

30 June 2010

## Deficit cuts threatens pace of recovery in Scotland

Scotland's pace of recovery from recession is threatened by the massive fiscal consolidation package introduced in the emergency Budget of 22nd June according to the latest Economic Commentary from the University of Strathclyde's Fraser of Allander Institute, which is sponsored by PricewaterhouseCoopers LLP.

While a double-dip recession producing negative annual growth should be avoided based on the central case, it will be a close call on the low growth case. The Institute's new revised central case forecast is for GDP growth of 0.7% this year – only 0.1% higher than the February forecast – growing to 1.1% in 2011 and 2.1% in 2012.

Professor of Economics at University of Strathclyde, Brian Ashcroft said:

"The speed of Scotland's slow recovery from recession is threatened by the massive fiscal consolidation package introduced by the new Conservative/Liberal Democrat coalition government in the emergency Budget of 22nd June. However, a double-dip recession producing negative annual growth should be avoided on our central case but it will be a close call on our low growth case."

"The anticipated cut in the budget of the Scottish Parliament will, if other things remain equal, lead to a significant decline in the provision of public services and a major loss of jobs. We urge the Parliament to consider all possible options embracing cost savings, and revenue raising as well as spending cuts in order to best preserve economic growth and social justice in Scotland."

The consequential real cuts to the Budget of the Scottish Parliament and government of around 14% may result, other things equal, in between 64,000 to 126,000 economy wide job losses and between 78,000 and 90,000 jobs losses in the public sector by 2014 - 15.

According to Paul Brewer, senior partner of PricewaterhouseCoopers LLP's Edinburgh office, the more flexibility that can be built into terms of employment across Scottish business and government, the greater the likelihood of hitting the lower job loss figures.

"Scotland has to live up to its reputation and be brave. The public sector needs to move now to provide clarity on its long term strategy to employees, the public and to both the private and third sector organisations that do business with it.

“Scotland simply cannot continue to meet the current level of public expenditure, and must take decisive action to determine where and to what extent the cuts will fall, implement effective planning and find new ways to deliver more with less. The key will be in planning ahead to make the right cuts in the right place to preserve vital front line services and free resources. Hopefully by taking this action, the sector can minimise the overall impact on the Scottish economy – and crucially reduce the number of jobs lost.”

He added:

“There has been some relief that further capital expenditure cuts were not imposed by Westminster last week, a move that could have threatened schools and roads programmes for example. However, as we endeavour to grow the economy out of recession, the focus must be on maintaining this investment rather than sacrificing it for short-term spending.”

**ENDS**

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## **Fraser of Allander Institute's Economic Commentary**

### **June 2010**

In their latest Economic Commentary, sponsored by PricewaterhouseCoopers, the University of Strathclyde's Fraser of Allander Institute notes that Scotland's slow recovery from recession is threatened by the massive fiscal consolidation package introduced by the new Conservative/Liberal Democrat coalition government in the emergency Budget of 22nd June. However, a double-dip recession producing negative annual growth should be avoided on our central case but it will be a close call on our low growth case. Negative growth in one or more quarters is possible in our central forecast and is more likely in our low growth case.

Our central forecast is for GDP growth of 0.7% this year, 1.1% in 2011 and 2.1% in 2012. That should be compared with our February forecast of 0.6% this year, 1.6% in 2011 and 2.2% in 2012. The changes introduced in the emergency Budget along with the postponement to 2011 of Scotland's share of the £6bn UK cuts introduced by the new government for 2010 and the fiscal tightening put in place in the March Budget of the Labour government, result in our central forecast for 2011 being 0.5% points lower than our forecast in February. This is despite the fact that wider economic forces driving recovery in 2011 are now considered to be somewhat stronger than was the case in February. On our low growth scenario, the economy teeters on the brink of recession for two years despite signs of stronger recovery worldwide.

The consequential real cuts to the Budget of the Scottish Parliament and government of around 14% may result, other things equal, in up to 126,000 economy wide job losses by 2014-15 comprising up to 90,000 in the public sector and 37,000 private sector job losses. However, if the resulting drop in demand and freeing up of resources leads to a moderation in Scottish real wages and lower purchased input and output prices then there will be a "crowding-in" effect as private sector activity, especially, benefits from improved competitiveness. In these circumstances of flexible wages and prices the shock will reduce jobs in the public sector by the slightly lower number of just under 78,000 while private sector employment rises by nearly 14,000. The overall job loss is thus just above 64,000, about half that in the fixed-price case. There is a "crowding in" effect on the private sector, but it is insufficient to offset the loss of activity in the public sector.

The potential cut to the Scottish Parliament and government budget is unprecedented. In such circumstances it is incumbent on the Scottish government to explore a range of options that can embrace cost savings and revenue raising as well as spending cuts. Moreover, the government will wish to identify those options that do the least damage to economic growth while preserving social justice. We hope that the Scottish Parliament and the wider public will have an opportunity to debate all of these options and build a countrywide consensus on the best way forward.

## Forecasts

The Scottish economy came out of recession in the fourth quarter of last year with the recovery seeming weak over the winter months. There is some evidence of recovery in nominal household expenditure and at a faster rate than we were predicting in February. This may in part be bolstered by evidence of gradually increasing activity in the housing market and some pick up in house prices. But housing market activity - lending for purchases and house sales - remains weak. Retail sales growth is also not strong. Consumer confidence appears lower in Scotland than in the UK.

The supply of bank credit remains hesitant. Sovereign debt risk for the banks has also risen appreciably due to the Greek crisis as fears of spillover to other countries rose. A generalised retreat by the banks from risk-taking would put further pressure on the recovery.

Recovery in Scottish economic growth and jobs is also much dependent on growth in our major markets: the rest of the UK, mainland Europe and the US. Recovery in mainland Europe remains weak and this may be exacerbated by fiscal consolidations in Germany and other major economies. But the IMF is forecasting a significant pickup in world trade in 2010 and 2011. Tourism demand remains weak. Some pick up may be expected in 2010 due to the lower sterling exchange rate although recent increases may dampen that effect. We anticipate that tourism spending will remain flat in 2010 returning to growth in 2011 and 2012.

Investment was badly hit during the recession but business investment in the UK had begun to rise again at the beginning of the year. Clearly, the pace of recovery in investment demand will not only be driven by the expected growth of the demand for goods and services but also the availability and price of credit. Confidence remains weak in Scottish construction where much investment activity occurs. But we do expect investment to recover appreciably from the large contractions seen in 2009 but positive growth will not appear until 2011 and 2012.

In many respects the 'elephant in the room' affecting our forecasts for aggregate demand and GDP is the outlook for government spending. Through cuts in spending on services, welfare benefits, cost savings and tax increases the government is seeking to rebalance the UK economy away from government consumption and debt at a time when private household consumption is weak. This therefore requires a significant increase in the contribution of net exports and investment to realise the OBR forecasts for the period. Specifically, the OBR predicts that net exports and investment will contribute +0.7% points and +1.2% points per annum respectively in the 2011-2015 period compared to +0.3% points and +0.5% points in the 2000-2008 period. It might be achieved but it poses a big challenge for the UK and Scottish economies.

Against this background we are now assuming stronger household spending growth than we had assumed in the central forecast for February, export growth to the rest of the world is now significantly higher than previously assumed, while the growth of government spending is weaker.

## GVA Forecasts

**Table 1: Forecast Scottish GVA Growth in Three Scenarios, 2009-2012**

GVA Growth (%) per annum)	2009	2010	2011	2012
High growth	-4.9	1.4	2.1	2.8
<i>February forecast</i>	<i>-4.7</i>	<i>1.7</i>	<i>2.2</i>	<i>2.8</i>
<b>Central</b>	<b>-4.9</b>	<b>0.7</b>	<b>1.1</b>	<b>2.1</b>
<i>February forecast</i>	<i>-4.8</i>	<i>0.6</i>	<i>1.6</i>	<i>2.2</i>
Low growth	-4.9	0.0	0.1	0.7
<i>February forecast</i>	<i>-4.9</i>	<i>-0.7</i>	<i>-0.3</i>	<i>0.8</i>

The key forecasts for GVA/GDP are summarised in Table 1 along with our February forecasts for comparison. We shall primarily focus on our central forecast here. Scotland is forecast to return to positive growth in 2010. But the recovery over the year is weak, household spending strengthens and by more than we forecast in February but increases only slightly this year. Exports to the rest of the world continue to recover and at a faster rate than predicted in February. This along with some recovery of investment helps raise the forecast to 0.7% growth compared to our prediction of 0.6% in February.

Recovery is weaker in Scotland than the OBR's forecasts for the UK and the median of independent, private and institutional forecasts for the UK, for the reasons that were well rehearsed in previous Commentaries and we see no basis for altering that view. Scottish GVA growth is better than the UK in 2010 on the High growth scenario only. Trend growth is realised on our Central scenario in 2012 but there is a high degree of uncertainty surrounding our 2012 forecasts because of the large unknowns determining the consequences of the fiscal consolidation.

We have incorporated the decisions on government spending and tax in the emergency Budget into our forecasting model. The most significant changes affecting our forecasting horizon to 2012 are the increase in VAT to 20% and the additional cuts in government spending to that date. IFS analysis indicates that by 2012 less than half of the cumulative fiscal consolidation planned for 2015-16 will be in place.

Taken together the consequences of the measures in the Budget lead to our GVA forecast being revised down by 0.1% points in 2010, 0.2% points in 2011, and 0.1% points in 2012 compared to what it would otherwise have been. These changes along with the postponement to 2011 of Scotland's share of the £6bn UK cuts introduced by the new government for 2010 and the fiscal tightening put in place in the March Budget of the Labour government, result in our central forecast for 2011 at 1.1% being 0.5% points lower than our forecast in February. This is despite the fact that wider economic forces driving recovery in 2011 are now considered to be somewhat stronger than was the case in February.

### *Employment Forecasts*

**Table 2: Forecast Scottish Net Jobs Growth in Three Scenarios, 2009-2012**

	2009	2010	2011	2012
High growth	-48,847	-20,399	35,142	53,059
<i>February forecast</i>	-60,488	-9,785	30,253	57,213
<b>Central</b>	<b>-48,847</b>	<b>-33,546</b>	<b>14,856</b>	<b>36,111</b>
<i>February forecast</i>	-64,218	-32,264	18,277	44,612
Low growth	-48,847	-48,129	-6,036	6,615
<i>February forecast</i>	-77,861	-57,002	-16,538	13,631

The key employment forecasts are summarised in Table 2. Job losses continue from 2009 into 2010, with a net 82,000 jobs lost in those two years and still not fully matched by job gains of 51,000 in 2011 and 2012. At the sectoral level, the service sector experiences the greatest decline in jobs in 2009 and 2010 with under 47,000 net jobs lost. With recovery the net gain in jobs in 2011 and 2012 of 20,000 means that it will take some time for services to recover 2008 jobs levels. Construction job losses amount to around 18,500 over the two years and as with services the number of construction jobs in 2012 remains below 2008 levels but there is recovery in 2011 and 2012 of more than 3,000 jobs. Finally, the production sector which principally includes manufacturing sheds around 13,000 jobs in 2009 and 2010 but through strong export growth net job creation in 2011 and 2012 is nearly 25,000.

## *Unemployment Forecasts*

**Table 3: ILO unemployment rate and claimant count rate measures of unemployment under each of the three forecast scenarios**

	2009	2010	2011	2012
<i>ILO unemployment rate</i>				
High growth	7.8%	8.4%	7.4%	6.2%
<b>Central</b>	<b>7.8%</b>	<b>8.9%</b>	<b>8.7%</b>	<b>8.1%</b>
<b>Numbers</b>	<b>202,021</b>	<b>227,820</b>	<b>223,646</b>	<b>210,749</b>
Low growth	7.8%	9.5%	10.1%	10.7%
<i>Claimant count rate</i>				
High growth	4.7%	5.0%	4.4%	3.9%
<b>Central</b>	<b>5.0%</b>	<b>5.3%</b>	<b>5.5%</b>	<b>5.1%</b>
<b>Numbers</b>	<b>138,147</b>	<b>145,143</b>	<b>152,935</b>	<b>144,115</b>
Low growth	5.3%	5.6%	6.0%	6.8%

The key unemployment forecasts are summarised in Table 3 above. On our Central forecast ILO unemployment is expected to peak at 228,000 or 8.9% this year falling to just under 224,000 or 8.7% in 2011 and further to 211,000 or 8.1% in 2012. Of major importance to the outcome for unemployment is not simply output and employment change but also the change in inactivity. That is, the extent to which people losing their jobs cease to look for work and so move into inactivity rather than unemployment. Recent changes in inactivity are documented in the *Overview of the Labour Market* section of the Commentary below. The rate of inactivity appears to have risen during the recent recession by 1.6% points in the last year, to stand at 21.7% for working age people.

## Impact of cuts in the Scottish DEL

We use a Computable General Equilibrium (CGE) model parameterised on Scottish data to identify the impact on the Scottish economy of the anticipated cuts to the Scottish departmental expenditure limit or DEL by 2014-15.

The anticipated reduction in Scottish DEL is taken to be a 14% real cut, which is the average cut to the UK DEL as estimated by the Institute for Fiscal Studies (IFS) in their post emergency Budget analysis. The size of the actual reduction is unlikely to be known until the publication of the Comprehensive Spending Review on October 20th. It may differ from 14% somewhat depending on relative size of the cuts borne by the comparable programmes that drive the Barnett formula which allocate the assigned budget to the Scottish Parliament and the cuts borne by reserved programmes.

The CGE model captures the linkages between industries within Scotland and between purchasers of goods and services, including government, produced by industries in Scotland. The model also allows for flexibility in prices, especially wages through local bargaining, and so we offer two simulations: a fixed-price analysis, where the cut in DEL leads to a straight reduction in the demand for goods and services produced in the Scottish economy; a flex-price analysis, where wages and output prices respond to changes in demand. To a certain extent these two simulations can be viewed as limiting cases defining the likely limits of the economy-wide impacts.

A summary of the results is presented in Table 4. In the fixed-price case, the DEL cut leads to a fall in the demand for goods and services in the public sector and in the wider economy in sectors that are either directly or indirectly linked to the public sector through purchases of inputs or the spending of wages and salaries. The result is output and job losses in both public and private sectors. By 2014-15, public sector job losses amount to nearly 90,000, while private sector job losses stand at nearly 37,000, an overall job loss of 126,000, a reduction in GDP of -4.2% and a fall in investment of -2.9%.

In the flex-price case, the reduction in demand from the public sector will cause real wages and intermediate input prices to fall below what they otherwise would be. This would lower production costs in Scottish industries, improve competitiveness and lead to an increased demand for goods, services and employment, especially in the private sector, on that account. which may serve to offset the loss of demand from the public sector.

The improvement in economy-wide competitiveness could, in principle, offset the reduction in output and jobs in the public sector as well. In the event our model estimates that the shock will reduce jobs in the public sector by the slightly lower number of just under 78,000 while private sector employment *rises* by nearly 14,000. The overall job loss is thus just above 64,000, about half that in the fixed-price case. The fall in GDP is -1.6% more than a third of the loss in the fixed price case. In addition, investment falls by -0.7% but exports rise by 2.1% because of improved competitiveness. There is a 'crowding in' effect on the private sector, but it is insufficient to offset the loss of activity in the public sector.

**Table 4: Change in sectoral jobs and GVA by 2014-15 following 14% Scottish DEL cut**

	JOBS		GVA/GDP %	
	Fixed Price	Flex Price	Fixed Price	Flex Price
Agriculture	-374	562	-1.1	0.9
Forestry	-14	66	-0.5	1.8
Sea fishing	-4	98	-0.1	2.4
Fish farming	-1	30	-0.1	1.9
Other mining and quarrying	-45	47	-1.8	1.2
Oil and gas extraction	-94	456	-0.4	1.3
Mfr food, drink and tobacco	-408	733	-0.9	1.1
Mfr textiles and clothing	-101	174	-1.0	1.5
Mfr chemicals etc	-108	166	-0.9	0.9
Mfr metal and non-metal goods	-400	927	-0.9	1.8
Mfr transport and other machinery, elec	-181	1,048	-0.3	1.2
Other manufacturing	-702	511	-1.9	1.1
Water	-207	-95	-4.9	-1.8
Construction	-5,003	667	-3.5	0.4
Distribution	-13,974	2,168	-2.6	0.2
Transport	-1,390	1,963	-1.5	1.9
Communications, finance and business	-13,514	3,979	-2.8	0.4
R&D	-384	-53	-4.2	-0.6
Education	-17,959	-14,977	-9.1	-7.4
Public and other services	-71,009	-62,817	-10.8	-8.8
Coal extraction	-30	22	-2.5	1.7
Oil refining and distribution	-36	16	-1.9	0.4
Gas supply	-69	-1	-3.4	-0.2
Electricity - Renewable (hydro and wind	-27	14	-2.4	0.5
Electricity - Non-renewable (coal, nuke	-205	120	-2.4	0.8
<b>Total</b>	<b>-126,240</b>	<b>-64,178</b>	<b>-4.2%</b>	<b>-1.6%</b>

Table 4 also provides a more detailed breakdown at the sectoral level of the DEL cut. In the fixed price case, the 6 manufacturing sectors lose 1,900 jobs but *gain* 3,559 jobs due to improved competitiveness in the flex price case. The construction sector loses -5,000 jobs in the former case but gains 667 jobs in the latter case. The much larger private service sector loses 28,878 jobs when there is only a demand reduction effect of the DEL but if regional wages and prices also adjust across the economy then there are net job gains in the sector of 8,110.

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