University of Strathclyde Business School

Fraser of Allander Institute
Economic Commentary

Vol 35 No. 1

In association with

pwc

Fraser of Allander economic commentary

June 2011

Vol 35 No 1

ISSN 2046-5378

The Fraser of Allander Economic Commentary was first published in 1975. The new association between PricewaterhouseCoopers and the University of Strathclyde's Business School provides the Fraser of Allander Institute with the support to continue the Commentary, and we gratefully acknowledge this support. The Fraser of Allander Institute is a research unit within the Department of Economics at the University of Strathclyde in Glasgow. The Institute carries out research on the Scottish economy, including the analysis of short-term movements in economic activity. Its researchers have an international reputation in modelling regional economies and in regional development. One-off research projects can be commissioned by private and public sector clients. If you would like further information on the Institute's research or services, please contact the Institute Administrator on 0141 548 3958 or email the Institute at fraser@strath.ac.uk.

The Fraser of Allander Institute was established in 1975 as a result of a donation from the Hugh Fraser Foundation. We gratefully acknowledge the contribution of the Buchanan and Ewing Bequest towards the publication costs of the Commentary.

PwC support the production of the Economic Commentary but have no control of its editorial content, including, in particular, the economic forecasts. PwC produces its own regular review of UK and international economic prospects, the next issue of which will be published on their website:
http://www.pwc.co.uk/eng/publications/uk_economic_outlook.html

Notes to contributors

The editors welcome contributions to the Economic Perspectives section. Material submitted should be of interest to a predominately Scottish readership and written in a style intelligible to a non-specialist audience. Contributions should be submitted to Cliff Lockyer c.j.lockyer@strath.ac.uk

Articles accepted for publication should be supplied electronically and conform to the guidelines available from Isobel Sheppard fraser@strath.ac.uk

If you are interested in receiving copies of press releases and being kept informed of other publications associated with the Commentary please click on the following link: http://www.strath.ac.uk/frasercommentary/registration and complete the registration form.

Fraser of Allander Institute
Department of Economics
University of Strathclyde
Sir William Duncan Building
130 Rottenrow
Glasgow G4 0GE

t: +44 (0) 141 548 3958
f: +44 (0) 141 548 5776
e: fraser@strath.ac.uk
w: http://www.strath.ac.uk/fraser/

Outlook and appraisal

Overview

The recovery continues to be weak in both Scotland and the UK. Our view of the performance of the economy has been distorted by the effects of the bad weather on production in December last year. However, once an allowance is made for weather effects it still looks as if GDP growth was stagnant over the last 6 months to the first quarter 2011. There are mixed messages on whether stagnation is continuing or whether the recovery has resumed again. It seems likely that the economy is still continuing to recover but at a fairly weak rate. Almost three years after the start of the recession the Scottish economy has only recovered about a quarter of the output lost, while the UK economy has recovered a third of lost output. These data support the evidence-based view that recovery from financially sourced recessions, particularly banking crises, are slow and painful. Exports are recovering slowly and business investment is fairly static with firms sitting on large piles of cash but unwilling to invest due to the uncertainty. So, the evidence seems to be moving in favour of those advocating a "Plan B" for the UK authorities to take some action to stimulate demand, it needs to be understood that while buttressing demand might be a necessary condition for a more rapid recovery it is not sufficient. We must be sure that our banking system is fit for purpose, able to freely lend to support the needs of the economy. It is not clear that we have presently reached that point. It is to be hoped that the final recommendations of the Independent Commission on Banking meet this requirement and that the proposals are adopted by the government.

Significant uncertainties cloud the prospects for future growth:

- contagion in the eurozone debt crisis as the fears of default on sovereign debt spreads from Greece to Spain and perhaps other peripheral eurozone countries, risks damaging bank lending, market and business confidence;

- fears of a slowdown in the growth of the Chinese economy as consumer price inflation takes hold;

- continuing uncertainty on the effects of the "Arab spring" with implications for oil prices and trade;

- the continuing weakness of the US economy and its effect on world trade;

- household expenditure is likely to continue to remain weak due to the continuing fiscal consolidation and the squeeze on real disposable incomes from the current high level of energy prices;

- consumer price inflation is above target and is likely to remain so for some time, household disposable incomes are being squeezed as a result. All of which runs the risk of a rise in inflationary expectations and strengthened wage claims, but there is little sign that this is happening with the demand for labour still relatively weak and earnings growth remaining at around 2% p.a.

Against this background we are forecasting that growth of GDP will be somewhat weaker in 2011 at 0.8%, than our forecast of 1% growth in March. Our forecasts remain below the OBR and consensus forecasts for the UK in 2011, 2012 and 2013, which largely reflects the weaker growth of household spending in Scotland and a sluggish outlook for private sector investment. Next year, we are forecasting growth of 1.5%, 0.1% points less than our March forecast, and an unchanged forecast of 1.9% for 2013. We expect that production and manufacturing output will continue to pick up reasonably strongly, but at a slightly lesser rate than in our previous forecast with production growing at 3.6% in 2012 compared to 4% in our March forecast. The service sector is forecast to continue on its weak growth path growing by 0.5% this year, 1.1% in 2012 and 1.3% in 2013, largely due to the weakness in the growth of household expenditure. Construction also continues to exhibit weak growth of 0.5% in 2011, 0.9% in 2012, and 1.1% in 2013, reflecting cut-backs in government capital spending and weak private sector investment.

We continue to expect net employment growth during this year and over the forecast horizon. Net jobs grow by 0.9% in 2011, 0.8% in 2012 and 1.7% in 2010. By 2013 total employee jobs are forecast to be 2,373,000, around 60,000 fewer than in 2007 but up by 80,000 from the end of 2010. By sector, the largest percentage growth in job numbers is forecast for the production sectors, but the greatest number of jobs created will still be in services, despite the low forecast for output growth, due to the sheer scale of the sector.

Even though growth in output picks up it will not be sufficient to prevent some pickup in unemployment. Unemployment in Scotland this year is therefore forecast to rise to 8.3%, or 217,000 by the end of the year and be largely stable through 2012 with a slight further rise to 220,000 by the year end. After that, the rate should fall to 8.2% by end 2013. However, as previous quarters have demonstrated there is considerable uncertainty around the unemployment forecast.

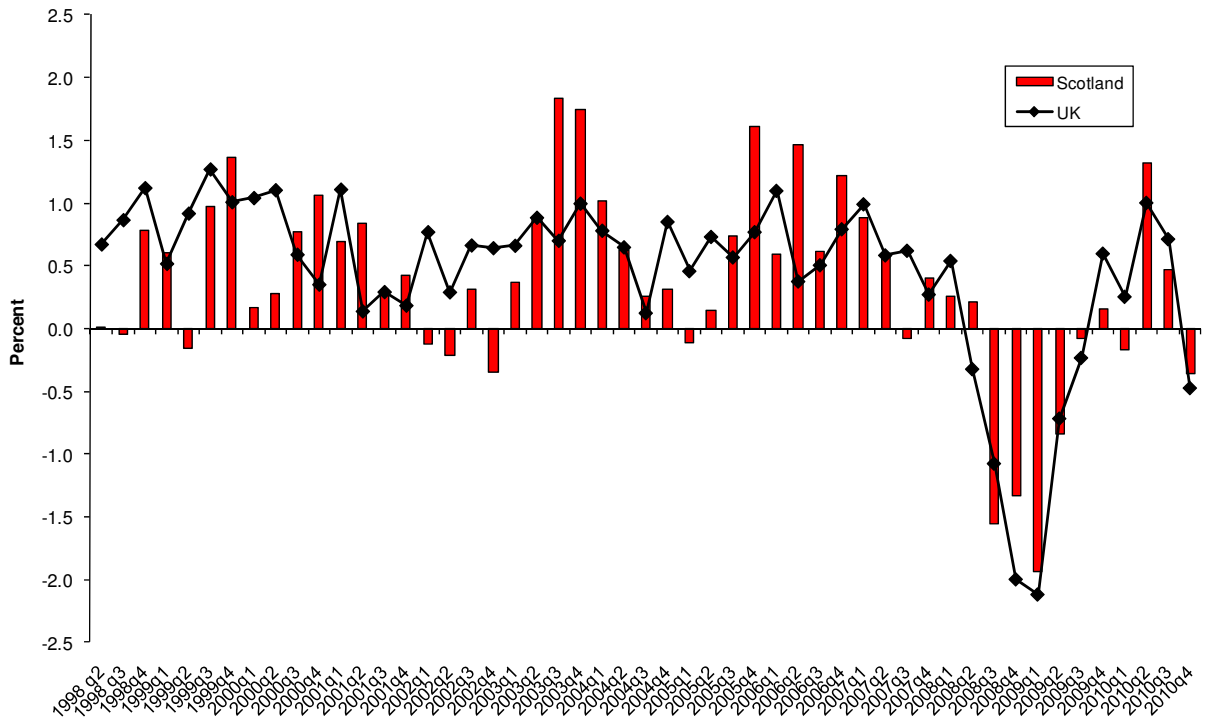
We also revisit the issue of the longer-term performance of the Scottish economy. We note the recent evidence of the rise in Scottish GDP per head relative to the UK during most of the last decade, which comes from UK Regional Accounts data published in December. Further analysis leads us to conclude that the evidence of an appreciably higher Scottish GDP per head relative to the UK by the end of the first decade of the new millennium is the result of both the differential effects of large cyclical movements and slower population growth on the relative. It does not appear to be explained by an improvement in Scotland's relative competitiveness, or underlying economic performance.

Recent GDP performance

The Scottish Government GDP data for the fourth quarter 2010 - released on 20th April - indicate that the Scottish economy suffered a marked decline in output, although a little less severe than the UK as a whole. Scottish GDP contracted by -0.4% while UK GDP fell, on revised figures, by -0.5% - see Figure 1.

The Office of National Statistics (ONS) estimate that -0.5% points of the UK GDP reduction was due to the unusually bad weather conditions in December in Britain, implying that growth in the British economy had stagnated after the strong recovery of the second and third quarters. As Figure 1 reveals, much the same can be said for the Scottish economy. Over the year to the fourth quarter, the Scottish economy grew by 0.8% compared to 1.4% in the UK, indicating a weaker recovery from recession here.

Figure 1: Scottish and UK quarterly GDP growth, 1998q2 to 2010q4



The comparative overall GDP performance of Scotland and the UK over the recession and subsequent recovery to 2010q4 is given in Table 1.

Table 1: Scottish and UK GDP: recession and recovery

	Scotland	UK
GDP fall in recession	-5.62%	-6.31%
Change from peak to 2010 Q4	-4.28%	-4.34%
GDP recovery to 2010 Q4	1.42%	2.11%

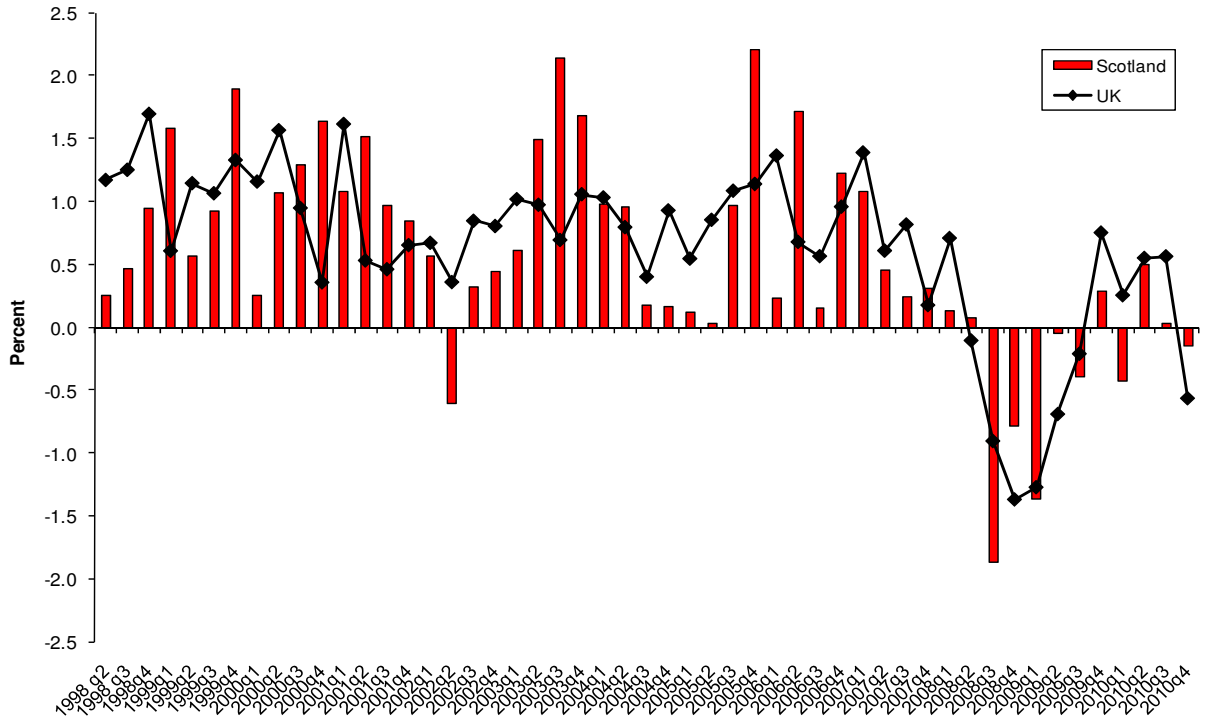
Table 1 shows that the recovery is clearly weak in both Scotland and the UK with both economies more than 4% below the previous peak before recession started in 2008q2 in Scotland and 2008q1 in the UK. So, almost three years after the start of the recession the Scottish economy has only recovered about a quarter of the output lost in recession, while the UK economy has recovered a third of lost output. These data support the evidence-based view that recovery from financially sourced recessions, particularly banking crises, are slow and painful[1]. Indeed, Reinhart and Rogoff (2009) make the point that after severe banking crises "countries in crisis that fail to fix their financial systems - such as Japan in the 1990s - can find themselves going in and out of recession and performing below potential capacity for years. The evidence seems to be moving in favour of those advocating a "Plan B" for the UK authorities to take some action to stimulate demand, it needs to be understood that while buttressing demand might be a necessary condition for a more rapid recovery it is not sufficient. We must be sure that our banking system is fit for purpose, able to freely lend to support the needs of the economy. It is not clear that we have presently reached that point. It is to be hoped that the final recommendations of the Independent Commission on Banking meet this requirement and that the proposals are adopted by the government.

In the 4th quarter of 2010, the service sector in Scotland – accounting for 74% of overall GVA on 2007 weights – suffered a fall in GVA of -0.1% while output in UK services fell much more by -0.6% - see Figure 2. Over the year to 2010q4, GVA in Scottish services fell by -0.1% compared to a rise of 1.1% in the UK. The comparative overall GVA performance of Scottish and UK services over the recession and subsequent recovery is given in Table 2.

Table 2: Scottish and UK Services GVA: recession and recovery

	Scotland	**UK**
GVA fall in recession	-4.39%	-4.48%
Change from peak to 2010 Q4	-4.17%	-.2.99%
GVA recovery to 2010 Q4	0.23%	1.55%

Figure 2: Scottish and UK services GVA growth at constant basic prices 1998q2 to 2010q4



It is clear from Table 2 that while the loss of output in the recession in Scottish services was similar to UK services, the sector had hardly started to recover in Scotland nearly 3 years later with just 5% of output lost recovered by 2010q4. In the UK, in contrast, the service sector, while still recovering weakly had nonetheless recovered 35% of lost output by 2010q4.

Within services, the almost flat performance in the 4th quarter was associated with considerable variation in the performance of the seven principal sectors that comprise the sector. On the positive side, 3 sectors exhibited positive growth during the quarter, with retail & wholesale growing by 0.5% in the quarter and by 1.8% over the year. The comparable UK retail & wholesale figures were growth of 0.2% and 2.9%, perhaps one indication that Scottish household spending has been more subdued than its UK counterpart over the year. Real estate and business services (REBS) grew by 0.4% in the quarter and by 0.5% over the year, a stronger performance than its UK counterpart in the 4th quarter, which contracted by -0.7% but grew more strongly by 2.7% over the year. Public admin, education and health also exhibited some growth in the 4th quarter with GVA rising by 0.2% and 0.3% over the year. The UK public sector grew similarly in the 4th quarter but with 1% growth over the year continued to expand by more than its Scottish counterpart. Presumably, now that fiscal consolidation has begun in earnest we should expect to see some negative outcomes in the measured growth of the public sector. On the negative side, other services contracted by -1.5% in Scotland in the quarter and by -3.9% over the year. This was a much bigger contraction in both time periods than other services in the UK which contracted by -1.2% in the fourth quarter but grew by 2.1% over the year. Hotels & catering, transport, storage & communication and financial services all contracted in the fourth quarter in Scotland by -0.3%, -0.8%, and -1.4%, respectively. This was somewhat better than their UK counterparts in Hotels & catering and Transport which contracted by -2.1%, -1.7% in the UK. Financial services in contrast contracted by -1.1% in the UK compared to -1.4% in Scotland - see Figure 3.

Table 3: Scottish and UK manufacturing GVA recession and recovery

	Scotland	UK
GVA fall in recession	-10.63%	-14.51%
Change from peak to 2010 Q4	- 8.17%	- 9.36%
GVA recovery to 2010 Q4	2.75%	.03%

It is evident from Figure 3 that Financial services continues in recession in the UK and with three successive quarters of negative growth has moved back into recession in Scotland. Hotels & catering can also be considered to be in recession

Figure 3: Scottish and UK financial services GVA growth at constant basic prices 1998q2 to 2010q4

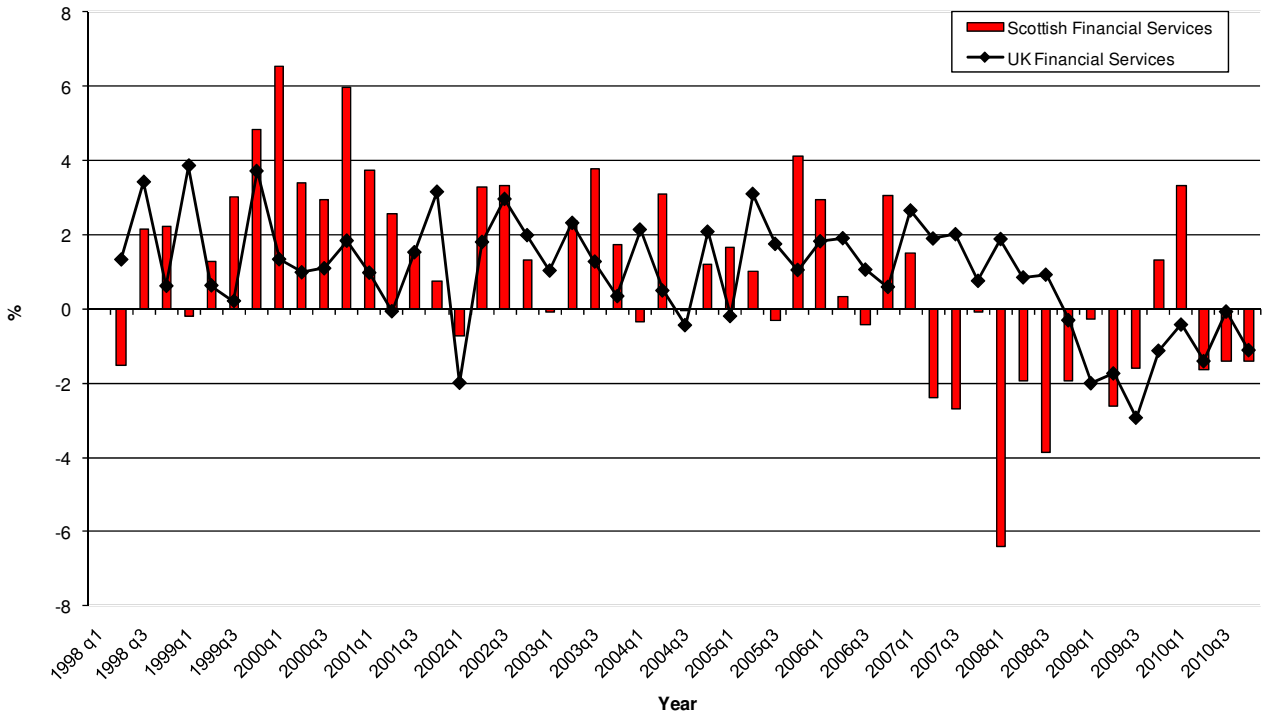
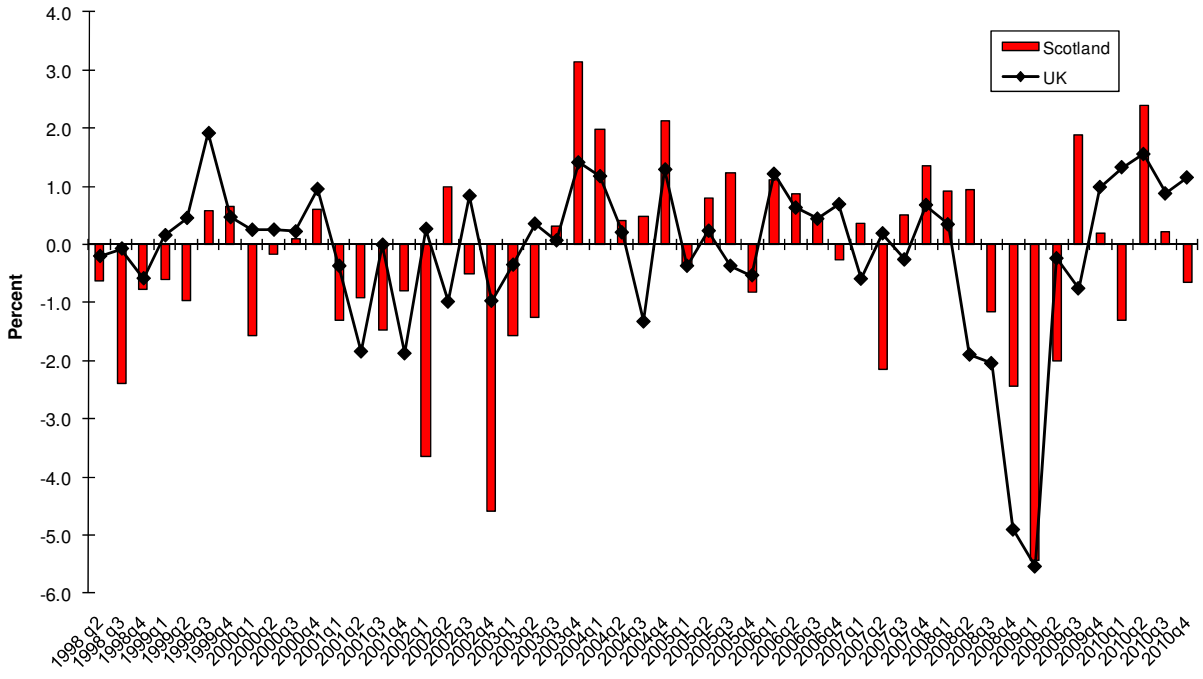


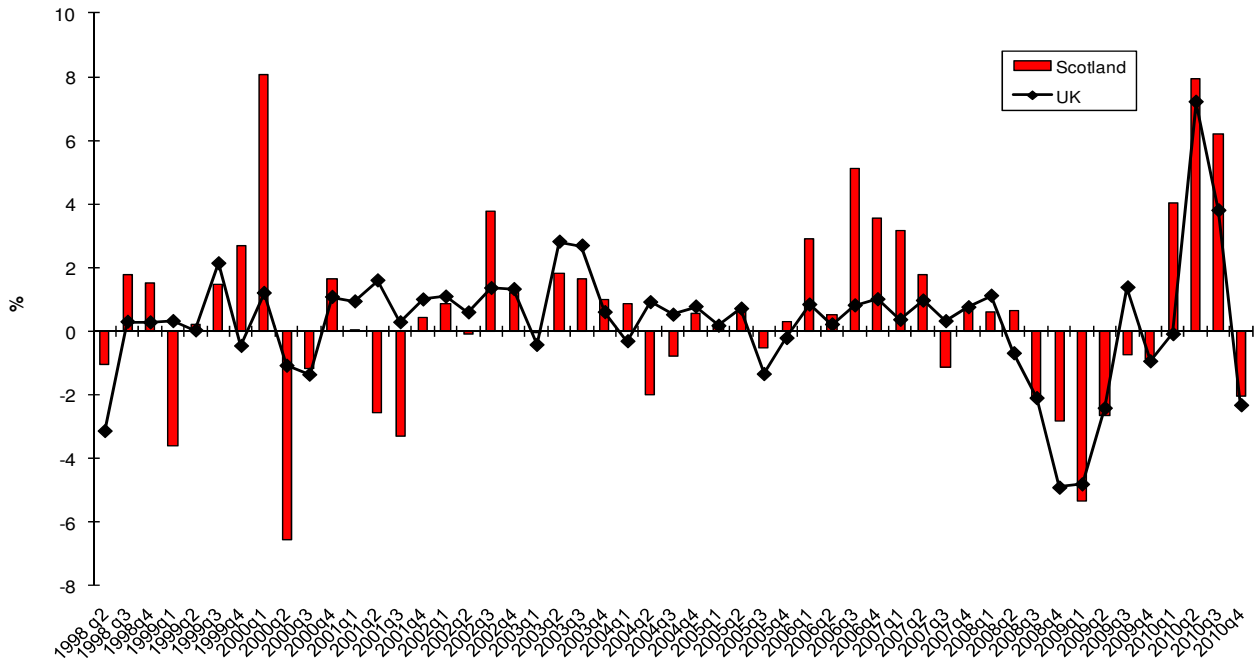
Figure 4: Scottish and UK manufacturing GVA growth at constant basic prices 1998q2 to 2010q4



The manufacturing sector in Scotland contracted by -0.6% in the fourth quarter while UK manufacturing grew by 1.1% - see Figure 4. Over the year, the sector grew by 1% in Scotland compared to 3.6% in the UK, again suggesting a weaker recovery here than in the UK. Table 3 reveals the extent of the recovery in manufacturing in Scotland compared to the UK. The recession in UK manufacturing was much greater than in Scotland. To the fourth quarter UK manufacturing had recovered 42% of the output lost while Scottish manufacturing had only recovered 26% of the production lost in recession.

Within manufacturing, some key sectors did enjoy positive growth in the fourth quarter despite the overall fall of -0.6% in Scottish manufacturing GVA. Engineering grew by 1.4% in the quarter and by 1.3% over the year. But within engineering the electronics sector contracted by -1.4% in the quarter and by -4.1% over the year. In contrast, transport equipment grew by 7.1% in the quarter and by 10.1% over the year, while mechanical engineering grew by 0.4% in the quarter and by 2% over the year. Outside engineering textiles, footwear and clothing grew by 2.5% in the quarter and by 7.9% over the year. The food & tobacco sector also grew by 0.3% and by 4% over the year. On the negative side, significant fourth quarter contractions were evident in refined petrol products & nuclear fuel where GVA fell by -9.1% in the quarter and by -3.7% over the year. Fortunately, the sector only accounts for 0.3% of overall GVA. In paper, printing and publishing GVA fell by -5.6% in the quarter but rose by 2.6% over the year. It is worth noting that, in the fourth quarter in manufacturing chemicals and electronics slipped back into recession displaying two quarters of negative growth, while refined petrol products & nuclear fuel has been in recession for 4 consecutive quarters.

Figure 5: Scottish and UK construction GVA volume growth 1998q2-2010q4



Finally, in this survey of the performance of the key productive sectors in Scotland we note that the construction sector weakened considerably in the fourth quarter as the effects of the poor weather caused work on activity to cease or be postponed. The sector contracted by -2% in the quarter compared to a similar contraction of -2.3% in the UK - see Figure 5. Over the year, Scottish construction performed more strongly than its UK counterpart growing by 11.2% compared to 6%.

Table 4 indicates that Scottish construction has tended to outperform its UK counterpart during both recession and recovery. Indeed, it continues to be the only principal sector in Scotland that has recovered the output lost in recession having recovered 122% of the GVA lost, whereas by the fourth quarter UK construction had only recovered 64% of the GVA lost in the recession, although this is still better than the performance of most other sectors.

Table 4: Scottish and UK construction GVA: recession and recovery

	Scotland	UK
GVA fall in recession	-13.71%	-14.08%
Change from peak to 2010 Q4	0.78%	-6.31%
GVA recovery to 2010 Q4	16.79%	9.05%

What is clear from this survey of industrial performance in Scotland is that the evidence points to a slowing of the recovery by the fourth quarter which looks to be more than simply weather related. Figure 6 presents the GVA performance of key Scottish growth sectors which we usually examine each quarter. What is clear from the figure is that growth in many sectors is weakening. Indeed, excluding the public sector 4 of the 10 private sectors were in recession by the fourth quarter for 3 successive quarters: financial services and hotels & catering, or for two successive quarters: electronics and chemicals. Given the need for the economy to export and invest its way to recovery the fact that two key manufacturing sectors have slipped back into recession is worrying.

The overall aggregate position in the economy during recession and recovery is presented in Figure 7. This figure contains the latest employment data for the UK and Scotland up to the first quarter of 2011. Overall, as noted above, the Scottish economy had by the fourth quarter of last year recovered only about a quarter of the GVA lost in recession compared with a third for the UK. This is not a dramatic difference as the graph of Scottish and UK GVA in Figure 7 shows. However, it does hide the fact that the strength of the recovery of Scottish output has been largely driven by construction and to a lesser extent manufacturing. With 5% output recovered the service sector has hardly shown any recovery at all. Moreover, even when allowing for the weather in the fourth quarter of last year the recovery appears to be weakening and this looks as if it has continued into 2011. This especially appears to be the case with job creation, which as Figure 7 indicates went into reverse in Scotland between the final quarter of 2010 and the first quarter of this year. It is true that there has been stronger job creation in Scotland in recent quarters than in the UK , but as we argued in previous Commentaries, the stronger Scottish jobs growth has probably been a reflection of the large shake-out of jobs that occurred between the final quarter of 2009 and the first quarter of 2010. The Scottish unemployment rate - ILO - measure - has fallen again by 10,000 in February to April compared with the previous three months to 7.7%, which places the rate on a par with the UK, where the unemployment rate also fell, even though employment in Scotland dropped by 7,000. But by the first quarter of this year total employment was still nearly 3% below the last peak before recession, whereas

Figure 6: Growth of key sectors in Scotland 1998q2 to 2010q4

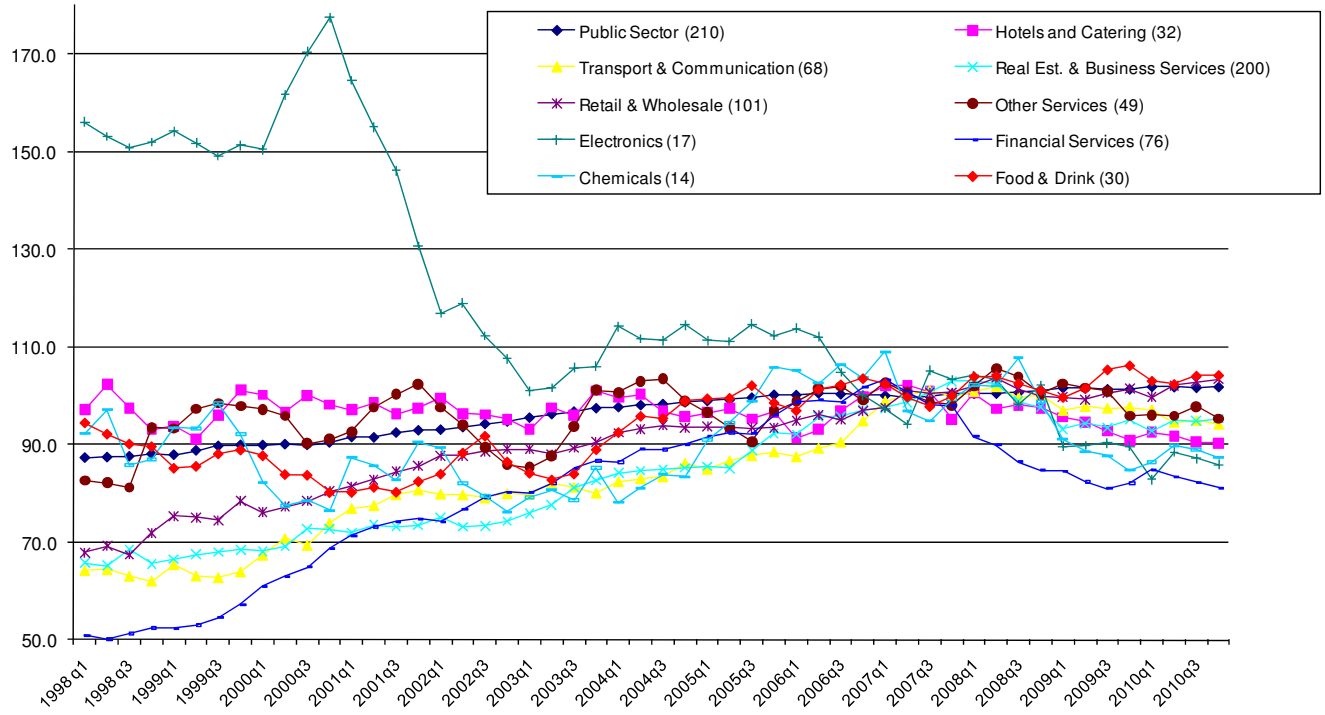


Figure 7: GVA and jobs in recession and recovery: Scotland and UK

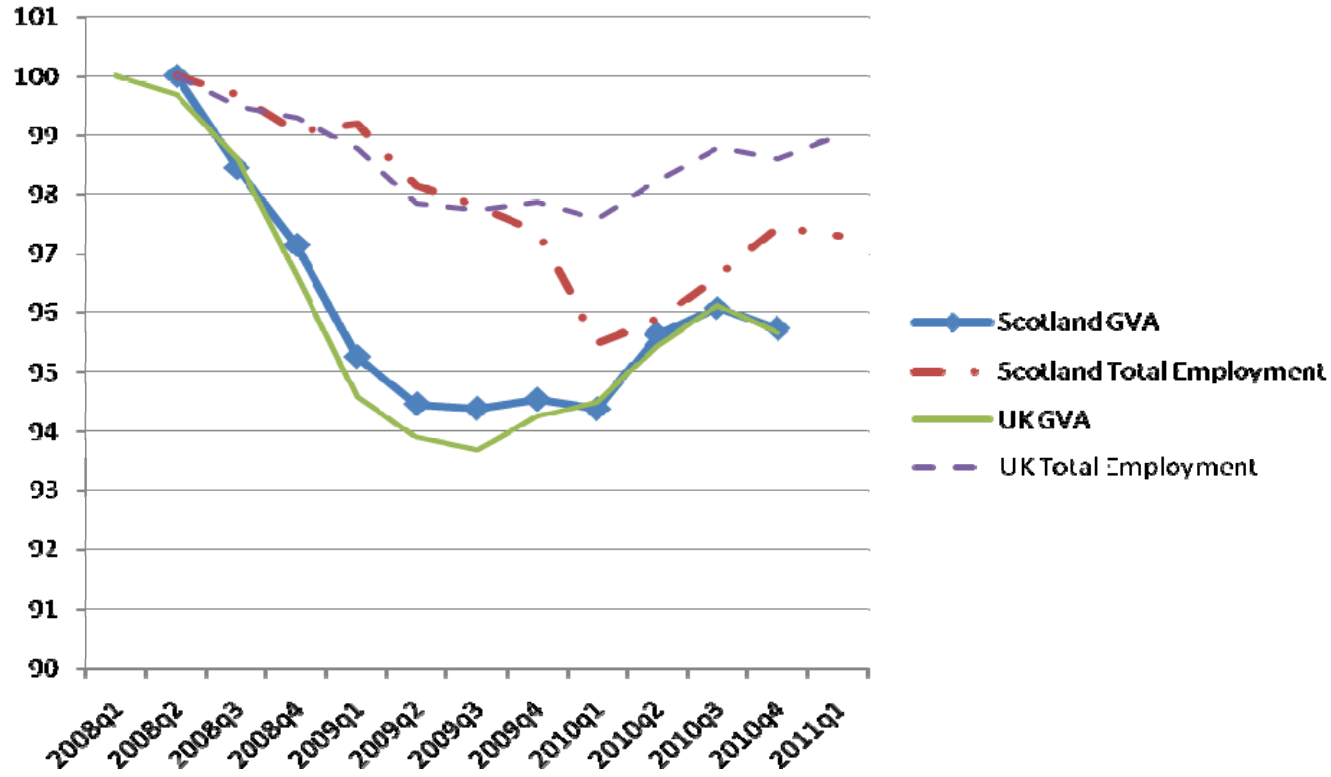
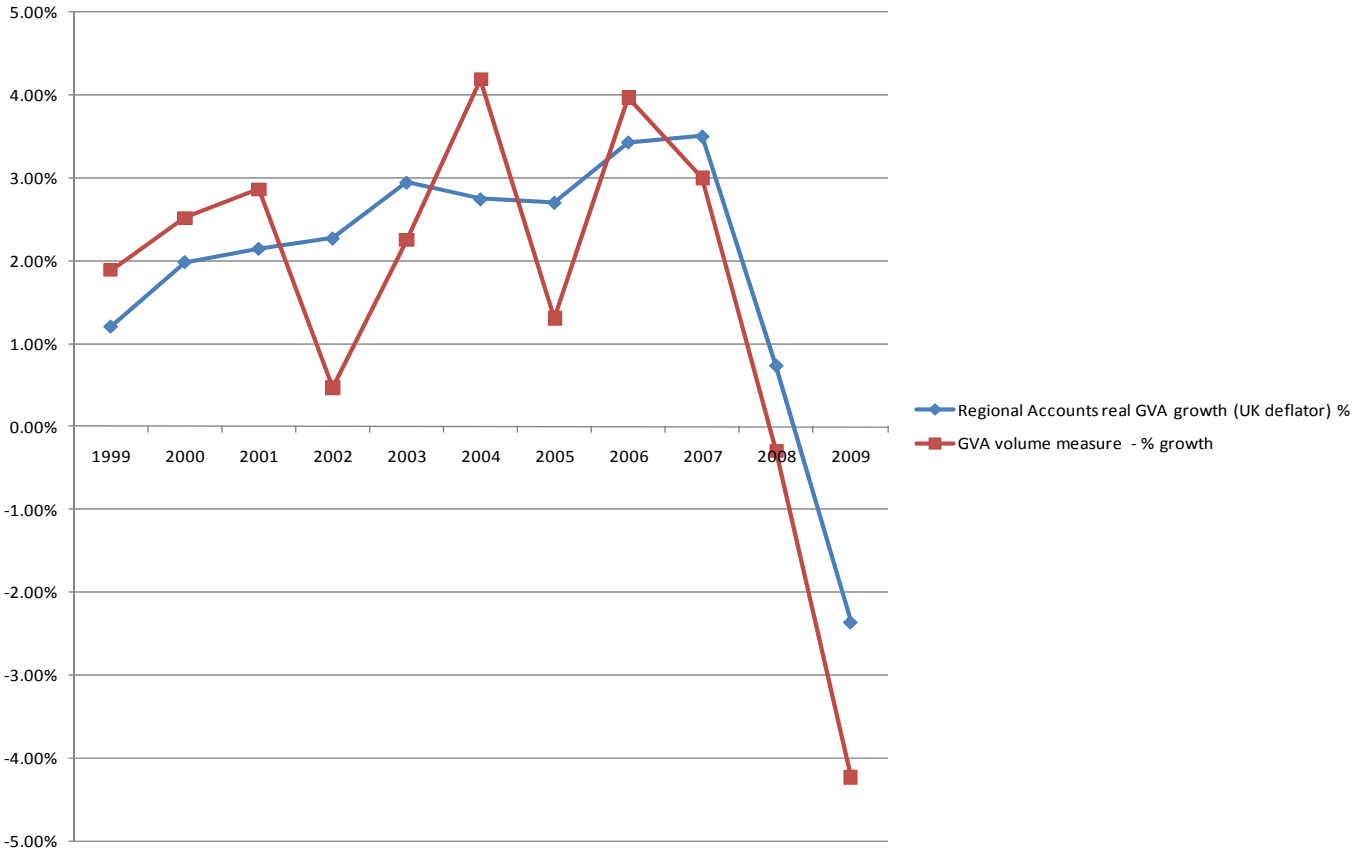


Figure 8: Scottish real GDP growth 199-2009 using regional accounts and volume measure – percent per annum



UK employment was only 1% below its pre-recession peak. That is a mark both of the greater job loss in the recession and the weaker recovery in Scotland; there can be no complacency about the state of the jobs market in Scotland.

Scottish Growth and GDP per head

In the March Commentary we analysed Scotland's growth performance over the last 50 years and came to the following conclusions:

- Scottish growth over almost 50 years is comparable to UK growth – a little lower in absolute terms – but middling by international standards. Trend growth in GDP per head is slightly higher in Scotland but largely due to weaker population growth;

- Mature economies tend to display similar trend growth close to 2%. Although, small open economies have scope for faster growth and decline due to significance of resource mobility e.g. capital and labour, into and out of the economy;

- Until the recent recession, the most important sectors for Scottish growth were real estate & business services, financial services, retailing & wholesaling, and transport & communication, much the same as in the UK;

- Ranking fifth in importance the public sector was much less important to growth than has often been suggested and no more important in Scotland than in the UK;

- The analysis suggested that if Scotland could move closer to the UK industrial structure it would get a growth dividend, because Scotland is somewhat less specialised in fast growing sectors such as business services & real estate, retail & wholesale and transport & communication;

- But the analysis also suggested that the performance of Scottish industry has been generally weaker than UK industrial counterparts and that suggests an intrinsic competitiveness problem;

- This is supported by evidence that Scottish labour productivity growth is weaker than UK. But unit labour costs are, on average, about 3% lower here, which suggests that we have a problem of lower total factor productivity: it is not simply low investment and low capital per worker that is the problem;

- Scotland's export base is narrowly focused, is declining, and may have been eroded further in the recession;

- To raise Scotland's growth rate we argued that there was a need to grow the export base by developing companies of scale and attracting inward investment, and enhancing its competitiveness through innovation, R&D and improved business sophistication, including promoting leadership and enterprise;

- Scotland's strong university research base, technological and sectoral know-how, graduate supply, high social capital and amenity, are strengths that offer a basis for future growth in key sectors;

- Small firms have a low export propensity but policy can raise economy-wide value added both by seeking raise the exports of SMEs and by encouraging new and small firms to seek to link into the supply-chains of the key 400 firms in the Scottish export base.

Following on from this analysis our colleagues in the Centre for Public Policy for Regions (CPPR) published independently an analysis of Scotland's relative economic performance since devolution compared to the UK and Wales and Northern Ireland. Using data from the Regional Accounts database CPPR analysed Scottish GDP per head relative to the UK over the period of devolution. They note ".. the growth rate on this measure has been above that of the UK every year since 2004 (and, since 2001, it has been faster than the UK in every year bar one, 2004). This apparent out-performance of the UK economy, both in good times as well as bad, is little commented upon by government(s) or academia[2].

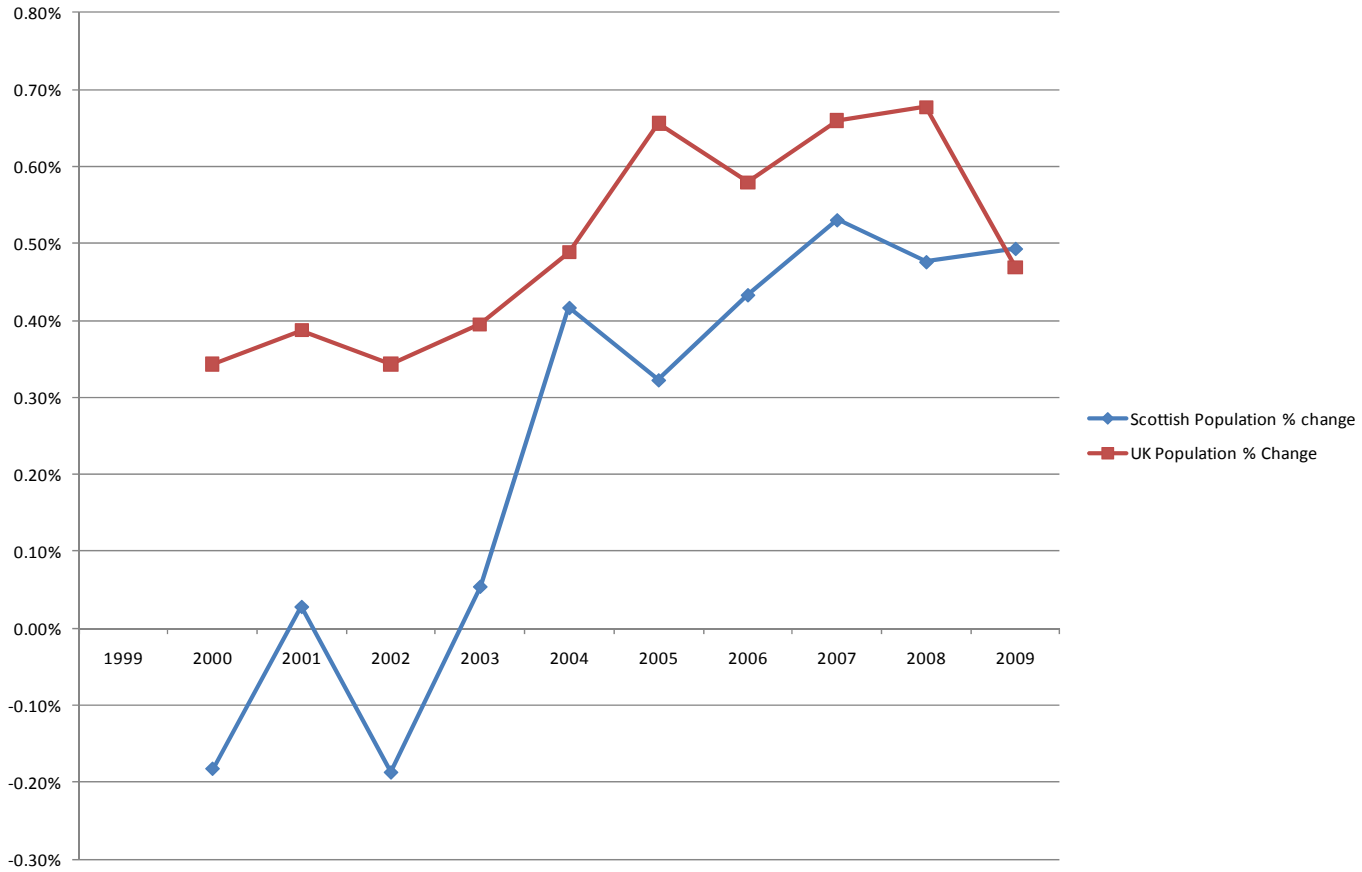
We welcome the opportunity both to comment on the performance of Scotland's GDP per head relative and to take the analysis further.

CPPR correctly note that using the UK Regional Accounts data, which estimates GVA at current basic prices by utilising data on incomes, Scotland's GDP per head relative to the UK has risen for most of the period between 2001 and 2009 - excepting 2004. So, in 2000, the first full year of devolution, the relative stood at 94 - i.e. average produced income amounted to 94% of the UK average. By 2009 this had risen to 99, or almost par with the UK. For the relative to rise it is correct to argue that GDP per head had risen faster than in the UK but the conclusion that the Scottish economy outperformed the UK during this period needs to be heavily qualified, for several reasons.

First, the UK Regional Accounts data give a quite different estimate of Scottish GDP growth over the period from the GVA at basic prices volume data produced by the Scottish government, and which is normally used to provide a picture of the growth of the Scottish economy. Figure 8 graphs the two series. It is evident that they are quite a bit different. The Regional Accounts Series is based on a weighted five year

moving average and so is a "smoothed" series whereas the volume measure employs no smoothing. In addition, the income based approach might be less robust than a production based approach as used by the Scottish government in their series, this is because of the difficulty of tracking incomes but also because comparison with the UK implies that a UK price deflator is used to deflate Scottish incomes. While a Scottish price deflator could be similar to the UK series it need not be the same. Yet, there is some merit in using a smoothing technique but it might not be the best way to remove the impact of short-term shocks to GDP such as a recession. So, we see that the smoothing has worked in Scotland's favour by producing a contraction at 2009 UK prices of GDP in 2009 of -2.36% but a much greater contraction of -3.68% in the UK (less extra-regio) series. The Scottish volume series shows that the Scottish economy contracted by less in the recession overall by -5.62% compared to -6.31% in the UK. The difference was not as marked as implied by the Regional Account series. The fact that Scotland did better in the recession relative to the UK says little or nothing about Scotland's long-run growth performance. Ideally, the series should be adjusted by a long-term growth trend rather than a moving average. We do this below.

Figure 9: Scottish and UK annual population growth 2000-2009



Secondly, while economists stress the importance of GDP per head as a measure of welfare and prosperity one needs to be careful about drawing conclusions on relative economic performance, in terms of say productive efficiency, from such series. This is because the series is affected by population movements and differences between the two jurisdictions can distort the GDP per head relative. Figure 9 indicates that during the devolution period Scottish population growth was consistently less than UK population growth, was negative in two of the years 2000 and 2002 but improved over the period to parity with the UK in 2009. The effect of weaker Scottish population growth is to boost GDP per head growth relative to the UK.

In order to deal with these issues we have recomputed the Scottish GDP per head relative to the UK using first the Scottish government's GVA series, we have also applied both Scottish and UK population growth rates to the two series to standardise for the differential movements in population on the GDP per head relative. The results are presented in Figure 10.

Figure 10 shows first the GDP per head relative using the Regional Accounts series with Scottish population as used by CPPR. The second series replaces Scottish population growth with UK population growth and the Scottish relative falls and is on average 1.7 percentage points lower over the

Figure 10: Scottish GDP per head, 1999 to 2009, with alternative GVA growth estimates and Scottish and UK population growth, (UK=100)

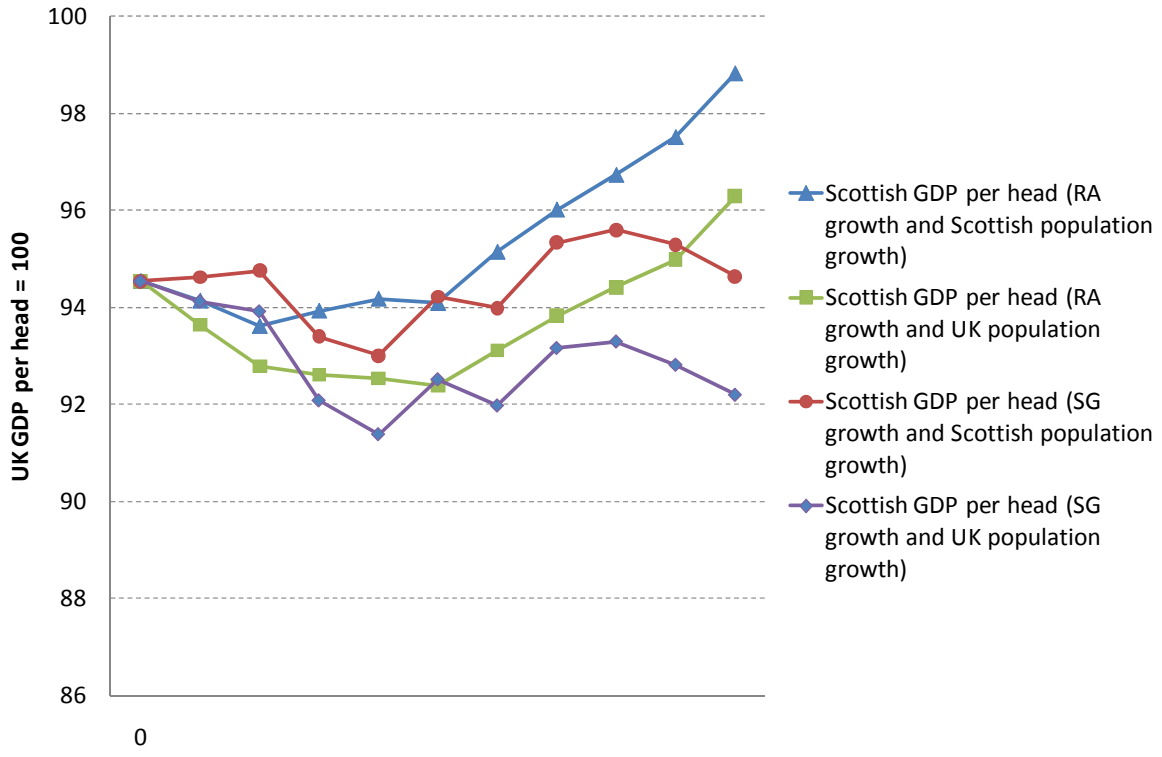
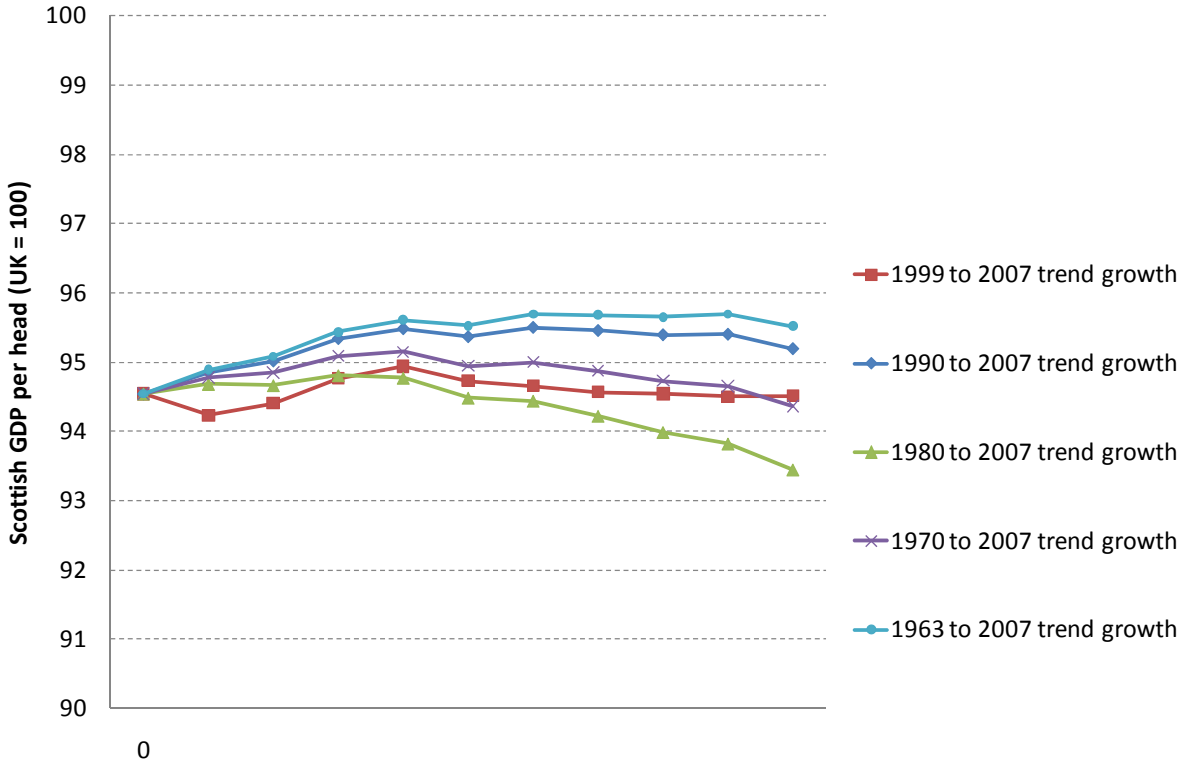


Figure 11: GDP per head in Scotland (UK=100) 1999 to 2009 applying historic trend growth to 1999 GDP per head for Scotland and UK, and dividing by actual population for Scotland and UK in these years



period from 2000-2009 averaging 93.7 against 95.4 before. The third series takes the Scottish government's GVA series and Scottish population growth to compute the relative. Here the average is 94.5, 0.8 percentage points below the Regional Accounts series. Finally, we apply UK population growth to the Scottish governments GVA data to get the final series, which has an average of 92.8 or 2.6 percentage points below the original Regional Accounts series. It is worth noting that it is only when the Regional Accounts series is used that there is any rise in the Scottish GDP per head relative between 1999 and 2009, when we standardise for population growth the series rises slightly from 94.5 to 96.3. However, when we use the Scottish government volume GVA series the relative is largely unchanged between 1999 and 2009 going from 94.5 to 94.6. However, when we standardise for population the relative falls over the period from 94.5 to 92.2. On this basis, it does not seem appropriate to characterise the Scottish economy as outperforming the UK economy between 1999 and 2009. The last decade was, of course, a period of marked short-term cyclical movements with a boom occurring in the middle part of the decade followed by a recession the scale of which was greater than anything we have experienced since the Great Depression of the early 1930s. It is a stylised fact that Scotland has a flatter business cycle than the UK, suffering less in recessions and recovering less strongly. These movements can therefore mask longer-term performance trends and their effect on the GDP per head relative. In Figure 11 we apply different GDP trends based on the (geometric) average Scottish and UK growth experience over different time periods prior to the severe recession of 2008 and 2009.

The first point to note is that the GDP per head relative changes little over the ten years. It rises slightly if Scottish trend growth is the 1963 to 2007 and the 1990 to 2007 trend. In the former, Scottish GDP averaged 2.24% p.a. against a UK average of 2.40%. In the 1990 to 2007 period growth averaged 2.38% p.a. in Scotland and 2.58% p.a. in the UK . For the other three trends the relative either remains the same or falls over the period.

So, we can conclude that the evidence of an appreciably higher Scottish GDP per head relative to the UK by the end of the first decade of the new millennium is the result of both the differential effects of large cyclical movements and slower population growth on the relative. It does not appear to be explained by an improvement in Scotland's relative competitiveness, or underlying economic performance.

Forecasts

Background

Both the Scottish and UK economies had clearly weakened by the end of last year and this was due to more than just the effect of bad weather. The surge in job creation, which followed the shakeout of jobs at the beginning of 2010 appeared to have come to an end by the beginning of 2011 as job creation in Scotland fell in the first quarter even though unemployment continued to fall (See Labour Market section in this Commentary below). In the first quarter of 2011, UK GDP rose by 0.5% but there is general agreement that this largely reflected a catch-up of activity postponed in the bad weather of the final quarter of 2010. UK growth had effectively been stagnant for 6 months. First, quarter GDP/GVA data for Scotland are not available until the third week of July. In the absence of outturn data we must rely on the business surveys for information on the performance of the Scottish economy in recent months.

Scottish business surveys (see Business Surveys section in this Commentary below) generally suggest a continuing weakness in the demand for their goods and services against a background of increasing cost pressures, with rising raw material and energy costs of particular concern. Consumer confidence and domestic demand remains weak with export markets key for manufacturers. Despite this the latest Lloyds TSB Scotland Business Monitor, for the three months to the end of May, reports that the economy is continuing to recover with a third of firms reporting increased turnover, and expectations of improving trade over the next six months at their highest level for more than three years. But the survey concludes that "the economy remains fragile as consumer spending is constrained by low confidence as a result of rising inflation, which is squeezing disposable incomes."

Yet, there are considerable clouds on the horizon:

- contagion in the eurozone debt crisis as the fears of default on sovereign debt spreads from Greece to Spain and perhaps other peripheral eurozone countries, risks damaging bank lending, market and business confidence;
- fears of a slowdown in the growth of the Chinese economy as consumer price inflation takes hold;
- continuing uncertainty on the effects of the "Arab spring" with implications for oil prices and trade;
- the continuing weakness of the US economy and its effect on world trade;
- household expenditure is likely to continue to remain weak due to the continuing fiscal consolidation and the squeeze on real disposable incomes from the current high level of energy prices;
- consumer price inflation is above target and is likely to remain so for some time, household disposable incomes are being squeezed as a result, all of which runs the risk of a rise in inflationary expectations and strengthened wage claim, but there is little sign that this is happening with the demand for labour still relative weak earnings growth remain at around 2% p.a.

It is against this background that we have prepared our latest forecasts.

GVA forecasts

Table 5 presents our forecasts for Scottish GVA - GDP at basic prices - for 2011 to 2013. As before we present a central forecast, which we hold to be most probable and high growth and low growth forecasts which define the range of outcomes in which Scottish growth is likely to fall. In the subsequent discussion we concentrate mainly on the central forecast. The full forecasts are presented in the *Forecasts of the Scottish Economy* section of this Commentary below.

Positive growth continues to be forecast in all years and on all 3 scenarios. However, Table 5 shows that we have revised downwards our central forecast for 2011 and 2012 reflecting the weakening in the economy that has been observed in recent months. Household spending is being hit by the debt overhang, the decline in real disposable

Table 5: Forecast Scottish GVA growth in three scenarios, 2011-2013

GVA Growth (% per annum)		**2011**	**2012**	**2013**
High growth		1.6	2.7	2.8
	March forecast	*2.1*	*2.4*	*2.6.*
Central		**0.8**	**1.5**	**1.9**
	March forecast	*1.0*	*1.6*	*1.9*
Low growth		0.3	0.8	1.0
	March forecast	*0.3*	*0.6*	*0.9*

Table 6: Forecast Scottish net jobs growth in three scenarios, 2011-2013

GVA Growth (% per annum)		**2011**	**2012**	**2013**
High growth		36,317	41,882	60,675
	March forecast	*42,626*	*51,025*	*57,262*
Central		**20,600**	**18,548**	**39,849**
	March forecast	*19,780*	*31,741*	*39,808*
Low growth		9,621	2,661	21,431
	March forecast	*5,895*	*11,586*	*19,256*

incomes as inflation moves further ahead of earnings, and uncertainties about job prospects as the fiscal consolidation starts to bite and the economy slows. Our forecasts remain below the OBR and consensus forecasts for the UK in 2011, 2012 and 2013, which largely reflects the weaker growth of household spending in Scotland and a sluggish outlook for private sector investment. This year, we are forecasting growth of 0.8%, and 1.5% in 2012 both less than our March forecast. We expect that production and manufacturing output will continue to pick up reasonably strongly, but at a slightly lesser rate than in our previous forecast with production growing at 3.6% in 2012 compared to 4% in our March forecast. The service sector is forecast to continue on its weak growth path growing by 0.5% this year, 1.1% in 2012 and 1.3% in 2013, largely due to the weakness in the growth of household expenditure. Construction also continues to exhibit weak growth of 0.5% in 2011, 0.9% in 2012, and 1.1% in 2013, reflecting cut backs in government capital spending and weak private sector investment. Finally, our forecast for 2013 continues to predict growth of 1.9%, just below trend. Over the whole period, the recovery continues to be weaker in Scotland than the UK.

Employment forecasts

Table 6 presents our forecasts for net employee jobs for the 3 years 2011 to 2013 on the 3 scenarios.

Table 6 indicates that our year-end employee jobs forecast for 2011 is broadly similar to our central forecast in March. As noted in the previous Commentary after the considerable shake-out of jobs at the start of 2010 job creation in Scotland has been reasonable buoyant. However, this came to an end in the first few months of 2011. Nevertheless, we do expect net jobs growth during this year and over the forecast horizon. Net jobs grow by 0.9% in 2011, 0.8% in 2012 and 1.7% in 2013. By 2013 total employee jobs are

forecast to be 2,373,000 around 60,000 fewer than in 2007 but up by 80,000 from the end of 2010. By sector, the largest percentage growth in job numbers is forecast for the production sectors, but the greatest number of jobs created will still be in services, despite the low forecast for output growth, due to the sheer scale of the sector. Within production, the largest forecast increases are in the Other manufacturing industries sector, with smaller increases in Mining and quarrying industries, Food and tobacco, Metals and metal products, and Electricity, gas and water supply. Within services, total employee numbers are forecast to rise, as noted above, however there are forecast declines in employee numbers in Public administration and defence, Education, and the Financial services sector. Some of the jobs lost in 2011 in the Financial services are forecast to be recovered during 2012 with employee jobs at the end of 2013 in this sector up slightly compared to the end of 2010.

Unemployment forecasts

The key unemployment forecasts are summarised in Table 7 below.

The ILO rate is our preferred measure since it identifies those workers who are out of a job and are looking for work, whereas the claimant count simply records the unemployed who are in receipt of unemployment benefit. We noted in the discussion of unemployment in the previous Commentary that the degree of labour hoarding may be less in Scottish firms. This could be the consequence of the bigger employment shakeout here in the recession and so the recovery to date has had a bigger effect on unemployment in Scotland than in the UK. Another factor affecting the change in unemployment is the change in the inactivity rate. This has been rising in Scotland in recent quarters and so has further contributed to falls in unemployment despite weak output and, even negative, jobs growth. But we continue to expect that the Scottish GDP recovery will continue to be weaker and at a rate below that which is required - from the estimated Okun relationship - to stabilise unemployment. We therefore continue to expect that there will still be some pickup in unemployment even as growth in output picks up. Unemployment in Scotland this year is therefore forecast to rise 8.3%, or 217,000 by the end of the year and be largely stable through 2012 with a slight further rise to 220,000 by year. After that, the rate should fall to 8.2% by end 2013. However, as previous quarters have demonstrated there is considerable uncertainty around the unemployment forecast due to independent variations in inactivity rates and the extent to which output change maps into job change.

Table 7: ILO unemployment rate and claimant count rate measures of unemployment under each of the three forecast scenarios

		2011	2012	2013
ILO unemployment				
	Rate	**8.3%**	**8.5%**	**8.2%**
	Numbers	216,723	220,350	213,308
Claimant count				
	Rate	5.0%	5.5%	5.3%
	Numbers	143,037	158,652	155,714

References

[1] " .. what we have really shown here is that severe banking crises are associated with deep and prolonged recessions ..." C M Reinhart and K S Rogoff "This Time is Different : Eight Centuries of Financial Folly", 2009. Princeton University Press, Page 173.

[2] "The relative economic performance's of Scotland, Wales and Northern Ireland since devolution" by John McLaren, Richard Harris, and Jo Armstrong. Scottish Parliamentary Elections 2011, CPPR Briefing No. 1, March 2011. (The quote is from page 4).

Brian Ashcroft
17 June 2011

The Scottish economy

Forecasts of the Scottish economy

Summary

We revise down our forecast for GVA growth in 2011 from 1.0% to 0.8%. This is due to three factors: weak domestic demand; low investment activity and slower growth in world trade than was expected earlier this year. Firstly, there is ongoing weakness in consumer confidence, in turn damaged by falling real incomes for households due to rising inflation rates impacting on spending power. Reduced real government spending on current and capital expenditures are due to impact on the Scottish economy particularly from April 2011, and the impact that this has on employment and activity in the public sectors will be critical for the short-term outlook. Business investment spending appears relatively static from previous periods, but will depend on expected demand as well as the availability of finances to undertake investment. To the extent that external finance sources remain challenging, internal financing will require the corporate sector to build up balance sheet strength. External demand remains slow, with lower growth forecasts for the UK economy as a whole (the largest market for Scottish exports) and weaknesses across the Euro area driven by sovereign debt concerns and major questions about the future path of this economic area. The outlook for the Scottish labour market remains poor, with the link between economic activity and employment growth uncertain, at the same time as some evidence of workers exiting the labour market to inactivity.

The Scottish economy

Value added and output

Figures published on the 20th of April 2011 revealed that the Scottish economy declined by 0.4% in the final quarter of 2010. This means that the Scottish economy has seen three quarters of negative growth in the last six quarters. Year on year growth (i.e. the average of the last four quarters on the previous four quarters) was +0.8%. Over the same basis the UK economy grew by 1.4% through 2010. The data reveals that a very strong performance by the construction sector in Scotland throughout the first three quarters of 2010 had stalled in Q4, falling by 2% in Q4. More significantly perhaps for the future strength of the economic recovery was the decline across the production, construction and services sectors in Q4. Service sectors saw growth of -0.1% through 2010, with GVA falling in the "Hotels and catering" (falling by 2.4% in the last four quarters on the preceding four quarters), "Transport, storage and communication" (-2.3%) and "Other services" (-3.9%). The production sectors of the economy grew by 0.5% over the year, during which period the same sectors in the UK as a whole saw growth of 2.0%.The 0.1% decline in the service sectors in Scotland was not matched at the UK level, with

GVA increasing by 1.1%. Scotland's growth performance relative to the UK as a whole would have been significantly worse had it not been for the better performance of the "Construction" sector in Scotland, which grew by 11.2% in Scotland, but only 6.0% in the UK as a whole.

Labour market

The most recent figures for the Scottish labour market at the end of 2010 are discussed in greater detail in the Labour market section of this month's Commentary. Prime among the recent trends in the labour market however was a continuing fall in the unemployment rate from previous quarters, down to 7.7 % of the economically active (16+) population in the quarter to April 2011. The total economically active of working age has fallen significantly (down 22,000 in the last six months), employment increasing by 2 thousand people, and the number of unemployed (but in the labour force) falling by 24,000 in the last two quarters. The movement between labour force and inactivity remains a complex issue, with the path that this takes critical for the forecasted performance of the labour market.

Total weekly hours worked continue to show that underemployment of labour in employment, i.e. through working less hours, remains a feature of the Scottish labour market, particularly for full-time workers. The number of total weekly hours worked to September 2010 was 2.9% lower than the same period one year earlier.

The claimant count level has risen since the start of the year, and remains higher than throughout 2010. The number of people out of work and receiving Jobseekers Allowance was up 4,900 in May 2011 compared to May 2010, rising 1,200 in the last month. As a rate of the number of those receiving benefits plus the number of Workforce Jobs, the claimant count rate stands at 5.2%.

Prices

Inflation measures for the UK suggest that prices are continuing to rise above the target inflation rate of the Bank of England's Monetary Policy Committee. In June 2011, the inflation rate remained at 4.1%, almost 2 percentage points above the MPC's medium term target. High and rising commodity and import prices, plus the impact of increased VAT accounted for the increase seen in the first quarter of the year.

The price of a barrel of oil has increased by almost 70% since July 2010, and stands at just under $120 at time of writing. This is slightly lower than the price during April. Other commodity prices on world markets have surged over the last year, under a combination of rising demand and falling output from shocks to production. Corn futures are trading at 240 euros/m tonne for June delivery, up from under 160 euros/m per tonne a year ago, while the price of soybeans is trading up almost 40% in the past year.

It appears that the increase in VAT from 17.5% to 20% in January 2011 has had a larger impact on CPI measure than the previous increase in VAT from 15% to 17.5% in January 2010. The Bank of England's latest inflation report cautions that it appears that more of the VAT increase was passed onto prices paid by consumers than the earlier increase. Measures of the CPI inflation excluding VAT, energy and commodity prices were below the 2% target as spare capacity in the UK put downward pressure on domestic prices.

There are no official measures of inflation in Scotland. As for evidence of different consumer inflation rates within the UK, recent evidence from the Institute of Fiscal Studies reported differences in the inflation experienced by people on low incomes or in "benefit dependent" households. By their calculations, while no income group saw consistently higher average inflation than any other group in every year of their sample period, "lower income households had higher inflation rates over the last decade than higher-income households".

Wage growth remains relatively flat in Great Britain as a whole, with average weekly earnings growth around 2%, down from pre-recession growth of closer to 4%. The lack of comparable data on Scotland limits the extent to which we can say that wage pressures are different in Scotland than the UK as a whole. As a simple comparison, however, average weekly earnings have risen slower in the private sector than the public sector since the start of 2009, so, with a slightly higher public share of employment in Scotland, it would appear likely that in the Scottish economy as a whole average weekly earnings growth has been stronger than in the UK as a whole (although still weak).

House prices in Scotland have been reported by the Lloyds TSB Scotland House Price Monitor, to have "return[ed] to the prices of four years ago", having fallen by 3.6% in the first three months of 2011. The average value of a house in Scotland is now £153,335. The number of housing transactions rose in March, but remains very low by the standard of pre-recession years. The link between house prices and consumer spending remained unexamined for Scotland, but evidence for the UK (published by the ONS in 2006) suggests that if there was any link between these variables, this may have weakened during the early part of the 2000s.

Surveys of business and consumer confidence

The survey evidence for Scotland is discussed in great detail in the "Review of Scottish Business Surveys" section of this Commentary. Broadly these appear to suggest weak growth at the start of 2011, with rising production from the second half of quarter one. Within manufacturing surveys, increased demand was reported, and some employment growth, however, also reported were rising cost pressures, particularly from commodities and energy goods. The weakness of consumer demand for household-facing operations, coupled with the fiscal spending reductions in

this year, and the additional impact of the Supplementary Tax charge on the Oil and Gas sector introduced in the March 2011 Budget, all appear to have a constrained effect on growth in this early part of 2011.

The Bank of Scotland's Purchasing Managers' Index for May 2011 reported continuing inflationary pressures, while output growth was slower and a decline in the level of new business reported. This PMI reported a slowdown in the rate of growth in the private sector, although this was still positive. Workforce growth reported was positive compared to some regions of the UK (Wales, Northern Ireland), but slower than most English regions.

Within manufacturing, Scottish Engineering, the Scottish Chambers Business Survey and the Bank of Scotland PMI all suggested an improvement in activity, with some signs of faster growth in Scotland than in the UK as a whole. The surveys would appear to indicate an anticipated uptick in demand continuing in the second half of 2011, albeit perhaps with declining margins on production.

Surveys of the construction sector reported weak and falling confidence in Q1 2011, with the exception of infrastructure and non-housing repair and maintenance. With squeezing margins due to rising costs, and public capital spending projects likely to see large falls in expenditure through the latter half of 2011, the outlook for the sector remains poor in the short-term.

Retail surveys give some indication of the state of consumer confidence in Scotland. On this basis, the weak trend in sales growth in Q1 and the fact that no firm expects an overall increase in total sales gives severe cause for concern.

Trends in drivers of the economy

Consumption

The macro-indicators for consumption indicate that consumption spending is recovering slightly, or at least is no longer declining on an annual basis. Figures for consumption spending on an annual basis show that spending in Scotland grew slightly more than spending in the UK as a whole in 2010. The savings ratio for Scottish households has fallen from its high in 2009Q2 of 8.8%, although is now below its average figure for the period since 1998. Consumption spending remains weak, and is unlikely to be the source of significant growth over the short term.

The Retail Sales Index for Scotland reported on the 4th of May 2011, that the first quarter of 2011 had seen a decline of 0.3% in real terms. Retail Sales in Great Britain as a whole were flat (+0.0%) over the same period, showing a weaker growth in Scotland.

In June, the Scottish Retail Consortium (SRC) revealed that, after relatively strong sales in April in part driven by weather and holiday periods, sales in May 2011 fell by their largest amount since the survey started in 1999. Like for like sales values were down 3.2%, while total sales were down by 1.1%. Both these declines are greater than in the UK as a whole, where sales values were down 2.1% on a like-for-like basis and total sales were down 0.3%, the SRC reported.

The outlook for private spending remains mixed. The Bank of England's "Inflation Report" from May notes that low interest rates could act as a spur to consumption, however to the extent that households are unwilling to spend their savings in order to protect against future unemployment or increased prices this will not occur, despite the actions of the MPC. It will likely be some more quarters until we know if households are adjusting their levels of desired savings to a higher level than prior to the recession. The feed through from unemployment fears (and possible realisations) and cost anxiety to reduced consumption spending is likely to be a feature of the Scottish and UK economies over the medium term.

Government spending

As we noted in March's Economic Commentary, the Scottish Parliament approved its one year Budget for 2011-12. The total size of the budget for the year is £33,620 million (Total Managed Expenditure), split between Resource Departmental Expenditure Limits (DEL) of £25,400 million, Capital DEL of £2,607 million and Annually Managed Expenditure of £5,612 million. While resource spending has been reduced in real terms, the most significant percentage reductions have fallen upon capital spending in the financial year 2011-12. The implications of this for overall investment spending is discussed in the next section. The challenge for the public sector in continuing to provide levels of service while undergoing significant reductions in income, particularly after a period of relatively strong growth of public resource – as well as capital – spending. A three-year freeze in public sector pay for those earning over £21,000 appears to be the significant way by which employment in the public sector may be protected at a time of reductions in public sector budgets. The most recent data for Scotland on the numbers employed in the public sector are discussed in the *Labour market* section of this commentary.

The UK Government announced its Budget in March 2011. Its policy decisions in this budget were broadly cost neutral over the five year policy window. Of the major changes to public revenues and expenditures announced here – rather than at the Comprehensive Spending Review in October 2010 – were the following.

On the government debit side, the major changes were to:

- Reduce fuel duty by 1 pence per litre from 23 March 2011 (costing 2,100 million per year by 2015-16);
- Reduce corporation tax to 26% from 2011, with a plan to reduce down to 23% by 2014-15 (costing 1,075 million per year by 2015-16);

- Increase personal income tax allowances by £630 in 2012-3 with adjustment to basic rate limit (costing 1,230 per year by 2015-16);
- Tax reform to "Controlled Foreign Company" rules (costing £840 million per year by 2015-16).

These changes were offset by revenue raising decisions including:

- Increasing the supplementary charge on North Sea Oil from 20% to 32%, and restricting decommissioning relief from 2011-12 (raising £1,780 million in 2011-12, rising slightly over each of the four years from this level);
- Indexing direct taxes to CPI from RPI (raising £1,080 million per year by 2015-16);
- Bank levy (raising £630 million in 2011-2, falling to £100 million by 2015-16);
- Changes to raise revenue from tax avoidance, tax evasion and administration, raising a total of £1,335 million by 2015-6, predominantly from raising revenue from "Disguised remuneration".

Changes to the supplementary tax on activities in the North Sea have prompted significant debate between the industry and governments about the impact that these changes will have on exploration and drilling activity, with knock-on effects on the economies from reduced activity, and also a lower tax take.

Investment

While investment spending appears to have recovered strongly through 2010 (witness the large increases in the construction sector seen throughout the year), this could have been necessary following the complete collapse of investment during the recession – the low base made for significant increases during the normal replacement and maintenance of the capital stock, perhaps, and also the "green-lighting" of new projects delayed from 2008-9.

Where the outlook for demand for goods and services is weak, it is likely that private investment will be sluggish, however this will also be affected by the abilities of firms to raise the appropriate finance for investment projects. March 2011 saw the publication of the latest "SME Access to Finance" survey, which examines the credit availability in the Scottish SME sector, which accounts for 53% of all employment in the Scottish economy. This now gives the fourth in a series of surveys of this crucial part of the Scottish economy.

This survey paints a mixed picture. Demand for new borrowing has fallen compared to previous surveys, in part due to respondents revising down their growth objectives. Further, while credit conditions appear to have eased for those renewing credit facilities, access to new credit remains difficult. Of course, the extent to which firms require external credit will depend upon firms' positions with regard to internal funds. One potentially critical issue is the availability of credit for firms exporting, where a higher than average rejection rate for new credit could limit the ability of Scottish firms to unlock export markets.

The Scottish Load Fund, setup with £40 million of private capital and a commitment of £55 million from the public sector intends to fill some of the gaps in SME finance availability. It was due to begin making loans of between £250,000 and £5million to established SMEs, with a preference for exporting firms. The Business Growth Fund, comprised of equity investment from five major UK banks, is an alternative model for private financing of investment, with loans of between £2 and £10million available to firms with turnovers between £10 million and £100 million. A of May 2011, the BGF was considering its first investments.

As well as private investment, government as a consumer of investment projects has seen significant retrenchment over the Budget in June 2010 and October 2010's Comprehensive Spending Review. The bringing forward of Government capital spending in Scotland means that there is a larger decline in public capital spending in 2011-2 than would otherwise be the case, however, capital spending in 2010-11 was protected. The bulk of the "hit" to capital spending in Scotland suggested by the CSR is projected to occur in 2011-2, with significantly smaller declines in future years (indeed a small upturn in capital spending in the final year of the CSR period). This is likely to have a significant impact on Scottish construction and other (non-public) activities. Ambitions by the Scottish Government to bring forward plans to borrow in order to fund capital projects – such as the Forth Road Bridge, could go some way to alleviating this decline in capital spending.

Exports to the rest of the UK

Growth in the rest of the UK remains critical for the export performance of Scottish firms, being responsible for over two-thirds of all Scottish exports in 2009. UK growth has typically been stronger than in Scotland over the last few quarters, with Q1 2011 showing a 0.5% increase. The terrible weather before Christmas meant that some expenditures were delayed into Q1, meaning that the rate of underlying growth in the economy over Q1 was broadly flat. Output in the construction sector which had provided strong growth during 2010 fell sharply in Q1, while manufacturing and services sector growth in Q1 was around 0.5%, excluding the effects of snow.

The Office for Budget Responsibility updated their forecasts for the UK economy in March 2011. Since their November 2010 forecasts, they noted the fall in Q4 2010 GDP, the rise in world oil prices and continued higher than expected inflation. They note that "these data have on average prompted external forecasters to reduce their estimates of economic growth in 2010 and 2011. The average external forecasts for CPI and RPI inflation have risen significantly, again reflecting recent data" (p. 11). They predict that "this recovery will be weaker than the recoveries of the 1980s and 1990s… [reflecting] the effects of the fiscal

consolidation, the relatively slow easing of tight credit conditions and ongoing private sector deleveraging" (p. 12). Their forecasted UK growth is again reliant on business investment and net trade, with a slight revision downwards of prospects for domestic demand, given continued squeezing of household budgets.

The OBR's forecasts for UK GDP growth in 2011 has been revised down by 0.4 per cent to 1.7 per cent, while the 2012 forecast has been revised down by 0.1 per cent to 2.5 per cent. This forecast for 2011 is 0.2 above the average of independent forecasts from June 2011, while the OBR's forecast for 2012 is 0.3 above the same average of 2012 forecasts. Within demand components of GDP, the OBR's household spending forecasts for 2011 and 2012 has been revised down by 0.7 per cent to only 0.6 per cent in 2011, while general government consumption and investment has been revised upwards. No changes have been made to the contribution anticipated from net exports.

Upward revisions have been made to the UK ILO unemployment rate which is forecast to reach 8.2% at the end of 2011, and 8.1% at the end of 2012, before falling slightly to 7.6% at the end of 2013.

Exports to the rest of the world

The most frequent survey of Scottish exports to the rest of the world is the Index of Manufactured Exports. The most recent results revealed that Scottish manufactured exports fell by 0.3% in real terms during Q4 2010, and increased by 1.6% in 2010 on 2009 levels (on a four quarters on the previous four quarters basis). Of the annual figure, a positive increase in exports was observed in all sectors, with the exception of Engineering and Allied Industries. This one sector is, however, responsible for over 41% of manufactured exports from Scotland. The strong export performance of the "Food, drink and tobacco" sector – growing by 4.9% in 2010 – shows that the export-led growth prospects for Scotland are perhaps not being equally felt across Scottish manufacturers.

Worldwide, the outlook for growth remains mixed. In the US, non-farm payrolls rose in the most recent month, albeit weakly, while the unemployment rate remained at 9.1%. The US economy grew in the first quarter of 2011 by an annualised rate of 1.8%, while inflation concerns continued as inflation grew to 3.6%, driven by increases in commodity, energy service and food prices. In the Euro area, overall growth on an annual basis appears relatively strong at 2.5% in Q1 2011, but this masks a divergence in the growth outcomes within the area. By the latest figures to Q4 2010, real GDP in Ireland, Greece and Estonia were around 15 percentage points below its Q1 2008 figure, while in Slovenia, Italy, Portugal and Spain output was down by between 5 and 10 percentage points.

Growth in the Euro Area, a key market for many Scottish products, remains uncertain, and there are concerns about a two-speed Euro Area with growth in "core" countries expected to exceed that in the struggling "periphery". Continued worries about sovereign debt and the sustainability of public finances and banking reforms, the lack of the ability to improve the competitiveness indicate severe challenges in these economies, and by implication the Euro project as a whole, over the medium term.

The recent outbreak of E-coli in European vegetables, initially suspected to have begun in Spanish cucumbers, and now most likely to have originated at a German beansprout farm, has – as well as its fatal effect on humans (with 34 deaths and 812 cases at time of writing – significantly undermined confidence of consumers of European vegetables. At one stage Russia imposed a blanket ban on all imports of vegetables from the EU. While agricultural exports from Scotland are low (exports of produced food are less than 2% of all manufacturing exports, while the Global Connections Survey reported that in 2009, "Agricultural, forestry and fishing" products comprised 1.2% of all Scottish exports), it is possible that consumers would avoid products from markets where affected foods have been found – these include Germany, France, Denmark and Sweden. Such disruptions, to the extent that new tastes are developed for the new types of produce and hysteresis results, could lead to permanent step changes in exports. It is also possible that new export markets may not contribute to agricultural sales in the UK, but UK and Scottish consumers could switch demand to UK-grown vegetables.

The GDP growth forecasts for 2011 and 2012 for the top five export markets for Scottish goods and services in 2009 are given in Table 1.

Table 1: GDP growth forecasts for 2011 and 2012 for top five export markets for Scottish products in 2009, % year on year change, plus United Kingdom and Euro area

	Share of Scottish exports ROW 2009	2011		2012	
		IMF, May	OECD, May	IMF, May	OECD, May
USA	15.5%	2.8%	2.6%	2.9%	3.1%
Netherlands	9.6%	1.5%	2.3%	1.5%	1.9%
France	7.5%	1.6%	2.2%	1.8%	2.1%
Germany	6.1%	2.5%	3.4%	2.1%	2.5%
Belgium	4.0%	1.7%	2.4%	1.9%	2.0%
Others Asia	9.8%	8.4%[1]	n/a	8.4%[1]	n/a
European Union	n/a	1.8%	2.0%	2.1%	2.0%
United Kingdom	n/a	1.7%	1.4%	2.3%	1.8%

Sources: International Monetary Fund, Regional Economic Outlook: Europe: Strengthening the Recovery, May 2011, International Monetary Fund, World Economic Outlook, April 2011 and OECD Economic Outlook No. 89, May 2011.

Forecast accuracy

Economic forecasts are often criticised for being inaccurate, i.e. the predicted outcome differs from the actual outcome. This is a valid criticism of forecasts, obviously, given that one purpose of economic forecasting is to attempt to predict the future values of specific variables.

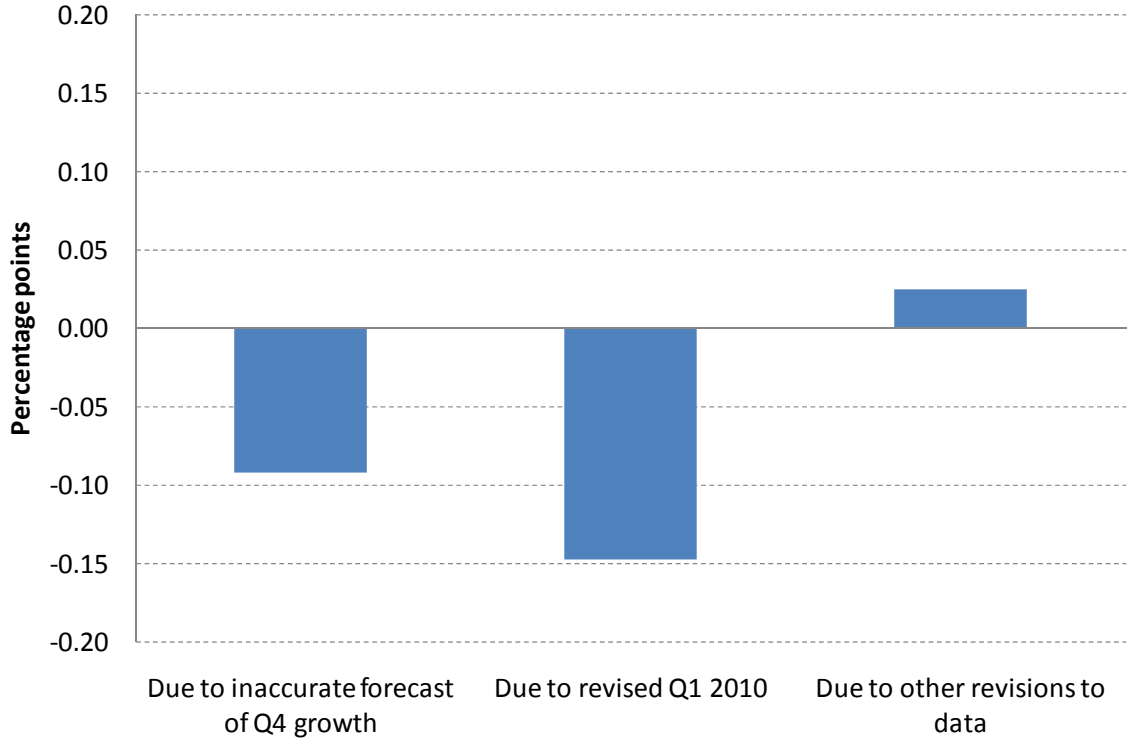
As part of an ongoing process of evaluating our economic forecasts we discuss here the difference between our forecast for 2010 growth published in March 2011, and that which was revealed by the published data in April 2011. Our forecasts was for growth in 2010 of +1.04% (which was published as +1.0) while the outcome figure for growth was +0.84. The absolute difference therefore between our forecast and the outcome was -0.21%.

We can separate out three reasons why the outcome data was different to that which we had forecast. Firstly, while growth in Q1-Q3 was known in March 2011, growth in Q4 was not. Mis-forecasting growth in Q4 would therefore lead to a difference between the annual growth forecast and outcome data for 2010. Secondly, there are revisions made to the GVA series as more information reveals the previous pattern of growth in the Scottish economy. Such revisions are a regular feature of all published economic statistics, and the growth figures for Scotland are no different[1]. Revisions to previous data are therefore another reason why forecast outcomes may not arise in actual outcome data (these can occur as we do not forecast revisions to past growth data, which seems sensible given the good quality of the Scottish GVA series).

We see that the absolute difference between our 2010 forecast and actual 2010 growth outcomes can be explained by a combination of own forecasting error for Q4 2010 and by revisions to past data. The major revision in the data published alongside Q4 2010 data was the revision of growth in Q1 2010 from 0.0% to -0.2%. Other revisions to the GVA series had the effect of slightly increasing the outturn growth for 2010. These are shown in Figure B1 below. Note the scale on the axis refers to percentage points: these are all small differences in absolute terms. One interesting result of this is that we can see that without the revision to Q1 2010, the outcome would have been annual growth 0.15 percentage points higher. Growth would therefore have been rounded to 1.0% - which would have had the impact of making our forecasts appear accurate despite our error in forecasting growth in Q4 2010.

We are continuing to examine our past forecast accuracy and will report on this in more detail in the next commentary.

Figure B1: Importance of forecast inaccuracy and revisions for difference between 2010 forecast and outcome



Notes:

[1] A paper published in December 2010 by the Scottish Government showed that in the five years to Q2 2010 the mean revision between quarterly GVA growth and its value one quarter and one year later was approximately zero, i.e. the first estimate of GVA growth was neither biased greater or lower than the outcome growth rate. The absolute mean revision was 0.1 percentage points after one quarter and 0.2 percentage points after a year.

Forecasts of the Scottish economy

As with the forecasts published in the last seven Commentaries, we give three alternative scenarios for growth, employment and unemployment in the Scottish economy from 2011 to 2013. We give a "Central" case, with "High growth" and "Low growth" as two respectively upper and lower growth alternatives. We intend these to capture the range of outcomes that are possible, given that there are considerable uncertainties surrounding any specific single or point estimates. While we do not give explicit probabilities for each of these outcomes, we see the "Central" scenario as being that which is most likely, while "High growth" and "Low growth" reveal the possible range of outcomes for the Scottish economy.. We will know the outcome for Scottish GVA growth in 2011 with the publication of Q4 2011 figures in April 2012.

The forecasts: Detail

In the three scenarios considered, the following elements are assumed to influence the demand for goods and services produced, and therefore the levels of economic activity, in the Scottish economy:

Households

In the Central scenario we forecast that household spending increases by 0.4% in 2011 and rises by 1.0% and 1.4% in 2012 and 2013 respectively. This is lower than the growth in household spending predicted by the OBR over this period. Three factors bear on this comparison being plausible. Earnings growth is anticipated to recover more strongly in the private sector than in public sector activities, where pay restraint is evident. As fears about job security for some, and slow income growth for public sector workers is revealed, the prospects for household expenditure remains weak. This could affect Scotland particularly badly with typically higher levels of public sector employment than the UK as a whole. Savings rates are anticipated to remain above levels seen prior to 2009 as households rebalance their debt levels and are reluctant to take on borrowing for consumption. High inflation in particular damages those on low and fixed incomes especially badly, with spending power of these households likely to be squeezed over the medium term, allied to the scheduled reductions in welfare spending affecting household incomes towards the end of the forecast period. Household spending is forecast to be closer to the OBR forecasts for the UK, in the High growth scenario, although for the reasons discussed above this is, in our opinion, an unlikely path for household spending in Scotland.

Government

In the Central scenario we anticipate real reductions in government current spending of 2.4% in 2011, -1.0% in 2012 and -1.9% in 2013. It remains the case that where government spending supports economic growth and activity will be through careful targeting of limited funds available to it, with declines in employment in public sectors likely by the end of the forecast period.

Investment

We reported in March's commentary that it appeared that investment spending in Scotland had responded later and fallen less than investment spending in the UK as a whole. This would be consistent with public sector projects being encouraged at a time of private investment projects being delayed, as appears to have occurred through 2009 and the first part of 2010 in the UK. The outlook for private investment appears to be relatively sluggish, with demand signals weak, with the exception of some export sectors. As private investment remains weak, the state of public investment remains poor with significant reductions in capital expenditures front loaded in 2011-2. Overall, we forecast investment spending to fall in real terms by 1.1% in 2011, before rising by 6.6% and 6.4% in 2012 and 2013 respectively.

Exports

In the Central scenario, we forecast a relatively strong ROW export growth by historic standards of almost 5% growth in 2011, increasing slightly in the two years subsequent. We would anticipate stronger performance in those sectors' exports to the rest of the world, rather than serving domestic or even UK markets. Even in ROW exporting sectors, however, continuing worries about the strength of the global, and particularly Euro area, recovery may mitigate some of the earlier hopes for immediate export led-growth. This is particularly given the lack of a significant rebound in exports from the increased competitiveness of the pound making Scottish exports cheaper on the international market. Exports to the rest of the UK grow relatively slower in comparison, broadly tracking UK domestic demand forecasts. For the real growth of UK exports, we anticipate growth of under 2% in each of the next three years, broadly as the UK consumer is likely to be a key part of the demand for Scottish goods and services, and incomes and expenditures are forecast to recover growth very slowly.

Tourism

Tourism spending is forecast to remain slower to recover than household spending as a whole through the forecast period. Discounting appears to remain a key feature of the Scottish tourist market, with occupancy levels remaining solid despite significant price reductions. It is likely that business spending on trips may recover as business growth picks up towards the end of the forecast horizon, however domestic spending on tourism activities – the key part of the market in Scotland – is likely to remain sluggish, with exceptions perhaps in niche sectors of the industry.

Results

All three scenarios forecast Scottish GVA growth for the calendar years 2011 to 2013. As before, we are forecasting year-on-year growth, so will know the accuracy of our

forecasts with the publication of Q4 data for each year, typically around the April of the subsequent year. The difference between our forecast for 2010 growth reported in March 2011 and the outturn growth rate for 2010, as revealed by the publication of Q4 2010 data in April 2011, is discussed in the Box above.

The three scenarios – Central, High and Low – are presented in Figure 1, alongside (for comparison only) the forecasts for the UK over the same period by the Office for Budget Responsibility (reported in March 2011). Forecasts for UK growth in 2011 and 2012 from City and non-City forecasters were collated in June 2011 and these are included for comparison. Also included is the independent average of new forecasts for the UK between 2011 and 2013, dating from May 2011. The average of UK growth forecasts for 2011 has been revised down between May 2011 and June 2011 from 1.7% to 1.5%, reflecting the underlying weakness observed during Q1 data for the UK.

Figure 1: GVA growth for Scotland, 2005 to 2010 and forecasts for 2010 to 2013, annual real %

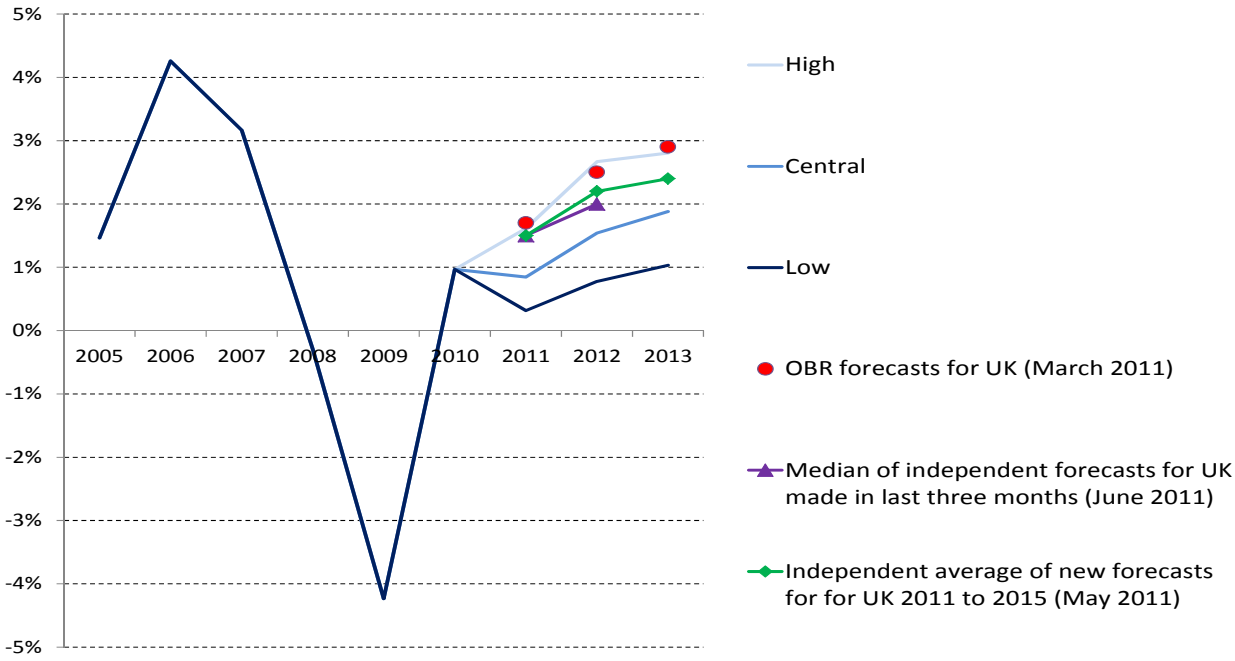


Table 2: Main forecasts of the Scottish economy (Central scenario), 2011 to 2013, % change from four quarters of previous calendar year

	2011	2012	2013
Gross Value Added	0.8%	1.5%	1.9%
Production	2.2%	3.6%	4.3%
Services	0.5%	1.1%	1.3%
Construction	0.5%	0.9%	1.1%

Table 3: Forecasts of GVA growth in three scenarios, 2011 to 2013

	2011	2012	2013
High growth	1.6%	2.7%	2.8%
Central	0.8%	1.5%	1.9%
Low growth	0.3%	0.8%	1.0%

Our Central forecast for growth in 2011 is now 0.8%, down from the 1.0% forecast in March 2011. This revision largely reflects more cautious outlook regarding household finances and expenditure plans in light of continuing uncertainty about employment security, the full impact of the fiscal consolidation and real incomes being reduced by higher than anticipated inflation. Our forecast for 2012 is lowered (by 0.1%) from March's forecast, and is now for growth of 1.5%. Our forecast for 2013 remains unchanged from March's Commentary at 1.9% under the Central scenario.

Forecast headline growth in all three scenarios are shown in Table 2.

As before, we present forecasts for growth over the forecast period at broad industry groupings. Figure 2 gives the GVA changes in "production" sectors (classified as categories CDE of SIC 2007), while Figure 3 and Figure 4 give the GVA changes forecast in "construction" (category F) and "services" (categories G-P). These figures have been put on the same vertical axis scale, to ease comparison in the growth forecasts across these broad sectoral groupings.

Figure 2: Forecasts of GVA growth in Production under three scenarios, 2011 to 2013

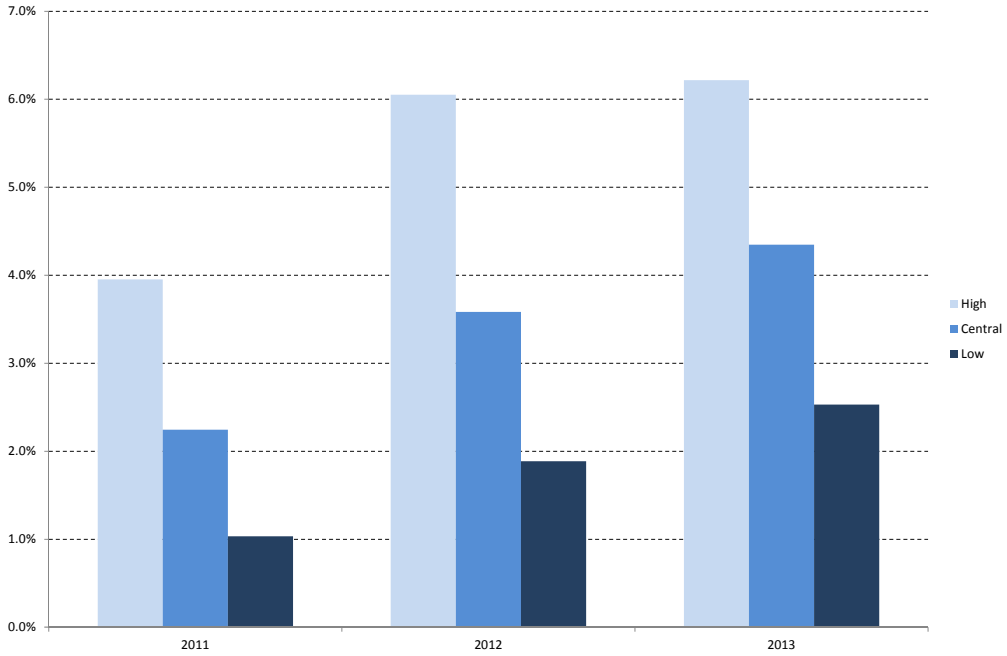


Figure 3: Forecasts of GVA growth in Construction sector under three scenarios, 2011 to 2013

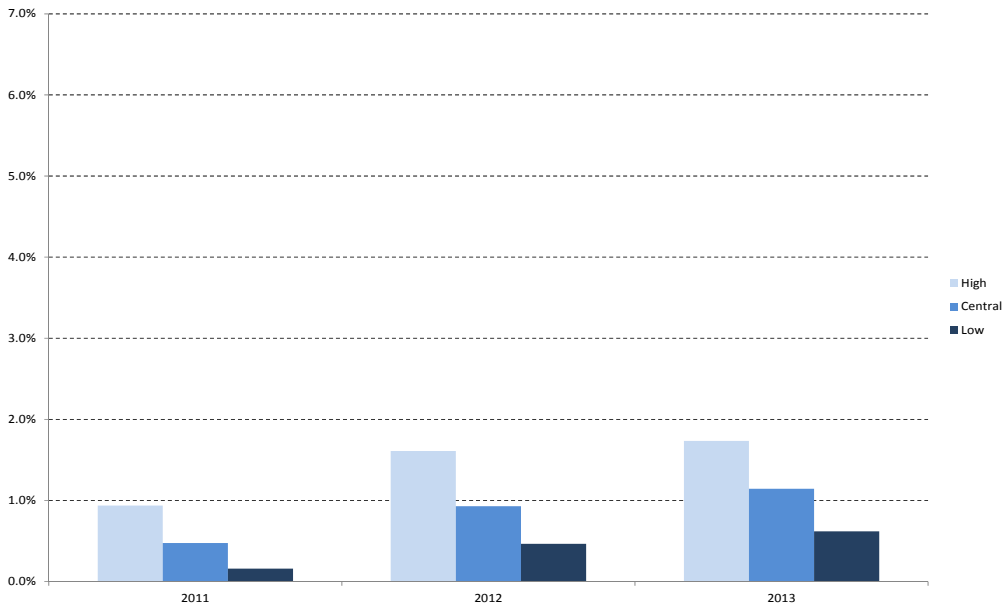
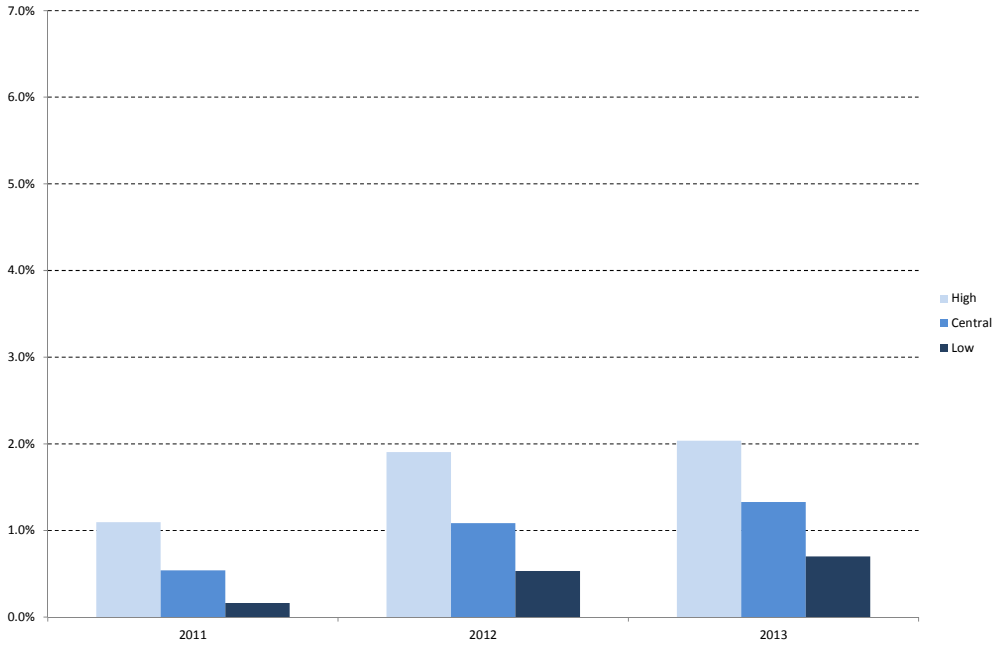


Figure 4: Forecasts of GVA growth in Services sectors under three scenarios, 2011 to 2013



Employment

Our forecasts for employment in Scotland for each of the years from 2011 to 2013 are given in Table 4 below. These forecasts are for (seasonally adjusted) employee jobs at the end of the year reported, rather than full-time equivalent job numbers or other measures of employment (e.g. workforce jobs). As with the GVA, we can assess the accuracy of our employment forecasts by examining the number of employee jobs in the quarter ending December. These are published early in the following year, with some revisions over the first half of the subsequent year as more complete data are available. As of December 2010, the number of employee jobs in Scotland stood at just under 2.3 million, and by the end of Q1 2011 had risen by 30 thousand to 2,325 thousand.

The major difference between employee and workforce jobs are that self-employment is included in workforce, but not employee jobs. Since these figures are job numbers, rather than the numbers in employment, these figures differ slightly from those reported in the labour market section of the Commentary.

Table 4: Forecasts of Scottish employee jobs (000s) and net change in employee jobs in Central scenario, 2011 to 2013

	2011	2012	2013
Total employee jobs (000s), Dec	2,315	2,334	2,373
Net annual change (jobs)	*20,600*	*18,548*	*39,849*
% change from previous year	0.9%	0.8%	1.7%
Agriculture (jobs, 000s)	33	34	36
Annual change	*748*	*981*	*1,493*
Production (jobs, 000s)	230	237	248
Annual change	*6,171*	*7,380*	*11,257*
Services (jobs, 000s)	1,915	1,925	1,950
Annual change	*12,489*	*9,605*	*25,249*
Construction (jobs, 000s)	137	137	139
Annual change	*1,192*	*582*	*1,850*

In our Central scenario, we therefore forecast that the number of jobs in Scotland at the end of 2011 will be 2,315 thousand. This is down slightly on the number of employee jobs in the first quarter of 2011. Within sectors, the largest percentage growth in jobs numbers is forecast for the production sectors, which are forecast to increase employee jobs by the end of 2011 by over six thousand. Services jobs are forecast to continue to expand slightly, and continue to provide the majority of the employee jobs growth over the year. Within production, the largest increases are forecast to be seen in the "Other manufacturing industries" sector, with smaller increases in "Mining and quarrying industries", "Food and tobacco", "Metals and metal products", and "Electricity, gas and water supply". Within services, total employee numbers are forecast to rise, as described above, however there are declines in employee numbers forecast in "Public administration and defence", "Education", and the "Financial services" sector. Some of these declines in employee jobs in 2011 in the "Financial services" sector are recovered during 2012 with employee jobs at the end of 2013 in this sector up slightly compared to the end of 2010.

In all, the number of jobs in 2011 is forecast to grow by just over 20,000 in 2011. In 2012 and 2013 the number of employee jobs is forecast to increase by 18,500 and almost 40,000 respectively. Total jobs at the end of 2013 are forecast to be 2,373 thousand, down 60,000 on employee jobs at the end of 2007, but up by 80,000 from the end of 2010. Table 5 shows the net growth in employee jobs forecast across each of the three scenarios between 2011 and 2013.

Table 5: Forecast net employee jobs growth in three scenarios, 2011 to 2013

	2011	2012	2013
High growth	36,317	41,882	60,675
Central	20,600	18,548	39,849
Low growth	9,621	2,661	21,431

Unemployment

We present our 2011 to 2013 forecasts for unemployment in the Central scenario, as measured by the ILO definition, as well as those receiving unemployment benefits, in Table 6. The preferred measure of unemployment is the ILO definition as given by the Labour Force Survey. This measure is typically preferred as it gives a better picture of the number of employees available for work in the labour market, and so a better measure of the spare labour capacity there is. One issue with increases in the inactivity rates over recent quarters in Scotland is that the unemployment rate has fallen despite weak growth, or even declines, in employment. The numbers unemployed by the ILO measure have typically declined, but there has also been increases in the inactivity rate, reducing the size of the labour force (and so the denominator in the calculation of the unemployment rate). As before, we would highlight the uncertainty around our unemployment estimates as there may be some further changes in the activity rates, and the size of the labour force as a whole as migration occurs, making forecasting more difficult than in more normal times for the labour market.

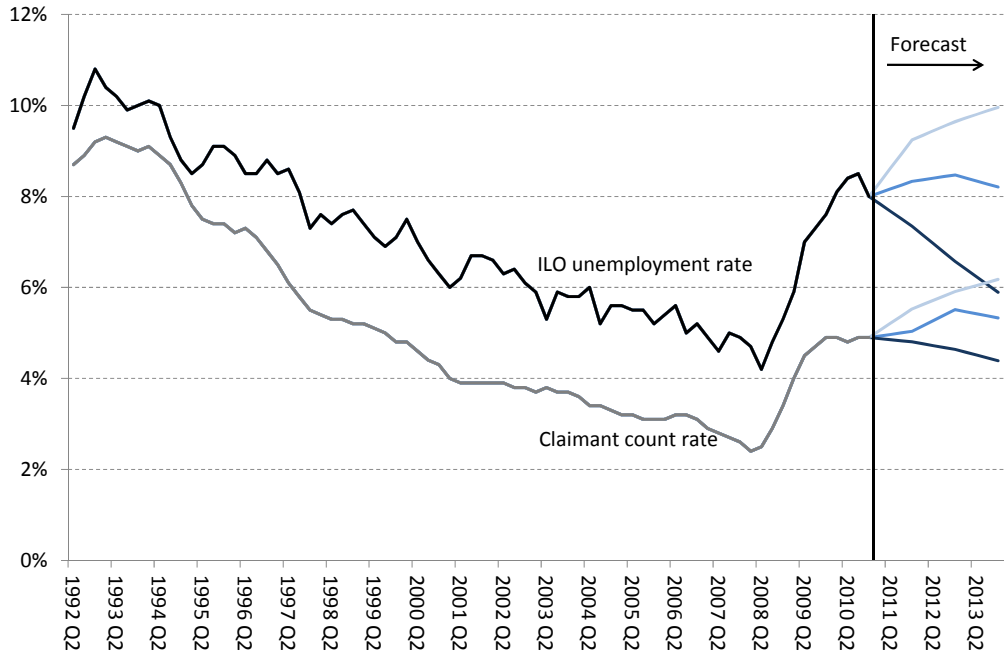
We show the claimant count and ILO unemployment rates over the period 1992 to 2010, followed by our forecasts from 2011 to 2013 in Figure 5.

Table 6: Forecasts of Scottish unemployment in "Central" scenario, 2010 to 2013

	2011	2012	2013
ILO unemployment	216,723	220,350	213,308
Rate[1]	8.3%	8.5%	8.2%
Claimant count	143,037	158,652	155,714
Rate[2]	5.0%	5.5%	5.3%

Notes: [1] = rate calculated as total number of unemployed on ILO definition divided by total economically active 16+ population.
[2] = rate calculated as claimant count divided by sum of claimant count and total workforce jobs. The latest figures for ILO unemployment in the three months to April 2011 are 207,000, at a rate of 7.7%. The latest figures for claimant count rate in May 2011 (on a provisional estimate) is 139,300, and a rate of 5.2%.

Figure 5: Scottish ILO and claimant count unemployment rate, past and forecast under three scenarios



Grant Allan,
17 June 2011

Review of Scottish Business Surveys

Overall

The effects of the harsh winter weather were a common theme in most business surveys covering the first quarter of 2011, with a number of surveys suggesting the Scottish economy to all intents stalled in the first quarter, although with some pick up in activity from February onwards.

Surveys covering manufacturing reported rising demand, activity and limited employment growth, although Oil & Gas UK noted a sharp downturn in longer term activity as a consequence of the increase in the Supplementary Tax charge in the sector.

A general theme in the surveys covering the first half of 2011 are the rising cost pressures, rising raw material and energy costs and, especially in retail and tourism the impact of inflation and consumer uncertainty on sales trends.

Surveys covering construction reported declining business optimism, pressures on margins and escalating cost pressures.

The Scottish Chambers' Business Survey (Q 1 2011) noted that once again for manufacturing firms raw material/suppliers prices (86%) and transport costs (65%) were the most widely reported cost pressures and for firms these pressures are now more evident than in previous quarters. More than three quarters of manufacturing, 93% of wholesale and 76% of retail respondents reported pressures to raise prices due to rising raw material/suppliers' prices. Firms are reporting increasing transport costs with 86% of wholesale, 65% of manufacturing and 67% of retail respondents reported rising costs.

Labour market activity remained largely subdued, although recruitment activity in construction improved. Recruitment difficulties remained at low levels. Pay increases ranged from 2.13% in wholesale to 5.4% in tourism, no construction firms reported increasing wages in the first three months of 2011.

Oil and gas services

The outlook for the UK oil and gas sector changed markedly in the first half of 2011. Without exception, all surveys published towards the end of 2010 and before 23rd March 2011 noted that oil prices were remaining on a slight upward trend and the signs were for a relatively stable continuation of the world economic recovery. Oil & Gas UK noted that the global growth in demand for energy was beginning to resume and 'every credible scenario shows further growth in demand for oil and gas over the next twenty years' (2010:4). Further evidence of rising confidence in the sector was noted in the Oil & Gas UK quarterly index (Q4 2010) which measures a combination of confidence, activity, revenue and investment. The overall index in Q4 2010 was the highest recorded since the survey began, and recorded increases across the sector, both amongst exploration and production companies and the supply chain.

In January a major report estimated that investment in the UKCS was expected to almost double, with spending expected to rise to £7.7 billion, compared with £4.4 billion in 2010 (Wood Mackenzie, quoted to the Herald 20.1.2011). Increasing recognition on the scale and value of decommissioning work, the longer term potential of offshore renewables and the application by oil and energy companies for European Union money to develop a carbon capture and storage facility (Shell UK, Petrofac and Scottish and Southern Energy) all reinforced the sense of optimism and increased activity.

The UK budget in March introduced an unexpected and potentially damaging tax increase on UKCS oil companies. Both the Chancellor and the OBR took the view that this increase would not impact adversely on either investment or activity in the UKCS. Claiming this measure was 'economically smart' the chancellor argued 'with the current oil price the prospects are for increased investment'. The OBR chairman likewise took the view 'we are assuming there is no significant effect on the investment and production profile from that change'. These views were not shared by Oil & Gas UK speaking on behalf of the industry, international and UK oil producers, investment companies, UK and international industry experts and international commentators.

The immediate reactions to the tax increase by Oil & Gas UK included seeking meetings with ministers and PILOT to outline that more frequent and unexpected tax changes potentially reduce the attractiveness of the UKCS as a location to companies choosing where to invest. It will lead to uncertainty and impact on the volume of work and long term competitiveness of the supply chain. The tax change was seen as hurried and ill informed and with little thought as to the potential impacts on investment and hence longer term energy supply and employment in the UK.

Evidence from the 14th Oil and Gas Survey (Aberdeen Chamber of Commerce) and OGUK oil and gas activity survey update (May 2011) indicates a significant decline in business confidence and investment plans for the future. OGUK suggest the impact of the increase in the Supplementary Charge has reduced the probability of some 60 projects proceeding. These projects have an estimated capital investment of £20 billion. 'In 20 instances decommissioning was likely to be accelerated by between 1 – 5 years' (OGUK May 2011:2). OGUK suggests this could mean a reduction in HM Treasury direct tax receipts of between £15 – 20 billion over time if the 25 most at risk

projects did not proceed and employment will fall by some 15,000 over the decade. These conclusions were supported by Kemp and Stephen's analysis of the effects of the 2011 budget on fields and projects that could be developed over the next 30 years as well as on existing sanctioned fields in the UKCS concluded that there will be long term reductions in field investment and oil/gas production as a consequence of the tax increase, and that these changes will reduce incentives to pursue exploration projects and reduce the ability to finance exploration and development projects.

The additional consequences of the tax changes will be to reduce the value of assets and adversely influence decisions to commit capital, and as the North Sea becomes less attractive investment, staff and assets will increasingly flow to other regions.

However, at the time of writing this review rumours were emerging that the Government might review the Supplementary charge.

Production

The latest issues of the Lloyds TSB survey covering the period November 2010 to February 2011 and with expectations to the end of August 2011 suggested the recovery was severely interrupted and possibly stalled by the adverse winter weather. However, it suggested 'the recovery from recession is likely to resume with expectations for the next six months at their highest level for three years. Forward looking indicators in the Business Monitor show the economy growing in the first half of this year. For the six months to August 2011 there are more firms (32%) expecting an increase in turnover compared to those (26%) expecting a decrease, indicating a return to growth from the weather affected last three months of last year'.

The Business Monitor noted that cost pressures remained high and increasing in the Scottish economy. The overall net balance of production businesses experiencing cost increases in the last three months is +66%, up significantly from the previous quarter and from the same quarter one year ago. Expectations for cost increases remain stubbornly high among production businesses with a net balance of +77%.

Manufacturing

Once again a common theme of export led growth appears to be underpinning improvements in the sector. The Scottish Engineering's Quarterly Review (March and June), SCBS (Q1 2011) and the Bank of Scotland PMI noted an improvement in manufacturing activity. The BOS – PMI for February reported firms recovering from the adverse weather. It noted improved demand conditions and an increase in new orders levels, although the increase in Scotland was weaker than for the UK. The March data confirmed the continuing growth in Scottish manufacturing, although the rate was lower than in February, data for April indicated a continuation of the growth, and the rate increased back to that reported in January and with the growth rate for Scotland stronger than that recorded for the UK as a whole. The May 2011 PMI noted that manufacturing activity continued to rise for the fifth consecutive month, although the rate of increase slowed.

In common with other surveys the BOS – PMI (February, March and April) noted that input price inflation remained high, driven by rising fuel, energy, raw material and wage costs, with the pressures accelerating in April. Input price inflation eased in Scotland, although remained above the UK average.

Both Scottish Engineering and SBS manufacturing respondents anticipate an improvement in demand in the second half of 2011, with the net trends in total orders and sales expected to be positive, again fuelled by export demand.

SCBS respondents noted cost pressures increased further in quarter one, raw material and to a lesser extent transport costs, continued to cause most concern to firms. Nevertheless, the net trend in turnover is expected to remain positive over the coming twelve months however a net balance of 21% expect profitability to decline.

Construction

SCBS and Scottish Building Federation construction respondents continued to report weak and declining business confidence through the first quarter. The Scottish Building Federation concluded that 'any recovery in the sector remains slow and bumpy'. Commenting on UK figures their chief executive commented ' these figures show precipitous falls in output from all sectors of the industry in the first quarter of this year, with the exception of infrastructure and non-housing repair and maintenance – most probably as a result of road and other repairs being undertaken following the sever weather.'

A major concern noted by both surveys was the rise in costs, the SBF noted that a third of respondents had been adversely affected by unexpected cost increases and one in 12 anticipated losing money as a result of underestimating the increase in raw material costs. Both surveys noted the increasing pressure on tender margins.

SCBS respondents reported weakening trends in demand with orders from all areas declining further during the first quarter. More than 70% of firms reported working below optimum levels, and, with the exception of orders from the public sector, expectations as to contracts over the next three months are still expected to ease. Turnover, tender margins and profitability over the next twelve months are expected to decline for more than half of responding firms. There is much to suggest that expectations continue to be influenced by continued speculation concerning reductions in public spending. Average capacity improved from 72% to 77%, an improvement over levels one year ago (65%).

Logistics and Wholesale

Business confidence amongst SCBS wholesale respondents remained weak as sales trends continued to weaken during the three months to March. More than half of firms reported increasing or level sales and the rate of decline is expected to ease in Q2. Cost pressures were widespread and significant, almost all firms reported pressures to raise prices, and more than 80% of respondents report rising transport costs and supplier prices. Although a net of firms anticipate an improvement in trading conditions over the coming year.

Retail distribution

Once again common themes in the surveys covering the Scottish retail sector, in addition to the longer term trends of the increase in on line sales and increasing competition amongst the major multiple retailers, have been the consequences of the harsh winter, food price inflation, cost pressures and a lack of consumer confidence dampening sales. The Scottish Retail Consortium reported a 0.9% decline in like for like sales in January. Sales trends in February were weaker with like for like sales down 1.3% on the year and trading conditions were described as getting 'steadily tougher' and weak sales were reported in March. Rising sales in April, like for like sales up 3.4% were seen as reflecting a combination of holidays and inflationary pressures. April, however was seen as a blip as The Scottish Retail Consortium reported that 'sales were down 1.1%, against a 2.4% increase in May 2010. This was the worst fall in total sales since the survey began in 1999. Like-for-like sales values were down 3.2% from May 2010, when sales had fallen 0.8%.'

SCBS respondents (mainly non major multiple retailers) reported weak trends in confidence in the first quarter, and the trend in sales remained weak with more than three-quarters reporting and 60% expecting a decline in the total value of sales. Only 7% reported increased sales during the first quarter of 2011, and once again continued concerns over consumer confidence are moderating sales expectations for the coming quarter with no firms expecting an overall increase in total sales.

SCBS respondents again reported rising cost pressures, especially suppliers' prices, and pressures to increase prices remain high. Firms are coming under more pressure from transport costs and regulation costs than in the previous quarter. Pressures on margins look set to continue with a net of 62% of firms anticipating a weakening trend in turnover and a net of 73% expect profitability to decline over the next year.

Tourism

SCBS firms noted a continued weakness in business confidence during Q1 2011 as occupancy levels weakened and demand declined sharply. Average occupancy declined from 56.4% to 46.2%, marginally better than a year ago (46.6%). Demand from Scotland, the rest of the UK, abroad and business trade all continued to decline, and the declines were greater than had been anticipated by respondents from the fourth quarter survey. Total demand and demand from the rest of the UK was lower compared to Q1 2010. Demand from all areas is expected to decline during the second quarter although the rate of decline is expected to ease. Trends in bar/restaurant trade and in conference/function facilities remained weak. Overall local and business demand accounted for 62% of total demand and tourist demand accounted for 38% of total demand in the first quarter. Visit Scotland data indicates hotel occupancy rates of 44% in January, 54% in February and 58% in March; these figures suggest little improvement in either room or bed occupancy for the past 4 years. The March figures for self catering and guest house/B & B suggest no evidence of an improvement over the past three years.

Almost 50% of SCBS respondents reported reducing average room rates and the discounting of rates is set to continue for almost a third of hotels in the three months to the end of June 2011. Once again, 70% reported that the lack of tourist demand remained the primary business constraint and once again around a third felt that their area had suffered due to poor marketing.

Outlook

The underlying weaknesses in demand and consumer spending were again evident. Cost pressures continued to rise faster than anticipated and together with rising fuel and energy costs will be of increasing concern in the second half of 2011.

Manufacturing respondents continue to rely on export orders, activity in construction is set to remain weak, and much will depend on Government action to stimulate activity. In the service sector weak consumer confidence and inflation will continue to adversely impact on retail sales trends. Activity and occupancy in hotels is little changed from previous years, and demand for bar/restaurant facilities remains weak.

Rising price pressures and weak demand are expected to continue and for many Scottish businesses the combination of slow and patchy growth, limited improvements in turnover, rising costs, pressures on margins and declining trends in profitability will pose real problems in 2011.

Cliff Lockyer/Eleanor Malloy
June 2011

Current trends in Scottish Business are regularly reported by a number of business surveys. This report draws on:

1. The Confederation of British Industries Scottish Industrial Trends Survey for the first quarter 2011;
2. Lloyds TSB Business Monitor for the quarter November 2010 – February 2011and expectations to August 2011;

3. Scottish Building Federation press releases;

4. Scottish Engineering's Quarterly Reviews for the first and second quarters of 2011;

5. The Bank of Scotland Markit Economics Regional Monthly Purchasing Managers' Indices for February - May 2011;

6. The Bank of Scotland Markit Economics Report on Jobs January 2011;

7. The Scottish Retail Consortium's KPMG Monthly Scottish Retail Sales Monitors for February – May 2011;

8. The Scottish Chambers of Commerce Quarterly Business Survey report for the first quarter of 2011;

9. Oil & Gas UK quarterly Index quarters 4 2010, Q1 2011;

10. Oil & Gas UK Activity Survey 2011;

11. Oil & Gas UK Activity Survey May 2011 Update;

12. Visit Scotland Occupancy Survey for February and March 2011;

13. The Scottish Construction Monitor quarter 4 2010

14. Jackson, P. (2009). The Future of Global Oil Supply: Understanding the Building Blocks (CERA);

15. Kemp, A & Stephen, L. (2011) The effects of Budget 2011 on Activity in the UK Continental Shelf. North Sea Study Occasional Paper no 120. April 2011. University of Aberdeen.

Overview of the labour market

Inevitably current interest in the Scottish labour market continues to focus on the trends in both employment and unemployment figures, a theme developed in other sections of this edition. Public interest continues to focus on public sector employment trends and for a further issue we return to these themes. Of interest is the impact of patterns and behaviour of immigrants to and emigrants from Scotland on recent employment patterns, and initially recent findings are considered.

Recent trends in migration

Estimates for population numbers for 2004 – 2009 by country of birth and nationality, drawing on the APS have recently been published, these show the number of people who were born abroad grew to 321,000 in 2009, an increase of 117,000 on 2004. These figures exclude students who do not have a UK resident parent and people in most other types of communal establishments (hotels, hostels, boarding houses etc.). Interestingly, a study of evidence from the 2001 census (Census sample of anonymised records) (McCollum 2011) suggests that some 40% of migrants into Scotland in the twelve months prior to the 2001 census were Scots born returnees, The study raises interesting questions as to whether the trends and characteristics of this population will be the same for studies covering a later period.

The latest available data for 2008 – 2009 (Characteristics and Intentions of Immigrants to and Emigrants from Scotland – Review of Existing Evidence, Scottish Government Social Research) suggests that 52% of migrants to Scotland came from the rest of the UK (this includes Scots born people returning to Scotland) from The General Register Office for Scotland (GROS), approximately slightly more than a quarter came from elsewhere and slightly less than a quarter form the EU.

The majority of immigrants (59%) were aged 16 – 34, reflecting the large inflow of students to Scotland. Data from the APS also provides information as to the sectoral distribution of non UK born Scottish residents. Some 27.5% were employed in Distribution, Hotels and Restaurants; 26.8% in Public Health and Administration; and 15.1% in Banking and Finance. The UK occupational pattern suggests a higher proportion than UK born residents are employed in the lowest occupational group but also in professional occupations. A8 statistics, available from the Worker Registration Scheme, indicates that of those registering between April and June 2010 were most likely to be employed in Hospitality and Catering (29%), Administration, Business and Management Services (25%) (but as the report notes 'this figure is likely to be inflated as all workers employed by employment agencies are included under this category, regardless of which sector they are working in' [page 9]), Agriculture and Food (12%), Fish and Meat processing (11%).

Recent trends and statistics

Comparable figures on the labour market between Scotland and the United Kingdom in the quarter February – April 2011 are summarised in Table 1. Labour Force Survey (LFS) data show that in the quarter to April the level of employment in Scotland fell by 7 thousand, to 2,473 thousand. Over the year to April 2011, employment in Scotland rose by 43 thousand. For the same period, UK employment rose by 376 thousand. The Scottish employment rate – those in employment as a percentage of the working age population – was 70.9 per cent, up 1.1 per cent compared to one year earlier. For the same period the UK employment rate was 70.6 per cent, up 0.4 per cent compared to one year earlier. Unemployment fell by 10 thousand, the seventh consecutive month in which unemployment has fallen.

In considering employment, activity and unemployment rates it is important to remember the bases and relationships of these figures. LFS data is provided for: (1) all aged 16 and over and (2) for all aged 59/64. The first measure (all aged 16 and over) leads to higher numbers in employment, in the total economically active and economically inactive – but reduces the economic activity rates and unemployment rates, but at the same time increases the economically inactive rate. Conversely the second measure (all aged 16 to 59/64) leads to lower numbers economically active, in employment and economically inactive – but leads to a higher economically active, employment and unemployment rates but lower economically inactive rates. Figures derived from the Labour Force Survey differ slightly from those derived from the Annual Population Survey.

The relationships between employment, unemployment, totally economically active and inactive are important in appreciating changing levels of employment and unemployment, and changes in the employment rates should be seen in conjunction with changes in the activity rates. If people leave employment and become unemployed (but are still economically active) the unemployment rate increases, but the economically active rate remains unchanged. However, if people leave employment and do not seek employment, as seems to be a continuing pattern, they are categorised as economically inactive, as such the unemployment rate remains unchanged whilst the activity and inactivity rates change. This is clearly shown in table 1. Over the year to April 2011, the numbers employed rose by 43 thousand, whilst unemployment fell by 10 thousand – and the numbers of those aged 16-59/64 who are economically inactive fell by 25 thousand and the numbers economically active rose by 33 thousand.

Table 1 shows that for Scotland the preferred International Labour Organisation (ILO) measure of unemployment eased to 207 thousand, between February – April 2011, and fell by 10 thousand over the year. The ILO unemployment rate eased in the three months to April 2011 and now stands at 7.7 per cent. This represents a 0.3 per cent fall over the last quarter and a 0.5 per cent fall relative to the same period a year earlier. The comparable ILO unemployment rate for the UK also stands at 7.7 per cent, and is down 0.3 per cent over the most recent quarter and also down 0.3 per cent over the year.

Table 1: Headline indicators of Scottish and UK labour market, October – February – April 2011

February - April 2011		Scotland	Change on quarter	Change on year	United Kingdom	Change on quarter	Change on year
Employment*	Level (000s)	2,473	-7	43	29,349	80	376
	Rate (%)	70.9	0.0	1.1	70.6	0.1	0.4
Unemployment**	Level (000s)	207	-10	-10	2,430	-88	-57
	Rate (%)	7.7	-0.3	-0.5	7.7	-0.3	-0.3
Activity*	Level (000s)	2,680	-16	33	31,669	-9	319
	Rate (%)	76.9	-0.3	0.8	76.7	-0.1	0.2
Inactivity***	Level (000s)	785	12	-25	9,368	39	-41
	Rate (%)	23.1	0.3	-0.8	23.3	0.1	-0.2

Source: Labour Market Statistics (First Release), Scotland and UK, June 2011

* Levels are for those aged 16+, while rates are for those of working age (16-59/64)

** Levels and rates are for those aged 16+, rates are proportion of economically active.

*** Levels and rates for those of working age (16-59/64)

The economically active workforce includes those individuals actively seeking employment and those currently in employment (i.e. self-employed, government employed, unpaid family workers and those on training programmes). Table 1 shows that the rate of the economically active fell 16 thousand between February – April 2011. There were 2,680 thousand economically active people in Scotland during February – April 2011. This comprised 2,473 thousand in employment and 207 thousand ILO unemployed. The level for those of working age but economically inactive rose by 12 thousand in the latest quarter, but over the year the total fell by 25 thousand to 785 thousand people; this indicates a fall of 0.8 per cent in the number of people of working age economically inactive over the last year.

Data on employment by age, derived from the Annual Population Survey, is available up to September 2010. In the year to September 2010 employment rates fell for all age groups, with the employment rate for those aged 16 – 64 falling by 1.3 percentage points and with the largest percentage point falls being recorded for those aged 16 – 17 (down 6.0%) and 25 – 34 (down 2.1%). Employment rates for men under 50 fell more than those for women, whereas employment rates for women aged 50 and above fell more than for the equivalent male age groups. Table 2 illustrates the changing employment rates by age group for the three years October – September 2008 – October – September 2010 and consistent declines across all age groups.

In the year to September 2010 (the latest available data) inactivity amongst 16 – 64 rose by 24 thousand, a 3.1% increase over the year and the inactivity rate (16 – 64) stood at 23.1%. Inactivity for men aged 16 – 64 rose by 16 thousand (5.6%) and for women rose by 8 thousand (1.7%). Inactivity rose 9.6% for men and by 2.6% for women aged 16 – 17. Over the year inactivity increased most in the age groups 16 – 34.

In the year to September 2010 inactivity rose by 24 thousand to 785 thousand. The main increases reported for the reasons for inactivity over the year were: being a student up 11 thousand, by retiring up 6 thousand, long term sick up 5 thousand; not wanting a job up 22 thousand and other 7 thousand. The numbers looking after family and home fell by 4 thousand and those temporarily sick fell by 3 thousand.

The most recent (seasonally adjusted) figure for Jobseekers allowance claimants in Scotland stood at 139.3 thousand in May 2011, up 1.2 thousand or 0.9% in the month and up 4.7 thousand or 3.6% over the year. The claimant count rate at May 2011 stood at 5.2 per cent, or 6.8% for men and 3.4% for women (note these figures are taken from table 7 in the

Table 2: Employment rates thousands (%) People by age for the three years October–September 2008, 2009 and 2010

	16+	16 - 64	16 - 17	18 - 24	25 – 34	35 - 49	50 - 64	65+
Oct 2007 – Sept 2008	60.9	74.2	40.1	67.9	81.6	83.7	66.0	6.0
Oct 2008 – Sept 2009	59.4	71.9	37.1	64.4	80.1	82.1	64.6	6.7
Oct 2009 – Sept 2010	58.2	71.0	31.1	63.7	78.0	81.1	64.2	6.5

Source: Labour Market Statistics (First Release), Scotland and UK, June 2011

Table 3: Employment, unemployment and inactivity rates by Local Authority Area 2007, 2008 and Oct 2009 – September 2010

	Employment rates			Unemployment rates 16+*			Economic inactivity rates		
Geography (Residence Based)	2007	2008	Oct2009/Sep2010	2007	2008	Oct2009/Sep2010	2007	2008	Oct2009/Sep2010
Scotland	76.0%	75.6%	71.0%	4.7%	4.9%	7.6%	20.1%	20.3%	23.1%
Local Authority Area									
Aberdeen City	79.1%	79.4%	78.1%	3.7%	3.6%	4.8%	17.3%	17.6%	18.1%
Aberdeenshire	82.6%	82.2%	80.4%	2.5%	2.6%	3.5%	15.6%	15.5%	16.5%
Angus	79.1%	80.0%	73.0%	4.5%	4.6%	6.2%	16.2%	15.6%	22.1%
Argyll & Bute	80.0%	77.6%	72.5%	4.0%	4.3%	6.0%	16.3%	18.4%	22.8%
Clackmannanshire	69.4%	70.9%	74.5%	5.5%	5.4%	7.7%	25.3%	25.4%	21.9%
Dumfries and Galloway	77.4%	76.2%	72.9%	4.2%	4.5%	5.9%	19.1%	19.5%	23.3%
Dundee City	72.1%	71.5%	69.0%	6.6%	6.3%	9.2%	22.4%	23.9%	24.3%
East Ayrshire	73.1%	74.6%	70.1%	6.3%	6.1%	9.3%	21.5%	20.4%	22.7%
East Dunbartonshire	78.9%	77.6%	75.7%	3.1%	3.9%	6.0%	19.0%	18.7%	19.4%
East Lothian	79.2%	77.9%	72.3%	3.5%	3.5%	6.7%	18.0%	19.4%	21.2%
East Renfrewshire	77.2%	76.5%	70.8%	3.4%	3.6%	6.4%	19.1%	20.5%	22.5%
Edinburgh, City of	77.4%	76.6%	69.7%	4.3%	4.5%	6.6%	19.5%	19.8%	25.5%
Eilean Siar	79.4%	78.7%	66.6%	4.2%	4.6%	6.7%	17.7%	16.3%	29.2%
Falkirk	78.1%	78.9%	73.4%	4.6%	4.4%	7.4%	18.5%	18.3%	20.8%
Fife	75.9%	76.5%	71.9%	5.6%	5.8%	8.1%	18.8%	17.7%	21.3%
Glasgow City	66.9%	66.6%	60.6%	6.8%	6.9%	11.5%	28.2%	28.8%	31.2%
Highland	82.0%	81.7%	80.3%	3.2%	3.5%	4.6%	16.0%	16.3%	17.6%
Inverclyde	68.4%	72.5%	71.2%	7.1%	6.4%	8.4%	24.8%	23.0%	22.7%
Midlothian	80.7%	79.9%	74.9%	4.2%	4.2%	6.9%	15.1%	16.2%	19.4%
Moray	80.4%	81.8%	78.8%	3.5%	3.8%	4.8%	17.2%	15.0%	17.9%
North Ayrshire	71.5%	71.8%	63.2%	6.4%	7.4%	11.7%	23.5%	22.0%	27.6%
North Lanarkshire	73.2%	71.0%	69.3%	5.4%	5.9%	10.0%	22.6%	23.8%	22.0%
Orkney Islands	86.4%	83.9%	81.8%	2.7%	2.9%	3.1%	11.2%	14.2%	15.9%
Perth and Kinross	78.1%	78.7%	72.5%	3.5%	3.7%	5.3%	18.8%	17.9%	22.5%
Renfrewshire	75.0%	76.0%	69.7%	5.1%	5.5%	9.0%	20.9%	18.9%	22.7%
Scottish Borders	81.4%	80.6%	71.0%	3.1%	3.6%	5.9%	16.2%	15.8%	23.9%
Shetland Islands	88.1%	88.0%	86.3%	2.6%	2.8%	3.5%	10.4%	10.8%	10.3%
South Ayrshire	77.2%	75.4%	68.1%	5.0%	5.4%	8.6%	18.9%	20.5%	24.4%
South Lanarkshire	78.9%	76.7%	72.2%	4.2%	4.4%	7.8%	18.5%	20.6%	22.0%
Stirling	76.8%	75.2%	69.8%	3.9%	4.5%	7.2%	19.2%	20.2%	24.1%
West Dunbartonshire	73.9%	71.2%	67.1%	6.3%	6.9%	10.2%	20.8%	23.3%	25.1%
West Lothian	77.8%	79.1%	72.2%	4.8%	4.6%	7.5%	17.7%	17.4%	23.0%

Source: 2007 and 2008 data from Annual Population Survey (Jan to Dec)
Oct 2009/September 2010 data from Labour Market Statistics (First Release), Scotland and UK, June 2011 (Source Annual Population survey, Job Centre Plus administrative system and Annual Business Inquiry)

Notes: See sources for definitions and original sources

Labour Market Statistics [First Release] June 2011 figures and measures the number of claimants on the second Thursday of each month). The latest unemployment data at the Scottish constituency level is available in a SPICe Briefing.

Statistics from the Annual Population Survey (2009) provide some indications of the impact of the recession at local area levels, by occupation and by sector (the APS combines results from the Labour Force Survey and the Scottish Labour Force Survey. Thus these figures differ slightly from those produced from the Labour Force Survey and the Annual Business Inquiry and from those published in Labour Market Statistics (First Release), Scotland and UK, June 2011). Table 3 indicates the continuing significant differences in employment, unemployment and inactivity rates before the onset of the recession, however, between 2008 and 2009 the gap between the areas with the highest and lowest employment rates widened by 5.8 percentage points. In the year October 2009 – September 2010 employment rates varied from over 80% in Aberdeenshire, Orkney and Shetland to under 70% in nine local authority areas. Likewise unemployment rates were again lowest in Aberdeenshire, Orkney and Shetland and highest, over 11%, in Glasgow and North Ayrshire, and inactivity rates were highest in Eilean Star and Glasgow City.

Table 4: Total workforce jobs* by industry, Scotland, June 2005–2010 and March 2011 (thousands)

Industry	June 2005	June 2006	June 2007	June 2008	June 2009	June 2010	March 2011
A : Agriculture, forestry and fishing	51	54	60	60	59	62	57
B : Mining and quarrying	25	28	30	30	29	27	29
C : Manufacturing	233	226	228	212	201	181	163
D : Electricity, gas, steam and air conditioning supply	10	10	13	16	19	19	19
E : Water supply; sewerage, waste management etc	16	18	17	16	14	14	14
F : Construction	181	194	203	199	185	188	183
G : Wholesale & retail trade; repair of motor vehicles etc	382	384	380	396	398	363	394
H : Transportation and storage	125	118	123	123	111	140	129
I : Accommodation and food service activities	189	190	188	191	186	197	185
J : Information and communication	72	73	79	69	68	75	69
K : Financial and insurance activities	114	107	91	98	100	95	106
L : Real estate activities	25	29	30	32	32	23	28
M : Professional, scientific and technical activities	145	154	161	176	174	157	180
N : Administrative and support service activities	174	180	192	200	185	176	185
O : Public administration & defence; social security	180	177	181	177	146	145	140
P : Education	199	200	192	208	208	197	212
Q : Human health and social work activities	384	399	383	398	401	375	427
R : Arts, entertainment and recreation	75	81	75	84	71	72	67
S : Other service activities	63	65	63	58	59	67	63
Column Total	2,644	2,685	2,690	2,740	2,651	2,571	2,651

Source: Labour Market Statistics (First Release), Scotland, June 2011

* Workforce jobs are a measure of jobs rather than people

Note: There have been considerable revisions to the June 2009 and June 2010 from previous figures

The most recent figures for the number of workforce jobs by industrial activity are detailed in Table 4. Total workforce job figures are a measure of jobs rather than people. Total seasonally adjusted employee jobs for the quarter ending March 2011 (the latest available figures) stood at 2,651 thousand, up 108 thousand on the year and 42 thousand on the quarter. Table 4, although it is necessary to note some revisions to the 2009 and 2010 figures since the last report, provides some indication of both the impact of the recession and the recovery on sectors. Services jobs continue to increase faster than production jobs. Of the increase of 108 thousand in total workforce jobs over the year to March 2011 total services jobs rose by 118 thousand (5.7%). The construction industry continues to voice concerns at official figures, and the rise in 19 thousand construction jobs over the past year would seem to add to these concerns. Of more significance is the decline in manufacturing jobs, down 22 thousand over the year (11.9%), especially given views that manufacturing is expected to play a significant part in the recovery and is expected to be more important given policies to 'rebalance' the economy. The increase in the number of jobs over the past year in Education, Human health and social work activities – contributing 59 thousand jobs over the past year, or some 50% of the increase in

workforce jobs - would appear to be potentially temporary, given the planned cuts in the public sector.
A continuing feature of the past two years has been the increase in the numbers of part time workers in Scotland, the latest data (to September 2010), indicates that over the past year the numbers of full time workers in Scotland declined by 57 thousand (-3.1%) whereas the numbers of part time workers rose by 19 thousand (2.9%). Over the two years Oct 2007 – Sept 2008 and Oct 2009 – Sept 2010 the number of full time workers has fallen by 118 thousand but the number of part time workers has increased by 32 thousand and temporary workers by 7 thousand. The majority of those working part time choose to do so, however over the year to September 2010 the numbers reporting working part time because they could not find a full time job rose by 18 thousand, whereas the numbers of those who did not want a full time job remained unchanged, suggesting that increasing numbers of workers were taking part time employment in the absence of full time work (the same argument applies to temporary work.

Table 5 of the Labour Market statistics (first release) provides information of the claimant count. The figure for May indicates a total number of all claimants of 140.1 thousand, up 4.6 thousand for the year, but the lowest monthly figure for 2011. Of interest are the differing trends in the claimant count for men and women. The claimant count for men, 97.9 thousand was down 2.1 thousand over the year, whereas the comparable figure for women, 42.2 thousand, was 6.6 thousand higher than a year ago.

Table 5 provides some limited indications of the experience of unemployment in terms of claimant count by age and duration. The latest figures suggest that 20.3 thousand have been claiming benefits for more than a year, down 500 over the year and 4.9 thousand have been claiming for more than 2 years, up 1.5 thousand over the year.

Public Sector employment in Scotland

As we noted in previous Commentaries there has been much evidence to suggest that most Scottish public sector organisations have been planning considerable budget reductions in recent months, given that staff costs account for around 52% or £18.8 billion of Scottish public spending (Audit Scotland). Audit Scotland noted 'the Scottish public sector is facing the biggest squeeze on budgets since devolution' (2009:8).

Table 5: Total claimant count and computerised claims by age and duration (Numbers and percentage change over year to May 2011)

	All computerised claims	All computerised claims Up to 6 months	All computerised claims Over 6 and up to 12 months	All computerised claims All over 12 months
All 16+ numbers	139,000	88,000	29,900	20,300
All 16+ % change over year	3.4%	5.2	1.4	-2.6
All 18 – 24 over year	39,100	30,200	7,400	1,500
All 25- 49 over year	77,400	45,500	12,600	14,200
All 50 and above over year	21,400	12,000	4,800	4,600

Table 6 indicates the changing pattern of public sector public sector employment (headcount) for 2010; total public sector employment has declined by 18,000 (2.9%) to 595,800 by the end of 2010 and now represents 24% (22.4% if Public Sector Financial Institutions are excluded) of employment. Total employment in the devolved public sector has decreased by 2.7% over the year. This has been mainly driven by a decrease in local government employment. Over the same period employment in the reserved public sector in Scotland has decreased by 4.5% over the year. In contrast employment in Public Sector Financial Institutions has increased by 1,700 (4.6%). Table 7 indicates the changes in headcount by local authority.

Table 7 sets out the changing levels of Local Authority employment for 2010 (data for Q1 2011 will not be published until 28 June) and indicates a decline in Local Authority employment of 9,100 over the year.

Outlook

The trends in employment have improved in 2011, nevertheless in the year to April 2011 the total number in employment fell by 7,000 and unemployment fell by 10,000 to 207,000 and the numbers economically inactive fell by 12,000. The pattern of employment continues to change with rising numbers of part time (up 19,000 in the year to September 2010), temporary employees (remaining level over the same period) and declining numbers of full-time workers (down 57,000 in the year to September 2010). Over the same period the numbers of part time workers who could not find a full time job rose by 18,000. Rising trends in employment in 2011mask concerns not only as to the shift towards part time employment, but equally the shift away from production and reliance on the service sector.

Changes to the public sector employment landscape will continue to be the main feature in 2011 with many sectors

Table 6: Total public sector employment in Scotland (headcount) 2010

Broad category	Area	Q1 2010	Q2 2010	Q3 2010	Q4 2010
Civil Service	Scottish Govt Depts.	5700	5700	5600	5400
	Crown Office	1900	1800	1800	1700
	Scottish Govt Agencies	8300	6800	6900	6500
	Non ministerial Depts.	1800	3400	3400	3100
Local Government	Teachers	62700	61100	na	na
	Other education	51600	51000	na	na
	Social work	54700	54000	na	na
	Police & Related services	24900	24800	24700	23600
	Fire & related services	5800	5700	5700	5500
	Other	104700	105200	na	na
Total Local Government		304300	301900	297800	295200
NHS		163000	162200	161300	160700
Public Corporations		4600	4600	4600	4400
Other public bodies		16100	15400	15400	15000
Total devolved sector		506000	502200	496600	493100
Armed forces		12100	12200	12300	12300
Civil Service	Min of Defence	5900	5900	5800	5700
	HM Revenue & Customs	10000	9800	9700	9600
	DWP	12200	12000	11600	11300
	Dept for International Dev.	500	500	500	500
	Scotland Office	70	70	70	70
	Other Civil service	3900	3900	3900	3800
Civil service		34300	35500	34800	31000
Public corporations		4600	4600	4500	4200
Public bodies		15400	15400	15400	13900
Public sector financial		36300	36700	36700	38500
Total reserved sector		104300	104300	103800	95600
Total Scottish employment		610200	606400	600400	595800

Source: Quarterly Public Sector Employment series, Scottish Government.
Note: Figures may not total due to rounding.

Table 7 Local Government employment by local authority (headcount) 2010 (Not seasonally adjusted)

Local Authority/Joint Board	Q1 2010 Totall all staff	Q2 2010 Total all staff	Q3 2010 Total all staff	Q4 2010 Total all staff
Aberdeen City	9,500	9,400	8,900	8,800
Aberdeenshire	15,000	14,900	14,500	14,400
Angus	5,700	5,600	5,600	5,500
Argyll & Bute	5,300	5,200	5,200	5,300
Clackmannanshire	2,800	2,800	2,800	2,700
Dumfries & Galloway	8,300	8,300	8,200	8,300
Dundee City	8,200	8,100	8,000	7,900
East Ayrshire	6,700	6,600	6,600	6,600
East Dunbartonshire	5,000	5,000	4,900	4,800
East Lothian	4,900	4,800	4,800	4,700
East Renfrewshire	4,700	4,500	4,600	4,500
Edinburgh, City of	19,100	18,800	18,500	18,500
Eilean Siar	2,600	2,500	2,500	2,500
Falkirk	8,000	7,800	7,900	7,900
Fife	23,200	23,100	22,400	22,300
Glasgow City	23,500	23,100	22,300	22,100
Highland	12,900	13,000	12,700	12,600
Inverclyde	4,700	4,700	4,600	4,600
Midlothian	4,800	4,800	4,800	4,600
Moray	5,100	5,100	5,100	5,000
North Ayrshire	7,200	7,200	7,100	7,000
North Lanarkshire	17,700	17,500	17,200	16,700
Orkney Islands	2,800	2,400	2,400	2,400
Perth & Kinross	6,200	6,100	6,000	6,000
Renfrewshire	8,600	8,400	8,300	8,400
Scottish Borders	5,700	5,700	5,700	5,700
Shetland Islands	4,100	4,100	4,100	4,100
South Ayrshire	5,500	5,600	5,600	5,800
South Lanarkshire	15,500	15,800	15,500	14,800
Stirling	4,500	4,400	4,500	4,400
West Dunbartonshire	6,700	6,300	6,200	6,100
West Lothian	8,500	8,500	8,400	8,300
Total Fire Joint Boards	5,800	5,700	5,700	5,600
Total Police Joint Boards	24,900	24,800	24,700	24,500
Total Valuation Joint Boards	600	600	600	600
Total Regional Transport (SPT)		700	700	600
SCOTLAND	304,300	301,900	297,800	295,200

Source: Joint Staffing Watch Survey, Scottish Government

Notes:

1. Figures are rounded to nearest hundred.
2. Totals may not add to the sum of the parts due to rounding.
3. Figures for Fire Service staff exclude volunteer and retained fire-fighters.
4. Police and Fire Service staffs in Dumfries and Galloway and Fife, who are not covered by Joint Boards, are included within the figures for Joint Boards for consistency.

seeking to reduce staff numbers and with increasing calls for industrial action by trade unions. Already in some quarters there have been calls for further legislation to limit the right to industrial action.

Unite Scotland, in a paper entitled 'Making Devolution Work' (April 2011) argues the case for the introduction of mechanisms in Scotland to determine wages and related issues at a sectoral level, arguing that evidence from Europe supports the view that centralised collective bargaining leads to lower wage inequality. Equally, there much is to suggest that the European systems of employee participation have contributed to higher levels of economic growth. Unite argues for the extension of the principle operating in Agriculture (The Scottish Agricultural Wages Board) to other sectors and to act as a vehicle to 'discuss wages, industry terms and conditions, investment, skills, apprenticeships and productivity levels' (Unite Scotland, 2011 pages 16-18). There is much to commend a reasoned debate as to such principles and to ask the question. What system and structures of employee relations would be best suited to Scotland, whether to continue to follow the UK or to see a more participative structure which encourages dialogue and problem solving?

References

Eirich, F. (2011). Characteristics and intentions of Immigrants to and emigrants from Scotland – Review of Existing evidence. Scottish Government Social Research.

General Register for Scotland. (2011). Estimates of Population by Country of Birth and Nationality.

McCollum, D. (2011). The Demographic and socio-economic profile of return migrants and long – term in-migrants in Scotland: evidence from the Scottish Longitudinal Study. Scottish Government Social Research 2011.

Unite Scotland. (2011) Making Devolution Work. Proposals for Prosperity.

Cliff Lockyer
June 2011

Economic perspectives

Opinions expressed in economic perspectives are those of the authors and not necessarily those of the Fraser of Allander Institute

Assessing the financial impact of the Scotland Bill: problems of Scottish Government accounting

Professor Arthur Midwinter, IPSAR, University of Edinburgh

The Scotland Bill contains proposals based on the Calman Report [1]to remedy the major financial weakness of the 1997 devolution settlement – namely its limited tax-raising powers[2]. (The new funding model will combine Block Grant with new tax revenues from a Scottish Income Tax, a Scottish Land Transaction Tax and a Scottish Landfill Tax. However, it has been heavily criticised by the Scottish Government for having a "long-term deflationary bias"[3] .

This is a strong attack on a model intended to maintain stability and promote accountability in devolution finance. The current approach is embedded in the UK fiscal framework, in which the UK Government has responsibility for the planning and control of the public finances, and resource allocation to UK Departments and Devolved Administrations. The Scottish Budget therefore benefits from

> "an automatic macroeconomic stabilisation level and a public expenditure per capita substantially above the UK average"[4].

The UK Budget process provides a high degree of stability. It operates through incremental change, in which the major part of the new budget is the existing baseline, and decisions are made around the margins of this budget base. In the case of the Scottish Budget, incremental adjustments are made through the Barnett Formula which delivers the same per capita increase/decrease as comparable UK programmes, and has delivered "stability and predictability" since devolution"[5].

Fiscal reform

The Bill states that the new model will create a system which will allow the Scottish Parliament to determine how revenues are raised to supplement its existing responsibility to determine how budgets are spent, and be accountable for those choices. It creates a degree of risk over revenue receipts, but will have borrowing powers to manage this flow

of resources As the majority of funding will still be provided by a Block Grant, stability and predictability will be maintained. These plans will operate within the UK fiscal framework which will allow the Treasury to retain aggregate control "consistent with the continuing reservation of overall macroeconomic policy"[6].

So the Scottish Budget will now have two revenue streams, from its "own revenues" and from a smaller Block Grant, calculated as at present, but reduced by the amount of anticipated revenues.

Initially, the tax revenues will be forecast and assigned to the Scottish Budget in a transparent way to show how much grant is being replaced by taxation, based on the current levels generated by 10p tax rate across all bands.

The full system is planned to be implemented by 2016. Firstly, the minor taxes will be introduced in 2015, with the new revenue borrowing powers of £200 million per annum, up to a £500 million limit, to manage any deficits from revenue shortfall, whilst surpluses can be retained in a new Scottish cash reserve for offsetting any deficits in future years.

In 2016, the main UK rates will be reduced by 10p for Scottish taxpayers, and the Scottish Parliament will set a replacement tax necessary to balance its Budget. There will then be a permanent reduction of Block Grant.

If there is an outturn deficit of less than 0.5%, the Parliament will be expected to absorb this in the Budget. Any borrowing can fund shortfalls for up to four years. Any shortfalls or surpluses arising from forecasting errors will be dealt with by transfers between the Scottish Budget and the UK Consolidated Fund.

The Scottish Government's response

In the Scottish Government's view, the new model will "generate greater volatility in future budgets" and result in "UK cuts by the back door", as they expect tax receipts to grow more slowly than the Block Grant, thereby reducing the Scottish Budget. Therefore

> "we estimate that these proposals would have cost Scotland £8 billion since 1999"[7].

Secondly, they claim it leaves Scotland exposed to the impact of changes to UK tax policy even though a detriment provision will prevent any loss of resources, which has been a key principle of devolution since 1999.

Thirdly, it regards the revenue borrowing powers as insufficient to manage revenue volatility. Overall, it sees the proposals as a "backward step" which "could make the spending and economic challenges Scotland faces more difficult".

This is a contentious interpretation of the financial impact of the Bill. The cumulative shortfall of £8 billion exaggerates the financial impact of the new system on the Budget. This Government uses this practice regularly in presenting spending plans and efficiency savings, or in forecasting future allocations.

More importantly, it is inappropriate when seeking to assess the financial impact of the new tax powers on the Scottish Budget. What matters is the stability of annual budgets and the capacity of the borrowing powers to cope with any volatility in the revenue stream.

The Scottish Government's estimate of the additive shortfall since devolution is £1.2 billion, or £109 million per annum on average. However, specific years can exceed this average and could be a concern. Fortunately, the Scottish Government's revenue estimates are significantly lower than the official estimates from HMRC.

The Finance Minister advised the Scottish Parliament (Official Report, 14/1/2011, col.157) that his Government's position had been strongly influenced by an academic paper by Professors Hughes-Hallet and Scott. This paper reports broadly similar conclusions, and the academics have since gone on record in The Scotsman of 14th January 2011 as supporting the Scottish Government's position, and that their cumulative shortfall assessment figures which they see as economically damaging (and indeed also use the term "deflationary bias"), is based on Scottish Government data[8].

The Scottish Government's estimate of the yield from a 10p tax rate is that on average, it is 15% of the Departmental Expenditure Limit. This is based on data in Government Expenditure and Revenues in Scotland, but GERS only provides an estimate of total yield. Their note does not illustrate how the 15% figure was reached, and also excludes revenues from the other taxes.

The official estimates, provided by HMRC, are much higher, at 17.25% over the same period, with a range from 14.6% to 20.2%. Table 1 compares the annual estimates of the Scottish Government with the official statistics on which the reforms will be based, and shows the official estimates are consistently higher, and add to a total of around £1 billion more than the Scottish Government's estimates between 1999 and 2007. This would result in a modest total shortfall of around £200 million, not £1.2 billion.

This suggests that the volatility will be much less than the Scottish Government assumed, but the range of scores from 14.6% to 20.2% is wide enough to create concerns over the degree of volatility in revenues and the intention to use an average figure for the permanent adjustment to the Block Grant.

This could be overcome, however, by continuing the practice of forecasting and assigning the tax revenues to the Scottish Budget as intended during the transition. The UK

Government objective is to increase the Parliament's financial powers and to link the Scottish Budget more closely to Scottish tax revenues. It is not its purpose to change Scotland's share of UK funding, but to increase choice at the margins. With two funding streams, however, there could be changes to the Budget, compared with the Barnett model, in any year. Now the changes will depend on the tax decisions of the Parliament and the performance of the economy.

The Bill acknowledges that the new tax powers give the Parliament "an interest in the economy" (i.e. to increase its tax yield). In the Scottish Parliament, the major division was over the lack of economic levers to influence growth. The Bill Committee's report[9] reflects the conflicting evidence over the causal link between fiscal devolution and economic growth. The report quotes several economic experts expressing scepticism over the Scottish Government's economic arguments. These included views that economic growth is driven mainly by factors other than taxes and spending, and that the fiscal powers should lead to better governance, which might lead to improved growth later.

This is a combination of empirical and theoretical arguments. The evidence on fiscal causality has been examined extensively, but "better governance" is a slippery concept. The Committee draws on this substantive body of evidence to reject the case made by Scottish Minister's for full fiscal autonomy, on the grounds that "the overwhelming balance of expert opinion" did not find any causal link between fiscal devolution and growth (paragraph 36).

The Committee then appears to adopt a contradictory position over the grant reduction mechanism in that "it should not insulate the Scottish Budget from the performance of the Scottish economy, so that the Scottish Parliament has a direct financial stake in Scotland's economic success!" (paragraph 74).

Politicians may be unwilling to publicly acknowledge their inability to influence economic growth under the devolution settlement. It is certainly the case that growth was heavily influenced by the growth of public spending between 1999 and 2005[10], but that simply reflects UK budgetary strategy.

The problem remains that the new model could result in a smaller Budget even if the Scottish Parliament simply maintained tax revenues as they are at present. This would blur the clear lines of accountability for tax decisions.

Implementation can be achieved without the need for a permanent adjustment to the Block Grant, thus maintaining stability. For the initial period, the intention is to deduct forecast revenues from the Block Grant total to provide a required level of grant, adjusted for any variation in tax levels, the tax revenues will then be assigned to the Scottish Budget.

This model could simply continue, removing the need for a permanent adjustment of the Block Grant based on average revenues as a proportion of the DEL. This would also remove the need for borrowing powers, the Block Grant will continue to be set by Barnett, minus the forecast revenues, and there would be no shortfall/surpluses on the Budget because of volatility in revenues.

Put more simply, the Scottish Budget would continue to have a full Barnett-based spending assessment, funded by assigned tax revenues and a reduced Block Grant. This would remove the volatility problem, and maintain our relative position in UK allocations, and only vary when tax decisions are taken to do so.

This approach would better meet the UK Government's objective "to ensure that the relative levels of public expenditure remain constant"[11]. The Scottish Budget's share of UK funding would remain stable, with any budget variations reflected in higher or lower taxes on Scottish taxpayers.

Conclusions

The Scotland Bill will increase the financial accountability of the Scottish Parliament by requiring tax levels to be set annually to balance the Scottish Budget, and to vary the Budget according to its political preferences by increasing or decreasing spending and taxation at the margins. The Scottish Budget will remain within the UK fiscal framework.

Whilst the new funding mechanism will create a degree of volatility in tax revenues, this will not result in the deflationary bias as suggested by the Scottish Government. Their estimating errors and practice of cumulative accounting greatly exaggerate the financial impact of the Bill on the Scottish Budget.

The degree of volatility is much less, and can be dealt with within the UK fiscal framework by maintaining the practice of forecasting and assigning revenues to the Scottish Budget, whilst reducing the Block Grant accordingly from the conventional Barnett spending assessment. This would remove the need for a permanent adjustment to the Block Grant, and for revenue borrowing powers. This would meet the Calman principles of autonomy, accountability and equity within the principles of the Union and Treasury management of the public finances.

This would operate in the same way as the grant system in local government. Barnett would continue to determine Scotland's appropriate share of the UK Budget. That figure would then be adjusted to reflect the tax yield set in Edinburgh. A reduction from 10p would reduce the allocation, whilst an increase above 10p would increase spending.

The Scottish tax decision would determine the total budget available, whilst Barnett would retain our relative position

and provide funding stability. Accountability would therefore be increased and the constitutional objectives met.

Table 1: Comparative estimates of 10p tax yield in Scotland Bill

Year	Scottish Government £million	HMRC £million
1999-2000	2651	2600
2000-1	2898	2980
2001-2	3018	3130
2002-3	3098	3210
2003-4	3207	3310
2004-5	3427	3510
2005-6	3746	3930
2006-7	4073	4260
2007-8	4394	4570
Total	30572	31560

Footnotes

[1]Commission on Scottish Devolution (2009) Final Report – Serving Scotland Better, Edinburgh.

[2]Arthur Midwinter and Murray McVicar (1996) "Uncharted Waters? Problems of Financing Labour's Scottish Parliament", Public Money and Management, Vol.16, No.2, pp.47-53.

[3]Scottish Government (2010) Scotland Bill Financial Provisions, Edinburgh, November.

[4]Brian Ashcroft, Alex Christie and Kim Swales (2006) "Fiscal Autonomy for Scotland – A Rejoinder", FAI Quarterly Economic Commentary, October, Vol.31, No.2, pp.54-56.

[5]Commission on Scottish Devolution (2008) First Report. The Future of Scottish Devolution within the Union, Edinburgh, p.59, para. 6.15.

[6]Strengthening Scotland's Future, CM7973, Chapter Two, page 22 (London: HMG).

[7]Scottish Government (2010) Scotland Bill, Financial Provisions, p.1.

[8]A. Hughes-Hallet and D. Scott (2010) Scotland: A New Fiscal Settlement, CDMA 10/09, working paper series.

[9]Scotland Bill Committee (2011) 1st Report 2011 (Session 3) Report on the Scotland Bill and relevant legislative consent memoranda.

[10]Experian (2006) "Economic Impact of the Scottish Budget", report for Scottish Parliament Finance Committee, October.

[11]UK Government (2011) "Modelling the potential impact of the Scotland Bill Income Tax Measures on the Scottish Budget". A technical note prepared for the Scotland Bill Committee.

The governance of Scottish ferry services

Professor Neil Kay, Department of Economics

1. Introduction

In this paper we argue that the present arrangements for review and implementation of Scottish Ferry policy are not competent and that, in particular the role and functions of Transport Scotland should be replaced by an independent regulator supported and directed by a sector-specific statutory framework. The arguments here are buttressed by reference to serious and well-documented failures on the part of this agency and its predecessor government department in dealing with the areas of ferry governance with which they have been given responsibility.

By "not competent" it is not intended to imply failures in terms of competence or performance on the part of any individual. Competence depends on context, training and perspective, the problems here are systemic and institutional and cannot be sorted by any review or reviews carried out by Transport Scotland itself. The former Home Secretary John Reid once famously remarked that his Immigration Department was "not fit for purpose". What can be said about the present role and functions of Transport Scotland in the context of Scottish ferry policy is that they were not **designed** for purpose.

This paper is intended to be read in conjunction with my 2009 Fraser Commentary paper on Scottish ferry policy[1] for which it can be treated as both an extension and update[2]. It can however be read independently of that paper, though for reason of brevity and economy we shall avoid much of the technical and legislative detail covered in that earlier paper where possible.

2. The 2009 Fraser Ferry Policy Paper and update

In the 2009 paper I concluded that "It is difficult to overstate both the scale of the failures in policy making with respect to Scottish ferries post-devolution, nor how unnecessary such failures have been".

Nothing that has happened since has done anything to moderate these views and indeed if anything, matters have worsened, the 2009 paper argued (as I and others had done since 2001) that whatever governance solutions were adopted as policy for Scottish ferry services that these should have as minimum specifications an independent regulator supported by a dedicated statutory regulatory framework and clearly specified operator of last resort, as tends to be standard as part of oversight provision for other UK essential public services.

None of these are in place though the Scottish Government has recently announced that it will explore the possibility of an industry regulator backed by statutory legislation, this is discussed further below.

However, the major problems that I identified in that paper still hold and in addition to the failures to put in place the regulatory safeguards that the network needs, there is still little evidence that there is proper recognition and understanding at official level of the opportunities and constraints represented by EU law in this context, in particular the roles played by public service obligations (PSOs), public service contracts (PSCs) and the Altmark principles. In turn, there is failure to fully appreciate and explore issues associated with exclusivity provisions and methods for dealing with cherry picking, all of which is provided for in EU law and associated guidelines.

The major changes since 2009 relate to the first of the three major public service contracts that are set to be decided between now and 2013. The case is that of Gourock-Dunoon[3] and the outcome is frankly a shambles and disastrous for the public interest as it affects the taxpayer, the users, and the dependent communities.

In 2007 the Scottish Government had come to power promising to build two vehicle-passenger ferries for the Gourock-Dunoon public service route, and indeed throughout the tender process it had been the Government's claim that they had been working towards a "town centre to town centre vehicle and passenger ferry service between Gourock and Dunoon[4]. The Government was aware that studies, including those sponsored by the Scottish Executive, confirmed the economic case for building these vessels[5] and also confirmed that they would have to be built specially since suitable vessels would be unlikely to be obtained through the second hand market[6]. They would have been aware there was no legal impediment to building and deploying these vessels[7] as long as suitable accounting measures were put in place to make sure there was no leakage of subsidy from the foot passenger side to the vehicle-carrying side, as the European Commission had confirmed in an answer in 2007. There was no change to EU law or guidelines relating to the issues that would have made a substantive difference to these issues over the period 2007-2011.

What actually happened was a series of prevarications and confusions that at the very least demonstrated the kind of systemic failures of governance that I had argued in 2009 showed the need for major institutional reform in this area. First, the Government claimed that EU law prevented them from building new ferries for the route[8]. This was not true and never has been true, even the most charitable interpretation is that it displays complete misunderstanding

of EU law as it applies. Second, the Herald newspaper recently revealed that the Government made a covert offer to the private operator Western Ferries in 2007 that the Government would withdraw the CalMac vehicle-carrying public service if Western would run some of their vehicle-carrying service into Dunoon Pier. This would have reduced the potential market for (profitable) vehicle-carrying on the public service town centre route, increased the need for subsidy on the public service route, and increase the probability that the only option left for bidders for the route would be a passenger-only option.[9] Third, the Government claimed that a survey they had sponsored showed that suitable vehicle-carrying ferries were available on the second-hand market for Gourock-Dunoon (and by implication precluding the need to build them). Freedom of Information requests showed that this was not true.[10]

There were other prevarications such as FoI-refuted claims by the Government that they were in active discussions with the European Commission[11] and attempts to persuade the European Commission to extend the deadline for the new tender on what could only have been spurious grounds.[12] In the end the winning tender for the town centre public service route was announced just after the May 5th Holyrood election, and as was widely expected was a passenger only option. At a stroke this will degrade the options open to users on the town centre route, heavily increase subsidy unnecessarily compared to what would have been needed if the modern vehicle-passenger ferries needed for the route had been built and made available for the tender, create a vehicle-carrying private unregulated monopoly over a strategically important transport route, and impact heavily and adversely on dependent local economies and communities.

However that is only one part of the Scottish ferry network, what is happening on Gourock-Dunoon is set to be a model that could destabilize much of the Scottish ferry network and fragile dependent communities. That is only one part of the risks and threats to the public interest that failures at governance and policy level are creating here.

3. How we got here

Domestic ferry services in most countries are treated as essential services and administered appropriately. On a straight mile-for-mile basis ferry travel can be one of the most expensive forms of transport modes and where ferries are used it is typically because there are few, if any, practical options. They tend to have natural monopoly characteristics and often high levels of externalities with respect to local regional economic development. For those reasons, most countries subject their domestic ferry services to careful and systemic control, either through state ownership or regulatory oversight.

Nationalization was the standard UK solution to an industry with these economic characteristics until Margret Thatcher's privatisation programme in the Eighties replaced state control with regulatory oversight in most of these cases. The pattern was fairly standard; a nationalised industry would be replaced by a competitive tendering resulting in a series of privately-owned companies with an independent regulator and a sector-specific statutory framework. Each case incorporated necessary checks and balances such as provision for an operator of last resort should any incumbent operator default or otherwise threaten breaches of its contract.

With post-war domestic Scottish ferry services being dominated by one large nationalized ferry operator Caledonian Macbrayne, this fitted into the first part of the story of how such natural monopolies came to be administered in the UK. Where the story parted company with the standard script in the Thatcher era of transformation through privatization and regulation was that Scottish ferry services remained for the most part in state-owned hands.

In my 2009 paper on Scottish ferry policy in the Fraser Commentary, I covered some of the background to this anomaly which to a large extent revolved around the fact that while ferry services were an integral part of much of the Scottish transport network in the north and west of the country, this was simply not a major issue south of the border apart from the very localized case of the Isle of Wight ferries which were already run by private companies.

A contributory problem here is that while air, rail, and road policy is highly visible to transport policy makers and commentators who may depend on (or at least observe) these services themselves, much of what happens on domestic Scottish ferry services tends to impact on peripheral, scattered and isolated communities. The debacle of the Edinburgh trams has received high levels of coverage in the Scottish media and there is high public awareness that there are major public interest issues at stake here - even if there is less awareness of exactly what the issues are. However, there was far little coverage and public awareness of the fact that the first Northlink ferry contract serving the Northern Iles (Orkney and Shetland from Aberdeen) effectively collapsed with forced retendering in 2004 after the operator receiving a multi-million pound bail out following its threats to withdraw from the route. Yet these ferry services to the Northern Isles are essential public services with many communities and businesses in Orkney and Shetland dependent on them for their survival. And no matter what can be done to salvage the Edinburgh trams project it is highly unlikely that it will ever achieve the status of essential public service.

Similarly, at the end of this month the CalMac Gourock-Dunoon town centre to town centre vehicle-passenger service will end after several decades of operation and be replaced by a passenger-only service. This leaves by default an unregulated private firm (Western Ferries) as monopoly operator of vehicle-carrying ferry services over the Clyde Estuary, the road option involving a detour of 84 miles. While the traffic numbers on The Clyde Estuary are of course much smaller than across the Forth Estuary, in

transport terms this is comparable to giving a private firm the keys to the Forth Bridge with no direct control by government over pricing and other strategic decisions.

A further problem is at the level of individual markets like Gourock-Dunoon, the scale of any possible market distortion is likely to fall below the radar of the OFT, even though they may have profound effects on local economies and communities. However, in the aggregate the failures of successive governments to put in place a coherent (or indeed any) statutory framework for regulating Scottish ferry services means that the system is simply unable to deal competently and coherently with standard problems that regulators of other essential services face on a regular basis, such as monopoly pricing and delivery of services, market entry, cherry picking, exclusivity, public service obligations (PSOs) versus public service contracts (PSCs) and operator of last resort.

The problem with the governance of Scottish ferry service is that for the last decade it has been mis-specified as a problem by government. It has been largely defined and seen as a transport sector where subsdised public services would now have to be made subject to competitive tendering to be made compliant with EU law. While this is correct as far as it goes, this has helped obscure the fact that the self-regulatory function that nationalisation had filled now left a regulatory gap that would have to be replaced for these essential services if matters were not to fall apart. But the supposed urgency of the need to comply with EU regulations meant government since 2000 brushed aside such arguments arguing that matters were too urgent for such luxuries as proper regulatory oversight. In 2000, the Executive stated they were "aiming to have the first tender in place by Spring 2001 with implementation to follow"[13] a time horizon which was never realistic as I and others pointed out[14]. In the event the first CalMac tender for Clyde and Hebrides ferry services began in October 2007, the imminent (though ever-receding) deadline for tendering effectively capping and neutering any chance of reasoned debate.

In 2001 when the issue of need for an Independent Regulator of competitively tendered ferry services was raised by me and others to the then Scottish Executive and the Scottish Parliament, the response was that *"The Transport Minister when questioned on (the subject of an Independent Regulator) continues to state that it is not needed since the Maritime and Coastguard Agency is responsible for safety[15].*

While of course it is the Minister who is held responsible and accountable for not knowing that the term 'independent regulator' generally refers to an agency with an economic function. Iit was such a briefing from officials which made it impossible to make headway on this issue with successive ministers, despite it being raised repeatedly by me and others to the Executive and Parliament, including in invited evidence to Inquiries into ferry tendering held in each of the first three sessions of the Scottish Parliament.

4. Where we are now

Two statements by Scottish Cabinet Secretaries with respect to the Gourock-Dunoon tendering issue in recent weeks reinforce the above points. First in response to the Gourock-Dunoon debacle, the Government news release quoted John Swinney, Cabinet Secretary for Finance and Sustainable Growth:

> *"the Government is now examining the scope for introducing a statutory ferry regulator which could have strong powers to ensure there is no predatory commercial activity on any Scottish ferry route"[16]*

While it may be seen as something that, at least, there is at last official recognition of the need for a regulator with statutory powers here, albeit ten years late, the reasons given for it reflect further misunderstanding of the scale and nature of the economic problem here. Predatory behaviour or predation in economics refers to anti-competitive behaviour such as pricing below cost to drive rivals out the market. This was not an issue on Gourock-Dunoon where the market distortions were largely created by government intervention rather than corporate action, nor is it likely to be one of the major issues for a regulator in the markets under discussion here. Indeed, the problems created and buttressed through government restrictions on the Gourock-Dunoon on Gourock-Dunoon were the opposite of predation with the dominant position already achieved for the private sector operator allowing it to achieve operating margins averaging about 27% in recent years[17].

Just talking about creating a regulator without first having a clear sight of what, how, and who he is she is supposed to be regulating is rather like appointing an umpire without giving them a rule book. Even who they would regulate needs to be made clear – for example, does it include private unsubsidized firms plying routes that are classifiable as public service routes under EU law? Eleven years after the issues of competitive tendering of nationalised ferry services first appeared on the political map there is no evidence that such questions are appearing on the agenda, let alone being answered.

The second statement regarding Gourock-Dunoon was by Alex Neil Cabinet Secretary for Infrastructure and Capital Investment to the Scottish Parliament June 2nd 2011

> ***Alex Neil:*** *"The origin of the contract and tender was essentially the European Commission. The Scottish Government had no option other than to tender the service. We had to take decisions on the basis of the tenders that were returned, and we took the option that involved the absolute minimum number of redundancies. Had we taken any other option, the number of redundancies involved would have multiplied by four. I take it*

> *that all members in the chamber will welcome the Government "s policy of minimising redundancies in such situations".*[18]

While some members and interested parties might indeed welcome a policy and decision under competitive tendering that was taken on the basis of minimising redundancies, such a policy raises serious questions under competitive tendering and extant law as it relates to these issues. It is perhaps a reflection of the low level of awareness of these issues that this point does not seem to have been picked up and subjected to further discussion and investigation, whether in or out of Parliament.

At this point it should be noted there is a Ferries Review[19] which has been conducted over most of the life of the last Parliament and is publicised by the Government as intended to provide a basis for "a long-term plan for ferry services to 2022". This will not shed much light on the issues that matter here, indeed it has the potential to not just have wasted much public money but to make things even worse.

The Review has been set up to heavily reflect the views of "stakeholders" which in the way it has been conducted more reflects commercial interests rather than those of the public and the communities seen to be served. This is rather like inviting the foxes to participate in the design of the chicken coup. By all means observe the reactions of creatures of a vulpine persuasion to your first efforts at a chicken coup and be prepared to modify your efforts in the light of these observations. But an effective chicken coup, just like an effective regulatory framework should first start with the experience of others who have faced similar problems, whether it is farmers in the case of stock protection or regulators in the case of essential public services. And the Summary[20] of consultation questions asked in the Review confirms that the quality and content of answers received will unfortunately reflect the quality and content of questions asked (how is anyone supposed to phrase a meaningful reply to "*Do you agree that the ferry service should be designed to meet the most important needs of the community?").*

So where do we stand now in terms of Scottish Ferry Services? We have a rag bag of pricing, investment, public procurement and public infrastructure policies that not only vary between contracts but sometimes even within contracts (such as the RET "trial" applied for several years so far to parts of the Clyde and Hebrides network but not others) . The Gourock-Dunoon contract has finished in a shambles, the Northlink tender is due for retendering in 2012 and there is no sign that the Government has learnt the lessons that matter from the previous fiasco that resulted in bail out and forced retendering here (my efforts to persuade the then Scottish Executive that this proved the need for an operator of last resort was rebuffed by officials).

But then in 2013 comes the retendering of CalMac and the Clyde and Hebrides contract again. This, more than anything else, reflects the crossed fingers and head-in-the-sand approach to these issues by government.

There are two possible scenarios from the tendering of CalMac in the form of the Clyde and Hebrides contract every six years under EU law. The first depends on CalMac (holding company state-owned David MacBrayne) winning the contract in perpetuity every time it comes up for retendering. In a level competitive playing field that is a bit like throwing a dice and betting on the same number coming up every time. It might happen, but then other parties might want to have a look at the dice, or at least question whether it is worthwhile tossing the dice at all. But if the "CalMac in perpetuity" scenario does hold and goes unchallenged, the only major cost is the unnecessary waste down the years of millions of pounds of public and private money spent on retendering process and a time horizon for operators and policy makers dictated by the time of the next retender. But if this scenario holds, then whatever it is, it is not competitive tendering and this would inevitably become clear to potential operators and the EC. .

The second and more dangerous scenario is that eventually CalMac loses its contract to another EU bidder. At this point, if there was a coherent regulatory framework in place as for other essential services then at least there is potential to guard against problems from moral hazard, adverse selection, opportunistic behaviour, technical or financial failure on the part of the incumbent operator. But obviously these safeguards would have to be in place before the tender process takes place, you do not start re-writing the rule book once the game has started and you are worried about who is winning, just as you do not start looking for an operator of last resort when you need then to start tomorrow.

The dangers of such a scenario would be great enough even with a coherent regulatory framework in place with one single private operator dominating Scottish ferry services. Without such a framework there would be numerous potential threats to the public interest, most obviously from opportunistic behaviour on the part of the new incumbent, as any experienced industry regulator would almost certainly advise. And with CalMac having been presumably been wound up since it had lost its contract and only business, there would be no obvious alternative open to the Scottish Government in the event of such problems. Even if Northlink as another subsidiary of state-owned David Macbrayne was still available in principle, the scale and diversity of the CalMac network is at much greater levels than that faced by Northlink. I simply do not know what would happen if a private operator that had won the Clyde and Hebrides contract from CalMac started acting opportunistically and threatened to withdraw unless the government paid up, but much more importantly it is fairly clear the government does not know either, or at least does not want to think about it. The lesson from other regulated industries involving essential services is that the crossed fingers and head-in-the-sand approach does not work with

operators whose obligations are to their shareholders, you have to anticipate how the operators might exploit any loopholes or other forms of advantage and set up regulatory safeguards in advance, not deal with them from a blank page once they arise.

Meanwhile, cherry picking and unrestricted market entry can proceed to undermine public service contracts quite unaffected by these contractual issues. Cherry picking has had varying degrees of success in different parts of the Scottish ferry network; it is fewer routes, that have been and will be, typically targeted for cherry picking. More segments of routes such as vehicle carrying, short crossings, freight and livestock, with high season cherry picking also being a possibility but not yet really in evidence. Cherry picking in the context of Scottish ferry services can cream off the profitable segments of the joint product provided by vehicle/freight/passenger vessels, leaving any high cost (mostly crewing levels for safety reasons) and low revenue loss-making passenger-only public service to bear a higher level of subsidy if it is to be provided at all. The dangers of cherry picking in ferry services are arguably greater than for most other essential services such as postal services since local natural monopoly characteristics reduce or more likely eliminate the chances of competition amongst cherry pickers. Also in general these tend not be contestable markets once entry has been achieved and incumbency established because of typically limited access to suitable vessels and/or infrastructure.

The failure to realize these issues is reflected in the possibility raised in the current Ferries Review consultation

> "As a first step, we could test some routes by tendering them singly. This would encourage the commercial ferries market to provide services wherever possible leaving only the services which are unlikely to attract operations on a commercial basis (i.e. without subsidy) to be funded through the public purse"[21].

But if there are any routes on the Scottish ferry network which could be profitable providing a full complement of user services, including what are usually loss-making services for foot passengers, a market entrant could potentially make even more profit by cherry picking the profitable segments of that market, such as vehicles. There is no exclusivity provision at the moment to stop market entry outside existing or projected public service contracts (part of the reason for the Northlink tender collapse), which is also exactly what happened in the case of Gourock-Dunoon. Why should any firm tender for a public service contract when it can cherry pick the time, level and form of entry that suits it and simply crowd out any similar services that are offered by the public service operator? Indeed just a few weeks before the Scottish Government's Ferries Review was asking questions last year as to whether Ardrossan-Brodick was one of the routes that should be considered for single route tender[22], Western Ferries had announced their intention to enter into direct competition with CalMac on Ardrossan-Brodick using a similar market entry strategy to that employed in Gourock-Dunoon; "*we are looking to take to Arran those elements of that model which have allowed Western Ferries to run a commercially successful service against a heavily subsidised service provided by CalMac.*"[23]

If anything could be taken to epitomize Government's current ferry policy it is the contrast between the unreality of what they think could happen here and the reality of what the market was and is actually planning. This was visible to see for anyone who picked up a national newspaper, and not just in 2010; Western Ferries also has had a long-standing and publicly expressed interest in entering the Bute market using a similar business model to Gourock-Dunoon.

5. What should be done?

The model (if it can be described as such) for governance of the Scottish ferry network is simply unsustainable. Either faith is placed in the likes of CalMac winning its retender indefinitely (an expensive and highly improbable outcome with competitive tendering and assuming a level playing field), or we face the unacceptable dangers of the major part of the Scottish ferry network and the associated essential public services being eventually captured by a commercial interest that is not subject to the normal checks and constraints that are standard practice in other essential public services in the UK. Further, even in the absence of the worst case of capture by a poorly regulated commercial interest, the network as a whole faces progressive disintegration and erosion though unrestricted and unregulated cherry picking It is not as if government has been unaware of the dangers of cherry picking, there has been public discussion of the dangers by the Scottish Executive and the Scottish Parliament since 2001. But it has proven difficult or impossible to convince policymakers that focusing only on routes does not get to the roots of what cherry picking will target. Just as in postal services they will seek low cost or high value services of individual routes and be willing, indeed delighted, to leave the high cost and low value segments of any route for a public service and the tax payer to pick up.

The problem is that there is absolutely no evidence that any of this is on the Scottish Government's radar. There is a debate to be had, and reasoned arguments on both sides, as to whether most of the Scottish ferry network should be run by a single state-owned holding company or whether most of it should be in private hands, much of it awarded through public service contracts. There is also a debate to be had, and reasoned arguments on both sides, as to whether or not some routes should be tendered separately rather than as part of the main CalMac bundle, effectively to institutionalize cherry picking and bring in a degree of oversight by government. Indeed these very debates were encouraged in the current Scottish Ferries Review. The problem is that the debates are irrelevant, a waste of time

and even counterproductive since they are not predicated on a real understanding of commercial logic and interests, let alone what EU law permits and prohibits in this context. In the absence of coherent oversight the market will provide its own solutions and one of the first lessons students learn in Economics 101 is that you cannot just rely on crossed fingers to ensure that private interest aligns with the public interest.

While the present outcomes for ferry services in Scotland are not sustainable, there are alternatives which are, and these include alternatives already put before the Scottish Executive and the Scottish Parliament. One example was in fact the default option which had been the outcome of discussions between the Scottish Executive and the European Commission in 2000 and included splitting the CalMac Clyde and Hebrides networks into 3 or 4 separate bundles and tenders. Advantages of this option included the fact that provision to act as operator of last resort for other tenders in the network could be simply included as a clause (with appropriate provision for compensation) in each tender agreement. Disadvantages included any possible sacrifice of economies of scale that could have been achieved through a single tender. Other options include the one which I submitted to the Scottish Executive and the Scottish Parliament in 2005 and which is discussed in more detail in my 2009 Fraser Commentary paper. This option provided for the operation of public services including the CalMac network by a single state owned body without the need for expensive regular retendering and under compliance with EC guidelines as reflected in the Altmark principles.

As discussed in my 2009 Fraser Commentary paper, the Executive rejected my proposal in 2005, advising the Scottish Parliament that the Altmark principles were not applicable to Scottish ferry services. Three years later in 2008, the European Commission opened up a State aid investigation of Scottish ferry services on the basis that the services had to comply with the Altmark principles and there were grounds for suspecting that the government had failed to ensure this.

Reading these last two sentences together should have been sufficient evidence that policy here was not being framed in a competent and coherent manner. However it made no visible or discernable difference as to who handled policy here or how it was handled.

How can this be changed? The first thing to recognize that what is completely missing from the governance of ferry services in Scotland is a set of institutional guidelines embedded in a statutory rule book similar to other essential services. What is needed here is a process by which ways for dealing with these problems can be set up. If the problem is defined properly by Parliament as *"the provision of competitively tendered essential ferry services under EC law"* this problem could be considered by a small, say 6 members, Independent Expert Group in which the core would be experienced experts from regulated essential services (such as energy, postal services, telecoms) with input from experts in relevant EC law and ferry services. The terms of reference of the Group would be to frame institutional and regulatory options for ferry services in Scotland.

How to pursue this? The normal procedure and default option would be for such a Group to be set up by the Scottish Government. But that brings us back full square to where we started with these problems. There have been three full sessions of the Scottish Parliament since 1999, there have been Inquiries into the tendering of Scottish ferry services in each one of them, and I and others have given invited expert evidence to each of these three Inquiries. The pattern has been fairly standard so far: evidence given by me and others; followed by polite, patient, and informed questioning by MSPs on the appropriate Committee; followed by representations and/or questions by the Committee to the Scottish Executive / Scottish Government; followed by explicit or implicit rejection of points for possible reform or re-assessment of policy by the Executive/ Government; followed by another Inquiry into the tendering of Scottish ferry services in the following session of parliament about 3 or 4 years later.

Proposals for such an Independent Expert Group have been made by me before through a Scottish Parliament Transport Committee Convener and suffered the same fate that most sensible proposals for reform have suffered once they faced neutralizing by advice and intervention of officials. This is understandable and quite rational, it takes a lot to expect any institution or group to objectively evaluate and advise on proposals that are based on the premise that the group or institution in question does not have the commences required to adequately perform the tasks with which they have been entrusted.

The only real opportunity that such an Independent Expert Group would have of being formed with the right skills on board and with resources and opportunities to do their job properly would be if it was truly independent of official interference in its formation and operation. For that you would need a strong Parliament and/or a strong Minister. I must say that my experience over more than a decade has led me to advise caution and against over-optimism on these counts but there is no choice other than to hope.

Endnotes

[1] Kay, N. M. Scottish Ferry Policy, Fraser of Allander Economic Commentary 2009, no.3, 46-58 http://www.strath.ac.uk/media/departments/economics/fairse/backissues/Fraser_of_Allander_Economic_Commentary_Vol_32,_No_3%5B1%5D.pdf .

[2] See also earlier paper; Kay, N. M. (1999) Sustainable competition: ferries and competition on the Clyde, Fraser of Allander Economic Commentary, 1999, no 3, 52-61.

[3] And in which context I must declare an interest as a user of the fery sernvices here
[4]See http://www.scotland.gov.uk/News/Releases/2011/02/18091820
[5]See http://www.brocher.com/Ferries/reality.htm
[6]See http://www.brocher.com/Ferries/duncs.htm
[7]See http://www.brocher.com/Ferries/eu.htm
[8]See http://www.scotland.gov.uk/News/Releases/2011/02/18091820
[9]See http://www.brocher.com/Ferries/truth.htm and http://www.scotland.gov.uk/News/Releases/2011/02/18091820
[10]See http://www.brocher.com/Ferries/suitable.htm and http://www.brocher.com/Ferries/vessels.htm and http://www.brocher.com/Ferries/vessels2.htm
[11]See http://forargyll.com/2010/12/professor-neil-kay-on-what-has-driven-his-foi-pursuit-on-the-dunoon-gourock-ferry-replacement/
[12]See http://www.brocher.com/Ferries/soldout2.htm
[13]Delivering Lifeline Ferry Services, Scottish Executive, 2000, http://www.scotland.gov.uk/consultations/transport/fese-03.asp
[14]Transport and Environment Committee Papers, June 18, 2001, op cit see papers TE/01/18/03 and TE/01/18/04. http://www.scotparliament.com/business/committees/historic/x-transport/papers-01/trp01-18.pdf
[15]Evidence by Captain Sandy Ferguson to Transport and Environment Committee, Scottish Parliament, 18th Meeting, 2001 (Session 1) Monday 18 June 2001 op cit,
[16]Scottish Government News Release: Gourock-Dunoon Ferry, 17/02/2011, http://www.scotland.gov.uk/News/Releases/2011/02/18091820
[17]See http://www.brocher.com/Ferries/expensiveferry.htm
[18]Official Report of the Scottish Parliament June 2nd 2011 http://www.scottish.parliament.uk/Apps2/Business/ORSearch/ReportView.aspx?r=6271&mode=pdf
[19]The Scottish Government: Scottish Ferries Review http://www.scotland.gov.uk/Topics/Transport/ferries-ports-canals/14342/Review
[20] See http://www.scotland.gov.uk/Publications/2010/06/17134718/11
[21]See Scottish Ferries Review: Consultation Document http://www.scotland.gov.uk/Publications/2010/06/17134718/6
[22]See http://www.scotland.gov.uk/Publications/2010/06/17134718/12
[23]Arran braced for new ferry war, David Ross, 5th January 2010, The Herald http://www.heraldscotland.com/news/transport-environment/arran-braced-for-new-ferry-war-1.996200