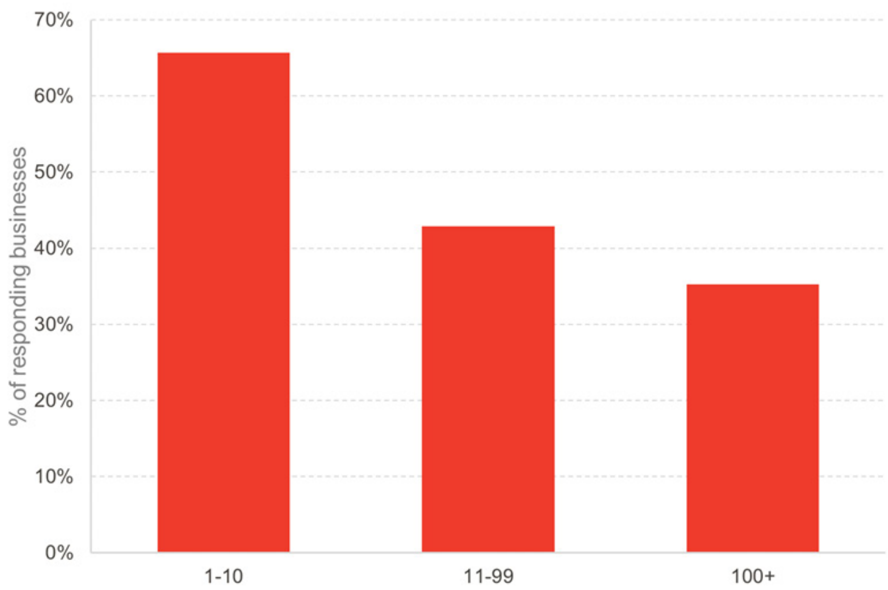
Economic uncertainty and affordability were the most cited reasons for investment delays or cancellations across the majority of sectors. Economic uncertainty was cited by 88% of professional services firms surveyed, 81% of hospitality firms and 71% of wholesale and retail firms. Affordability was cited by 94% of hospitality firms, followed by 74% of wholesale and retail firms and 72% of manufacturing firms.

We also examined how responses changed with firm size. Larger firms (100+ employees) were less likely to report cancelling or delaying investment (41%), compared to 46% of small firms (1-10 employees) and medium firms (11-99 employees). However, larger firms were more likely to report cancelled or delayed investment in physical assets (90%) than small (63%) and medium firms (76%).

Smaller firms were more likely to cite affordability as the reason for cancelling or delaying investment: 73% of small firms and 75% of medium firms, compared to 52% of firms with 100+ employees. However, larger firms were more likely to cite economic uncertainty: 81% of large firms, compared to 77% of small firms and 71% of medium firms. Smaller firms were also more likely to cite the cost of borrowing, return on investment and lack of skilled workers than larger firms.

Smaller firms were also more likely to report that they were unsure of when they would initiate delayed investment or that they planned to initiate delayed investment in 2025 or beyond. See Chart 16.

Chart 16: Businesses, by firm size, that are either unsure when they will initiate delayed investment, or anticipate initiating delayed investment in 2025 or beyond



Source: *Scottish Business Monitor*

Conclusions

The Scottish Government has a target to reach the top quartile of productivity among OECD countries however, in over two decades, we have seen little to no change.

Business investment plays an important role in driving productivity however, Scotland's business investment performance has been lagging behind the UK and international comparators for some time. Over the past decade, sentiment around capital investment has also been extremely poor, and despite a slight uptick in optimism following the height of the pandemic, the ongoing cost-of-doing-business crisis has put intentions firmly in the red.

Over the past year, 40% of firms across all sectors have delayed or cancelled investments due to, for the most part, the cost of borrowing, affordability, and economic uncertainty, with smaller firms' investment decisions particularly hindered by financial constraints and higher credit payments.

Our analysis also finds that half of the firms that have delayed/cancelled investments over the past 12 months are either unsure when they will initiate them, or they are not planning to until 2025 or beyond.

Scotland's economic growth and productivity story has been challenging for 15 years now, and business investment can play a key role in improving the productive capacity of the economy. However, businesses, particularly small firms, need further support in these challenging and uncertain times otherwise, investments will continue to be delayed or cancelled.

What can we expect from the Autumn Statement?

The Chancellor has now set a date for the Autumn Statement, which will be delivered to the House of Commons on the 22nd of November.

One year on from the mini-budget debacle, this looks like a much more standard fiscal event, both in terms of process – the Office for Budget Responsibility (OBR) has been involved right from the start, and has already published its timetable – and in terms of scope, as all indications point to relatively modest policy decisions.

News ha been on real growth since the pandemic, as the Office for National Statistics (ONS) has revised UK real GDP up by 0.6% in 2020 and 1.6% in 2021. This is a big revision in historical terms, and means that the fall in UK output was less severe during the pandemic than previously thought – and that the recovery from it was quicker too.

This has raised hopes in some quarters that there might be some scope for loosening of fiscal policy, particularly for cutting taxes.

Is it likely that the Chancellor will have much headroom?

Given that nominal GDP – the most important measure for the public finances, as tax and spending are defined in nominal terms – has been revised up by much less than real GDP, the outlook will remain challenging. A large part of the ONS revisions has focused on better metrics for discerning real activity from price increases, and much less on the level of nominal activity as a whole.

While there is an argument that the stronger recovery could lead the OBR to revise its judgment on medium-term productivity growth – which itself would improve the public finances forecast – it seems unlikely it will do so on the basis of this data.

Instead, it seems more probable given tax revenues that the OBR will judge that the economy is less tax rich than previously thought. That is because tax receipts are unchanged (cash in the bank received in years gone by will not change), but with a higher level of GDP, that implies taxes were lower as a share of national income.

Projecting that forward could conceivably reduce the OBR's view of future tax revenues, constraining the Chancellor's options.

The other reason why we might not see much in the way of improvement in the fiscal outlook is that the outlook for the new target year (2028-29) for the Chancellor's main fiscal rule – falling debt excluding the Bank of England as a share of GDP – looks particularly challenging given current policy.

The freeze in the personal allowance and other thresholds for income tax and National Insurance at UK level is due to expire at the end of the 2027-28 financial year, and it is bringing in significant additional revenue through 'fiscal drag' – the process of pushing taxpayers into higher band by holding thresholds fixed in cash terms while earnings continue to grow. With headroom limited already, the Chancellor might have to pencil in further freezes to have any room for manoeuvre.

Finally, the Chancellor's target looks even more challenging to achieve because of the Bank of England's quantitative tightening and its losses on holdings of UK government debt.

For most of the existence of the asset purchase facility, the Treasury was receiving profits from the Bank's unconventional monetary policy. But now that interest rates are much higher, the Bank is making heavy losses on government debt, and the Treasury must indemnify those losses.

This might seem like an obscure and inconsequential part of the public finances, especially given that both institutions are part of the public sector. But given the Chancellor has decided to exclude the Bank of England from his main fiscal target, it means that it has very real consequences – and could be a deciding factor on whether the Treasury can spend any money and still meet its fiscal rules.

HS2 cancelled – does that mean increased headroom, and what could that mean for Scotland?

The Prime Minister announced at the Conservative Party Conference that the Birmingham-Manchester leg of High Speed 2 would be cancelled.

Spending on HS2 was meant to be around £6 billion a year for the next few years, but while the Prime Minister stated any savings would be redirected towards local transport projects, the timing will be crucial to understand its consequences.

Will spending be redirected immediately, or will it be re-profiled until after the end of the forecast period?

If spending were re-profiled so it would not happen until 2029-30, then headroom would be increased by around £6 billion – roughly the estimated cost a 1p cut on the basic rate of income tax levied by the UK government. This is a measure which had been announced by Rishi Sunak as Chancellor for 2024-25 in his March 2022 Budget, only to be brought forward by Kwasi Kwarteng in the mini-budget and subsequently cancelled altogether by Jeremy Hunt. The Chancellor might be tempted to announce this at the Autumn Statement if total headroom allows – especially as delaying it to March could leave him hostage to the economy's fortunes.

What does this all mean for Scotland?

The Barnett consequentials of HS2 are already included in the Scottish Government's capital allocation from the Treasury. If spending does go ahead in other projects, then nothing will change.

But if it does get pushed into later years, there would be a corresponding fall of as much as £500 million in the Scottish capital budget – which itself is already tight over the medium term.

If there were to be a income tax cut by the UK government, this fall would be partially offset through an increase funding for Scotland via lower block grants adjustments, all else equal, though it would still leave the Scottish Government will lower funding than prior to any changes.

What are the other areas to look out for?

On public spending, settlements for departments and devolved administrations – including the Scottish Government – look even tighter than they did back in March as UK and devolved governments have agreed higher pay increases than they had budgeted for with no commensurate increase in their expenditure limits.

University of Strathclyde Business School

Fraser of Allander Institute
University of Strathclyde

The Fraser of Allander Institute (FAI) at the University of Strathclyde entered Scottish public life in 1975. Since then, it has become established as a leading independent economic research institute working with a wide range of clients on a variety of different topics.

What we do

For 45 years, the Fraser of Allander (FAI) has been monitoring and commentating on the Scottish economy. Our regular publications include:

- FAI Economic Commentary – Quarterly – First published in 1975, our quarterly Economic Commentary provides the authoritative independent assessment of economic conditions in Scotland, along with a wide range of economic and policy issues.
- Scottish Business Monitor – Quarterly – Since 1998, the FAI Scottish Business Monitor has been a key leading indicator of the Scottish economy. This survey of Scottish business sentiment provides vital insights into the Scottish economy well in advance of official statistics.
- Scotland's Budget Report – Annual – The Fraser of Allander Institute's analysis of the Scottish Budget and the choices, risks and opportunities facing the Finance Secretary.
- Our blog – Launched in 2016, and viewed over 200,000 times, our FAI blog is a keenly watched discussion platform on the Scottish economy. The blog publishes short reflections on economic developments as well as the policy debate.

Keeping in touch

You can follow our commentary and stay up to date with our latest publications at:

Website: www.strath.ac.uk/fraser/
Blog: fraserofallander.org
Twitter: @Strath_FAI
Linkedin: Fraser of Allander Institute

Fraser of Allander Institute
University of Strathclyde
199 Cathedral Street
Glasgow G4 0QU
Scotland, UK

Telephone: 0141 548 3958
Email: fraser@strath.ac.uk
Website: fraserofallander.org
Follow us on Twitter via @Strath_FAI
Follow us on LinkedIn: FAI LinkedIn