

Economic Data Inquiry

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Introduction

In general, the state of economic data for Scotland is above average for a region but significantly below that which would normally apply for a country.

In most cases such a status would be sufficient as the national (UK) level is in control of most macro-economic powers and fiscal powers. However, the latter is becoming more of a joint responsibility, between the UK and Scottish governments, as revenue powers, although not overall fiscal limits and targets, are increasingly devolved.

To attain a higher standard of economic statistics and analysis would require two major advances on the present position:

- 1) a full set of National Accounts, together with a balance sheet on a Whole of Government basis (i.e. including the assets and liabilities of all public sector organisations);
- 2) a proper working model of the Scottish economy.

Meeting these ambitions will require additional resources, in terms of both funding and experienced personnel.

The following contribution briefly outlines some of the key areas where added resources and analysis are most needed. Each area offers opportunities for further discussion at the evidence session on the 19th September.

Key areas and issues of interest:

- Real terms GDP as a measure of economic size and growth (vs GNP, GNI, modified GNI, cash terms etc)

Scotland has a complicated economy that, even in traditional 'GDP' terms, is not easily understood by a single measure of economic growth. This is primarily due to the existence of significant non-Scottish (in terms of both Rest of the UK (RoUK) and the Rest of the World (RoW)) ownership across a number of industries, including: North Sea activity; energy; the financial sector; brewing; retail; etc. This means that, as is the case for countries like Ireland and Luxembourg, GNI is a more relevant measure than GDP.

Furthermore, due to the presence of a natural resource (oil & gas) the cash terms, as well as the real terms, measure of GDP is relevant, as is the case in other countries like Norway.

Ireland provides a good illustration of how such unusual elements of an economy lead to different measures being used. Ireland currently publishes data on GDP and GNI, but despite this still comes up with a, clearly warped, growth rate of 16-26% in 2015. The Irish government has now introduced a further new measure, modified GNI, to try and resolve some of these issues and reach a more realistic understanding of the underlying position of the economy. (Note: this modified GNI measure is also used to better evaluate Ireland's debt ratio and its debt sustainability. Furthermore, a modified Current Account is also published as a result of distortionary multi-national company behaviour.)

Scotland's position may not be as extreme and as complicated as that of Ireland but it still requires different measures of economic growth and levels for different purposes and to gain a fuller understanding of its growth performance.

Without discussion of these alternative measures we are having a very narrow and limited debate over the state of the Scottish economy.

See background paper: '**Analysis of Scottish GDP measures over time**', (April 2015) -discussion of the impact and merits of using alternative measures of the Scottish economy. (<http://fiscalaffairsscotland.co.uk/wp-content/uploads/2015/04/Scottish-GDP-revised-data.pdf>)

- GDP(O) by industrial sector anomalies

There are number of industrial sub-sectors which are performing unusually, or relatively poorly, but where our understanding of the reasons for this underperformance remains weak. For example:

- 1) Construction: allegedly grew by 25% in one year (2014 Q2 to 2015 Q2), although without impacting on employment levels;
- 2) Hotels & Catering: effectively no growth in this sector since 1998, despite the apparent expansion seen on high streets across Scotland and the 50% rise experienced at the UK level;
- 3) Transport & Communications: no growth between 2003 and 2013, followed by a sudden jump, then back to no growth since 2014. Again, this contrasts with strong and steady growth experienced at the UK level.

In the cases of Construction and T&C, the performance of these industrial sub-sectors can have an important influence on future productivity levels.

Without a better understanding of the drivers of such trends it is difficult to set out economic industrial policy in order to address any underlying weaknesses.

- Productivity

This is a key statistic but also tricky one to collect and to analyse. In order to make like-for-like comparisons with other countries a number of adjustments need to be made, in terms of working hours, industrial composition (e.g. the very high

productivity North Sea sector) etc. With each such adjustment an element of imprecision is introduced which leads to the figures becoming closer to guesstimates than estimates.

Furthermore the key element within 'productivity' is 'Multi Factor Productivity' (MFP). MFP measures the residual growth that cannot be explained by the changes in labour and capital inputs. More specifically it measures the contribution to economic growth made by factors such as technical and organisational innovation.

As it is a residual and as elements like technical innovation are very difficult to measure then explaining shifts in MFP is very challenging. Hence, despite all the attention on the UK's flat-lining or falling productivity in recent years, there is little consensus over what are the most important causes are and on how to redress them.

Overall, more study of this topic is vital although fixating on the actual published figures is less so.

- Labour Market

Labour Market data is probably the area where existing data is the most robust and the most developed at present.

However, what is lacking is much in the way of analysis and interpretation of the data. For example, there is little understanding of the driving forces behind the Scottish employment rate moving from being well below that of the UK up to 2002 to being well above it in a relatively short five years, as well as the recent partial reversal of this shift.

- Inflation

It has long been a frustration of many economic commentators that no official Scottish inflation rate exists. While there will usually be a close relationship between Scottish and UK inflation this need not always be the case. For example, in recent years UK inflation was added to by the big jumps in tuition fees applying in England, although clearly this would have had very little impact on Scottish inflation. Furthermore, increasing tax and benefit powers for the Scottish Government mean that the scope for diverging inflation rates is enhanced.

At present three high level measures in particular are used by the Scottish and UK Government's:

- CPI, until recently the official measure and still used as the Bank of England target rate;
- CPIH, the new headline measure of household consumer price inflation;
- RPI, the old headline measure but since discredited and no longer a national statistic.

However, data on hundreds of prices feed in to these ONS inflation measures at present, so it would be a challenging and expensive business if done in full on a Scottish basis.

- Balance of Payments

Scotland's external balance (i.e. its Balance of Payments) measures the net inflow or outflow of funds with respect to the rest of the world (including the rest of the UK). As such, it is a crucial variable when evaluating the underlying health of an economy.

The BoP's includes trade in goods and services as well as international transfers relating to overseas earnings and dividends. The BoP's also covers both onshore and offshore activities.

By the time of the meeting on the 19th September I hope to be able to forward a copy of my report on Scotland's Balance of Payments, commissioned as a background paper feeding into the SNP's Growth Commission work led by Andrew Wilson. This report outlines many of the important issues connected with understanding the BoP as well as the difficulties currently relating to Scotland. It is not an easy read, even for economists and statisticians who are familiar with this area of work, but it covers a vital area in understanding Scotland's underlying economic well-being.

- Alternative's to GDP

Wider measures of economic success e.g. 'Measures of Economic and Social Well-being' for Scotland and even by Local Authority are potentially available. However, there are a number of issues involved with such alternatives: - data connected to education or health results, for example, are often only available after a lengthy delay;

- such data is often available only on an annual, rather than quarterly, basis;
- changes in such data tend to be gradual and so emerging problems, or successes, can be slow to be identified.

Because of such concerns it is important for any such new indices to be seen as complementary to existing measures like GDP, which, while also having its faults, is relatively timely, robust and sensitive to change over a short period of time.

Potential may also exist for finding new ways of incorporating 'Environmental' and 'Wealth Distribution' measures into mainstream economic discussion.

I am currently working on an example of such an alternative Index and, again, would hope to get a copy of this to the Committee prior to the meeting on the 19th September.

- Forecasting

Economic forecasting is an important activity but tends to be difficult, expensive, and ultimately a pretty thankless task.

Important, as without it we are flying blind. In the same way that a company may not know what its future sales will be but will still make sales projections based on the best information available, so too a Government will want to (even broadly) anticipate a country's economic performance and its ability to fund its own expenditure.

At the UK level this task is performed by the independent Office for Budget Responsibility (OBR), though others, like HMT, DWP and HMRC will also feed into the process as well as providing a degree of 'challenge' function to OBR forecasters. Few would acclaim the OBR's forecasting record in recent years but, equally, few would argue against its role in attempting to predict future paths for key variables, even if these are repeatedly revised, sometimes substantially.

Difficult, because most economic models are based on extrapolating past behaviour into the future. However, changes in such behaviour can occur (e.g. the recent downturn in productivity) or may be fairly erratic in the first place (e.g. business investment), rendering the forecast prone to error. Furthermore, models tend to gravitate towards a long term status quo position, whereas reality staggers from highs to lows and back again, with, sometimes, a lack of long term underlying trend in evidence. As a result, turning points are rarely, if ever, picked up. This is not a feature of economic models that is going to change anytime soon.

Clearly, post the Great Recession, we are in a period of great turmoil and economic forecasting is particularly difficult, with old economic relationships breaking down and uncertainty surrounding the emergence of any new ones.

Expensive, due to the need for good survey data to feed into the economic model, the building of the model itself (involving relatively rare technical skills) and regular updating. The data can also be technically difficult to collect (e.g. the location of profits of multinational companies) and the bigger the survey sample the more robust the data but also the more expensive is its collection.

UK forecasting and data collection has well known problems but is still well ahead of where Scotland is at present. Scottish data restrictions exist in a number of key areas (e.g. Balance of Payments). To help remedy this would involve a considerable expansion of: data collection; model building; and data analysis, each requiring additional, suitably qualified, staff.

At present all current Scottish forecasts (and nowcasts) could be described as educated guesswork. This is largely due to the lack of, poor quality of, or lateness of, the data. Scottish forecasts take their lead from UK forecasts with a little local knowledge thrown in, although as local knowledge accrues over time such a reliance on UK approaches may lessen. The Scottish models are also still at a developmental stage with regards to the complexity of public finances

forecasting, a key element of the OBR model. This should change as a result of the work of the new Scottish Fiscal Commission, but the outstanding quality issues germane to existing Scottish economic models will still place a question mark against the reliability of any Scottish public finance forecasts until improvements in modelling capability are forthcoming.

Ideally, there would be multiple providers of such forecasters, as there are for the UK economy (literally dozens if City forecasters are included) and most other countries. For such a situation to occur in Scotland would require, first, the data to be available, then, private sector companies or research bodies to fund such models and publish the results. Alternatively, greater collaboration amongst Scottish forecasters and sharing of best practice may bring about improvements.

In summary, while economic forecasting may seem like a fool's errand it is a necessary activity, particularly for governments who are open to financial risk from greater (devolved) tax powers, in order to help plan their future spending. Sophisticated forecasting capability, based on the best information available, also sends out a strong message to investors i.e. prospective Scottish Government bond purchasers. Such investors will want reassurance over the future strength of the Scottish economy and the ability of the government to guarantee interest and principal payments.

- Political and public understanding

In all of the areas discussed above, one of the biggest challenges is in bringing about a greater awareness and understanding of the importance and relevance of existing and new sources of economic data. This applies equally to politicians, the media and the public and would be a crucial development in terms of holding the government to account.

In order to enhance this capacity requires three further areas of development:

- 1) a variety of think tanks to independently analyse data and policies e.g. IFS, NIESR;
- 2) academics who have an interest, often specialised, in the Scottish economy;
- 3) media commentators (business or political) with an understanding of economic ideas and an ability to critique the data.

In each of these cases the government has a limited role, e.g. via funding routes in academia, in bringing about change. However, so far, the private sector has shown very little interest in helping fund such think tanks and the public sector has shown very little interest in making the study of a region, Scotland, attractive to academia.

Until progress is made in all of these areas then the debate over the Scottish economy, at all levels, is likely to remain fairly lacklustre.

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