This is the thirteenth edition of the Scottish Economic Report (SER). It is published twice-yearly and incorporates a review of the progress and prospects for the Scottish economy, together with a review of the broader economic context in which the Scottish economy is set, as well as a selection of summary articles of key topical interest.

This thirteenth edition of the Scottish Economic Report has four main sections:

- **Chapter 1: The Scottish Economy: Recent Developments and Future Prospects**, provides an overview of the Scottish economy. This section summarises the recent developments and future prospects for the Scottish economy.
- **Chapter 2: Global, European and UK Economic Developments** demonstrates the linkages between Scotland and the wider economic environment. The chapter provides a synopsis of economic developments in the United Kingdom, European, and global economies.
- **Chapter 3**: This chapter discusses the Executive’s key policies for growing the economy, through outlining the progress in taking forward the key elements of the Framework for Economic Development in Scotland. This edition focuses on the new Sustainable Development Strategy, as well as the Executive’s response to the Enterprise & Culture Committee’s Business Growth report.
- **Chapter 4: Selected Economic Issues** provides an opportunity for brief surveys of selected economic issues to be presented.

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Preface

This is the thirteenth edition of the *Scottish Economic Report* (SER). The SER is published bi-annually and presents a detailed review of the progress and prospects for the Scottish Economy, together with analysis of the broader context in which it is set.

**The Scottish Economic Report June 2006**

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- **Chapter 4:** *Selected Economic Issues* provides an opportunity for brief surveys of selected economic issues to be presented.

**Other economic related publications**

The *Framework for Economic Development in Scotland* (FEDS) has a clear vision for economic development: ‘to raise the quality of life of the Scottish people through increasing the economic opportunities for all on a socially and environmentally sustainable basis’.

In March 2005, Scotland joined the UK Government and the other devolved administrations in signing up to a new UK framework for sustainable development *One Future – Different Paths: The UK’s Shared Framework for Sustainable Development*\(^1\). This framework sets out a common goal for sustainable development across the UK.

The model for the UK’s strategic approach to sustainable development reflects the structure of decision-making established by the devolution of powers to Scotland, Wales and Northern Ireland. Each devolved body will have its own strategy,

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though there are still common challenges and goals and the Executive will work with the UK Government and other devolved administrations towards achieving those goals.

**Choosing Our Future: Scotland’s Sustainable Development Strategy**, published in December 2005, sets out in further detail Scotland’s commitment and contribution to fostering a sustainable future, building on the actions already being taken by individuals, businesses, local authorities and communities.

The Executive has now published its response to the recent **Business Growth Inquiry**, carried out by the Enterprise and Culture Committee of the Scottish Parliament. It sets out the Executive’s thinking on business growth, placing it in the context of recent global economic developments, and highlights policies, programmes and projects that have been rolled out in order to positively influence business growth in the Scottish economy.

Finally, the **Atkinson Review**, published in January 2005, considered the future development of government output, productivity and associated prices indices for the UK national accounts. In response to the Review, the Executive published a Scotland-focused implementation strategy in June 2005 that sets out exactly how the principles and recommendations of the Atkinson Review will be taken forward in Scotland.

The Executive’s strategy committed the Executive to review its initial action plans at regular intervals and to produce updates every quarter. These updates are available from the Scottish Executive website.

**Acknowledgements**

Finally, I would like to acknowledge the major contributions to the preparation and compilation of this report by David Ritchie, John Jellema and Karin Seyfert. The report reflects major contributions from colleagues in the Office of the Chief Economic Adviser and the Executive as a whole. I would also like to thank Stephen Boyle and Patrick Watt from Futureskills Scotland for their paper on Skills and Scotland’s economy.

**Dr Andrew Goudie**  
Chief Economic Adviser  
Scottish Executive  
June 2006

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2. Full response can be found at: [http://www.scottish.parliament.uk/business/committees/enterprise/Businessgrowthexecutiveresponse.htm](http://www.scottish.parliament.uk/business/committees/enterprise/Businessgrowthexecutiveresponse.htm)  
chapter one: The Scottish Economy: Recent Developments and Future Prospects
1 SCOTTISH ECONOMY: RECENT DEVELOPMENTS AND FUTURE PROSPECTS5

1.1 OVERVIEW

This Chapter reviews the performance of the Scottish economy at a detailed level during 2005 and into 2006, and looks at recent developments in the context of trends over the past decade. This first section summarises some of the key messages that emerge from the analysis presented in the later sections, and gives a brief overview of the key performance indicators that best depict Scotland’s economic performance.

In 2005, Scotland’s economy grew (in terms of GVA6) at a rate consistent with its long-run annual average7, while Scotland’s manufacturing sector continued to decline, but at a considerably slower rate than in recent times. Meanwhile, the service sector continued to perform very strongly – with growth evident right across the sector. The labour market, which is dominated by services employment, continued to perform impressively in 2005 and early 2006, maintaining the positive levels that had been evident in the preceding three years. Indeed, in 2005, employment reached an all-time high and unemployment fell to its lowest rate on record.

Both output and labour market performance suggest that the fundamentals of the Scottish economy remain positive, but to achieve a more rounded assessment it is important not to examine the Scottish economy in isolation, but in the wider context of the UK and the UK regions (known as the 12 Government Office Regions or GORs). On this wider basis, whole-economy and service sector growth in Scotland was equal to that of the UK in 2005, although it is important to highlight that UK growth slowed during this period. In early 2006, Scotland’s employment rate was higher than that of the UK and, and for the first time in 10 years, Scotland’s unemployment rate matched that of the UK. Moreover, according to the latest data, Scotland’s position in terms of GVA per head and labour market performance relative to most other UK regions is also positive.

The performance of the Scottish economy is discussed in much greater depth throughout this chapter, but in summary the key trends that emerge are:

- Stable total GVA growth;
- Strong service sector growth;
- A slowing manufacturing contraction;
- Record levels of employment and low unemployment;
- Strong labour market performance relative to the UK and the GORs; and

5 This chapter incorporates data available up to 13 June 2006.
6 Gross Value Added.
7 Long-run average annual rate is 1.8 per cent between 1975 and 2005.
• High standards of living relative to the UK regions (as represented by GVA per head).

1.2 RECENT PERFORMANCE

1.2.1 Output

Scotland’s economy grew at an annual rate of 1.8 per cent in 2005, in line with its long-term trend rate and equal to growth in the UK economy as a whole (see Chart 1.1). Growth in the final quarter of the year was robust at 0.6 per cent and this bodes well for 2006.

![Chart 1.1: Annual GVA Growth, Scotland and UK, 1999 - 2005](chart.png)

The closure of the growth gap between the UK and Scotland in 2005 was primarily a result of a slowdown in the UK economy, rather than an increase in Scottish growth. Indeed, the Scottish economy lost a little momentum in 2005, but to a much lesser degree than the UK economy. The Scottish economy, as the chart above shows, has grown with little volatility in recent years and avoided the post-Millennium recessions seen in some other parts of Europe. However, headline growth has been at or around its long-run average.

Looking at the quarterly data we can see that economic growth strengthened over the course of 2005. At the outset of the year growth was weak, at just 0.1 per cent in Q1. However, in the next three quarters growth was 0.5 per cent, 0.5 per cent and 0.6 per cent respectively.
The service sector, which accounts for over two thirds (71 per cent) of the Scottish economy’s output, has been growing strongly since 1999 and, as Chart 1.2 shows, this robust performance has been sufficient to more than offset the declines experienced in production sector output. Service sector output grew by 2.8 per cent in 2005 and by 0.7 per cent over the final quarter of the year. The expansion over the year was on a par with services growth in the UK as a whole.

In contrast to services, the production sector was a drag on economic growth in 2005. The output of the production sector contracted 2.0 per cent over the year, though the falls were greatest at the beginning of the year and output had broadly stabilised by the year-end. The annual output trends for production were mirrored in manufacturing, though the quarterly position in manufacturing was somewhat worse, with the sector experiencing four successive quarterly decreases over 2005.

In order to put Scotland’s economic performance in context, it is useful to look at Scotland’s performance alongside other regions of the UK. Of the 12 GORs, Scotland was ranked fourth in 2004 in terms of GVA per head, which is the most widely recognised measure of relative living standards (see Table 1.1). Although Scotland remained behind the UK average, the gap, at 3.8 per cent, was relatively small.

Scotland’s ranking remained stable between 1994 and 2004 despite the fact that GVA per head dropped slightly relative to the UK average. This slight deterioration in Scotland’s position reflects the strength of the London and South East economies. In nominal terms, per capita incomes in London and the South East grew by 65 per cent and 71 per cent respectively in the decade to 2004 – the two highest growth rates of
all the GORs (Northern Ireland also saw growth of 65 per cent). Scotland’s GVA per head grew by 56 per cent during the same period, and only Wales and the North East saw slower growth.

| Table 1.1: UK Regional GVA, 2004 |
|-------------------------------|-----------|------------|
|                               | Total (£Bn) | Per Head (£) | Per Head Ranking |
| United Kingdom                | 1005.4     | 16,800      | n/a               |
| London                        | 165.0      | 22,200      | 1                 |
| South East                    | 158.2      | 19,500      | 2                 |
| East of England               | 100.3      | 18,300      | 3                 |
| Scotland                      | 82.1       | 16,200      | 4                 |
| South West                    | 78.7       | 15,600      | 5                 |
| East Midlands                 | 65.8       | 15,400      | 6                 |
| West Midlands                 | 81.8       | 15,300      | 7                 |
| North West                    | 102.0      | 14,900      | 8                 |
| Yorkshire & Humber            | 75.2       | 14,900      | 9                 |
| Northern Ireland              | 23.1       | 13,500      | 10                |
| North East                    | 34.2       | 13,400      | 11                |
| Wales                         | 39.2       | 13,300      | 12                |

Notes: UK data exclude extra-regio

The UK average is considerably influenced by London because of its unusually high incomes (32.2 per cent above the UK average) and its large population. London’s economic strength is influenced by the agglomeration – or clustering – benefits associated with cities, reinforced by its position as a capital city. Of course, London is not unique in this regard; many cities – and particularly capital cities – around the world exert a strong influence on their national economies.

In Scotland, the three biggest cities, Glasgow, Edinburgh and Aberdeen, together account for around 45 per cent of Scotland’s economic output. The largest single agglomeration of economic activity in Scotland is in the central lowland area around Glasgow and Edinburgh – the ‘Central Belt’. This area has the highest population density in Scotland and encompasses the cities of Glasgow, Edinburgh and Stirling. The Central Belt is a hub of industrial and commercial activity, containing over half of Scotland’s population, and accounting for approximately 60 per cent of the country’s economic output.

Whereas many areas of Scotland are currently experiencing shrinking and ageing populations, the population in many areas of the Central Belt, particularly around Edinburgh, continues to expand (though there are local pockets where populations are declining). In recent years, an ongoing surge in Edinburgh and Glasgow housing prices has contributed to the development of commuting towns elsewhere in the Central Belt. This, in turn, has been aided by improved transport links and other services, and assisted the transmission of wealth to elsewhere in the Belt.

The capital city effect associated with London is also seen in relation to Edinburgh. It has the highest GVA per head in Scotland at £25,901 in 2003 and has recorded significant economic growth since 1999 (27.9 per cent compared to the Scottish
average of 20.8 per cent\(^8\)). The service sector is the main economic driver in Edinburgh, hosting 91 per cent of employee jobs, compared to 81 per cent in Scotland overall (2004).

Though Edinburgh has the highest GVA per head in Scotland, other cities, including Glasgow and Aberdeen, also benefit from agglomeration effects. Glasgow is Scotland’s largest city and, between 1995 and 2003, its annual average GVA growth rate was 6.7 per cent – the fastest rate of any area in Scotland. Although associated in the past with heavy industry and shipbuilding, Glasgow has re-established itself as a centre for light industry and services, particularly telecommunications. Despite the presence of many low-income districts within Glasgow and a relatively high unemployment rate, its average GVA per head is £22,231 – well above the Scottish average of £15,523 (2003).

Aberdeen is the commercial centre for the North East of Scotland, accounting for 63 per cent of employment in the area (2003). Over recent years, Aberdeen has consistently enjoyed one of the highest average weekly earnings levels in Scotland, currently 8 per cent higher than the Scottish average (2004). A significant contributor to this performance has been the North Sea’s oil and gas industry and its related service industries. High-technology sectors and retailing are other areas that are proving to be key growth areas for Aberdeen.

1.2.2 Labour market

The fundamentals of the Scottish labour market remain strong according to data from the latest Labour Force Survey (LFS), which cover the period February to April 2006. Scotland’s employment rate was 75.5 per cent in the quarter to April, up 0.2 percentage points over both the previous quarter and by 0.6 percentage points over the year. The current rate is the highest employment rate recorded since quarterly records began, and is above that of the UK average. Employment in Scotland has been above the UK average since 2004, and as Chart 1.3 shows the gap between the two rates has increased over the last two years.

\(^8\) As no constant price series is available at the national or sub-national level, these growth rates are expressed in nominal terms.
An interregional comparison of employment rates shows that Scotland had the fifth highest employment rate among the 12 GORs in the quarter to April 2006 (see Chart 1.4); higher rates were recorded in the South East (78.8 per cent), the South West (78.2 per cent), the East (77.4 per cent) and the East Midlands (76.9 per cent). However, in contrast to Scotland, where employment continues to increase, employment in the South East, the South West and the East has been broadly stable or falling over the last five years. The situation in these English GORs may reflect the fact that in 2001 they were close to, or indeed at, the level of full employment. In such a situation, it is difficult to increase employment further due to, for example, skills shortages and the possible impact on wages and prices. In contrast, there was scope for increases in Scotland’s employment rate, though increasing numbers of people entering employment has now led to a tightening of the Scottish labour market.
According to the Office for National Statistics (ONS), the UK had the fourth highest employment rate (71.6 per cent) in the EU-25 in the period October-December 2005, behind Denmark, the Netherlands and Sweden. Scotland’s adjusted employment rate was 75.4 per cent, 0.9 percentage points above the adjusted UK rate over the same period. Therefore, it is reasonable to suggest that Scotland’s employment rate was ranked 4th or higher in the EU-25 in the last quarter of 2005. Moreover, Scotland’s rate was above the OECD average, with a rate above both the United States and Japan.

The recent strong performance of the labour market in Scotland – especially in terms of employment – has been achieved during a period of considerable structural change within the Scottish economy. As we discussed earlier, sectoral contributions to growth in the Scottish economy, have changed considerably over recent times – most notably the declines in manufacturing output versus the continued strength in the service sector. Chart 1.5 illustrates changes in employment by broad sector for Scotland and Great Britain (GB) over the period 1998-2004; from these it is obvious that the structural changes in the composition of output are also evident in the labour market.

Total employment has risen faster in Scotland than in GB as a whole. Within this strong performance, total service sector employment has increased by over

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9 International comparisons of employment rate statistics are difficult to make since data gathering and statistical methodologies differ significantly across countries.
10 Seasonal adjustment is a process of estimating regularly occurring seasonal effects and removing them from the raw data.
11 Data available for GB only, that is the United Kingdom minus Northern Ireland.
17 per cent – more than offsetting the considerable declines that have been evident in manufacturing since late 2000. Most services industries have experienced robust employment growth, though some sub-sectors have shown growth below the average of the economy as a whole. However, as with GVA, the main driver of the expansion of growth in private service sector employment between 1998 and 2004, and in total Scottish employment, has been financial services (36.6 per cent) and real estate & business services (25.4 per cent). In contrast, the manufacturing sector has experienced declines in employment in both Scotland (27.8 per cent) and GB (23.5 per cent) – a similar trend has developed across most developed economies.

**Chart 1.5: Changes in Employment, Scotland and GB, 1998 – 2004**

Source: Annual Business Inquiry
Box 1.1: Occupational Change in the Service Sector

In Scotland, the financial services sub-sector has accounted for most of the recent increase in total employment. However, contrary to the widely held view that the majority of jobs have been created in lower paid posts, the highest relative increase in employment was in professional, associate professional and technical occupations which include, amongst others, accountants and analysts. As the table below shows, this group saw its share in employment increase by 7.8 percentage points between 2001 and 2005. The largest occupational groups in the financial sub-sector were administrative & secretarial occupations – with more than a third of people employed in the financial services sector working in these occupations. However, its share declined by nearly 10 per cent between 2001 and 2005.

Table 1.2: The Financial and Business Services Sectors

<table>
<thead>
<tr>
<th>Financial Intermediation</th>
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<tr>
<td></td>
<td>Managers/Senior</td>
<td>Professional/Tech</td>
<td>Admin</td>
<td>Total</td>
<td></td>
</tr>
<tr>
<td>2001</td>
<td>16,000</td>
<td>19,000</td>
<td>44,000</td>
<td>96,000</td>
<td></td>
</tr>
<tr>
<td>% of total</td>
<td>16.6%</td>
<td>20.3%</td>
<td>45.7%</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>2005</td>
<td>25,000</td>
<td>34,000</td>
<td>43,000</td>
<td>120,000</td>
<td></td>
</tr>
<tr>
<td>% of total</td>
<td>20.8%</td>
<td>28.1%</td>
<td>35.9%</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Real Estate, Renting and Business Services</td>
<td></td>
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<td></td>
</tr>
<tr>
<td></td>
<td>Managers/Senior</td>
<td>Professional/Tech</td>
<td>Admin</td>
<td>Total</td>
<td></td>
</tr>
<tr>
<td>2001</td>
<td>28,000</td>
<td>77,000</td>
<td>36,000</td>
<td>198,000</td>
<td></td>
</tr>
<tr>
<td>% of total</td>
<td>14.0%</td>
<td>38.7%</td>
<td>18.3%</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>2005</td>
<td>36,000</td>
<td>85,000</td>
<td>36,000</td>
<td>202,000</td>
<td></td>
</tr>
<tr>
<td>% of total</td>
<td>17.9%</td>
<td>42.2%</td>
<td>18.0%</td>
<td>-</td>
<td></td>
</tr>
</tbody>
</table>

Source: Scottish Executive

The real estate & business services sub-sector employed 202,000 Scots in 2005. The picture of employment growth emerging from the real estate & business services sector resembles that observed in the financial sector, with professional occupations (surveyors, architects, planning officials) and managerial staff increasing faster than other occupations. In contrast to the financial sector, the employment share of administrative & secretarial occupations remained broadly stable from 2001 to 2005. This is probably due to the fact that this sector is less subject to scale effects and that labour processes dominating this sector allow fewer efficiency gains through ICT investments.

There are sectors within services that have experienced growth in lower paid employment. In the wholesale, retail trade & motor trade and hotels & restaurants sectors, the largest occupational groups were, on average, less skilled than the occupational groups most represented in the financial or real estate sectors. Sales and customer service occupations were the largest occupational group in the sales sub-sector in 2005 - accounting for more than 45 per cent of all staff, while elementary occupations made up about 51.9 per cent of employment in hospitality in 2005. In both sub-sectors, managers constitute the second largest occupational group. However, they made up a much smaller share of total employment. Total employment in these sectors increased only marginally. In both sectors the less skilled, but largest occupational groups saw the highest increase in employment from 2001 to 2005.

Source: Scottish Executive

Scotland continues to perform strongly by historical standards in terms of unemployment. The unemployment rate (according to the ILO\textsuperscript{12} definition) in February to April 2006 was 5.3 per cent – up by 0.2 per cent over the previous quarter, but 0.3 per cent lower than in the same period of 2005. Despite the modest rise over the quarter, the jobless rate remained close to its lowest ever level. The gap between the Scotland and UK unemployment rates has narrowed in recent years –

\textsuperscript{12} International Labour Organisation.
indeed, the Scottish rate is now equal to the UK rate for the first time since 1996. Furthermore, Scotland is the only GOR where unemployment has declined over the last year. As Chart 1.6 illustrates, Scotland’s unemployment rate has been on a consistently downward trend since 1993.

Chart 1.6: Regional Unemployment Rates

Examining Scotland’s unemployment performance in the international context shows that Scotland performs strongly compared to other developed economies. Scotland’s unemployment rate was well below the euro area (8.0 per cent), EU-25 (8.3 per cent), and EU-15 (7.5 per cent), though it was above that of that of the United States (4.7 per cent)\(^\text{13}\).

Scotland’s economic activity rate in the quarter to April 2006 (79.8 per cent), was 0.9 percentage points above the UK average (78.9 per cent) and at its historic best. People are defined as being economically active if they are participating in the labour market – that is, they are either in work or are seeking employment. As Chart 1.7 shows, Scotland’s activity rate has been on an upward trend over the past decade, whereas the UK position has remained relatively stable. This indicates that the Scottish economy has been moving closer to operating at full capacity and that the labour market has tightened.

\(^{13}\) Unemployment for the euro area, EU-25, EU-15 and the United States refers to the period April 2006.
In comparison with other UK regions, Scotland ranks fifth among the GORs in terms of economic activity. Interregional comparisons of economic activity are instructive as they can yield insights on labour market performance. For instance, in the case of Northern Ireland, unemployment decreased substantially while employment increased over the last decade. However, economic activity did not increase substantially and, at 72.6 per cent, is well below the UK average. Therefore, rather than increasing the number of people actively participating in the labour market, as has been the case for Scotland, in Northern Ireland there has been a shift from unemployment into employment.
Despite this very strong performance at the Scotland level, pockets of inactivity remain, particularly in the West of Scotland. In 2004, of the nine areas with inactivity rates above the Scottish average (see Chart 1.9); only Dundee City was situated outside the West of Scotland. Glasgow City has the highest inactivity rate (29.6 per cent) overall, well above the Scottish average of 21.0 per cent.

The data also show that sparsely populated areas, such as the Shetland & Orkney Islands, Highlands and Eilean Siar, tend to have lower inactivity rates than the more densely populated urban areas. That said, it is also obvious that there are many urban areas in Scotland that have inactivity rates below the Scottish and UK averages. Aberdeen City (19.0 per cent), East Dunbartonshire (16.8 per cent), Midlothian (17.0 per cent), East Renfrewshire (17.4 per cent), Edinburgh City (20.3 per cent) and South Lanarkshire (20.7 per cent) all fall into this category. Therefore, the disparity in rates of inactivity across Scotland does not appear to merely reflect urban and rural issues.
1.3 SECTORAL PERFORMANCE

1.3.1 Service Sector

As was noted earlier, the service sector in Scotland continues to be the main driver of growth in the Scottish economy, averaging annual GVA growth of 3.1 per cent since 1999. There are few signs that this trend will change in the near future, with the most recent data showing growth of 2.8 per cent over the year and 0.7 per cent growth over the fourth quarter of 2005. Moreover, the majority of private sector business surveys indicate that prospects for the service sector in 2006 remain positive.

Over the year, all services sub-sectors increased their output and some grew strongly (see Chart 1.10), many at faster rates than the equivalent sectors in the UK economy. The largest output increases were seen in real estate & business services (4.9 per cent), transport, storage & communication (4.5 per cent), and financial services (4.0 per cent). This demonstrates that the Scottish economy has not only been performing steadily at the aggregate level, but has also been growing dynamically at a detailed sectoral level. For example, within financial services, banking services experienced double-digit growth over the year (10.3 per cent), which highlights the role that Scotland is now playing as a major European centre for financial services and associated activities.
The longer-term performance of the sub-sectors within total services is shown in Chart 1.11. The chart shows that financial services has been, by far, the fastest growing sub-sector over the period, growing by an annual average rate of 7.7 per cent. In addition, real estate & business services has performed strongly (5.0 per cent), as has transport, storage & communication (4.0 per cent), and other services (3.5 per cent). Retail & wholesale experienced the least rapid growth over the period (1.0 per cent).
An alternative way to look at growth in GVA is to consider how much the growth in an individual sub-sector (such as financial services) contributes to overall growth in a sector (such as total services) – a sector’s ‘weighted growth contribution’. This ‘contribution’ takes account of both the sector’s rate of growth and the size of the sector – its weight. For example, 10 per cent growth in a sector making up 5 per cent of the economy would contribute the same as 1 per cent growth in a sector accounting for 50 per cent of the economy.

Chart 1.12 illustrates the growth contribution of sub-sectors within Scotland’s service sector between 1998 and 2005 by taking their weighted change as a proportion of the overall increase in service sector GVA. The chart paints an interesting picture of developments within the service sector. For example, real estate & business services (which accounts for approximately a quarter of service sector output) is shown to have accounted for almost 40 per cent of overall services growth between 1998 and 2005. Two other key sectors – financial services, and transport, storage & communication – have grown strongly.
Consumer expenditure as a proportion of final demand stands at 52 per cent in the real estate & business services sector. This demonstrates, not surprisingly perhaps, that the position will be much more sensitive to conditions in the domestic market. Higher activity in the sector, in part, reflects increased activity in the Scottish housing market, which, in turn, has led to house price increases. On the downside, this can have an impact on other prices, such as retail goods and services, as well as generating increased pressure on wages. Moreover, increasing house prices create some important affordability issues – and these are discussed in greater depth in the housing section later in this chapter.

It is also important to consider the positive impact that higher house prices can have in the short-term on confidence, consumer demand and activity in business services. For example, solicitors and estate agents are a key part of the real estate & business services sector and, as demand has increased in the housing market, it has become evident that wages and profits (GVA) have increased in the sectors that facilitate this activity. Therefore, this gives a further indication that the structural changes that the Scottish economy has experienced – declining manufacturing and increasing services – have had a positive impact on economic performance overall.

**1.3.2 Financial Services in Focus**

Financial services has been one of the fastest growing sectors of the Scottish economy in recent years. Interestingly, the main component of final expenditure in the financial services sector is exports to the rest of the UK – standing at 73 per cent. This compares to real estate & business services where demand from UK markets
accounts for 29 per cent. Obviously this highlights that the financial services sector is not as reliant on Scottish domestic demand, and is much more dependent on the strength of the UK economy which produces the majority of demand for these services. The sector’s average annual GVA growth between 1999 and 2005 was 7.7 per cent, compared to an annual average of 1.8 per cent across the economy as a whole. Financial services output grew by 4.0 per cent in 2005 and by 0.7 per cent in the final quarter of the year.

Since the start of the 1980s, the weight of financial and business services to Scottish GVA has increased from approximately 16 per cent to 26 per cent. The weight of financial services to total GVA in Scotland and in seven comparator countries, including the UK as a whole, is shown in Chart 1.13 below. The increasing importance of financial services to Scotland’s economy is shown by the rise in its share of total GVA by 2.3 percentage points between 2000 and 2003. Only the UK as a whole has seen a comparable rise in the weight of the sector to total GVA. However, in countries such as Ireland, growth in financial services has been registered against a backdrop of strong growth in the wider economy, resulting in the sector’s weight to total GVA remaining unchanged. A further notable point is that as a proportion of the total economy, only the US has a larger financial services share than Scotland.

The strong output performance of financial services is also reflected in the most recent employment data which report that employment stood at 113,000 during 2004 an increase of 36.6 per cent since 1998. This rate of growth is considerably higher than that of both the Scottish economy as a whole and the wider UK financial services sector. Within financial services, banking accounts for the majority of the sector’s employment and has also witnessed high levels of growth since 1998.
Growth in financial sector employment (see Box 1.1 for more information) has been considerably higher in Scotland than in most advanced economies (see Chart 1.14). This may be due to companies increasingly moving services out of London to locations such as Glasgow and Edinburgh where costs are lower. This could also explain why employment growth has been strong in Scotland but almost static in the UK as a whole. A similar phenomenon may account for some of the growth in financial services employment in Ireland.


Average earnings in the sector are also significantly higher than the national average in Scotland. Even when looking at median earnings, which reduces the impact of a few very high earners, the sector compares favourably at £25,000 per annum, in comparison to median earnings in the wider economy of £21,000 during 2005. Such high salaries reflect both the large number of graduates employed and the relatively tight labour market faced by companies operating in the sector.

Comparing mean salaries within the sector shows that wages in Scotland were broadly in line with the rest of Europe in 2002 with only UK earnings as a whole being significantly higher. The UK figure is likely to reflect the greater proportion of higher paid jobs within the City of London. Chart 1.15 also shows that growth in Scottish financial services average salaries has been, by far, the most rapid.
Therefore, it is clear that in addition to outperforming the rest of the Scottish economy in terms of growth, the financial services sector in Scotland has outperformed similar sectors in many other advanced economies. The fact that wages are similar to the rest of Europe also indicates that this growth has not been due solely to a rise in low-value activity, but has also included many higher value jobs.

**1.3.3 Retail in Focus**

As indicated earlier, the financial services sector is characterised by the majority of its demand being from outwith the Scottish economy. In contrast, the retail sector in Scotland is dominated by domestic demand – with some 76 per cent of final demand in the sector coming from domestic consumer expenditure. The continuous rise in UK consumer spending over the past 5 years has been widely reported. However, although not as dramatic as that witnessed at the UK level, Scotland has also seen a considerable increase in retail expenditure, as reflected in the retail GVA data. Between 1998 and 2005, retail GVA rose by 23.7 per cent compared to a rise of 13.8 per cent in the Scottish economy as a whole. The sector now accounts for 5.7 per cent of Scottish GVA and generates annual turnover of around £19 billion.

In spite of concerns about consumer debt more recently, the retail sector performed strongly over 2005, growing by 2.6 per cent over the year as a whole. However, the position over the fourth quarter was less positive as GVA declined by 0.5 per cent. The Scottish Retail Consortium produces monthly reports in conjunction with the Royal Bank of Scotland. These data have been indicating for some time that retail...
sales have been positive over the course of the past few years, a position which is also evident at the UK level.

A further key trend in the retail sector over recent years has been the level of consolidation which has occurred, together with the expansion of supermarket chains into the local convenience store market. Both these trends are reflected in the fact that despite continued GVA growth, the total number of retail units fell by 14 per cent from 22,430 to 19,320 between 1998 and 2004. On average, small and medium sized firms bore the brunt of these closures. During the same period, the number of large firms (those with 250 or more employees) increased, by 14 per cent, to total 290 in 2004.

The effect of both of these trends is further reflected in the sector’s recent employment trends. While employment in small and medium sized firms fell by 18 per cent to 72,650 between 1998 and 2004, employment in large firms rose by 27 per cent to 162,760 over the same period. Overall, employment in the sector increased by 7 per cent over this period to 246,500.

The economies of scale, which are likely to have resulted from both consolidation and the expansion of supermarkets, may also explain some of the improvements in productivity seen in the sector. From 1998 to 2003, productivity in the sector, as measured by GVA per head, grew by 37 per cent. This corresponds to an annual growth rate of 6.5 per cent. In the same period, the average productivity growth in the economy as a whole was 1.4 per cent. However, overall productivity in the sector remains half the level of the Scottish average due in part to the labour intensive nature of activity in the sector.

1.3.4 Manufacturing Sector

As with other industrialised economies, the overall proportion of Scotland’s output and employment accounted for by manufacturing has fallen over the past 30 years – this is a global phenomenon. However, despite the emerging dominance of the service sector, manufacturing is still a vital sector of the Scottish economy, contributing almost one fifth of Scotland’s GVA and directly employing almost 250,000 people.

Over the period 1995 to 2000, annual growth in Scotland’s manufacturing output (GVA) averaged 2.8 per cent. However, since then there has been a consistent decline across the sector in Scotland – principally, as a result of the emergence of competition from relatively low-cost regions such as Eastern Europe and Asia. This has resulted in domestic manufacturing companies – particularly electrical & instrument engineering (E&IE) companies – either outsourcing activity or completely closing their Scotland-based operations and relocating. The impact of this is starkly illustrated by the annual average decline in the manufacturing sector, between 2000 and 2005, of 3.3 per cent.
The data for 2005 as a whole show that, manufacturing output declined by 0.8 per cent; indeed, output fell in each of the four quarters, with the fourth quarter exhibiting a decrease of 0.2 per cent. At a sub-sector level (Chart 1.16), on a quarterly basis, engineering & allied industries declined by 1.1 per cent – within this, E&IE declined by 0.4 per cent. Elsewhere, the quarterly decline in manufacturing output was also driven by the decreasing output of other manufacturing (1.8 per cent), in particular the paper, printing and publishing industries (0.8 per cent). However, strong quarterly growth took place in both refined petroleum products & nuclear fuel (1.1 per cent) and chemicals (2.0 per cent).

![Chart 1.16: GVA Growth in Manufacturing Sub-sectors, Quarter and Year to 2005 Q4](image)

Over the year to 2005 Q4, the largest output declines were experienced in textiles, footwear & leather (12.9 per cent), refined petroleum products (7.8 per cent) and engineering & allied industries (3.5 per cent). However, these declines were partially offset by the strong performance of the chemicals & man-made fibres sector, which grew by 7.0 per cent over the year. On account of its position as the largest sector in manufacturing, the engineering & allied industries sector (and within it the electrical & instrument engineering industry) continued to be a key driver of the negative performance in production and manufacturing in Scotland. This was despite the fact that the sector did not itself exhibit the largest sectoral decline. This can be illustrated by applying the same ‘contributions to growth’ analysis that was highlighted earlier in the service sector section. Obviously the trends are somewhat different when manufacturing is compared to services – the former experiencing declines compared to the latter’s considerable increases.
Chart 1.17: Contributions to Manufacturing Sector Decline

Chart 1.17 shows that the engineering & allied industries sector is responsible for over 50 per cent of the overall decline in manufacturing output over the period 1998-2005, even though it only constitutes around a third of total manufacturing output. Two thirds of the decline in the engineering & allied industries was driven by the sharp contraction of E&IE output.

However, there are some sub-sectors which grew during this period (1998-2005). As the chart illustrates, the food, drink & tobacco, chemicals, and the refined petroleum & nuclear fuel sub-sectors delivered positive growth during a period of strong global competition. This highlights that, despite the strong emergence of low-cost producers over the past decade, there are still many Scotland-based manufacturers who, through adapting their traditional core activities, have been able to demonstrate comparative and competitive advantage and expand their outputs.

For example, expenditure on manufacturing R&D increased by 53 per cent in real terms between 1998 and 2003 to £440 million, with growth being particularly strong in the pharmaceutical sector. Productivity has also risen with GVA per worker in 2003 being 25 per cent higher than the Scottish average at £46,000, although care must be taken with this measure given the volatility of the data. Taken together, these trends should ultimately assist the sector by moving it away from low-margin processes, where competition is particularly intense, into more specialised higher value sub-sectors.

Pharmaceuticals is one of the smaller sectors of Scotland’s economy, accounting for just 0.7 per cent of total GVA and 3.6 per cent of manufacturing GVA in 2003. It
consists of around only 40 enterprises and employs just over 4,000 staff. The size of the sector has declined in recent years. Employment fell by 33 per cent between 1998 and 2004 and the sector’s contribution to GVA and turnover has also declined over this period. However, the sector’s decline must be considered in the context of the restructuring which has occurred in the wider manufacturing sectors of both Scotland and many other advanced economies. This process has seen the number of companies engaging in relatively low value processes decline and a repositioning of the remaining companies into higher value and more specialised areas.

The clearest indication of this movement into more specialised areas is the fact that expenditure on R&D in the sector has grown rapidly. Business expenditure on R&D (BERD) in the pharmaceuticals sector was £194 million in 2003. The level of R&D undertaken in the industry has grown strongly in recent years with its contribution to manufacturing BERD increasing from 16 per cent in 1998 to 44 per cent in 2003.

Of course, the manufacturing sector relies on a high proportion of demand from overseas markets. Therefore, it is not only important for manufacturers to adapt through the production of new products and processes to give it some competitive and comparative advantage, it is also critical to take advantage of any emerging new markets.

Manufacturing export sales performed positively in 2005 Q3 and Q4, with quarterly growth taking place in contrast to the declines witnessed in the first two quarters of the year. The data for 2005 Q4 show an increase in manufactured exports from Scotland over the quarter (1.9 per cent), but a decrease over the year (1.8 per cent). Over the quarter, there were a number of strong performing sectors, particularly metals & metal products (9.0 per cent), chemicals (7.8 per cent) and engineering & allied industries (3.6 per cent). In contrast, industries showing a decline in export sales were textiles, fur & leather (4.3 per cent) and food, drink & tobacco (5.3 per cent). Within engineering & allied industries, rising quarterly export sales in E&IE is particularly positive given the significant global re-structuring within the sector over recent times. However, E&IE was the main contributor to the overall yearly decline, with export volumes falling by 11.5 per cent.

The graph below shows the severe downturn that has taken place in engineering & allied industries as a result of falling exports in E&IE since early 2001. Excluding E&IE, exports for all other industries have grown by around 10 per cent.
1.3.5 Agriculture Sector

In terms of GVA, the agriculture sector within Scotland is relatively small, accounting for 1.7 per cent of the total economy. However, the GVA proportion accounted for by agriculture is higher than in the UK, which has an equivalent GVA share of 1 per cent. Moreover, there are other indirect linkages that the agriculture sector has in the Scottish economy, such as in the food & drink sector. For example, over one third (36 per cent) of the total inputs to the Scottish food manufacturing sector are sourced from Scottish agriculture. With regard to employment, the annual Agricultural Census for 2004 recorded an aggregate figure of around 45,000 full-time equivalents (FTEs) employed in the sector. This represents 2.2 per cent of the total workforce and 5 per cent of the workforce in rural Scotland.

The performance of the agriculture sector over time can be looked at in a variety of different ways, such as the standard analysis of GVA and employment. However, perhaps the most insightful approach to analysing the sector is to compare the trends in GVA, productivity and labour usage (represented here by the series Annual Work Units of entrepreneurial labour or AWUs). Chart 1.19 converts these series into index numbers for comparison purposes and gives data for Scotland for the period 1995 to 2004.
The GVA series broadly reflects the commonly reported trend in farm incomes over the last ten years. The GVA figures start with a peak in the mid 1990s reflecting good harvests, strong global prices, and the favourable exchange rate – which benefited both exporters of agricultural produce and recipients of Common Agricultural Policy subsidies (which are valued in €s). The level of GVA then fell rapidly in the late 1990s as the value of sterling rose, commodity prices decreased, and the impact of BSE began to be felt on the sector – it was only in the aftermath of foot and mouth disease (FMD) in 2001 that agriculture began to recover. In the past couple of years the value of sterling relative to the euro has declined, giving agricultural exports a competitive advantage.

The labour usage (or AWU) figures show a gradual decline over the ten year period of about 2,000 AWUs (or around 7 per cent of total labour usage). This reflects a slow decrease in labour requirements as a result of continued increasing mechanisation across the industry and consolidation of farm holdings in some sectors (e.g. the dairy sector). The combined result of the trends in GVA and labour usage is that the trend in productivity has been positive over this period. The average growth in productivity over the last ten years has been around 1.5 per cent per annum, although it has been more than double that rate (on average) in the three year period following the FMD outbreak in 2001. Although this growth is welcome it should be treated with some caution, as it largely represents the agriculture sector recovering from the problems of BSE and FMD. Moreover, input costs fell by 0.2 per cent over the period 2004 to 2005. This has occurred in the face of the significant rise in fuel and oil costs that occurred in 2005 and increases in fertiliser, machinery and interest.
servicing costs. Therefore, it may be the case that farmers are adapting well to the new decoupled era through tight control of costs.

**Box 1.2: Rural Scotland**

There are just over 5 million people in Scotland, of which almost 1 million live in rural areas. However, in terms of land mass, rural Scotland accounts for 98 per cent. In terms of population change from 2001 – 2005, the population is actually increasing particularly in accessible rural areas, while in the rest of Scotland it has shown a decline. At the same time, as the following chart shows, the population of rural areas is ageing more than the rest of Scotland and that a higher proportion of young people leave rural areas.

**Chart 1.20: Percentage of Population by Age Band and Geographic Area, 2004**

![Chart showing population distribution by age band and geographic area in Scotland.]

The employment rate is higher in rural areas than the rest of Scotland (80 per cent for remote rural and 79 per cent for accessible rural versus 74 per cent for the rest of Scotland). Of those employed, self-employment is higher in rural Scotland than in the rest of Scotland. The unemployment rate is lowest in rural areas.

The primary industries (agriculture, forestry, fishing and energy) are the most significant in remote rural areas (in terms of the number of employees) followed by wholesale, retail & repairs. Manufacturing is the most important sector in accessible rural areas. In contrast, financial services is the most important industry in the rest of Scotland, though there are also financial services in rural areas.

Small businesses (those with 0-49 employees) account for a particularly high percentage of businesses in rural remote rural areas (84 per cent) but are also common in accessible rural areas (61 per cent). This compares to 33 per cent in the rest of Scotland. Rural areas (remote and accessible) accounted for 48 per cent of all new business registrations in Scotland in 2004. The start up rates per head of population are higher in rural areas (72 per cent for remote rural and 75 per cent for accessible rural) compared to 18 per cent for the rest of Scotland.

Source: Scottish Executive
1.3.6 Construction

Historically, output in the construction sector has been more volatile than in the wider economy. This reflects its greater sensitivity to changes in both consumer confidence and the wider economic cycle. Despite such fluctuations, the sector has broadly grown in line with the economy as a whole over the past 25 years. The sector’s more recent performance is illustrated in the chart below. As can be seen the sector suffered a large contraction in GVA during the global downturn in 2001 and 2002. However, performance improved strongly thereafter with GVA growing by 12.8 per cent between 2002 and 2005.

As with GVA, employment in the sector also tends to exhibit greater fluctuations than the wider economy. In the autumn of 2005, employment stood at 201,000 and has been steady at around that level for the previous two years according to the Labour Force Survey. However, over the past six years employment in the sector has shown an upward trend, increasing by around 11 per cent since 1998. The sector is predominantly composed of small and medium sized enterprises (SMEs), with 97 per cent of registered businesses in the sector having less than 50 employees. About 43 per cent of these are registered as having zero employees, reflecting the high level of self-employment within the sector. Despite the prevalence of small firms and self employment, with 47 per cent of those working in the sector, large firms retain a significant proportion of employment.
1.3.7 Oil and Gas

Although oil & gas production from the UK Continental Shelf peaked in 2000, the UK remains a significant producer and the sector continues to make a major contribution to both the Scottish and UK economies. High oil prices have also ensured that turnover in the sector has grown rapidly in recent years despite declining production. However, in the Regional Accounts, the UK Continental Shelf is included as a separate region of the UK (the Extra-regio territory) and is not allocated to specific geographic regions. Following this convention, North Sea revenues are excluded from the allocation of revenues to Scotland.

According to the Inter-Departmental Business Register (IDBR) employment in oil and gas enterprises registered in Scotland fell by 27 per cent between 1998 and 2004 to 18,120. However, as not all companies operating in the North Sea are registered in Scotland’s IDBR, this approach is likely to understate the true level of employment supported by North Sea activity. For example, the UK Offshore Operators Association (UKOOA) Economic Report for 2005 suggests that the sector employs almost 63,000 in Scotland including both indirectly employed contractors and suppliers. The recent decline in activity in the North Sea is also reflected in the level of production. The DTI reports that over the period October to December 2005 oil production totalled 21.1 million tonnes, 11.7 per cent lower than in the previous year. Quarterly oil production levels from 1995 are illustrated in chart 1.22. As can be seen, production remained relatively stable during until 2000 but has declined in each year since.

![Chart 1.22: Quarterly Production – Crude Oil and Total, 1995 - 2006](chart)

Source: DTI
Notes: Data for 2006 Q1 onward are DTI forecasts.
Despite the decline in production, high oil prices together with sterling’s continuing strength against the US dollar led to a strong financial performance between 1998 and 2003 with turnover increasing by 49.4 per cent, to £14,366 million in real terms. GVA also showed a strong upward trend, increasing by 61 per cent over the same period.

1.4 HOUSING MARKET

The Department of Communities and Local Government (DCLG) mix adjusted house price index (to March) reported an average house price of £132,271 for Scotland as compared to £186,519 for the UK; Scotland’s average price represented an annual increase of 10.8 per cent (UK = 3.3 per cent). The index continued to demonstrate that Scotland’s annual house price inflation remains robust and in double digits, albeit showing a 0.5 per cent month-on-month decrease. Similarly, DCLG also reported that annual house price growth was subdued in all other regions, except Northern Ireland, South West, East of England and London.

Figures released by the Registers of Scotland (RoS) reported a 1.2 per cent decline in average house prices in the first quarter of 2006 as compared to the previous quarter, although Scotland’s year-on-year house price inflation is up by 8 per cent. The average house price for the first quarter was £124,481 compared to £125,934 in the previous quarter. Similarly, the latest HBoS house price index indicated that in the first quarter, Scotland’s annual house price growth was 6.9 per cent, compared to 6.2 per cent for the UK. This data show that despite the fact that this is above the UK average, the latest annual house price increase lagged that recorded in the North West of England, Wales, Yorkshire and Humberside and Greater London, which all recorded growth rates of over 7 per cent.

1.4.1 First-Time Buyers

Halifax Bank of Scotland (HBoS) report that first time buyer activity remains stretched at the UK level. In the past year, first time buyer activity reached its lowest level in 25 years. A significant problem for first time buyers has been the significant deposits required to purchase. The share of deposits to purchase prices has been increasing with time, with as much as 20 per cent of the purchase price being required as a deposit in London – this is due to house prices rising much faster than average salaries. HBoS report that it now takes an average first time buyer up to five years to save for their deposit, up from three years in 2000. As a result, the average age of first time buyers has increased – across the UK, the average age of first time buyers is now 34 years. Furthermore, according to HBoS, Scotland has the oldest first-time buyers of any UK region. In 2004, the average age of a Scottish first time buyer was 37 years, up from 34 years in 1999. With increasing demands to save huge deposits, some first time buyers are increasingly obtaining their deposits by other means than saving; such as taking out a personal loan or borrowing from family and friends.
Data from the Department of Communities and Local Government (DCLG) show that the growth of prices paid by first-time buyers surmounts inflation in the wider market, with first time buyers in December 2005 paying 4.1 per cent more than a year earlier, as compared to former owner occupiers who saw an annual increase of 2.5 per cent. With rising house price inflation, many first time buyers are being priced out of the market. Consequently, affordability remains of concern, as house prices are already historically high relative to income. Though the Stamp Duty threshold has been raised for a second year running, the latest increase of £5,000 is not expected to have a significant impact on first time buyer activity.

1.4.2 House and Land Prices

House price indices take into account both new build and second-hand properties. New build properties account for around 20 per cent of total house sales, while the remainder were sales of second hand properties.

New build property prices are made up of a number of different elements – broadly speaking, profit, construction costs and land costs. Across the market as a whole, the cost of building a particular type of house will be relatively standard as the inputs into the construction process are supplied through competitive markets, often with a number of alternative uses. Levels of profit are also controlled because the second hand market is sufficiently large to constrain the overall selling price margin of a new build property – i.e. developers are effectively price takers.

Therefore, land, as the fixed asset in the process, is the input most sensitive to price movements in the retail housing market. As the graph below shows, land prices across the UK show a reasonably strong correlation with new build house prices. Where there has been either a positive or negative house price growth in the market, this has characteristically been reflected in the value of land. Inevitably, a strong growth in the price of land affects supply of new (affordable) housing.
Chart 1.24 shows land prices in £/ha for sites built out with flats/maisonettes. It shows that there is a considerable range of land prices within Scotland from £7.5 million in Edinburgh to £0.6 million in Dumfries. Edinburgh land prices appear to have peaked for the moment, but they are still at a level considerably above the rest of Scotland. Glasgow, Aberdeen and Ayr saw average prices pick up beginning in 2003, but they appear to have stabilised again. Of course, not all land is sold in parcels destined for flats and maisonettes. Data for residential building land for larger sites, show that prices in Edinburgh have consistently been the highest in Scotland, though the differentials are smaller and there is greater variation across Scotland.
1.4.3 Affordability

In the November 2004 edition of the Scottish Economic Report, the relationship between housing affordability and annual house price inflation for different regions of the UK in 2004 Q2 was investigated. Affordability was represented by the ratio of house prices to earnings. The data revealed that there was a negative relationship between house price inflation and the price/earnings ratio. This means that, as the price/earnings ratio increases, house price inflation decreases, as it becomes more difficult for households to afford to buy property. The implication of this was that house prices should rise fastest in the most affordable areas. As Chart 1.25, drawn from SER November 2004, shows, this result was evident for most UK regions, with the North and Wales each experiencing house price inflation of 33 per cent per year. However, Scotland seemed to buck the trend: although it was the most affordable region in which to buy property, its annual house price inflation was around 24 per cent.
In the time since November 2004, significant changes have taken place within the UK housing market. There is extensive evidence of a slowing of house price inflation across the UK from a variety of sources. Therefore, it is interesting to compare the relationship between house price inflation and affordability shown above with that given by more recent data. Chart 1.26 compares the position in 2004 Q2 with that in 2005 Q3, which represents the most recent price/earnings data\textsuperscript{14}.

\textsuperscript{14} In the time between the November 2004 edition of the Scottish Economic Report and this one, there has been a significant revision to Northern Ireland’s price/earnings ratio for 2004 Q2 (from a value of 6 to a value of 4.8). This has affected the level of the trendline in Chart 1.25.
There are several interesting features of Chart 1.26. The first key difference between the two periods selected is the rate of house price inflation in each. House price inflation has fallen markedly in almost every region in the UK between 2004 Q2 and 2005 Q3. For instance, house price inflation in Scotland has declined from 24 per cent to 7.1 per cent, while the North has seen a decline from 33 per cent to 2.6 per cent. London, Outer Metropolitan and Outer South East have seen house price inflation decline from 10.5 per cent, 9.3 per cent and 12.5 per cent respectively in 2004 Q2 to 1.7 per cent, 0.4 per cent and -0.2 per cent in 2005 Q3. Meanwhile, affordability conditions in regions with lower price/earnings ratios in 2004 Q2 have worsened slightly over the period, while those with higher ratios in 2004 have become slightly more affordable as their price/earnings ratios have fallen. Overall, the relationship between house price inflation and affordability seems to have become stronger over the period, with regions like Scotland, that exhibit the highest rates of house price inflation, having the lowest price/earnings ratios.

1.4.4 Market Outlook for 2006

While a combination of improved economic growth, low interest rates and high employment levels will continue to sustain housing demand, a number of factors should continue to curb prices from significant acceleration. These include increases in council tax and utility bills which may put pressure on household finances. The majority of forecasts for 2006 anticipate a slight rise in house prices. HBoS expect prices to rise by about 3 per cent – less than the expected rise in average wages.
1.5 FUTURE PROSPECTS

The overall picture of the Scottish economy in the latter half of 2005 was one of steady growth, accompanied by a strong labour market performance. However, upward pressure on global energy prices remains the key downside risk – not just in Scotland but in the world economy – with sustained high oil prices having a continued negative impact on firms’ profit margins in a number of sectors.

Looking ahead to 2006, despite the situation in global oil markets, various business surveys indicate that Scotland’s positive performance continued into the first quarter of 2006, and independent forecasters suggest that this should be sustained through the remainder of the year.

The Royal Bank of Scotland’s Purchasing Managers Index (PMI) Report for April indicates that Scottish private sector output continued to expand – with both the manufacturing and service sectors contributing to this positive performance. The service sector reported a thirty-fifth consecutive month of expansion, with respondents attributing this growth to a continued upturn in new business. The PMI further reports that manufacturing output growth continued in April for the fifth successive month. This positive performance was driven by increased demand in both domestic and overseas markets.

The positive performance of manufacturing in the first quarter is also suggested by the latest Lloyd’s TSB Business Monitor, which covers the three months to the end of February. According to Lloyds TSB, manufacturers are more optimistic than businesses in the service sector. This appears to be due to a pick-up in growth in Scotland’s main export markets in the euro area. Indeed, Lloyds TSB report that improved economic conditions in the euro area led to stronger demand for Scottish goods in the quarter to the end of February 2006. Lloyd’s TSB suggest that this overall performance appears to have had a positive impact on business sentiment for the next six months, with levels of optimism showing a marked increase on the previous quarter.

For the first quarter of 2006, the CBI also report substantial growth in total manufacturing new orders, as well as a significant increase in output. This reflects growth in domestic demand – which increased at the highest rate ever recorded by the CBI – as well as strong growth in export demand. According to the CBI, as global economic conditions improve, manufacturers expect the export position to strengthen further, while although domestic orders may ease slightly, strong growth is still anticipated.

Similarly, Scottish Engineering suggests that overall optimism for the next three months has shown an increase, though large companies are less optimistic. The latest Scottish Engineering report – covering the three months to March – is broadly consistent with the picture from the PMI. Scottish Engineering reported that demand in the manufacturing sector was buoyant over the quarter, with overall
order intakes showing a significant increase. This was largely due to the positive performance reported by both small and medium-sized firms. In contrast to the PMI, the increase in overall orders was driven by strong demand from export markets, as well as domestically.

However, in contrast to the positive result being reported by the majority of the business surveys, the latest Scottish Chambers survey reported that the Scottish retail sector continues to report a weak set of results. Optimism, sales and expected sales were all negative – with smaller retailers in particular reporting a weak trading position. As for the wholesale sector, sales were higher than expected and are anticipated to improve in the next quarter. Respondents are also more confident that turnover will increase over the year.

The Scottish economy’s long-run growth rate, from 1975 to 2005, has been calculated by the Executive as 1.8 per cent. Three of the four independent forecasters monitored by the Executive expect GVA growth in the Scottish economy to exceed this long-run annual average growth rate in 2006, albeit two of these are only marginally above 1.8 per cent. EBS is the most optimistic with a growth forecast of around 2.0 per cent. In 2005, three forecasters expected Scottish growth to exceed the rest of the UK – the latest data suggest that both Scottish and UK GVA growth was equal at 1.8 per cent in 2005. For 2006, all four forecasters expect growth in the UK to exceed Scotland.
Box 1.3: Actual Growth Versus Independent Forecasts

The Scottish Executive monitors the main economic projections presented by Experian Business Strategies (EBS), Cambridge Econometrics (CE), the Fraser of Allander Institute (FAI) and the Item Club (began Scottish forecasts in December 2004). Given the wide variety of data available in the forecasts, these projections provide useful information for policymakers and analysts alike. However, it is important to consider these forecasts in the context of actual, realised economic outcomes. Chart 1.27 shows the gap between actual GVA growth and the projections by each of the forecasters (excluding ITEM) in their last forecast of the preceding year. A negative value indicates an under-forecast in GVA growth, while the opposite is true for a positive value. The data show that FAI has tended to be the most accurate forecaster, though it should be noted that FAI produce four forecasts per year compared to two per year for both EBS and CE. This greater frequency in forecasts allows Fraser to update its forecasts with more timely economic data. The data also indicate that the forecasts appear to have some form of optimism bias.

Chart 1.27: Preceding Year Forecast – Gap Between Forecasts and Actual GVA Growth

![Chart 1.27](image)

Source: FAI, EBS, CE and Scottish Executive

Chart 1.28 shows the gap between actual GVA growth and the projections by each of the forecasters in their last forecast going two years back. Forecasting growth rates this far in advance is inherently difficult as domestic and global events – which can have major economic impacts – are impossible to predict. This difficulty is captured in the graph below, which indicates an often significant gap between actual growth and forecasts. However, it should be noted that these forecasts have become more accurate in the last several years, possibly as a result of more stable growth patterns. However, there does again appear to be an optimism bias.

Chart 1.28: Preceding 2 Year Forecast – Gap Between Forecasts and Actual GVA Growth

![Chart 1.28](image)

Source: FAI, EBS, CE and Scottish Executive
### 1.6 SUMMARY OF MAIN ECONOMIC INDICATORS

#### Scotland Gross Value Added: Service Industries (2002 = 100)

<table>
<thead>
<tr>
<th>2002 Weight</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Services</td>
<td>711</td>
<td>91.3</td>
<td>96.0</td>
<td>100.0</td>
<td>102.2</td>
<td>104.4</td>
</tr>
<tr>
<td>Retail &amp; Wholesale</td>
<td>116</td>
<td>96.8</td>
<td>96.9</td>
<td>100.0</td>
<td>100.9</td>
<td>102.8</td>
</tr>
<tr>
<td>Hotels &amp; Catering</td>
<td>39</td>
<td>93.6</td>
<td>97.6</td>
<td>100.0</td>
<td>100.0</td>
<td>100.6</td>
</tr>
<tr>
<td>Transport, Storage &amp; Comm.</td>
<td>77</td>
<td>86.6</td>
<td>96.3</td>
<td>100.0</td>
<td>99.3</td>
<td>102.4</td>
</tr>
<tr>
<td>Financial Services</td>
<td>63</td>
<td>84.0</td>
<td>95.5</td>
<td>100.0</td>
<td>103.0</td>
<td>109.7</td>
</tr>
<tr>
<td>Real Estate &amp; Business Services</td>
<td>180</td>
<td>87.1</td>
<td>92.8</td>
<td>100.0</td>
<td>104.1</td>
<td>106.6</td>
</tr>
<tr>
<td>Public Admin, Education &amp; Health</td>
<td>219</td>
<td>94.9</td>
<td>97.2</td>
<td>100.0</td>
<td>103.0</td>
<td>106.2</td>
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<tr>
<td>Other Services</td>
<td>55</td>
<td>88.4</td>
<td>92.4</td>
<td>100.0</td>
<td>105.7</td>
<td>104.9</td>
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<tr>
<td>Financial Services Adjustment</td>
<td>-38</td>
<td>84.2</td>
<td>87.7</td>
<td>100.0</td>
<td>109.8</td>
<td>122.1</td>
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</table>

#### ABI Workforce Jobs

<table>
<thead>
<tr>
<th>2004 Share</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
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</thead>
<tbody>
<tr>
<td>Total Jobs</td>
<td>1,639,900</td>
<td>1,725,200</td>
<td>1,811,200</td>
<td>1,813,900</td>
<td>1,870,100</td>
<td>1,894,800</td>
<td>2,307,000</td>
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<tr>
<td>Wholesale &amp; Retail Trade</td>
<td>350,300</td>
<td>393,300</td>
<td>378,000</td>
<td>378,100</td>
<td>372,700</td>
<td>371,200</td>
<td>371,200</td>
</tr>
<tr>
<td>Hotels &amp; Restaurants</td>
<td>151,200</td>
<td>165,500</td>
<td>167,500</td>
<td>169,200</td>
<td>167,700</td>
<td>171,200</td>
<td>171,200</td>
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<tr>
<td>Transport, Storage &amp; Comm.</td>
<td>118,900</td>
<td>118,500</td>
<td>129,400</td>
<td>125,900</td>
<td>122,300</td>
<td>127,500</td>
<td>127,500</td>
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<tr>
<td>Financial Intermediation</td>
<td>93,600</td>
<td>105,100</td>
<td>106,900</td>
<td>106,900</td>
<td>109,800</td>
<td>113,200</td>
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<td>Real Estate &amp; Business Activities</td>
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<td>277,900</td>
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<td>271,900</td>
<td>303,100</td>
<td>305,800</td>
<td>305,800</td>
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<tr>
<td>Public Admin &amp; Defence</td>
<td>145,800</td>
<td>147,200</td>
<td>146,600</td>
<td>143,700</td>
<td>149,500</td>
<td>150,700</td>
<td>150,700</td>
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<tr>
<td>Education</td>
<td>163,800</td>
<td>180,500</td>
<td>186,400</td>
<td>193,000</td>
<td>198,500</td>
<td>199,100</td>
<td>199,100</td>
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<tr>
<td>Health &amp; Social Work</td>
<td>258,100</td>
<td>271,800</td>
<td>284,900</td>
<td>299,000</td>
<td>319,000</td>
<td>330,400</td>
<td>330,400</td>
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<tr>
<td>Other Community Activities</td>
<td>120,100</td>
<td>121,400</td>
<td>124,200</td>
<td>126,200</td>
<td>127,500</td>
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### Scotland GVA Manufacturing Industries (2002 = 100)

<table>
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<tr>
<th>Industry</th>
<th>2002 Weight</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
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</thead>
<tbody>
<tr>
<td>Manufacturing</td>
<td>161</td>
<td>114.9</td>
<td>108.5</td>
<td>100.0</td>
<td>97.7</td>
<td>98.1</td>
<td>97.3</td>
</tr>
<tr>
<td>Refined Petroleum Prod &amp; Nuclear Fuel</td>
<td>3</td>
<td>94.0</td>
<td>90.7</td>
<td>100.0</td>
<td>103.7</td>
<td>111.4</td>
<td>102.8</td>
</tr>
<tr>
<td>Chemicals &amp; Man-made Fibres</td>
<td>15</td>
<td>90.2</td>
<td>98.1</td>
<td>100.0</td>
<td>93.2</td>
<td>93.6</td>
<td>100.2</td>
</tr>
<tr>
<td>Metals &amp; Metal Products</td>
<td>14</td>
<td>105.0</td>
<td>99.0</td>
<td>100.0</td>
<td>92.8</td>
<td>91.8</td>
<td>92.5</td>
</tr>
<tr>
<td>Engineering &amp; Allied Industries</td>
<td>55</td>
<td>141.8</td>
<td>121.8</td>
<td>100.0</td>
<td>97.0</td>
<td>98.6</td>
<td>95.1</td>
</tr>
<tr>
<td>Food, Drink &amp; Tobacco Industries</td>
<td>32</td>
<td>97.8</td>
<td>102.6</td>
<td>100.0</td>
<td>101.0</td>
<td>101.6</td>
<td>103.0</td>
</tr>
<tr>
<td>Textiles, Footwear, Leather &amp; Clothing</td>
<td>7</td>
<td>132.5</td>
<td>117.9</td>
<td>100.0</td>
<td>92.7</td>
<td>85.6</td>
<td>74.5</td>
</tr>
<tr>
<td>Total Other Manufacturing</td>
<td>36</td>
<td>107.0</td>
<td>102.8</td>
<td>100.0</td>
<td>100.3</td>
<td>100.1</td>
<td>100.4</td>
</tr>
</tbody>
</table>

### ABI Workforce Jobs

<table>
<thead>
<tr>
<th>Manufacturing Industries</th>
<th>2004 Share</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total for Manufacturing</td>
<td>100</td>
<td>315,000</td>
<td>302,000</td>
<td>285,000</td>
<td>263,400</td>
<td>243,300</td>
<td>236,300</td>
</tr>
<tr>
<td>Food Beverage &amp; Tobacco</td>
<td>21</td>
<td>56,900</td>
<td>55,500</td>
<td>53,100</td>
<td>51,500</td>
<td>50,300</td>
<td>48,700</td>
</tr>
<tr>
<td>Textiles, Footwear, Leather &amp; Lace</td>
<td>6</td>
<td>29,600</td>
<td>22,900</td>
<td>19,400</td>
<td>17,400</td>
<td>15,200</td>
<td>13,600</td>
</tr>
<tr>
<td>Wood &amp; Wood Products</td>
<td>3</td>
<td>9,100</td>
<td>8,100</td>
<td>8,400</td>
<td>9,200</td>
<td>8,200</td>
<td>7,900</td>
</tr>
<tr>
<td>Pulp, Paper, Publishing &amp; Printing</td>
<td>11</td>
<td>31,100</td>
<td>30,100</td>
<td>30,100</td>
<td>28,300</td>
<td>26,900</td>
<td>26,800</td>
</tr>
<tr>
<td>Refined Petroleum &amp; Nuclear Fuels</td>
<td>1</td>
<td>1,900</td>
<td>2,000</td>
<td>2,100</td>
<td>2,400</td>
<td>2,300</td>
<td>2,300</td>
</tr>
<tr>
<td>Chemicals, &amp; Man-made Fibre</td>
<td>6</td>
<td>15,900</td>
<td>15,900</td>
<td>15,600</td>
<td>14,800</td>
<td>14,100</td>
<td>13,600</td>
</tr>
<tr>
<td>Rubber &amp; Plastic Products</td>
<td>4</td>
<td>12,800</td>
<td>12,300</td>
<td>12,900</td>
<td>11,200</td>
<td>10,800</td>
<td>11,600</td>
</tr>
<tr>
<td>Other Non-metallic Products</td>
<td>3</td>
<td>9,000</td>
<td>8,800</td>
<td>8,700</td>
<td>7,700</td>
<td>7,800</td>
<td>7,100</td>
</tr>
<tr>
<td>Metals &amp; Fabricated Metal Products</td>
<td>11</td>
<td>32,900</td>
<td>30,300</td>
<td>31,500</td>
<td>29,700</td>
<td>26,900</td>
<td>25,100</td>
</tr>
<tr>
<td>Machinery Not Elsewhere Classified</td>
<td>8</td>
<td>23,500</td>
<td>26,700</td>
<td>23,300</td>
<td>21,400</td>
<td>19,600</td>
<td>19,600</td>
</tr>
<tr>
<td>Electrical &amp; Optical Equipment</td>
<td>15</td>
<td>62,300</td>
<td>61,500</td>
<td>53,500</td>
<td>44,600</td>
<td>37,300</td>
<td>35,800</td>
</tr>
<tr>
<td>Transport Equipment</td>
<td>7</td>
<td>21,100</td>
<td>19,400</td>
<td>18,200</td>
<td>16,000</td>
<td>14,900</td>
<td>15,600</td>
</tr>
<tr>
<td>Manufacture Not Elsewhere Classified</td>
<td>4</td>
<td>8,900</td>
<td>8,600</td>
<td>8,200</td>
<td>9,100</td>
<td>9,000</td>
<td>8,300</td>
</tr>
</tbody>
</table>
chapter two: Global, European and UK Economic Developments
2 GLOBAL, EUROPEAN AND UK ECONOMIC DEVELOPMENTS

2.1 SCOTLAND IN THE GLOBAL CONTEXT

As the world economy has become increasingly globalised, international trade has become more important for Scotland and other advanced economies. Over time, technological advances have enabled the freer and faster movement of people, products and capital across international borders. This trend has been reinforced by political changes, most notably the creation of the European Single Market, the accession to the European Union (EU) of many former Eastern Bloc states, and the ongoing economic liberalisation and re-engagement of the world’s two most populous nations, China and India.

2.1.1 Scotland’s Trade

By exporting, businesses located in Scotland are able to tap into larger markets overseas; the global economy (in GDP terms) is over 200 times as large as the economy of Scotland. Moreover, the ability to import enables businesses and consumers in Scotland to access goods and services that would not otherwise be available or which can be produced more efficiently in other countries by exploitation of their comparative advantage.

Given Scotland’s position as a high-wage developed economy, businesses located in Scotland tend to find comparative advantage in high value-added sectors (see Chart 2.1), such as electrical & instrument engineering, financial services and niche products like whisky (which constitutes a large proportion of the food & drink sector). As a consequence of the specialisation of economic activity in high-value production, around 90 per cent of Scottish exports go to other developed economies, in particular the rest of the UK, Europe and North America.

Over two-thirds of Scotland’s exports in 2002 (63 per cent) were sold to the rest of the UK. This is unsurprising given the obvious links in terms of geography, shared language and currency as well as the size of the potential market (the UK is the world’s fifth largest economy). The strength of the economic linkages between Scotland and the rest of the UK implies that the performance of the wider UK economy bears significantly on the performance of the Scottish economy (see UK commentary below).

Beyond the UK, Scotland’s major export market is the euro area (see Chart 2.2). Europe is a natural destination for Scottish exports due to its relative prosperity, geographical proximity and the free trade rules that apply within the European Single Market. In 2004, the euro area was the destination for 46 per cent of

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15 The International Monetary Fund (IMF) defines globalisation as “the growing interdependencies of countries worldwide through the increasing volume and variety of cross-border transactions of goods and services, of international capital flows and through the rapid and widespread diffusion of technology.”
Scotland’s identifiable non-UK exports (£16.7 billion\textsuperscript{16}), having fallen from 51 per cent in 2003. This decline reflected the relative economic weakness of the ‘core’ economies of the euro area (see Box 2.2, below). Within the EU, much of the most impressive recent growth has been outwith the euro area – in the UK and in the 10 new EU Member States\textsuperscript{17}.

The United States (US) was Scotland’s largest national export market in 2004, with the Netherlands in second place. The relative buoyancy of consumer and business demand in the US boosted its importance as an export destination for Scotland, while the weaker economic performance of Germany saw it decline from being Scotland’s largest export market in 2002 to third place in 2004.

Asia is a relatively modest export market for Scotland (accounting for only 12 per cent of Scotland’s exports) although its importance to Scotland as a source of imports is much greater (see Chart 2.3). The largest Asian economies of Japan and China have carved out a dominant global position in a range of sectors from textiles to technology goods. Indeed, according to the Organisation for Economic Cooperation and Development (OECD)\textsuperscript{18}, China became the world’s largest exporter of information and communications technology (ICT) goods in 2004 – surpassing Japan and the EU in 2003 and taking over from the US in 2004. Looking ahead, the rapid economic development of China and India should further boost Scottish

\textsuperscript{16} Total exports, derived from the Executive’s Global Connections Survey (2004), were £17.5 billion.

\textsuperscript{17} In 2004, the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovakia and Slovenia joined the European Union.

\textsuperscript{18} OECD, ITS database.
exports to Asia, which increased from 9 per cent of Scotland’s total in 2003 to 12 per cent in 2004.

**Chart 2.2: Scotland’s Non-UK Exports by Destination, 2004**

Source: Scottish Executive

**Chart 2.3: Scotland’s Non-UK Imports by Origin, 2004**

Source: HM Customs & Revenue
2.2 UK ECONOMY

2.2.1 Output and Demand

The UK economy grew by 1.8 per cent in 2005 and the latest data indicate that GDP rose by 0.6 per cent in the first quarter of 2006, and by 2.2 per cent over the year to 2006 Q1. This year-on-year growth rate was up on the preceding quarter and may suggest that the UK economy is regaining momentum. The UK economy had grown above trend in 2004, but began to lose momentum in the latter half of that year and this trend continued into, and through, 2005. Chart 2.4 shows that despite the below trend growth rate of last year, growth in UK GDP still remained above that of both Germany and France, as well as the EU25 average.

The output of the UK’s production sector rose by 0.8 per cent between 2005 Q4 and 2006 Q1. Growth occurred in all sub-sectors, including manufacturing – accounting for 80 per cent of industrial production – which grew by 0.7 per cent. In contrast, the production sector contracted over the year to 2006 Q1, with output down 0.9 per cent. This decline took place across all production sub-sectors, with the exception of electricity, gas & water supply. Manufacturing output declined by 0.6 per cent over the year.

The service sector continued to be the engine of growth in 2005, and this has continued into 2006 Q1. Services output increased by 0.6 per cent during the quarter and by 3.0 per cent over the year to 2006 Q1. Within the service sector, which accounts for around three-quarters of total UK output, strong quarterly growth
occurred across all sub-sectors in the first quarter – ranging from 0.4 per cent in distribution, hotels & catering to 0.8 per cent in business services & finance. In terms of annual GVA growth, business services & finance was the best performing sub-sector in the year to 2006 Q1, with output up by 3.9 per cent.

Looking at the performance of the UK economy over a longer time frame reveals that GVA growth has been largely driven by the service sector (given its large relative weight) and, to a lesser extent, by construction. Chart 2.5 shows that services and construction GVA has grown by around 10 per cent between mid-2002 and 2005 Q4\(^9\). The data also show that manufacturing output has been broadly stable, while production output has contracted by around 2.5 per cent.

![Chart 2.5: UK GVA Index, 2002 Q1 – 2005 Q4](chart)

On the demand side, household consumption expenditure is by far the largest component of GDP, accounting for approximately 65 per cent of the total. In other words, large changes in households’ spending on goods and services will tend to have a significant effect on GDP. The latest quarterly data show that households’ consumption expenditure grew by 0.2 per cent over the quarter to 2006 Q1, and by 1.7 per cent over the year. Household spending still appears to be relatively subdued in comparison with recent years. Several factors, such as the cooling housing market, rising energy prices and the relatively high level of households’ debt, might explain the easing of household expenditure growth. Household debt increased from 110 per cent of disposable income in 2000 to 150 per cent in 2005.

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\(^9\) This index is derived from Scottish Executive GVA at basic prices statistics, and the latest data available is for 2005 Q4.
Government consumption expenditure – accounting for over 20 per cent of UK GDP – grew by 0.6 per cent between 2005 Q4 and 2006 Q1, and by 4.6 per cent over the year as a whole. This component of demand has been strongly supportive of GDP growth since around late 2000, on the back of significant investment in the public services – particularly in health, education and transport. For example, in construction, government investment (either directly or through the Private Finance Initiative) in school buildings, health facilities and social housing has continued to bolster activity in the sector.

Over the quarter to 2006 Q1, whole economy investment – gross fixed capital formation (GFCF) – increased by 1.5 per cent, and by 3.7 per cent over the year. The annual growth rate of investment in 2005 was down on the six-year high recorded in 2004 (4.9 per cent), but it was faster than total GDP growth and provides some indication that businesses and consumers are optimistic about future economic prospects. Investment expenditure is spending on assets which will be repeatedly or continuously used over a number of years to produce goods and services, for example, machinery used to create a product. Higher levels of investment are generally viewed as desirable since they usually indicate that an economy’s productive capacity is being increased.

The final component of demand is net exports – exports of goods and services minus imports of goods and services. A positive net exports balance makes a favourable contribution to GDP, while the opposite is true for negative net exports (net imports). The UK has been a net importer since 1998. Weaker economic growth in many of the UK’s key export markets – such as Germany, France and Italy – has meant that they have demanded relatively fewer goods and services from the UK. The most recent data show that exports grew more slowly than imports in the year to 2006 Q1, with annual exports growing at 11.9 per cent, compared to 12.0 per cent for imports.

Chart 2.6 shows how the components of UK demand have grown since 2000. Imports have been the fastest growing component. However, exports have also grown, albeit at a slower rate. The export position has seen a strong upward trend since mid-2003, which perhaps reflects strong demand in the US. The data also show that household consumption has been a strong contributor to economic growth, particularly from late 2000 through to 2004 Q3. This is due to a number of factors but, in particular, rising real disposable incomes, rapidly rising housing wealth and buoyant consumer confidence. High consumption spending over the period has also come at the expense of a lower household saving ratio.
The chart above demonstrates which changes in the components of demand may have been critical in explaining changes in the growth rate of GDP. For example, UK GDP growth reached 3.2 per cent in 2004, before slowing to 1.8 per cent in 2005. The above trend growth rate in 2004 was achieved despite a slowdown in GDP growth in the latter two quarters of that year. Chart 2.6 is consistent with that position – household consumption growth was broadly static between 2004 Q3 and 2005 Q1 prior to picking up at a subdued rate through the remainder of 2005. In addition, both exports and GFCF moderated between 2004 Q2 and 2005 Q1/Q2. During the same period, import growth continued unabated. Overall, the position over the period was one of slower growth in the components of GDP, and continuing growth in imports which acted as a drag on overall GDP growth.

### 2.2.2 Labour Market

Since 1997, UK employment has risen by over 2 million, while unemployment has fallen by almost 450,000. However, as Chart 2.7 shows, the trend in the employment rate has been downward since early 2005, while the trend in the unemployment rate has been upward over the same period. This pattern is consistent with the UK economy operating below trend in 2005. However, data show that employment increased over the latest quarter, and given that the UK economy is forecast to move back to trend growth in 2006, this could be the start of a turnaround in the downward trend.

The employment rate for people of working age was 74.7 per cent for the period February to April 2006 – up 0.2 per cent from the previous quarter, but down from
74.8 per cent over the year. The number of people in employment was 28.93 million, up 130,000 over the quarter and up 272,000 over the year.

The unemployment rate was 5.3 per cent (February to April 2006), up from 5.0 per cent over the quarter and up from 4.7 per cent over the year. The number of unemployed people increased by 77,000 over the quarter and by 199,000 over the year, to reach 1.61 million. The claimant count was 950,900 in May 2006, up 5,800 on the previous month, and up 96,700 on a year ago.


Source: ONS

2.2.3 Inflation and Monetary Policy

The Monetary Policy Committee (MPC) of the Bank of England has the responsibility for setting interest rates to meet the UK government’s symmetrical inflation target of 2 per cent. Subject to that, the MPC is also required to support the government’s objective of maintaining high and stable growth and employment.

As Chart 2.8 shows, CPI inflation started 2005 at 1.6 per cent, before rising above the Banks’ 2 per cent target rate in July, and staying there until December. This transitory movement above the inflation target was largely due to the impact of the rise in global energy prices. The latest data show that inflation in the year to April 2006 stood at 2.2 per cent. This relatively benign inflationary environment led the MPC to leave interest rates unchanged at 4.5 per cent in June 2006, for the tenth consecutive month.
The Bank of England’s latest Inflation Report\textsuperscript{20} shows that the Bank expects inflation to move above 2 per cent over most of 2006 and 2007, before falling back to target by the end of 2007 – this forecast assumes that interest rates remain at current levels. According to the Bank, downward pressure on inflation stemming from spare capacity will be more than offset by upward pressure from higher energy prices. Towards the end of 2007, the Bank expects the effects of higher energy prices to diminish.

**Box 2.1: Business Surveys and Official Data**

State-of-trade surveys (more often called business surveys) provide prompt information on the performance of the private sector economy – both recent outturns and future prospects. The key advantages of business surveys are their timeliness – they tend to be available before official data are published – and the fact that they provide information on matters such as business optimism for which official data are not available. The key drawbacks of business surveys concern their relatively small sample sizes compared with the larger samples used to produce official statistics, and the qualitative nature of business survey responses (e.g. firms are asked whether output is ‘more’, ‘less’ or the ‘same’). On the first point, official GDP estimates for Scotland are derived from responses from around 5,000 businesses each quarter (data that are augmented by information from large corporations and trade bodies), while the NTC/RBS Report on Scotland, for example, is based on an average response rate of around 600 firms. The concern with aggregating qualitative responses is that they may at times misrepresent actual changes in output, particularly when sub-sectors are experiencing large changes in output compared with the rest of the sector.

The timeliness of business surveys ensures that they are widely used by the media, commercial organisations (e.g. investors and forecasters) and economic policymakers such as the HM Treasury and the Bank of England. The Bank of England (*Quarterly Bulletin*, Spring 2005), says that business surveys “often form an important input into the MPC’s economic assessment”, in particular at the “earlier stages of the ONS’s data production cycle”. The Bank has published several papers\(^2\) that discuss their use of business survey information as a means to augment official statistics and their own sources of information (e.g. Agent reports). This research outlines techniques that can be used to convert survey balance statistics\(^2\) into quantitative estimates that can be compared directly with official statistics; it also describes the statistical relationship (derived from correlation and regressions analysis) that exists between particular business survey indicators for the UK economy and equivalent official data.

Comparing the balance statistics for UK manufacturing activity from the CBI’s Industrial Trends Survey and official estimates of quarter-on-quarter growth in UK manufacturing output, the Bank of England (*Quarterly Bulletin*, Spring 2005) observe a correlation\(^2\) of 0.40. Similar comparisons made using Scottish data yield a correlation value of 0.49. Using the CIPS survey for UK manufacturing activity, the Bank finds a somewhat higher correlation with official data of 0.54; the equivalent value derived from Scottish data (NTS/RBS report and Scottish GVA statistics) is 0.47. For service sector activity, the strongest correlation the Bank found in UK data was between the CIPS survey and quarter-on-quarter changes in services GVA (0.43). For Scotland, the highest correlation (0.3) with official estimates of services sector GVA growth involved the RBS/PMI survey for services.

The Monetary Policy Committee of the Bank of England meet every month to set interest rates, therefore, timely and accurate economic data is of particular value to them. To help inform the process, Bank officials use the best survey-based estimates and combine them with ONS’s early GDP estimates, which are produced from a subset of survey responses, to produce a ‘best guess’ of actual changes in GDP. These calculations have been shown to reduce the uncertainty that surrounds ONS’s preliminary estimates of GDP (produced seven weeks after the end of the quarter) compared with their later balanced estimates published in *Quarterly National Accounts* and the annual *Blue Book*. The Bank’s research shows that the value of business surveys in reducing data uncertainty is greatest (a) in the short time span before official data are produced, and (b) between preliminary GDP and the later estimates in *Quarterly National Accounts*, which are produced around three months after the end of the quarter.

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\(^2\) That is, the weighted percentage balances of businesses reporting that their output/orders/etc. are *Up*, *Down*, or the *Same* in one period compared with an earlier time.

\(^2\) A correlation value of 1 suggests a perfect positive correlation; a value of 0 indicates that there is no link; and -1 that there is a perfect negative correlation.
2.2.4 Public Finances

The UK government’s fiscal policy framework is based on the five key principles set out in the Code for Fiscal Stability – transparency, stability, responsibility, fairness and efficiency. The UK government’s fiscal objectives are:

- Over the medium term, to ensure sound public finances and that spending and taxation decisions impact fairly within and between generations; and
- Over the shorter term, to support monetary policy and, in particular, to allow the automatic stabilisers\(^\text{24}\) to help smooth the path of the economy.

These objectives are implemented through two well-established fiscal rules, against which the performance of fiscal policy can be judged:

- The golden rule – over the economic cycle, the government will borrow only to invest and not to fund current spending; and
- The sustainable investment rule – public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level. Other things being equal, net debt will be maintained below 40 per cent of GDP over the economic cycle.

Table 2.1 – from Budget Report 2006 – shows the latest projections for the UK’s public finances. The table shows that the UK government expects to meet its golden rule, with an average annual surplus on the current budget over this economic cycle (defined as taking place between 1997/1998 and 2008/2009) of approximately 0.1 per cent of GDP. The cyclically adjusted surplus, which allows structural trends in the public finances to be assessed more clearly by removing the effects of the business cycle, shows a deficit of 0.3 per cent of GDP in 2005/2006, followed by a surplus of 0.4 per cent in 2006/2007 and higher surpluses from that point onwards.

The UK government also expects to meet its sustainable investment rule over the economic cycle. In 1996, public sector net debt stood at 44 per cent of GDP, before falling to 30 per cent in 2001/2002. It has grown since then, and is projected to reach 38.3 per cent by the end of the current cycle, and stabilising at this level for the remainder of the forecast period. The projection for core debt, which excludes the impact of the cycle, rises to 36 per cent by the end of the forecast period.

\(^\text{24}\) Government borrowing will tend to fall when output is above trend, and rise when output is relatively low. Rising government borrowing represents a net increase in domestic demand, so this automatic fiscal effect will tend to moderate economic downturns. Conversely, falling government borrowing helps to dampen economic booms. Over most economic cycles, the effects of these automatic stabilisers will come close to balancing out.
In April 2006, the public sector current budget was in surplus by £3.0 billion; this is a £1.3 billion higher surplus than a year ago, when there was a surplus of £1.7 billion. Public sector net lending was £1.4 billion; this is £0.5 billion higher net lending than in April 2005, when net lending was £0.9 billion. At the end of April 2006 public sector net debt was £437.1 billion (equivalent to 36.3 per cent of GDP). This compares to £418.4 billion (34.8 per cent) as at the end of April 2005.

2.3 GLOBAL DEVELOPMENTS

North America, Developing Asia and, to a lesser extent, the UK have been the major drivers of recent global economic growth, while the euro area and Japan have lagged behind. The International Monetary Fund (IMF) expects these trends to continue in 2006 and 2007 (see Table 2.2) as the world economy continues to enjoy robust growth. The IMF attributes much of the recent strength of the world economy to the rapid expansion of international trade – to greater flows of goods, services and capital between countries. In the euro area, exports have been the principal driver of growth, while domestic demand has remained weak; in contrast, inflows of goods and capital to the US have enabled greater consumption relative to domestic production. The IMF also believes that a surge in inexpensive merchandise exports from Developing Asia has helped to suppress world inflation.
The upward trend in commodity prices (including oil) remains a major downside risk to world growth. If worldwide economic activity increases as IMF suggests, it is likely that demand for natural resources will remain high and this may act as constraint on aggregate supply growth and engender upwards pressure on inflation.

2.3.1 Euro Area

The euro area economy lost momentum in 2005 as weakening industrial production and subdued consumer demand combined to produce annual GDP growth of 1.3 per cent, down from 2.1 per cent in 2004. Eurostat’s ‘flash estimate’ of first quarter GDP indicated that euro area growth picked up slightly in the first quarter of 2006 to 0.6 per cent quarter-on-quarter, up from 0.3 per cent in 2005 Q4. The upturn in early 2006 may reflect better underlying economic conditions, such as employment and business/consumer confidence, which generally became more conducive to growth. According to the OECD, these positive trends should be translated into more sustained and widespread improvements in domestic demand and activity both this year and next.

The sectoral performance of the euro area has been uneven. The private service sector is the major contributor to growth, whilst public administration is growing slowly and agricultural production is in decline. Robust growth in trade, repairs, hotels & restaurants, transport & communication (2.3 per cent in 2005) and financial, real estate, renting & business activities (1.9 per cent) has meant that, although these two combined account for a little under half of the economy, they constituted two thirds of the euro area’s growth in 2005.

Weak growth and high unemployment have characterised the euro area’s economic performance since the Millennium. Annual euro area GDP growth has surpassed two per cent in only one year since 2000 due to the lacklustre performance of the area’s three largest economies: Germany, France and Italy. In 2005, the German economy grew by just 0.9 per cent, while France’s GDP increased by 1.5 per cent and the Italian economy was static. However, this pattern of modest expansion has not been universal across the currency union: many of the smaller and more geographically peripheral euro area economies – such as Ireland, Luxembourg and Greece – have regularly achieved growth rates in excess of four per cent in recent years (see Box 2.2, which discusses the distribution of economic growth within the EU).
Box 2.2: Disparities in Economic Performance in the European Union

Economic performance has varied widely within the European Union since 2000. The highest rates of GDP growth have been recorded around the geographical periphery of Europe – in Ireland, Greece, Spain, United Kingdom and Finland (see Box 2.3 on the Scandinavian economies). In contrast, key economies at the geographic core of Europe – Germany, France, the Netherlands and Italy – have performed less well in growth terms. The fact that this group of countries contains three of the EU’s four largest economies helps to explain the recent lacklustre performance of the EU15 economy in aggregate.

The accession of ten new EU Member States in 2004, has served only to reinforce the pattern of unevenness, with strong GDP growth being recorded in the largest former Eastern Bloc economies of Poland, the Czech Republic and Hungary. That said, the impact of accession on total EU25 growth has been fairly muted given that the combined GDP of the ten accession economies in 2004 was equal to only a quarter of the total output of the German economy.

The recent performance of the UK economy has been in the middle ground in European terms, outperforming the ‘core’ economies, but not performing as strongly as the most economically dynamic countries around the periphery of Europe. According to Eurostat forecasts, the distribution of economic growth within the EU will remain broadly similar to its current distribution at least until 2007 (see Chart 2.10).

Broad convergence in living standards between Member States is central to the ethos of the European Union and, as the chart below illustrates, there is evidence that this is happening. Relatively high rates of GDP growth in Eastern Europe are reducing the gap in per capita incomes between the new Member States and the EU15 average. This trend is set to continue. In Slovakia’s case, Eurostat forecasts that per capita income will increase from 47 per cent of the EU15 level in 2003 to 54 per cent by 2007. Over the same period, per capita income in France is forecast to fall slightly from 103 per cent of the EU15 average to 101 per cent; Ireland, by contrast, will move further ahead of the EU15 average (from 123 per cent in 2003 to 132 per cent by 2007). Living standards relative to the EU15 average in the UK and Germany are predicted by Eurostat to remain broadly stable with respect to their 2003 position (at around 108 per cent and 100 per cent respectively in 2007).

Chart 2.10: Growth in Selected European Countries Relative to the EU25 Average

Source: Eurostat
Notes: The 2005 figures for France & Ireland are Eurostat forecasts, as are 2006 & 2007 figures for all countries. All figures in graph are reported at purchasing power parity and are compared with the EU15 average of 100 per cent.
Labour market conditions in the euro area improved in 2005 even though the key indicators remained a considerable distance behind those of the world’s best performing economies. Employment growth gathered pace during the year, and in the third quarter of 2005 (the latest quarter for which we have data) 359,000 new jobs were created. Consistent with trends in the previous few years, euro area jobs continued to be lost in the agriculture and manufacturing sectors in 2005 Q3. By contrast, the largest quarter-on-quarter increases in employment were seen in construction (0.6 per cent) and finance, real estate, renting & business services (0.6 per cent).

The trend in euro area unemployment remained downwards in 2005, and by March this year the area’s unemployment rate had fallen to 8.1 per cent, down from the peak of 8.9 per cent that prevailed through much of 2004. Despite these improvements, unemployment in the euro area at the start of 2006 was well above the rates seen in the US (4.7 per cent), Japan (4.7 per cent) and the UK (5.2 per cent). High unemployment partly explains the subdued pace of wage growth in the euro area. The average hourly cost of labour increased by just 2.6 per cent in 2005.

The lack of momentum in consumer spending, which accounts for around 57 per cent of the euro area’s expenditure-based GDP, was central to the modest pace of economic growth in 2005. Despite this, the European Central Bank (ECB) started to remove the monetary stimulus provided by very low interest rates as concerns about the outlook for inflation emerged. The ECB has sought in recent years to stimulate interest-sensitive demand in the euro area through low interest rates, but to date this has proved only a partial success. The ECB raised interest rates in June 2006 by 0.25 percentage point to a base rate of 2.75 per cent; low by historical standards and well below equivalent base rates in the UK and US (4.5 per cent and 5 per cent respectively in June 2006).

The euro area’s inflation rate of 2.4 per cent in April was above the Bank’s 2 per cent target. The fact that inflation has been above target for most of the past five years while euro area growth has been below trend hints at underlying structural issues which need to be addressed. The European Commission has acknowledged these issues, and the Lisbon Agenda (released in 2000) is designed to enhance the competitiveness of the European economy.

Confidence (measured by Eurostat’s economic sentiment indicator) picked up in the latter half of 2005 and continued above its long-term average throughout the early part of 2006. Individual indicators underlying the composite index suggest that consumers expect future improvements in their economic situation and firms expect modest increases in orders. Although expectations data can offer an early insight on economic prospects, the real test of confidence is whether consumers and firms are prepared to increase their actual spending. Euro area retail sales increased by just 1.5 per cent in 2005, the same growth rate as in 2004.
Investment expenditure, on the other hand, was consistent with the survey indicators, growing by 2.3 per cent in 2005. This increase made a major contribution to year-on-year growth in 2005 (see Chart 2.11, below). The precise factors underlying the buoyancy of investment are unclear, but it may be an indication of firms’ improving confidence in the near-term economic future and therefore offers some hope that the acceleration evident in Eurostat’s ‘flash estimate’ of first quarter growth may persist. Recent price rises on the European stock market\textsuperscript{26}, which tend to lead changes in GDP, suggest that expectations of corporate profitability may have improved.

\begin{center}
\textbf{Chart 2.11: Contributions to Annual Euro Area GDP Growth}
\end{center}

![Chart 2.11: Contributions to Annual Euro Area GDP Growth]

Government consumption in the euro area grew at a slower rate than total GDP in 2004 and in 2005. According to the ECB, the euro area’s general government deficit declined to 2.4 per cent of GDP in 2005, from 2.8 per cent in 2004. Despite this, the average euro area debt ratio increased slightly in 2005, to 70.8 per cent of GDP. Three euro area economies (Italy, Greece and Belgium) were estimated to have debt ratios above, or near to, their annual output in 2005 (i.e. approximately 100 per cent of GDP). Published plans for future government spending suggest that the fiscal situation is set to improve, but slowly. Stability programme plans show that government debt is projected to decline from 70.8 per cent of euro area GDP in 2005 to 68.3 per cent in 2008.

As a consequence of relatively weak domestic demand and strong world GDP growth, the euro area was a net exporter of €22.2 billion worth of goods and services

\textsuperscript{26} Dow Jones EURO Stoxx
in the fourth quarter of 2005. Despite this, the euro area’s positive trade gap shrank. While external demand for euro area products increased by 3.8 per cent in 2005, the euro area’s demand for imported products rose at an even faster pace (4.6 per cent). The closing of the trade gap can be explained partly by a rapid rise in the price of oil imports in 2004 and 2005. Taking a longer-term perspective, the hike in oil prices plus higher consumption has meant that the area’s deficit on trade in oil has quadrupled over the past decade and is now equal to 1.1 per cent of GDP.
Box 2.3: Economic Performance of the Scandinavian Countries

The Scandinavian economies of Norway, Sweden, Finland and Denmark have performed well relative to the EU15 average over recent years (as Chart 2.12 shows). The Finnish economy, in particular, has grown strongly and Eurostat projections indicate it will lead the Scandinavian growth table again this year and next as it recovers from the paper industry dispute that temporarily dented industrial production and growth in 2005. Recent high prices for oil and gas have helped to bolster industrial production in Norway and, to a lesser extent, in Denmark.

The picture from Scandinavia is consistent with the general trend in the EU for stronger growth around the geographic periphery rather than in the more centrally-located economies (see discussion in Box 2.2). According to Eurostat projections, the growth gap will narrow somewhat by 2007 as growth slows in Scandinavia and accelerates in France and Germany.

Chart 2.12: Economic Growth in Scandinavia Relative to the EU15 Average

![Chart showing economic growth in Scandinavia relative to the EU15 average over 2003 to 2007. Finland and Sweden are ahead of the EU15 average, while Norway and Denmark are below.]

Source: Eurostat

The performance of Scandinavia’s labour markets has been mixed. The unemployment rate is extremely low in Norway and Denmark, but is considerably higher in Finland (8.1 per cent). Inflation, on the other hand, is low (2 per cent or lower) across the board.

All the Scandinavian countries have per capita incomes above the EU15 average of $28,700. However, only Norway is among the very best performers in Europe. In 2004, Norway’s per capita GDP was $40,600 – second highest in both the EU and OECD areas, behind only Luxembourg. The Scandinavian countries also perform well in relation to broader measures of welfare. The UN’s Human Development Index, which uses a range of indicators such as educational attainment and life expectancy in addition to per capita incomes to measure living standards, finds that Norway has the world’s highest living standards. Of the other Scandinavian countries, Sweden comes in 6th, whilst Finland and Denmark are 13th and 14th respectively. When a social inclusion indicator is included in the index, the Scandinavian countries fill four of the top five places, split only by the Netherlands in 3rd. This is largely a result of low levels of inequality, both in terms of income and skills.

Source: Eurostat and OECD

According to the OECD, the short-term prospects for the euro area are reasonably favourable, with economic growth forecast at 2.1 per cent this year and 2.2 per cent in 2007 (up from 1.4 per cent in 2005). This growth is fairly modest compared with trends prior to 2000; nevertheless, it is expected to be sufficiently strong to sustain
employment growth and unemployment is projected to fall from 8.7 per cent in 2005 to 8.1 per cent by 2007.

2.3.2 Eastern Europe

The eight Eastern European economies that joined the EU in 2004 (Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Slovakia and Slovenia) have performed well in recent years compared with the EU15 average. As Chart 2.13 shows, this growth differential has helped to narrow the gap in living standards between the new Members States and the EU15 average. That said, living standards among the accession states vary widely; Estonia, for example, had a per capita income in 2004 which was over twice as high as that of Latvia.

In terms of their economic size, the accession economies are dominated by Poland, the Czech Republic and Hungary, which together account for around 80 per cent of the new Members States’ total GDP. In 2005, these economies grew by 3.2 per cent, 6.0 per cent and 4.1 per cent respectively.

As is characteristic of transition economies, investment has played an important role in underpinning growth, especially in the larger accession economies. For instance, capital formation rose by 3.7 per cent in the Czech Republic in 2005 and 6.8 per cent in Hungary, while the latest data for Poland (2005) show year-on-year investment growth of 6.2 per cent. Annual private consumption growth has lagged investment expenditure, but has been fairly robust nevertheless. In 2005, households’ consumption in the Czech Republic expanded by 2.6 per cent; in Hungary it increased by 2.4 per cent and in Poland, consumption increased 2.3 per cent in 2005.

The gulf in living standards between the accession states and the EU15 average is reflected in wage levels. In general, this differential has narrowed in recent years, but still offers the accession economies a competitive edge in labour-intensive production. For example, the average hourly wage in Denmark in 2004 was €30.70; in Poland the equivalent rate was just €4.74. Although Denmark is at the top end of the EU’s wage spectrum, this is indicative of the substantial wage gap that exists between the high-wage Scandinavian economies and low-wage EU transition economies; the Mediterranean economies of Portugal (€11.10) and Spain (€14.75) fall somewhere between the two extremes.

The gap in wages is unlikely to close in the short-term due to low rates of labour utilisation in the new Members States, where the average unemployment rate in 2005 was 13.4 per cent. This is a decrease of 0.8 percentage points compared with the previous year, but is high in relation to the EU15 average of 7.9 per cent.
On the whole, the government finances of the transition countries are in a reasonably healthy state relative to the EU average. According to Eurostat, Cyprus is the only accession country whose government debt in 2005 is expected to be greater than the EU25 average of 64.1 per cent of GDP. The latest data show that government consumption in Poland increased by 2.7 per cent in 2005, whilst in Hungary it fell by 0.3 per cent, and in the Czech Republic the equivalent series rose by 0.8 per cent in 2005.

Entry into the EU has enabled all the new Member States to access the European Single Market and expand their trade. For example, in 2005, Hungarian exports grew by 10.6 per cent while imports increased by 5.8 per cent. Similarly, Polish exports grew by 7.1 per cent – more than twice as fast than imports (3.4 per cent). In the Czech Republic exports increased by 11.1 per cent while imports increased by 4.8 per cent.

2.3.3 Russia

The Russian economy, which is roughly equal in size to the Italian economy, has performed strongly since the downturn of 1998; annual GDP growth averaged almost 7 per cent during the period 1998-2005. Despite the robustness of this performance, concerns have been expressed about the reliance of the Russian economy on natural resources, particularly oil, and the upwards trend in domestic inflation, which rose by 10 per cent in the year to April 2006.
Russian growth in recent years has been principally export-driven. In March 2006, Russia’s annual trade balance was in surplus by $129.9 billion; which was higher than even China’s trade surplus. This export surge has occurred largely as a consequence of high energy prices, with oil and gas accounting for over half of Russia’s exports. Russia is the world’s second largest exporter of oil, behind Saudi Arabia and is the largest exporter of natural gas. The Russian economy’s reliance on natural resources is substantial considering that approximately 70 per cent of industrial production and one third of GDP growth relate to oil and gas extraction and processing.

The Russian government has managed the tax windfalls from high energy prices with prudence, running a budget surplus in 2005 equal to 7.9 per cent of GDP, and has used the funds to top up its pension fund and reduce its debts. However, some analysts feel that the current buoyancy of tax receipts may have reduced the government’s incentive to make much needed structural reforms.

2.3.4 North America

The robust performance of the North American economies remains an important driver of growth in the world economy. In 2005, the US achieved, for the third consecutive year, the highest annual growth of any G7 country (3.5 per cent), though output in the final quarter was dented significantly by hurricane-related disruptions. The Canadian economy also delivered a solid performance in 2005; its GDP growth, of 2.9 per cent, was the second highest amongst the G7 countries. Forecasts suggest that the North American economies will continue to perform well in 2006 and 2007.

Considering the relatively larger size of the US economy compared to the Canadian one, the commentary below concentrates solely on the United States.

Growth in households’ consumption, which accounts for approximately 70 per cent of US GDP, has been the primary driver of the US economy’s expansion since the downturn of 2001/02. The pace of annual consumption growth eased in 2005, due largely to a sharp slowdown in the fourth quarter, but nevertheless remained robust at 3.5 per cent. As Chart 2.14 shows, consumer confidence dipped sharply in late summer last year as the devastation wrought by Hurricane Katrina, which displaced 1 million people, became clear. However, the Hurricane’s effects on confidence and consumption are likely to be short-lived and the fundamentals supporting consumer demand – employment, real income growth and asset prices – remain sound.

27 For example, the Economist Intelligence Unit and OECD Observer.
The buoyancy of US consumer demand in 2005 was underpinned by robust job creation as civilian employment rose by over 2 million. By April this year, employment was around 144 million and the US unemployment rate had fallen to 4.7 per cent – down 0.4 percentage points over the previous year to one of the lowest rates amongst the developed economies. Despite the tightness of the labour market and the surge in world energy prices, earnings growth has remained fairly muted: the average hourly wage in April 2006 was $16.61, only 3.8 per cent higher than it had been at the same point in the previous year. Wage inflation at this level looks fairly benign in the context of the prevailing rate of consumer price inflation (3.5 per cent in April) and strong gains in labour productivity that have acted to contain unit labour costs. Output per hour worked increased by 2.7 per cent in 2005 and by 3.6 per cent in the year to 2006 Q1.

US consumer price inflation picked up markedly during 2005, peaking at 4.7 per cent in September, before falling back to an annual rate of 3.8 per cent by April this year. While this rate was well above the G7 average in April and relatively high by the standards of the past 15 years, it was still fairly low by historical standards. Nevertheless, the Federal Reserve has responded to the emerging inflation risk, posed by shrinking labour market slack and higher oil prices, by gradually raising interest rates – most recently by 0.25 percentage points to a base rate of 5.0 per cent on 10 May.

The counterpart of high levels of households’ consumption was low and falling personal saving. In 2005, total consumers’ expenditure exceeded total personal
disposable income by $33.5 billion, resulting in a negative personal saving rate of 0.4 per cent. This represents a significant decrease from the positive saving rates of 2.1 per cent in 2003 and 1.8 per cent in 2004. The personal savings rate deteriorated even further in 2006 Q1 to -0.5 per cent of households’ total disposable income, with consumer expenditure exceeding disposable income by $50.5 billion. Such low levels of saving reflect a host of factors, including US consumers’ confidence in the strength of the US labour market and the short-term economic outlook, as well as low real interest rates and high asset prices – particularly house prices – which have boosted the wealth of homeowners.

Total investment spending (gross fixed capital formation) increased by 8.1 per cent in 2005 and by 9.9 per cent in year to 2006 Q1 as both residential and business investment rose strongly. Real spending on residential construction rose 7.1 per cent in 2005, and 2.6 per cent in 2006 Q1 as housing transactions and house prices soared. However, with interest rates moving upwards, the housing market appeared to peak around the turn of the year and prices and transactions weakened somewhat in early 2006. Real business investment rose 6.1 per cent in 2005, boosted by a 17 per cent rise in investment in high-tech equipment. Investment growth has continued into 2006, with first quarter data showing a 6.5 per cent rise. Despite these increases, investment’s share in US GDP in 2005 (16.7 per cent) was still slightly below the G7 average (18.5 per cent).

In terms of the supply-side of the economy, the production (or goods) sector has been performing more strongly than the service sector, partly as a result of strong investment. The output of the goods sector expanded by 4.7 per cent in 2005 and 9.3 per cent in 2006 Q1, with particularly strong growth in sales of computers which rose by a remarkable 39.6 per cent over the year and 13.0 per cent over the first quarter of 2006. Meanwhile, the performance of the service sector has been slightly more subdued, albeit still growing by a robust 2.7 per cent in 2005 and by 3.1 per cent in the year to 2006 Q1.

The majority of macroeconomic indicators suggest that the US economy is healthy: growth is robust, unemployment is low and falling, and productivity is high and increasing. The key risks in the short-term appear to be centred on the sectoral balances that exist with respect to trade and national saving. As the US economy has moved towards potential, inflationary pressure has picked up and interest rates are increasing, albeit from a low base. Looking ahead, the OECD expects annual US GDP growth to remain robust at 3.5 per cent this year, easing only slightly to 3.3 per cent in 2007.

The federal government’s budget deficit narrowed by approximately $100 billion in the financial year 2005 (ending 30 September) to $318 billion, as the growth of government expenditure eased and tax receipts soared. Strong economic growth boosted profits and wages, which in turn generated higher federal tax receipts – up

28 Expressed as a proportion of households’ total disposable income.
by 14.5 per cent in financial year 2005. The stock of federal debt continued to climb in 2005, albeit at a slower rate (see Chart 2.15, below). Of the total stock of federal debt in 2005, over half was held by the US public and approximately 45 per cent by foreign investors. Foreign investors’ share of US government debt is now at record levels, having risen sharply from around 30 per cent in 2001.

Although the scale of federal borrowing in 2005 was not particularly high in comparison with other advanced economies or past US experience, it was nevertheless a cause for concern especially in the context of the US’s very low rate of personal saving and the ageing of the population. The fact that the US government has run up such large deficits during a robust cyclical upswing, leaving it little scope for a fiscal response in the event of an economic slowdown, has also attracted attention. In this context, it is notable that most of the increase in public spending resulting from Hurricane Katrina occurred after the 2005 financial year ended.

US export growth was strong in 2005, at 6.9 per cent, (12.1 per cent over the year to the first quarter 2006) bolstered by rapid increases in global GDP and the depreciation of the US dollar in previous years. However, import demand also grew by 6.3 per cent over the year and by 13 per cent in year to 2006 Q1. The strength of US demand growth in recent years, supported by very low national saving (relative to the EU and Japan) helps to account for the US’s significant trade deficit. Whilst the US economy exported $58 billion more services in 2005 than it imported, this was greatly overshadowed by the negative balance on trade in goods of -$782 billion, over a quarter of which was accounted for by trade with China. The trade deficit
combined with net income flows, such as cross-border movements of dividends and wages, produced a US current account deficit in 2005 of over $800 billion, or about 6.25 per cent of nominal GDP.

The US’s current account deficit reflects the national savings position discussed above and is an indication that the US economy is consuming more output than it is itself producing. Ultimately, this deficit will have to be repaid, but for the time being there are sufficient lenders prepared to finance this consumption in return for building up their own stock of US assets. Given the relatively high levels of saving in Asia and Eastern Europe, there are sufficient funds on the world capital markets for the US to attract investment without having to offer excessive interest rates. There is no general consensus as to what level of current account deficit is sustainable in the medium-term. However, the OECD suggests that the level is around 2-3 per cent of GDP, which is less than half of the current US level.

2.3.5 Japan

Asia is performing strongly and is, alongside the US, one of the main drivers of the world economy – China and India continue to develop rapidly and Japan is finally showing signs of shaking off deflation and overcoming the weak performance of the past decade.

The most recent figures suggest that Japan’s recovery from its post-bubble adjustment is gaining strength. Japanese GDP growth in the year to 2005 Q4 was 4.3 per cent, significantly higher than in the other G7 countries. Alongside robust output growth, corporate profits and domestic demand are strong and the previous downward trend in employment and wages has been reversed. Perhaps most significantly, given Japan’s recent deflation problem, inflation in the year to January 2006 was higher than in any 12-month period since November 2004 (see Box 2.4, below).

Growth in industrial production in the year to March 2006 was 3.0 per cent – higher than in the UK where production grew by 0.3 per cent but lower than the US, which saw growth of 3.6 per cent. Production growth in the year to December 2005 was particularly strong, rising more rapidly (at 5.6 per cent) than in any other G7 economy in that period. Over the year to December 2005, services output increased by 2.8 per cent.

Consumer demand, which accounts for around 56 per cent of Japanese GDP, also grew strongly in the year to 2005 Q4, by 3.5 per cent. This revival of consumer demand is particularly encouraging for the Japanese economy because of its close link to consumer confidence, which has been weak in the recent period of slow growth and deflation. The revival in consumer confidence was confirmed by the Japanese government’s consumer confidence index which stood at 50.0 in April 2006, its highest point since June 1990. It is also reflected in expectations of prices a year in the future; since September 2005 over half of households have
anticipated increased prices, though a significant minority (37.8 per cent in April 2006) still anticipate stable prices.

Increased confidence amongst Japanese consumers was underpinned by improved labour market conditions. Employment in non-agricultural industries increased by 0.8 per cent over the year to March 2006, in contrast to the 0.1 per cent growth in the previous year. Wages rose by 2.1 per cent in 2005, the highest rate since the year to 1997 Q3 and Japan’s unemployment rate – which remained low by international standards throughout its period of sluggish growth – has fallen from over 5 per cent in 2001-03 to 4.1 per cent in March 2006.

Alongside recovering consumer demand, investment growth has rallied too, rising 3.3 per cent in 2005. This rise came solely through private investment; public investment actually declined significantly over the same period, by -0.6 per cent, towards the end of 2005 public investment declined at a much lower rate (-1.8 per cent over the year). Japanese investment remains at a higher rate (around 23 per cent of GDP) than in any other G7 country – with France and Italy, at around 20 per cent of GDP, the next highest investors.

Though public investment in Japan fell in the most recent year, government consumption expenditure rose by 1.7 per cent in 2006. While this component comprises only a small proportion of GDP relative to other countries (18 per cent), Japanese government debt is high by international standards, standing at 83 per cent of GDP.

Exports of Japanese goods and services continued to grow strongly last year, up by 6.9 per cent in 2005. Imports grew by 6.2 per cent, and the trade surplus remained positive at 103.5 billion yen in 2005.
Box 2.4: Consumer Prices in Japan

Japan’s post-war period of strong economic growth came to an abrupt end in the late 1980s. The stock market collapse, which followed a wider asset price bubble, led to a long period of sluggish economic growth that exposed some fundamental weaknesses in the Japanese economy. Of these, perhaps the most significant concerned the high level of non-performing loans held by Japan’s commercial banks. Alongside the sluggish growth, Japan endured a lengthy period of deflation, as Chart 2.16 illustrates.

Deflation – a period where the level of prices falls – can be a more significant problem even than high and unstable inflation, creating a vicious circle from which it is difficult to escape. The expectation that future prices will be lower than present prices creates an incentive to delay purchases, which reduces demand and forces firms to cut prices still further. Falling prices also inflate the real burden of debt. Interest payments remain the same in nominal terms, but falling prices mean that the income from which companies have to repay their loans falls. This can, in turn, lead to bankruptcy and even failures in the banking system. Monetary policy can also become ineffective because falling prices mean that even with interest rates set at their lowest possible level (zero) the real cost of borrowing remains positive.

This difficulty was obvious in Japan, where the official interest rate has remained close to zero since February 1999. In a further effort to address deflation, the Bank of Japan announced a policy of ‘quantitative easing’ in March 2001, essentially increasing the money supply through credit creation. The Bank committed to maintaining this policy until such times as the year-on-year rate of change in the CPI (excluding fresh food) registered zero per cent or higher on a sustainable basis.

In March 2006, the Bank announced that this condition had been met, with four periods of CPI at or above zero since October 2005. Some, including the Japanese Prime Minister, believed that the Bank should have waited for clearer evidence of an end to deflation. However, their concerns should be alleviated by the fact that the Bank has committed itself to maintaining interest rates at zero for a further unspecified period, and most commentators believe that this is a significant step in Japan’s recovery from deflation.

Chart 2.16: Consumer Price Inflation in Japan, 1990 – 2005

Source: HM Treasury
The OECD expects Japan’s improved economic performance to continue, with growth forecast to be 2 per cent in 2006 and 2007 – though there is, of course, considerable uncertainty around these forecasts following the period of economic weakness. The OECD expects the growth revival to be supported across the whole economy. Private consumption is forecast to increase, business investment is likely to be sustained albeit at a more moderate rate, and export growth is expected to pick up. External risks to sustained expansion include the possibility of a significant appreciation in the yen and a slowdown of exports due to higher oil prices, while the most significant internal risks are rising public debt and the possibility of a sharp rise in long-term interest rates following the announcement to end the period of ‘quantitative easing’ (see Box 2.4, above).

Looking further forward, the potential for Japan’s economy to grow as strongly as it did before its asset price bubble burst is constrained by demographic trends, with Japan’s falling birth rate leading to a shrinking and ageing labour force. There is also limited scope for growth through further improvements in productivity, as Japanese investment in industry is already very high relative to other countries, and the country already has a flexible labour market.

### 2.3.6 China

The expansion of the Chinese economy continued apace in 2005 and early 2006. Economic growth averaged close to 10 per cent during 1993 to 2005, and most commentators expect this pace to be maintained for the foreseeable future. Investment and exports have been the mainstays of China’s GDP growth in the last decade, though private consumption has increased in importance as average disposable incomes have risen. China’s per capita GDP has increased by 60 per cent in the past five years from US $3,900 in 2000 to US $6,800 in 2005\(^29\), though this average conceals a wide and growing disparity in living standards between urban and rural residents.

Investment in productive capacity and infrastructure has taken place on an immense scale in recent times and this trend continued in 2005 and the early months of 2006. Total investment in fixed assets leapt by 26.6 per cent in the first two months of 2006, compared to the same period a year previous, with huge increases reported in construction (27.5 per cent) and purchases of engineering equipment and tools (29.2 per cent). China has developed a history of strong saving and this, alongside massive injections of foreign direct investment (FDI), has helped to underpin large additions to the capital stock. Traditionally, because of the lack of a well-developed social protection system, Chinese households have saved heavily to fund healthcare, education and old age.

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\(^{29}\) These figures are given at purchasing-price parity, which is why they differ from the figure in Box 2.5 which is in nominal terms.
Box 2.5: Why China’s Development Matters for Scotland

China’s rapid economic development is reshaping the global economy with important implications for Scotland and other advanced economies. Up until the industrial revolution, China was the world’s largest economy, reflecting its relatively high level of technological advancement and large population. In 1820, China accounted for around a third of the global economy. However, through the 19th and 20th centuries, Western economies came to dominate global economic activity as a result of industrialisation. China’s share of the global economy in 1950 had fallen to below 5 per cent.

In 1978, a series of economic reforms was started that gradually opened up and liberalised the Chinese economy. Since that date, Chinese real GDP growth has averaged nearly 10 per cent per annum – meaning that China’s economy has been doubling in size about every eight years. As a result, at the dawn of the 21st century, China had already regained its place among the world’s most important economies.

China’s economic growth and development has much further to run. With income per capita at around $1,700, China is still classified as a developing country: Scotland’s income per capita is around twenty times higher. As China continues its transition from a largely agrarian and heavy-industry based, closed, command economy to an advanced, open market economy, the size of its economy will increase significantly. At the end of 2005, the value of China’s economy surpassed that of the UK. So far, during this century, China has contributed more to global economic growth than all of the G7 major advanced economies combined. The only parallel to this in history was the rise of the United States in the second half of the 19th and early 20th century.

Long-term economic projections are always laced with uncertainty and it is clear that China’s growth will slow down considerably over time from its current rapid pace. Chart 2.17 shows one well-known set of projections for China with other key economies shown for comparison. Although there are risks associated with these projections, and they may turn out to overstate China’s growth prospects, they set useful working assumptions for current decision making, in particular for how Scotland should respond.

Chart 2.17: GDP Projections

<table>
<thead>
<tr>
<th>Year</th>
<th>US$bn</th>
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<tbody>
<tr>
<td>2005</td>
<td></td>
</tr>
<tr>
<td>2015</td>
<td></td>
</tr>
<tr>
<td>2030</td>
<td></td>
</tr>
</tbody>
</table>

Source: Goldman Sachs
The buoyancy of investment was reflected in the value of industrial production, which expanded by 20.1 per cent in the year to February 2006. According to the IMF, annual production growth is set to moderate in 2006 to 8.2 per cent. China’s importance as a producer has increased rapidly in the last fifteen years: between 1990 and 2005, China’s share of world output more than doubled from 5.7 per cent to 13.6 per cent (see Chart 2.18, below).

External demand is crucial for China’s economic transition and development. Annual growth in China’s exports, which has consistently topped 30 per cent since mid-2003, is expected by the World Bank to have moderated in 2005 to around 20 per cent. Despite this slowdown, the value of China’s total annual exports is now almost as large as the value of total US exports. The abundance of cheap labour confers a strong comparative advantage in the production of labour-intensive products and allows businesses located in China to produce goods at prices that are extremely competitive internationally. The competitiveness of Chinese exports is boosted by the relative weakness of the Renminbi (RMB). China’s exchange rate regime was reformed in July 2005, when the RMB’s peg to the US dollar (8.28 per dollar) was removed in favour of a link to a wider basket of currencies. Since July, the RMB has appreciated only slightly to around eight to the US dollar.

*Rapid growth in China and other emerging economies, alongside rapid technological change and increasing integration in the global economy presents Scotland with significant new opportunities for wealth creation. However, it also poses challenges to industries and sectors that have historically been the preserve of advanced economies. This process of structural change requires economic flexibility, dynamism and entrepreneurship – that enable the productivity growth required by businesses to maintain international competitiveness – supported by a flexible and responsive welfare state.*

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Consumer demand has picked up on the back of higher household incomes. In the first two months of 2006, household consumption reached a level 12.5 per cent higher than it had been a year earlier. The fastest growth (13.3 per cent) occurred in the cities, though the trend was similar in the more rural county areas (10.6 per cent) and under-county (11.4 per cent) levels. This rise in consumer demand was supported by higher rewards to labour – for instance, the disposable income of the average urban resident increased by 11.4 per cent in 2005.

Despite rapid consumption growth and the overall vibrancy of the Chinese economy, upward pressure on prices has been muted. The aggregate level of consumer prices in March 2006 was just 0.8 per cent higher than it had been a year previously; there was a modest surge in property prices, of 5.2 per cent, but this was partly offset by falling clothing and transport & communication costs. The modest pace of inflation suggests strongly that the Chinese economy is still operating well below its full capacity, and that there remains considerable scope for further non-inflationary growth. Looking ahead, the IMF forecasts annual GDP growth of 9.5 per cent in 2006 and 9.0 per cent in 2007.
2.3.7 India

China is not the only large Asian country that is enjoying rapid economic growth – India’s GDP performance in recent years has been described, by the IMF, as ‘truly extraordinary’\(^{31}\). The government of India has set ambitious economic targets to achieve growth rates of 8 to 10 per cent per annum alongside ambitious reductions in poverty. The IMF suggests that these goals are attainable; however, there are some risks to them being achieved – notably rising inflation and the size of India’s fiscal deficit. The IMF also suggests that in order to consolidate growth, in the long-run, the current spate of liberalisation of trade, foreign direct investment and the labour markets need to be continued further.

The development of the Indian economy has been impressive in recent years, albeit not as spectacular, or as long lived, as China’s economic rise. In 2005, output in India was 8.0 per cent higher than it had been a year previously. Over the period, rapid output growth was reported in the manufacturing (9.0 per cent) and construction (11.6 per cent) sectors. Meanwhile the growth performance of agriculture, forestry and fishing was comparatively modest, at just 2.3 per cent over the year. In terms of industrial production, India has become increasingly important to the world economy, with its share of world output having risen from 4.3 per cent in 1990 to over 6 per cent in 2005 (see Chart 2.18, above).

The sectoral breakdown of Indian output, described above, is informative as it provides evidence that India is developing in an atypical fashion, moving away from being a primary producer, but fuelled by the service sector, which grew at 10.1 per cent in 2005, more so than the traditional route of the manufacturing sector. The service sector accounts for over half of India’s output, agriculture for around a fifth and secondary production approximately a quarter. The strength of India’s service sector – for example, in IT services and call centres – reflects the comparative strengths of the workforce in terms of education and English language skills.

Given that India is experiencing population growth, output per capita is increasing slightly below the overall growth rate of GDP, at 6.1 per cent. Despite recent growth, average incomes in India remain low – at purchasing price parity, per capita income in India was $3,491 in 2005, which is only just over half the Chinese level. Thus, India’s current growth rate will need to be long sustained, or improved upon, in order to move the bulk of its population away from being amongst the world’s poorest.

Indian consumption has been growing strongly, but not quite as quickly as the economy as a whole. Consumption in 2004-05\(^{32}\) increased by 6.3 per cent overall, which meant a 4.6 per cent per capita increase. However, Indian consumers are continuing to show prudence with high, and rising, saving levels. Gross domestic saving in 2004-05 was equal to 29.1 per cent of GDP, 0.2 percentage points higher

\(^{31}\) India’s accelerated reforms can hasten economic takeoff, IMF Survey, March 13 2006.

\(^{32}\) The Indian statistical year runs from April to March. Therefore 2004-05 would be April 2004 – March 2005.
than they had been a year earlier. This was principally due to higher savings from individuals and private companies, although there was also a modest increase in government saving.

One of the principal drivers of Indian growth has been the strength of investment. Gross domestic capital formation increased by 15.7 per cent in 2004-05 – investment grew more quickly than savings as a result of a net capital inflow from abroad. GFCF now accounts for 30.1 per cent of GDP, which is significantly higher than the average level in developed countries (the G7 average was 18.5 per cent in 2005). This is indicative of the lower stock of capital that currently exists in India, and therefore the greater benefits that can be obtained from investing in the country. Such high levels of investment have led to robust increases in industrial production, which in March 2006 was 7.7 per cent higher than it had been a year previously.

Rapid growth in India has placed some pressure on prices in the economy, which have grown more quickly than would generally be desirable, though they have certainly not escalated out of control. Consumer prices increased by 4.9 per cent in the year to March 2006, providing some evidence of tightness in the economy. However, given that growth has been predominantly investment driven then output is able to increase quickly enough to match demand. Furthermore, whilst unemployment figures are not available for India, there is anecdotal evidence that there remains a considerable supply of labour. Therefore, the chances of inflation reaching levels where it reduces living standards and destabilises the economy would seem small.

Growth in foreign trade has been strong in India, although the net effect on the economy has been negative. The US dollar value of Indian exports increased by 24.7 per cent in 2005-06, although this was offset by a 31.5 per cent rise in imports. Export growth has been especially significant for manufacturing, particularly engineering and machinery. Petroleum accounts for almost a third of India’s imports – the current high price, combined with further increases in demand, have meant that it has been the principal driver of import demand over the past year. In the year to February 2006, India ran an overall trade deficit equal to $38 billion.
chapter three: The Framework for Economic Development in Scotland
3 THE FRAMEWORK FOR ECONOMIC DEVELOPMENT IN SCOTLAND

Chapter three of the Scottish Economic Report sets out progress made towards the economic development priorities set out in The Framework for Economic Development in Scotland (FEDS). In this issue, two areas are covered, sustainable development and business growth issues. Of course, the two are not independent – sustainable development encompasses not only environmental issues but economic and social concerns too.

The vision for economic development in FEDS is:

‘to raise the quality of life of the Scottish people through increasing the economic opportunities for all on a socially and environmentally sustainable basis’.

It is highlighted further in the Executive’s first Sustainable Development Strategy – the subject of the first part of this chapter – which sets out the measures that can be taken to turn the UK’s shared framework for sustainable development into action.

The second part of this chapter focuses on actions which can be taken to establish an accelerated and sustainable rate of economic growth – viewed by the devolved Scottish government as a pre-requisite for building first class public services, social justice and a Scotland of opportunity. FEDS highlights increased productivity in enterprises and the public sector as the key to improving Scotland’s competitiveness and its economic growth rate. At present, output per hour worked in Scotland and the UK is below that of main competitor nations and, as Chart 3.1 shows, the productivity gap has not narrowed appreciably over time.
FEDS identifies five key drivers of economic development which the devolved Scottish government believes are especially important and to which it will give priority. These are:

1. **basic education and skills**: crucial to any strategy for economic growth and the bedrock for the foundation of a competitive economy;
2. **research & development and innovation**: the foundations for improvements in productivity and for sustainable global competitiveness;
3. **entrepreneurial dynamism**: the creation of new enterprise and a positive, risk-taking attitude to enterprise are central to the establishment of a dynamic economy;
4. **the electronic and physical infrastructure**: joining business to business, consumer to business, and ensuring the efficient movement of goods, people, and ideas to the right places at the right times; and
5. **managing public sector resources more effectively**: improving the efficiency and effectiveness with which resources are deployed in the provision of public services.

Many of these drivers were investigated during the Business Growth Inquiry carried out recently by the Enterprise and Culture Committee of the Scottish Parliament. The second part of this chapter sets out the economic case for the Executive’s response to that inquiry, covering issues such as entrepreneurial attitudes, foreign direct investment and skills & learning.
3.1 SUSTAINABLE ECONOMIC GROWTH: THE NEW SUSTAINABLE DEVELOPMENT STRATEGY FOR SCOTLAND

3.1.1 Introduction

The Executive’s new Sustainable Development Strategy, published in December 2005, sets out in further detail Scottish Ministers’ commitment to fostering a sustainable future, building on the actions already being taken by individuals, businesses, local authorities and communities.

3.1.2 Context

The model for the UK’s strategic approach to sustainable development reflects the structure of decision-making established by the devolution of powers to new democratic bodies in Scotland, Wales and Northern Ireland in 1999. Instead of one strategy document, each body will have its own. However, there are still common challenges and goals and the Executive will work with the UK Government and other devolved administrations towards achieving those goals without compromising the strengths which a diversity of approach can offer.

In March 2005, Scotland joined the UK Government and the other devolved administrations in signing up to a new UK framework for sustainable development One future – Different Paths: The UK’s Shared Framework for Sustainable Development. This framework sets out a common goal for sustainable development across the UK: ‘to enable all people throughout the world to satisfy their basic needs and enjoy a better quality of life without compromising the quality of life of future generations’.

The five principles which underpin this goal are as follows.

- **Living within environmental limits**: Respecting the limits of the planet’s environment, resources and biodiversity – to improve our environment and ensure that the natural resources needed for life are unimpaired and remain so for future generations.
- **Ensuring a strong, healthy and just society**: Meeting the diverse needs of all people in existing and future communities, promoting personal wellbeing, social cohesion and inclusion, and creating equal opportunity for all.
- **Achieving a sustainable economy**: Building a strong, stable and sustainable economy which provides prosperity and opportunities for all, and in which environmental and social costs fall on those who impose them (polluter pays), and efficient resource use is incentivised.
- **Promoting good governance**: Actively promoting effective, participative systems of governance in all levels of society – engaging people’s creativity, energy, and diversity.
- **Using sound science responsibly**: Ensuring policy is developed and implemented on the basis of strong scientific evidence, whilst taking into
account scientific uncertainty (through the precautionary principle) as well as public attitudes and values.

3.1.3 Scotland’s Sustainable Development Strategy

Following on from the publication of the UK framework, the Executive published *Choosing Our Future: Scotland’s Sustainable Development Strategy* in December 2005. It sets out the Executive’s high level sustainable development objectives and provides the strategic framework for a number of the Executive’s new and emerging strategies on climate change, transport, renewable energy, green jobs and biodiversity. Chart 3.2, below, summarises the vision of the strategy and the links between the issues and those involved in making it a reality.

**Chart 3.2: Why Sustainable Development Matters**

The diagram has, at its core, the key aims of: supporting thriving communities; protecting Scotland’s natural heritage and resources; supporting the well-being of Scotland’s people; and ensuring that Scotland contributes to global sustainable development. Each of these is considered in more detail below. The two outer...
circles reflect that progress towards sustainable development can be best achieved through learning, skills, education and capacity building and that all parties bear some responsibility for achieving it.

3.1.4 Well-being of Scotland’s People

The sustainable development strategy highlights a mix of factors which contribute to individual and national well-being. These include good health, a decent income, a high quality local environment, spending time with friends and family, and taking part in activities that are not linked to work. While many of these can best be achieved by individuals, the Executive has a role in promoting improved well-being through:

- increased economic opportunities for all;
- an environment that provides the conditions for health and well-being; and
- a focus on the promotion of good mental health and well-being.

The goal of increased economic opportunities for all is highlighted in FEDS, in relation to the principal outcome objective of closing the opportunity gap. Economic growth is seen as a pre-requisite for all in society to enjoy the same economic opportunities; social development in turn contributes to national economic prosperity.

In terms of employment and economic activity Scotland performs relatively well. The employment rate (75.5 per cent) and the economic activity rate (79.8 per cent) are at record levels, and both compare favourably with other parts of the UK/Europe. However, there are still some areas of concentrated unemployment, economic inactivity and deprivation. Alongside other actions, these will be addressed by the Employability Framework for Scotland and the NEET (16-19 year olds not in education, employment or training) Strategy, to be published this year.

The quality of the environment is also a necessary condition for well-being. In this context the environment covers a range of issues including air quality, the availability of safe and healthy food and water, protection from the threat of flooding, and the safe managing of waste, as well as the quality of the home environment. Progress has already been made towards a better environment, and many actions are still ongoing. For example:

- air quality has improved over the last 10-15 years as a result of technological improvements and tighter legislation. However, increasing traffic levels are forecast to start offsetting these gains. Councils are required to declare and take action in Air Quality Management Areas; and
- programmes such as Warm Deal and the Central Heating Programme have contributed to the substantial decline in the proportion of people living in fuel poverty. The Executive has the target of eradicating fuel poverty, as far as
reasonably practical, by 2016 and is consulting on how best to take forward this work when the present programme ends in 2006.

The Executive is committed to further developing an understanding of the components of well-being and will support the work of the Department of Environment, Food and Rural Affairs to investigate the concept of well-being and policies that will best support it.

3.1.5 Supporting Thriving Communities

Healthy and thriving communities engender a sense of pride in those who live and work in them, and can make it easier to live in a sustainable way. Putting local people at the heart of the process can help to combat social exclusion, strengthen community spirit and encourage equitable economic development. Sustainable development can be planned for and delivered through new infrastructure investment (transport, schools, hospitals), housing development and community regeneration. The Executive wants a Scotland that:

- has well connected places;
- regenerates local environments; and
- puts people at the heart of change.

In this context, well-connected places means the ability to connect with others (including family and friends) and to have ready access to a range of services, such as work, shops, medical assistance and leisure. The Executive’s planning, transport, housing and regeneration policies all have a vital role in encouraging people to exercise and play outside and to walk and cycle for shorter journeys.

Information and communications technology also offers new opportunities to connect remote communities. The Partnership Agreement contained a commitment to making broadband both affordable and pervasive throughout Scotland. In December 2005 the Deputy First Minister announced that this commitment had been met and that broadband was available in every Scottish community.

As noted in the section on well-being, high concentrations of poverty and disadvantage still exist in some parts of Scotland. Regeneration has an important contribution to make towards economic prosperity, tackling poverty and disadvantage, improving health and delivering sustainable development. The Executive is providing funding of £50 million in both 2005-06 and 2006-07 through the Quality of Life fund to support Local Authorities in improving the local environment. Similarly, Community Planning Partnerships have been supported in delivering community regeneration. The £318 million Community Regeneration Fund will be used to deliver local environment improvements alongside improvements in employability, education, health and access to local services.
Communities Scotland is supporting the Community Planning Partnerships to make best use of its National Standards for Community Engagement. This reflects the fact that putting people at the heart of change can produce improvements while ensuring that people have a stake and confidence in their community.

3.1.6 Protecting Scotland’s Natural Heritage and Resources

As well as helping to shape Scotland’s national cultural identity, Scotland’s natural heritage is a key economic resource. Many sectors including tourism, food and drink, farming and fishing depend on successfully safeguarding the natural environment. Tourism, for example, has been estimated to inject £4.5 billion annually into the Scottish economy and is one of Scotland’s largest employers, employing around 9 per cent of the workforce. The Executive wants to see a Scotland where:

- biodiversity is preserved;
- natural resources are managed sustainably; and
- the environment is protected effectively on the basis of evidence and using the best available science.

Scotland’s biodiversity includes over 90,000 species, including some of the most iconic: the golden eagle, red deer, salmon and the Scots pine. However, much of Scotland’s biodiversity has already been lost and further change is inevitable, from the way land is used to the impact of climate change. The challenge is to ensure that Scotland’s ecosystems are in good health and have the resilience to adapt. A comprehensive biodiversity strategy for Scotland was put in place in 2004. The Executive, with its partners in the Scottish biodiversity forum, will deliver the priority actions identified in the strategy as a first step towards making Scotland a world leader in biodiversity conservation by 2030.

Actions have also been taken to safeguard Scotland’s landscapes. Protection for 36 National Scenic Areas has been achieved through the planning system, while Historic Scotland and Scottish Natural Heritage work together to ensure the protection of gardens and historic landscapes. Two National Parks have also been designated – Loch Lomond & the Trossachs, and in the Cairngorms – in recognition of the outstanding natural and cultural heritage of these areas. The designation recognises the need to safeguard that heritage and promote its enjoyment while providing for local social and economic development.

Scotland’s coasts and seas also play an important role in meeting Scotland’s economic, social and leisure needs. The Executive’s marine and coastal strategy, *Seas The Opportunity* provides a clear vision for the sustainable management of Scotland’s coasts and seas. It aims to secure clean, healthy, safe, productive and biologically

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diverse marine and coastal environments, managed to meet the long term needs of nature and people.

Meeting the goal of living within environmental limits will require an increased understanding of ecosystems as well as strategic assessment of environmental impacts. The Executive will take advantage of the UK scoping studies which were recently published to review its approach to environmental management. These studies covered environmental limits, the valuation of the environment (economic and non-economic), pressures on the natural environment and the UK policy framework for the natural environment\(^\text{34}\). The introduction of Strategic Environmental Assessment means that plans will in future be considered at a very early stage to identify and mitigate potential impacts on, for example, biodiversity, soil, water, air and landscape.

### 3.1.7 Scotland’s Global Contribution

Ultimately, the goal of sustainable development is to enable all people throughout the world to satisfy their basic needs and enjoy a better quality of life without compromising the quality of life of future generations. In thinking about the global consequences of development, the Executive wants to see a Scotland which:

- has reduced its own greenhouse gas emissions;
- is reducing its ecological impact; and
- is contributing to the Millennium Development Goals.

Scotland supports the UK Government in its efforts to promote international action to tackle greenhouse gas emissions and is committed to making an equitable reduction in greenhouse gas emissions. The new Scottish Climate Change Programme will for the first time quantify this equitable reduction in carbon terms. It will demonstrate the level of achievement to date and set a framework for delivery of the commitment over time. All in society can contribute to the reduction. Scotland’s emissions come mainly from fossil fuels that are used to generate electricity, fuel transport and provide heating. Using energy more efficiently will not only help to tackle climate change but also make the economy more productive – it is estimated that UK energy use could be reduced by more than 30 per cent without compromising the benefits derived from it. The Executive has a target that 40 per cent of energy should come from renewable energy by 2020, and 18 per cent by 2010.

As well as the domestic greenhouse gas emissions, there are climate change consequences from products bought from overseas. There is also growing awareness of the social and environmental consequences of goods purchased form overseas. The Executive will continue to support the work of WWF and partner organisations in rolling out the ecological footprint tool to increase understanding of

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how to make sustainable choices. In relation to the Millennium Development Goals, the contribution that the Executive can make in partnership with the UK Government is set out in its international development policy.

3.1.8 Putting the Sustainable Development Strategy into Practice

As well as the specific actions highlighted above, the strategy sets out a more general approach to pursue the goal of sustainable development. This will build on actions already taken which include: the consideration of sustainable development built into recent spending reviews; the development and use of ‘pre-expenditure assessments’, a new tool to evaluate expenditure decisions including the likely economic, social, and economic impacts; and the continuing use of *The Green Book, Appraisal and Evaluation in Central Government* which requires that the environmental costs and benefits are fully taken account of in relation to Government policy-making.

An implementation plan will be developed in conjunction with partner organisations and key stakeholders and a Cabinet Sub-Committee chaired by the First Minister will monitor delivery, supported by quarterly reports in relation to the strategy’s actions and indicators.

3.1.9 Summary

The FEDS vision highlights the need for economic development to raise the quality of life for all in Scotland on a sustainable basis and the Executive’s Sustainable Development Strategy, sets out in further detail the Executive’s commitment to fostering a sustainable future. It identifies four key aims, setting out progress to date and further actions that will be taken. As well as these four key aims, the strategy considers some of the key cross-cutting areas of relevance to sustainable development, and how the strategy can be put into practice. The public sector has a vital role to play in delivering the strategy – implementing key programmes at a national and local level and reducing its own environmental impact, for example, through its procurement practices. However, as the strategy makes clear, it is people who will make the strategy work, bring it to life, spot new ideas and opportunities, and turn the principles into action.

An updated strategy will be published in 2010, informed by the progress made and measured against a broad set of sustainable development indicators, a strategic assessment of performance by the Sustainable Development Commission and the results of an independent study of Scotland’s footprint in 2008.
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http://www.scotland.gov.uk/Publications/2005/08/26102543/25539

3.2 BUSINESS GROWTH IN SCOTLAND

3.2.1 Introduction

This section provides a summary of the Executive’s response to the recent Business Growth Inquiry\textsuperscript{35}, carried out by the Enterprise and Culture Committee of the Scottish Parliament. It sets out the Executive’s thinking on business growth, placing it in the context of recent global economic developments, and highlights policies, programmes and projects that have been rolled out in order to positively influence business growth in the Scottish economy.

3.2.2 Context

Scottish Ministers’ overarching strategy for increasing economic growth through dynamic competitiveness and, in particular, higher productivity is set out in \textit{The Framework for Economic Development in Scotland} (FEDS). FEDS is based on the underlying principle that growth is primarily determined by the success of private enterprises that can compete effectively both domestically and throughout the world. While government can make an important contribution by creating an environment in which enterprise can flourish, it is the dynamism of the private sector on which future prosperity depends. FEDS underpins the Executive’s enterprise strategy, \textit{A Smart Successful Scotland} (SSS), one of the key themes of which is growing businesses.

3.2.3 Business Start-Ups

Following the global downturn in flows of Foreign Direct Investment (FDI), and the withdrawal from Scotland of some foreign-owned enterprises, particularly in the electronics sector, the creation and success of domestic firms has assumed a position of renewed importance. FEDS highlights the development of new firms as one of the prime drivers of growth in the Scottish economy. In addition, SSS notes that the rate of start-ups is an indicator of potential economic growth. Research\textsuperscript{36} attributes 30-50 per cent of productivity growth in the UK and US to the entry and exit of firms in their markets, as firms are replaced by more competitive enterprises. Therefore, a high rate of business births can be expected to drive up levels of competitiveness and productivity.

Chart 3.2 shows the number of businesses registering for VAT – an indicator of business start ups – in 2004 (excludes most of the very small one person businesses). With 29 new business registrations per 10,000 resident adults, Scotland has a relatively low rate of business starts compared with the UK figure of 38. The UK figure is boosted by a higher number of start-ups in London and the South East; their exclusion results in the UK figure falling to 33 per 10,000 resident adults. Scotland also has a lower stock of VAT-registered firms: 307 per 10,000 resident adults.

\textsuperscript{35} Full response can be found at \url{http://www.scottish.parliament.uk/business/committees/enterprise/Businessgrowthexecutiveresponse.htm}

\textsuperscript{36} Productivity in the 1990s: Evidence from British Plants, Barnes and Haskel, University of London 2000.
compared with the UK’s 378. Scotland’s relative position on these measures has changed little over the past ten years.

Global Entrepreneurship Monitor (GEM) evidence allows an international comparison of the proportion of working age adults who are starting or running their own business that is less than three years old. Results show an upward trend in Scotland, closing the gap with the UK, but lagging the average for five small high income nations selected as a benchmark.

3.2.4 FDI

Notwithstanding the global downturn, there are still benefits to having FDI, such as technology transfer and improved innovation. Official data show that productivity in foreign owned firms is higher than their domestic counterparts (60 per cent higher in foreign manufacturing firms and 20 per cent higher in the service sector\textsuperscript{37}) while wages are higher, suggesting jobs are higher skilled. Moreover, foreign owned companies contribute a significant proportion of Scotland’s business expenditure on R&D (BERD) – 70 per cent of the total in 2002.

Therefore, although inward investment projects supported by Scottish Development International (SDI) have fallen from a peak of 102 projects in 2000-01 providing 14,000 jobs, to 46 projects providing 5,000 jobs in 2004-05, it is clear that there is value in having high value FDI in the Scottish economy. For that reason, a balanced

\textsuperscript{37} Annual Business Inquiry, 2003.
approach to encouraging both indigenous start-ups and inward investors is important for sustaining growth in the economy.

### 3.2.5 Growing Firms

SSS states that “increasing new business starts are not enough to impact significantly on overall productivity. There remains significant scope to improve productivity levels in established businesses and, while Scotland has successful, innovative businesses, it lacks a critical mass of larger businesses. A key challenge is growing and sustaining businesses of scale – both nationally and relative to others in their local area.”

An independent review of Scottish Enterprise’s Business Birth Rate Strategy (BBRS) argued that the organisation ought to increase the proportion of its programme spent on high-growth starts because “additional high-growth starts offer the potential for a significant direct contribution to the economy … while the probability of displacement is lower given their focus on new products and processes and their greater export orientation.”

Scottish Enterprise has recently taken the strategic decision to focus more on businesses with the potential for high growth. However, the body of research evidence does not yet allow a firm conclusion to be made as to whether such a focus is more effective than encouraging more starts in general.

A related issue is the economic effect of headquarters. A recent study identifies only a modest impact in terms of employment but argues that their main contribution is in longer term developmental effects through spillovers, such as innovation and supply linkages. Interventions to promote business growth include Account Management, which in addition to Business Gateways Local Enterprise Companies (LECs), assists growth businesses through a client and account managed process. Additionally, the Scottish Executive Investment Readiness Programme provides support to help business attract potential investors.

Finally, Regional Selective Assistance (RSA) is available to aid investment and employment in the Assisted Areas. The scheme seeks to enable or lever additional investment in order to secure or generate new employment in EU designated Assisted Areas. The objective of the scheme is to secure employment in disadvantaged areas by assisting projects which otherwise would not have gone ahead.

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38 A Smart Successful Scotland: Strategic Direction to the Enterprise Networks and an Enterprise Strategy for Scotland, Scottish Executive 2004.


3.2.6 Entrepreneurial Attitudes

FEDS highlights the need for positive and supportive attitudes towards business, while SSS identifies entrepreneurial attitudes, creativity and drive as increasingly important differentiators of national economic performance. It stresses that these attitudes and behaviours are not only relevant to rates of business start-ups, but are also relevant to innovation in established businesses, the public and voluntary sectors, as well as education establishments.

Evidence of entrepreneurial dynamism in Scotland is mixed. GEM\(^\text{41}\) and MORI/Scottish Enterprise\(^\text{42}\) survey findings suggest that Scotland lags behind the UK in terms of positive attitudes to entrepreneurship. However, both surveys show evidence of the gap closing. Moreover, the Household Survey of Entrepreneurship found very few statistically significant differences in attitudes to entrepreneurship between Scotland and England.

The Executive has several actions in place to promote entrepreneurial activity, with SSS stressing the leading role of the education system in developing the skills, experience and behaviours which support creativity and entrepreneurship. Determined to Succeed (DtS), launched in 2003 – is an education strategy aiming to instil enterprise and enterprising values in young people. DtS aims to help Scotland’s young people develop self-confidence, self-reliance and ambition to achieve their work and life goals. Early evaluation has been positive.

3.2.7 Access to Finance

SSS notes that access to finance continues to be a barrier to growth for some companies. Surveys show that finance is cited as by far the biggest obstacle to starting a business,\(^\text{43}\) However, survey evidence for small businesses shows that, over time, finance has been mentioned less often as a problem for firms.\(^\text{44}\) The current relatively low interest rate environment is a major factor and also, with an increasingly competitive UK finance market, banks appear to be paying more attention to the needs of small and growing firms. A key source of finance for growing firms, apart from commercial lending, is equity capital. Here, recent studies\(^\text{45}\) have found considerably more venture capital available in Scotland than previously thought, though access by Scottish businesses, especially technology based start-ups, remains an issue. Nevertheless, these studies also found evidence that the high transaction cost of screening means that smaller projects are much less likely to be able to attract venture capital investment.

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\(^{41}\) Global Entrepreneurship Monitor, University of Strathclyde 2005.
\(^{42}\) Attitudes to Entrepreneurship, MORI/Scottish Enterprise 1999.
\(^{44}\) NatWest/SERTeam Quarterly Survey of Small Business in Great Britain 2005.
Policy can take two forms. Firstly, programmes to improve signalling, such as the Investment Readiness Programme, help growth businesses with the cost of developing robust proposals to attract equity investment. Secondly, the public sector can provide finance targeted at particular points in the firm cycle. Policies include the Scottish Co-investment Fund, a programme of co-investment in a range of new and existing private sector led equity funds; and the Business Growth Fund, now redesigned as a debt and equity vehicle for investment in new and early stage growth businesses. The Small Firms Loans Guarantee Fund guarantees loans from the banks and other financial institutions for small firms that have viable business proposals but who have tried and failed to get a conventional loan because of lack of security. This is a UK wide policy but has had a high rate of take-up in Scotland.

The introduction of the Scottish Venture Fund providing valuable second round funding for deals in the £2-5 million range is expected to invest some £20m a year in Scottish companies. While the establishment of investment gaps is by no means an exact science, there is strong evidence of a dearth in venture capital finance at the levels the Executive is seeking to address.

### 3.2.8 Innovation

FEDS identifies innovation as a key determinant of technical change and productivity in the Scottish economy. Around two-thirds of total factor productivity growth in the UK is explained by innovation, while differences in innovation performance may account for around one quarter and one sixth of the productivity gaps with the US and France respectively. Innovative firms tend to be faster growing; by offering new and/or improved products and services and creating new markets they can more easily gain competitive advantage. As SSS notes, opportunities to innovate occur at all stages of product and service life cycles and in the processes used to support delivery.

Evidence from the Community Innovation Survey (covering both product and process innovation) shows that Scotland performs well relative to the UK in terms of the proportion of firms innovating, but poorly relative to other European countries. Early indications from the forthcoming survey show that innovation activity in Scotland has increased, though detailed analysis will not be available until later in the year. However, Scotland has a poor record in Business Expenditure on Research and Development (BERD) compared to the UK as a whole and the OECD. The value of BERD in Scotland as a percentage of GDP is just over half of the UK figure though this has been rising in recent years, increasing by 80 per cent in real terms between 1997 and 2004 compared with UK growth of just over a fifth.

Support for businesses has been significantly enhanced in recent years, and a wide range of support measures are now in place.
Record levels of grants are being provided through the highly successful SMART and SPUR/SPURPLUS programmes supporting SMEs to develop new, highly innovative and commercially viable products or processes.

The Local Enterprise Companies administer the Small Companies Innovation Scheme (SCIS), a grant scheme which aims to help small companies develop new products and processes. The innovation criteria are less demanding than those for SMART and SPUR support.

Scottish Enterprise administer R&D PLUS – a grant designed to assist large companies to fund industrial research and commercially viable pre-competitive R&D into new products and processes.

The Proof of Concept Fund aims to address a gap in the commercialisation market between scientific discovery and prototype or proof of concept stage. In Knowledge Transfer programmes, academics work with companies on strategic projects lasting 2-3 years.

Cooperation between Scottish firms and the science base is also promoted through the Executive’s SEEKIT46 and SCORE programmes, which encourage greater co-operation and knowledge transfer between the Scottish public sector science base and Scottish SMEs.

The Scottish Funding Council’s Knowledge Transfer Grant (KTG) was introduced in 2001-02. KTG funds a wide variety of knowledge transfer activity.

Three market-based Intermediary Technology Institutes, were set up in Scotland in 2004 with the aim of identifying future emerging markets and developing the technology required to exploit these commercially.

The Executive intends to consult with business about a further scheme linking business rates relief with R&D expenditure.

Overall, public sector funding for R&D and product/process development has increased from £5.3m in 2000-01 to £11.8m in 2004-05 – an increase of 123 per cent.

3.2.9 Skills and Learning

Skills and learning constitute one of the three key priorities identified in SSS. Promoting the continual enhancement of skills is a key element of FEDS. This is an important facet of the Scottish Ministers’ drive to improve productivity and promote economic growth. An emphasis on skills is also a vital part of the commitment to tackling poverty and disadvantage – Closing the Opportunity Gap. SSS has a focus on narrowing the gap in employment and reducing economic inactivity.

There is a substantial academic literature on the returns to education and training. A recent paper47 suggests that a 1 percentage point increase in worker training leads to an increase in productivity of around 0.6 per cent and an increase in wages of around 0.3 per cent. This suggests that there are potentially significant returns to

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46 Scottish Executive, Expertise, Knowledge and Innovation Transfer Programme.
47 Deerden, Reed and Van Reenen, The Impact of Training on Productivity and Wages: Evidence From UK Panel Data and Deerden, Reed & Van Reenen, CEP discussion paper 674 February 2005.
training available at least at the industry level. There are several reasons for the Executive’s focus on skills. For example, skills impact on the other drivers of productivity, and innovation is facilitated by the skills of those responsible for creating innovative products or procedures. Another example is that enterprise will be boosted through the skills that school pupils are developing through the Determined to Succeed programme – and government has greater leverage on skills than on other drivers.

Despite the increase in productivity that skills development can bring, there can be market failures that discourage employers’ investment in training. For example, the investment in human capital is lost to the firm when an employee moves jobs, which is particularly relevant with workers now moving between jobs much more frequently.

Demand for skills is a derived demand – skills at a particular level are required because employers require that level of understanding or aptitude. In Scotland there are many jobs which do not require a high level of skill to be performed effectively, which creates a lack of demand by employers for high-skilled employees. Skills interventions are required at two levels:

- to meet replacement demand as people retire from jobs, to equip people to operate effectively in the workplace, where posts are not being filled because of a skills shortage or are not being carried out properly because of a skills gap and to guard against any reductions in current productivity; and
- to ensure that the workforce in Scotland as a whole has the appropriate skills required to grow the economy. This addresses market failures where the Scottish workforce lacks the skills to support productivity growth, and business development.

Recent work by Futureskills Scotland (FSS) has found that skills shortage vacancies amount to around only one per cent of all employees and affect around 5 per cent of establishments. Businesses themselves reported that “attracting appropriately skilled staff” was a mid-ranking challenge. It is notable that skills shortage vacancies were more common amongst growing rather than non-growing businesses at 2.5 per cent and 0.6 per cent of all employees respectively.

FSS data suggest that the current priority for skills in Scotland is to address the small number of skill gaps that arise disproportionately:

- among people in jobs that require lower levels of skills and qualifications;
- because of weaknesses in ‘softer’ core skills such as communication and team working; and
- in organisations that are innovative or growing.

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49 Skills shortages are discussed in greater detail in Chapter 4 article Skills and Scotland’s Economy: Help or Hindrance?
3.2.10 Conclusion

Growing the economy is the Executive’s top priority. FEDS is based on the principle that growth is primarily determined by the success of private enterprises that can compete effectively both domestically and internationally. Moreover, SSS recognises that there is scope to not only raise the number of business starts, but to encourage growth in existing businesses in order to increase the Scottish economy’s mass of larger, globally competitive firms. Therefore, while the dynamism of the private sector is crucial to the success of the economy, the Executive views targeted and focused intervention to promote business growth as being a key part of the effort to raise the competitiveness and dynamism of the Scottish economy.
chapter four: Selected Economic Issues

2006
4 SELECTED ECONOMIC ISSUES

4.1 SKILLS AND SCOTLAND’S ECONOMY: HELP OR HINDRANCE?

By Stephen Boyle and Patrick Watt
Futureskills Scotland

4.1.1 Introduction

Output per person in Scotland was 13 per cent lower than the average among the top quartile of advanced economies\(^{50}\) in 2004. To what extent do labour market factors, particularly the availability of appropriately skilled labour cause this gap?

This paper tries to answer that question by examining four sets of evidence:

- how Scotland’s labour market performance and labour quality compare with other rich countries;
- what employers report about the supply of labour;
- the implications of the recent substantial inflow of migrant workers from new member states of the European Union (EU); and
- wider indicators of aspects of economic performance.

The evidence points clearly to the conclusion that the supply of labour and appropriate skills are among Scotland’s economic strengths. They are not a leading constraint on economic performance, although there are a number of clearly identifiable improvements to aspects of labour supply that could boost growth.

4.1.2 Scotland in an International Context

Comparing aspects of labour market performance, especially labour quality, across countries is difficult, even where conventions exist about how to define and count indicators. However, it can be done if the data are treated with appropriate caution. International Comparisons of Labour Market and Skills Performance\(^{51}\) does that by:

- using only official data published by bodies like the Organisation for Economic Cooperation and Development (OECD) and Eurostat;
- grouping indicators that relate to a theme – e.g. labour utilisation – and testing whether they present a consistent picture or a conflicting one. This approach means that less emphasis is placed on any specific indicator; and
- focusing on the quartile of the international league table in which Scotland sits, rather than on the precise position of each indicator.

\(^{50}\) Based on data produced by OECD and Office for National Statistics. In this comparison, the countries in the upper quartile of the OCED on GDP per person are USA, Norway, Ireland, Switzerland, Iceland, Austria and Denmark. Luxembourg is also in the top quartile and has an unusually high level of GDP per person, much of which is attributable to workers commuting into Luxembourg. For that reason, it has been excluded from the calculation of the average.

The data were grouped into three categories: the quantity of labour supply, labour utilisation and the quality of labour supply.

On indicators of the quantity of labour supply, there is no consistency in Scotland’s ranking in the OECD league table. However, on each indicator the gap between Scotland and the top quartile of the OECD’s economic performers is small. This suggests that while an increase in the quantity of labour available could enhance economic performance, the gains would be modest.

Indicators of labour utilisation generally place Scotland in the third quartile of the OECD league table and the gap between Scotland and the best performing economies is large. Demand is insufficient to employ the available labour. If demand had been on a par with the best performing economies, the number of people in work would have been 195,000 higher in 2002. So, higher labour utilisation would be consistent with significantly improved economic performance.

Across a range of indicators of labour quality, Scotland ranks consistently in the top quartile of the international league tables. The quality of labour in Scotland stands favourable comparison with the world’s best performing economies, suggesting that it is unlikely to be a leading explanation of the economic performance gap. Rather, labour quality seems likely to be a factor that enhances Scotland’s economic performance relative to other countries.

Its strength in labour quality partly reflects the returns that Scotland earns from sustained investment in education and training. Bell and Sarajevs\textsuperscript{52} note that public expenditure per head on education in Scotland has exceeded the level in England by at least 18 per cent in each year during the last three decades.

4.1.3 What Employers Report

Between 2002 and 2004, Futureskills Scotland conducted 19,000 interviews with employers in three separate waves. The main purpose of the interviews was to obtain evidence from employers about a range of issues from the perspective of the demand side of the labour market. That included evidence about skill shortages and skill gaps, as well as the pattern of training activity and employers’ satisfaction with aspects of the education and training system. The search for evidence was prompted in part by a widespread belief that the supply of skills was constraining economic growth. Results of the surveys are available on the Futureskills Scotland website\textsuperscript{53}.

The main conclusion from the surveys is that the labour market and the education and training system work well for most employers most of the time. The evidence lies mainly in three areas. First, the survey sets employers’ responses to skills-related questions in a wider context by asking what business challenges they face over the next 12 months. Attracting appropriately skilled staff is consistently a middle-

\textsuperscript{52} Bell, D and V Sarajevs (2005), Scottish education: spending more – earning less?, Scotecon

\textsuperscript{53} \url{http://www.futureskillsscotland.org.uk/web/site/home/Reports/WhatEmployersThink.asp}
ranking challenge for Scottish employers. It was cited by five per cent of workplaces in 2004. Employers more commonly report competition, business regulation and cash flow as challenges they face.

Secondly, skill shortages are uncommon. They affect one in 20 workplaces and are equivalent to less than one per cent of jobs. Around one in four vacancies is a skill shortage.

Thirdly, while skill gaps are more widespread, the headline results exaggerate their significance. Gaps affect one in five workplaces and one in ten employees. However, around two-thirds of gaps arise because employees have recently started a job and/or because they have not completed their training. Thus, most skill gaps are the natural result of recruitment. Interestingly, half of employers with gaps report that they arise because of innovation or other, growth-enhancing activity in the organisation.

Other positive conclusions that emerge strongly from the surveys include high proportions of employers:

- reporting that recruits from Scotland’s colleges and universities are well prepared for work; and
- expressing satisfaction with the supply of work-related training from training providers and colleges.

There is also evidence from the surveys of instances in which the generally positive conclusion does not hold. Improvements in these areas could support faster economic growth. First, skill shortages and recruitment difficulties more generally are concentrated disproportionately among two types of business: growing and very small firms. In the case of growing businesses, the extent of recruitment difficulties and skill shortages is greater than among other firms, even making allowance for the fact that they are more likely than others to recruit. Skill shortages are equivalent to 2.5 per cent of employees in growing firms, four times the rate in non-growing businesses. For very small firms, the 53 per cent leaver rate is markedly above the 23 per cent among other businesses. Thus, the recruitment and retention of staff is a particular challenge for growing and very small firms.

Secondly, when asked what skills job applicants and employees lack when they have reported shortages or gaps, employers’ responses are consistent. Most frequently, they report weaknesses in:

- planning and organising (54 per cent of workplaces cited this as lacking among staff with a skill gap in the 2004 survey);

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54 A skill shortage vacancy is a specific type of hard-to-fill vacancy that occurs when applicants lack the required skills, qualifications or experience for the job. A skill gap exists when the employer judges someone who is in a job to be not fully proficient. While skill shortages refer to applicants for a job, skill gaps refer to those already in employment.

55 In this case, a very small firm is one employing fewer than five people.
• customer handling (52 per cent);
• problem solving (50 per cent);
• team working (49 per cent); and
• oral communication (45 per cent).

Behind these rank the technical skills needed to do a job as well as basic literacy, numeracy and IT skills.

The most frequently reported characteristics that people with skill gaps lack are not ‘skills’ in a conventional sense and certainly not technical skills. They may be ‘soft skills’, ‘non-cognitive skills’, ‘generic skills’ or some other term, but they seem more closely linked to attitudes and behaviours than the skills that are learned in a classroom or lecture theatre, or at a work station.

One interpretation of these results is that Scotland’s education and training system is relatively effective at imparting technical skills. To the extent that it is reasonable to expect the education and training system to do so, the challenge for it is to be as effective in imparting these other skills.

Thirdly, skill gaps arise disproportionately among people in jobs that typically demand lower levels of skills and qualifications. These employees are also less likely than others to receive job-related training.

People in jobs that require lower levels of skills and qualifications generally have less initial education and training and may be regarded as less ‘train-able’, while both labour turnover and the extent of part-time working are greater than in other jobs. These factors combine to reduce the return to employers from investing in training. So providing less training to this group is rational behaviour by an employer. In aggregate, however, if all employers behave similarly, the effect of allocating training budgets in this way may be to contribute to higher rates of skill gaps among this group of employees. There may be market failure in the provision of training to lower-skilled employees.

Finally, employers’ experiences of recruiting school leavers are quite different from their positive experiences of recruiting people from colleges and universities. More than one-third of employers who had recently recruited school leavers reported in the 2004 survey that these recruits had been poorly-prepared for work. In the 2003 survey, 76 per cent of employers reported that in their experience of recruiting, school leavers do not understand the world of work and 57 per cent that school leavers do not have a positive approach to employment.

Subsequent to the 2003 survey, 30 employers who had recruited school leavers took part in detailed case studies. These suggested that poor understanding of, and attitudes towards work manifest themselves in similar types of behaviour in school leavers, notably in the following areas:
• poor timekeeping;
• poor attendance;
• a lack of understanding of their role in the workplace;
• the inability of school leavers to work without supervision or to use their initiative;
• poor appreciation of the need for training or the possibilities of career development;
• poor appreciation of the need to provide customer service;
• poor performance on the job; and
• problems with interpersonal relationships among staff.

These attributes are not skills in the conventional sense. Rather, they are modes of behaviour, or attitudes closer to the ‘soft’ or similar skills described by employers in relation to skill gaps.

4.1.4 Recent Migration to Scotland from the EU Accession States

In May 2004, ten new member states joined the EU, allowing citizens of those countries to live and work in the UK. The Home Office established the Worker Registration Scheme for citizens of the eight eastern European accession states, known as the A8, under which migrants from these countries register when they come to work in the UK. This provides detailed information about the jobs the migrants do, with results published in the quarterly *Accession Monitoring Report* 56.

Between May 2004 and December 2005, almost 24,000 A8 migrants to the UK registered as working in Scotland. To put that figure in context, annual migration to Scotland from all countries outside the UK averaged 17,000 during the ten years to 2001. So the inflow of migrants from the A8 has been large when set against Scotland’s recent experience of in-migration.

From the perspective of this article, the most interesting evidence from the Worker Registration Scheme is about the jobs migrants are doing and how much they earn because these shed light on aspects of labour demand and supply in Scotland 57. The most common jobs A8 migrants do are:

• factory process operative, which accounts for 18 per cent of A8 migrants in Scotland;
• kitchen and catering assistant (nine per cent);
• crop harvester (six per cent); and
• maid/room attendant (six per cent).

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57 The Home Office provided the data in this section directly to Futureskills Scotland.
The industries in which migrants most commonly work are:

- hospitality and catering, which accounts for 26 per cent of A8 migrants in Scotland;
- agriculture (21 per cent);
- food processing (14 per cent); and
- administration and business services (13 per cent).

Workers from the A8 are generally low paid. 90 per cent earn less than £6.00 per hour. According to the Annual Survey of Hours and Earnings, in 2005, 20 per cent of all employee jobs in Scotland paid less than £6.00 per hour. While two per cent of A8 migrant workers earn £8.00 per hour or more, 59 per cent of employee jobs in Scotland paid at least £8.00 per hour in 2005.

The inflow of A8 migrants is a sign that the labour market is working effectively for some employers and the migrant workers. Employers in Scotland have vacancies that need filled and people from the A8 countries are travelling to Scotland to do the jobs. However, this is overwhelmingly low paid and low skilled work. Migrants are not typically in jobs that demand even mid-range skills. Employers might have found these vacancies difficult to fill, but that could not generally have been so because indigenous candidates lacked the technical skills to do the jobs.

Evidence that the market operates effectively in matching migrant workers with low skilled vacancies suggests that were there more highly skilled jobs that employers found it difficult to fill, similar recruitment channels could be used for that purpose. The corollary of this is that the pattern of employment among A8 migrants is an indication that labour demand pressures in Scotland may be greater among lower skilled than higher skilled jobs.

Both local research studies58 and reports from business organisations59 suggest that employers recruit and value migrants for ‘positive traits’ they bring to the workplace such as a strong work ethic, reliable attendance and flexibility. That is, migrant workers appear to demonstrate characteristics that some employers report that certain school leavers and indigenous employees lack.

More generally, migration from the A8 to do low paid and low skilled work is consistent with the view of employers recorded in successive surveys that skill shortages are uncommon.

4.1.5 Wider Indicators of Economic Performance

The Scottish Executive regularly commissions and publishes independent assessments of progress towards a Smart, Successful Scotland. The most recent
report\textsuperscript{60}, published in December 2005, concludes that Scotland’s performance is strongest on the range of skills and learning measures. In contrast, the greatest weaknesses are in the growing businesses indicators. Specifically, Scotland is in the lower half of the OECD league tables on:

- the number of new business starts per 10,000 people, the core indicator of ‘enterprise’ activity; and
- business research and development spending as a proportion of GDP, the core indicator of ‘innovation’.

In addition to indicators of skills, enterprise and innovation, both the Scottish Executive in The Framework for Economic Development in Scotland and successive reports from HM Treasury in its productivity series, identify investment in physical capital and competition as the other factors that affect the rate of productivity growth, that in the long-run is the main source of economic growth. Direct evidence on these factors is not part of the Smart, Successful Scotland measurement framework. However, indirect evidence suggests that the extent of competition in Scotland may be less than in other economies. For example, a lower rate of business creation than in other areas means fewer new entrants contesting incumbents in markets in Scotland, while a relatively large public sector means that less of the sum of economic activity is open to competition.

O’Mahony and de Boer have produced further evidence\textsuperscript{61}. They compared labour productivity in the UK with the USA, France and Germany. In 1999, output per hour worked in the UK lagged these countries by 30 per cent, 29 per cent and 17 per cent, respectively. The authors sought to explain the causes of the gaps and found that skills accounted for:

- 1 per cent of the gap in the case of the USA;
- 12 per cent in the case of France; and
- 19 per cent in the case of Germany.

Put differently, in comparing the UK with the other countries, factors other than skills explain more than 80 per cent of the gap in productivity. Given the evidence that Scotland’s skills are generally better than the rest of the UK, this implies that a smaller proportion still of the productivity gap between Scotland and other countries will be accounted for by skills.

The evidence from wider indicators of economic performance is consistent with the evidence on labour supply and labour quality: the supply of labour and appropriate skills is not a leading constraint on Scotland’s economic performance.

\textsuperscript{60} Scottish Executive (2005), A Smart and Successful Scotland: Measuring Progress Towards a Smart Successful Scotland: 2005.

\textsuperscript{61} O’Mahony, M and W de Boer (2002), Britain’s relative productivity performance: Updates to 1999, National Institute of Economic and Social Research.
4.1.6 Conclusions

An adequate supply of appropriately skilled labour is a necessary condition for economic growth. The balance of evidence points clearly to the conclusion that Scotland’s labour supply is one of the country’s economic strengths. That emerges from comparisons of Scotland with other countries; the views of employers from their experience of recruiting and training staff; and the lessons of migration from the states that joined the EU in 2004. Scotland is reaping the benefits of investment by government, employers and people in the nation’s human capital.

None of this is to be complacent. Scotland is unlikely to prosper by diminishing its supply of skills, and FEDS recognises that. Moreover, there are clearly identifiable areas in which the labour market and education and training system could perform better in ways that would enable faster growth. In addition, the economy’s demand for people with high-level skills will continue to grow.

Beyond these considerations, investment in skills has an important role to play in improving the life chances of Scotland’s people. These are genuine challenges, but the greater challenges in enhancing economic performance lie in areas other than the labour market and the supply of skills.
4.2 SOCIAL SERVICES LABOUR MARKET

By David Keenan
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4.2.1 Introduction

Social services have a vital contribution to make to society through supporting the most vulnerable and excluded people, protecting those at risk of harm and working with other services to close the opportunity gap.

Since devolution, the social services sector has undergone a series of radical, ongoing changes, encompassing the regulation of the sector and a process of registration for the entire workforce. The Regulation of Care (Scotland) Act 2001 legislated for the establishment of the Care Commission and Scottish Social Services Council (SSSC). The Care Commission aims to regulate and raise service standards of social services care in Scotland through service registration and inspection. The SSSC aims to improve the capacity and skills of the workforce by registering workers and regulating education and training standards and practice.

In the last twelve months a number of important policy developments have occurred, not least the 21st Century Social Work Review. This took a fundamental look at local authority social work services and published the ‘Changing Lives’ report with 13 main recommendations.

The development of social services policy since devolution has been matched by an increase in resources provided for service delivery by the Scottish Executive. Grant Aided Expenditure allocations (GAE) for local authority social work services increased by 67 per cent; from £1,200 million in 1999-2000 to £2,007 million in 2006-07.

The social services sector covers a varied range of services, delivered by a variety of staff with assorted skills, providing direct care and support to service users. Services can be broadly split into children & young people’s services and adult care services. Services are delivered by a combination of local authority, voluntary and private sector providers. A wide range of different types of staff are employed in the sector, from the highly qualified specialists such as social workers and occupational therapists to the equally essential ancillary staff and care assistants.

This article uses Labour Force Survey (LFS) data and draws on the Scottish Executive’s 2nd Social Services Labour Market Report to highlight key factors in the social services labour market in comparison to the Scottish labour market. The main points are that over the period from 1995 to 2004:

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62 Further information can be found at, http://www.21csocialwork.org.uk/
63 Scottish Executive, 2005.
64 Increase is in nominal terms.
65 For further information: http://www.scotland.gov.uk/Publications/2006/03/13112609/0
the social services labour force has grown faster than the Scottish labour force;
full-time employment in social services has grown faster than part-time employment, the opposite is true in the Scottish labour force;
male employment has grown faster than female employment in social services whilst this trend is reversed at the Scottish level; and
the qualification levels of the workforce have increased in both social services and Scotland wide (1996-2004).

4.2.2 Employment Growth

Since devolution both social services employment and Scotland-wide employment have risen to the highest levels on record. Social services employment expanded by 44 per cent from 1995-2004, to stand at 138,000. In 2004, Scotland wide employment was 2,414,000, an increase of 7 per cent on 1995. Social services employment was 4.3 per cent of total Scottish employment in 1995, rising to 5.7 per cent of the total in 2004. This rise in social services employment is associated with an increase in resources devoted to the sector, highlighting the important role it has played since devolution.

The growth in individual sectors within social services and the Scottish economy has not been uniform. In social services, employment growth in the independent sector, consisting of private and voluntary sector providers, has been striking, expanding by 88 per cent from 1995 to 2004. At the same time, public sector social services employment increased by 7 per cent. The different degrees of expansion have meant that the composition of the social services workforce has changed. Independent sector employment has overtaken local authority employment, increasing from 44 per cent of the total in 1995 to 61 per cent in 2004, as shown in Chart 4.1.

Over the same period, employment growth at the Scotland wide level has been slower and more evenly balanced between the sectors. Independent sector employment has grown by 8.3 per cent in the overall economy, compared with public sector employment which has increased by 3 per cent.
4.2.3 Male and Female Employment

The social services workforce is primarily female, with women making up 81 per cent of the workforce in 2004. However, this breakdown has altered as male employment has grown by around 70 per cent since 1995, compared with a 27 per cent increase in employment for women. This is in contrast to the full Scottish labour market, where 53 per cent of all jobs are filled by men and growth over the period is larger for women than for men, at 8.9 per cent compared to 4.4 per cent respectively.

The growth in male employment is symptomatic of a broader shift in the economy from primary and manufacturing sectors towards the service sector. It also suggests that concerted efforts to diversify the workforce and dispel the view that the sector is solely a female domain have been successful.

4.2.4 Full-time and Part-time Employment

Traditionally, the social services sector has had a high proportion of part-time workers. However, the recent trend has seen an increase in the number and percentage of full-time workers, which rose from 46,000 (47 per cent of social services employees) in 1995, to 88,000 (64 per cent) in 2004. Part-time employment has fallen by 2 per cent over the same period. Economy wide, changes in working hours have moved in the opposite direction over the same period, with part-time employment increasing by 10 per cent; whilst full-time employment has increased by 5 per cent. This difference might reflect the general fact that a growing number of
women are working full-time and, since women make up a significantly greater share of social services employment than of total employment, this could explain why full time employment increased more sharply in this sector.

4.2.5 Age Profile

Compared with the Scottish workforce as a whole, the social services workforce has an older age profile with a lower proportion of employees below 35. This is highlighted in Chart 4.2 below.

Since 1995, the numbers in each age group have increased. The strongest growth was in the 55-64 year old age group where numbers have increased by 91 per cent. This meant that the percentage of social services workers in the 55-64 age group increased from 11 per cent to 15 per cent. The difference in age composition between the social services sector and the overall economy may be a result of linked supply and demand factors. Younger workers may simply prefer to work in other sectors and therefore not supply their labour. On the demand side, employers may consider older workers to be more likely to hold the skills required for many social services posts.

4.2.6 Vacancy Rates

The Annual Business Inquiry suggests that the number of vacant posts has risen across the Scottish economy over the past few years along with overall employment
levels. The 2004 data show that the vacancy rates in social services are around five per cent compared to four per cent across the economy as a whole.

### 4.2.7 Qualifications and Registration

Delivery of quality services to social services users needs a competent, qualified workforce. The Scottish Executive set up the Scottish Social Service Council (SSSC) in 2001 to regulate the social services workforce and develop workforce education and training. The SSSC is in the process of a phased approach to registration of key groups of social services workers; beginning with highly qualified staff and those in leadership positions.

Registration is a major part of the drive for higher standards in social services and will bring the workforce into line with other public service colleagues. Nursing, medicine and teaching are all regulated professions where workers have to register with the relevant regulatory body to undertake work in their field. The social services workforce is distinct from other sectors as the whole sector will be covered. To register, a worker must satisfy various criteria, including achieving the appropriate qualification level.

The differences in qualifications between social services and the whole of Scotland’s workforce highlight some interesting trends. The LFS uses the framework of National Vocational Qualifications\(^{66}\) (NVQ) to classify workers qualifications.

- NVQ level 5 includes first degrees and higher degrees;
- NVQ level 4 includes HNC and HND qualifications;
- NVQ level 3 includes SVQ 3 and higher grades;
- NVQ level 2 includes SVQ 2 and standard grade at credit level; and
- NVQ level 1 includes SVQ 3 and standard grade at general level.

Overall qualification levels in both social services and all of Scotland have been increasing from 1996-2004, outlined in Table 4.1.

<table>
<thead>
<tr>
<th>Table 4.1: Qualifications by Year and Sector</th>
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<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>None</td>
</tr>
<tr>
<td>Other</td>
</tr>
<tr>
<td>NVQ1</td>
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<tr>
<td>NVQ2</td>
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<tr>
<td>NVQ3</td>
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<tr>
<td>NVQ4</td>
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<tr>
<td>NVQ5</td>
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</tbody>
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Source: Scottish Executive

\(^{66}\) For information on NVQs: [http://www.qca.org.uk/14-19/qualifications/index_nvqs.htm](http://www.qca.org.uk/14-19/qualifications/index_nvqs.htm)
Social services are part of the economy-wide trend towards an increase in qualification levels, with employer and employee awareness of approaching registration deadlines likely to have been a factor. There was a decrease in the percentage of workers across Scotland with no qualifications, whilst the social services have seen larger reductions in the percentage of the workforce with no qualifications. The Scottish percentage of the workforce with NVQ1 and NVQ2 was broadly similar in both 1996 and 2004. Conversely, in social services the percentage of staff with these qualifications declined. The percentage of staff with NVQ4 has increased at the Scottish level. However, in the social services the percentage of staff with NVQ4 increased by a greater proportion.

4.2.8 Human Capital

The Framework for Economic Development in Scotland (FEDS) identifies increases in education and skills of the workforce as essential to economic growth. Human capital theory suggests that increases in education and skills can increase the productivity of the workforce, which can lead to an increase in economic growth.

In relation to the social services workforce, any increase in education and skills as a consequence of registration will have the dual benefits of improving the quality of services to service users, and subsequently outcomes, while also promoting economic growth in the wider economy by increasing productivity.

FEDS also acknowledges that market failures exist in education that can lead to a sub-optimal level of investment in human capital. These failures can be magnified where incentives to train differ between employees and employers. Registration helps to regulate quality within the sector but does little to address any under investment caused by employees’ myopia or employers’ inability to capture the full benefits of any investment in training. However, registration does help to better align the incentives of employers and employees to help ameliorate the impact of any market failures.

4.2.9 Challenges

The transitional phase from the present system to a registered workforce is not without its challenges and there are currently many staff who are not qualified to registration standard. Registration of the social services workforce is a phased process. Consequently, the challenges faced by the sector are over the medium and the longer term and they relate to:

- maximising the benefits of improvements in human capital;
- increasing total factor productivity; and
- dealing with demographic changes.
4.2.10 Maximising Human Capital

The transition towards registration is a large cultural and management change for the sector. Registration is the responsibility of both employer and employee alike. The allocation of limited resources requires careful consideration of the tradeoffs that result. To achieve registration, individual and organisational level decisions need to be taken about how best to meet the requirements. An effective and efficient process of registration means that both the intensity of effort needed for each staff member to register and the volume of staff needed to deliver services should be taken into consideration. This is a matter for individuals and employers based on their own situation. Registration may eventually require that some existing staff exit social services employment. Therefore, when targeting resources to meet registration, employers are also faced with the choice of directing training at incumbent staff or trying to attract and train new staff or some balance of the two. Again, this is a matter for each employer. However, the transitional registration period needs careful planning to balance these trade-offs while continuing to deliver quality services.

4.2.11 Total Factor Productivity

Whilst social services productivity relies heavily on human capital to efficiently deliver services, other factors, notably technology and physical aids are also vitally important. Improving the mix between different factors can boost productivity in the social services; e.g. harnessing technology to provide integrated back office functions to avoid duplication and smooth service delivery, or further provision of physical aids in older people’s homes which enables them to stay longer in their own home. Getting the total factor productivity mix right is an important element of delivering efficient and effective social services.

4.2.12 Demographics

Social services are affected by the changing age structure of the Scottish population in comparable ways to the rest of the economy. Projected population decline, population ageing and population density changes all affect social services similarly to other services. However, the change in age profile, caused by population ageing and a lower birth rate, could result in a shift in the demand for employees from children’s services to adult services.

The age profile change could also affect the supply of social services by shrinking the available pool of working age people available for employment. This challenge can be met by increasing human capital and improving total factor productivity, as identified above, and also by measures that seek to expand the labour pool by eliminating barriers and improving incentives for employment.
Supporting the flexibility of social services staff through training and development opportunities might also be an important element of addressing both the demand and supply challenges caused by demographic change.

These changes are in the medium to longer-term. Nevertheless, facilitating this shift in services means that the sector needs to plan ahead to allow for the lead in time needed to gain new knowledge and skills.

4.2.13 Conclusions

The social services labour market exhibits a number of different trends to the overall Scottish labour market. From 1995-2004, social services employment increased by a greater percentage than employment at the total economy level. In social services, male employment increased by a greater percentage than female employment and there was a larger increase in full-time employment compared with part-time. The opposite is true in both cases across the full economy.

One similarity between the social services labour market and the Scottish labour market is the general increase in qualification levels from 1996 to 2004. Whilst social services are part of the wider trend towards increasing qualification levels, one cause of the increase in qualifications may be the awareness and preparation for registration.

The changes produced through the SSSC registration requirements should increase the quality of services by recognising and supporting staff professionalism and ensuring that those working in the sector have the appropriate skills to deliver quality services.

There are transitional challenges that both employers and employees will need to address individually and collectively to ensure that knowledge and skills are used efficiently. There is a need to plan to maximise the number of workers that are able to meet registration requirements. To have maximum impact, the increases in human capital should be combined with an effective use of other factors of production, in particular technology. Over the long term, social services will face the challenge of addressing Scottish demographic changes, which implies a shift of focus from service delivery to the young to service delivery to the elderly.
This is the thirteenth edition of the *Scottish Economic Report* (SER). It is published twice-yearly and incorporates a review of the progress and prospects for the Scottish economy, together with a review of the broader economic context in which the Scottish economy is set, as well as a selection of summary articles of key topical interest.

This thirteenth edition of the *Scottish Economic Report* has four main sections:

- **Chapter 1:** The Scottish Economy: Recent Developments and Future Prospects, provides an overview of the Scottish economy. This section summarises the recent developments and future prospects for the Scottish economy.
- **Chapter 2:** Global, European and UK Economic Developments demonstrates the linkages between Scotland and the wider economic environment. The chapter provides a synopsis of economic developments in the United Kingdom, European, and global economies.
- **Chapter 3:** This chapter discusses the Executive’s key policies for growing the economy, through outlining the progress in taking forward the key elements of the *Framework for Economic Development in Scotland*. This edition focuses on the new *Sustainable Development Strategy*, as well as the Executive’s response to the Enterprise & Culture Committee’s Business Growth report.
- **Chapter 4:** Selected Economic Issues provides an opportunity for brief surveys of selected economic issues to be presented.