EY ITEM Club Scottish Autumn Forecast

November 2024

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EY ITEM Club Scottish Forecast

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The report is based on data and information available before October 2024. The quarterly EY ITEM Club Scottish report is part of the EY Economics programme which provides knowledge, analysis and insight to help businesses understand the economic environments in which they operate, both in the UK and globally.

Foreword

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While our 2024 forecast now looks to be weaker than last quarter, we continue to expect low inflation, continued recovery of household budgets and rising consumer spending to support growth. However, growth prospects vary greatly across local authority areas, partly due to sectoral differences but also down to factors such as infrastructure, inward investment and demographics.

Population growth remains a key concern for Scotland's longer-term progress – particularly our working-age population, which is forecast to decline in 21 of Scotland's 32 local authority areas in the next five years. High levels of economic inactivity has been identified as a drag on growth, with inactivity rates higher in Scotland than the wider UK.

Our forecast shows economic growth is fragile and highly sensitive to market conditions. Many organisations find themselves largely between a rock and a hard place on recent government policy changes. And what's front and centre are employer NIC increases.

This poses a number of challenges: if you attempt to pass-through the cost fully, this potentially fuels a higher inflationary environment which impacts confidence levels, in turn keeping interest rates higher for longer – generally not a good thing for investment and reinvestment; do nothing and accept a lower profits environment for a sustained period, again with a detrimental impact on investment, reinvestment, transformation and innovation – which impact companies' ability to stay competitive in today's market; trim back on future wage rises, compounding an already differentiated Scottish rate of income tax in terms of bottom line pay – impacting employees wage inflation and key lifestyle choices in the future, such as access to mortgages especially when property prices run well ahead of real wage inflation.

A conundrum, to say the least, and a set of circumstances many clients and business leaders are struggling with. While our forecast doesn't have these answers, it does starkly show ahead of the Scottish Government's budget the need to amplify policies that help restore economic growth and provide encouragement that there can be a pro-business platform.

The Scottish Government will have many decisions to make on key priorities ahead of the Budget, but what our forecast shows is that fast action is needed to overcome barriers to economic growth and forge a competitive advantage for the Scotland's business sector.

Highlights

- Scotland's economy recorded strong growth in the first half of 2024 and is broadly keeping pace with the UK, but there are signs that growth is slowing in the second half of the year. GVA should expand by 0.7% over the course of 2024, slightly below the UK average of 0.9%. This growth is expected to pick up in 2025 and 2026, though the forecast is a bit weaker than presented last quarter and we continue to expect Scotland to lag UK growth over the forecast period.

- The UK Government presented its first Budget setting out its tax and spending plans in October. It included a rise in employers' national insurance contributions and tweaks to the fiscal rules, which will allow the UK government to increase investment spending funded by borrowing. The Autumn Budget increased spending by around £70 billion a year, with around half covered by additional tax revenues and the rest funded through more borrowing. The Budget also included a £3.4 billion real-terms increase for the Scottish budget through the Barnett formula.

- The Scottish Government will set out its plans for public spending when it delivers its Budget in December, with spending on public sector pay, healthcare and infrastructure projects likely to be the key priorities. A tax strategy will be published alongside the Budget setting out the government's medium-term ambitions for the Scottish tax system.

- The expansion in Scotland's economy in the first half of this year was broad brushed, with contributions from production sectors as well as service sectors. However, the rapid growth in largely consumer-facing sectors recorded in Q1 was not sustained in Q2, and construction has struggled. We anticipate that consumer spending will expand by 1.5% a year supporting GDP growth in coming years, and private services alongside the healthcare sector are set to drive long-term growth.

- Labour market activity appears to have cooled with employment growth stalling and an easing of pay growth. Despite weaker employment demand, ongoing high rates of economic inactivity have limited the impact on joblessness, with the unemployment rate falling in the latest estimates and set to remain at current rates for the next few years.

- Jobs growth will be concentrated in health and social work and private services, including administrative and support services and professional, scientific and technical services. Together, these three sectors are expected to account for almost 60% of new jobs created in Scotland between 2025 and 2029.

- Scotland's population reached an all-time high in 2023 according to official statistics, with growth driven entirely by migration, mainly from people outside of the UK. However, the statistics showed that population growth in Scotland was slightly weaker than in England and Wales. We expect this trend to continue in the future, which affects Scotland's economic prospects over the long-term.

- Future growth is forecast to be concentrated in and around Edinburgh and Glasgow, with weaker prospects for the islands and rural parts of the country. This is principally due to sector mix with private services that are expected to drive growth located in Scotland's larger urban areas but also the presence of a range of other factors that support economic growth in these areas, including working age population growth, skills, physical and IT infrastructure, and public and private sector investment, with the inflow of Foreign Direct Investment (FDI) in particular directly related to increases in labour productivity.

Latest developments

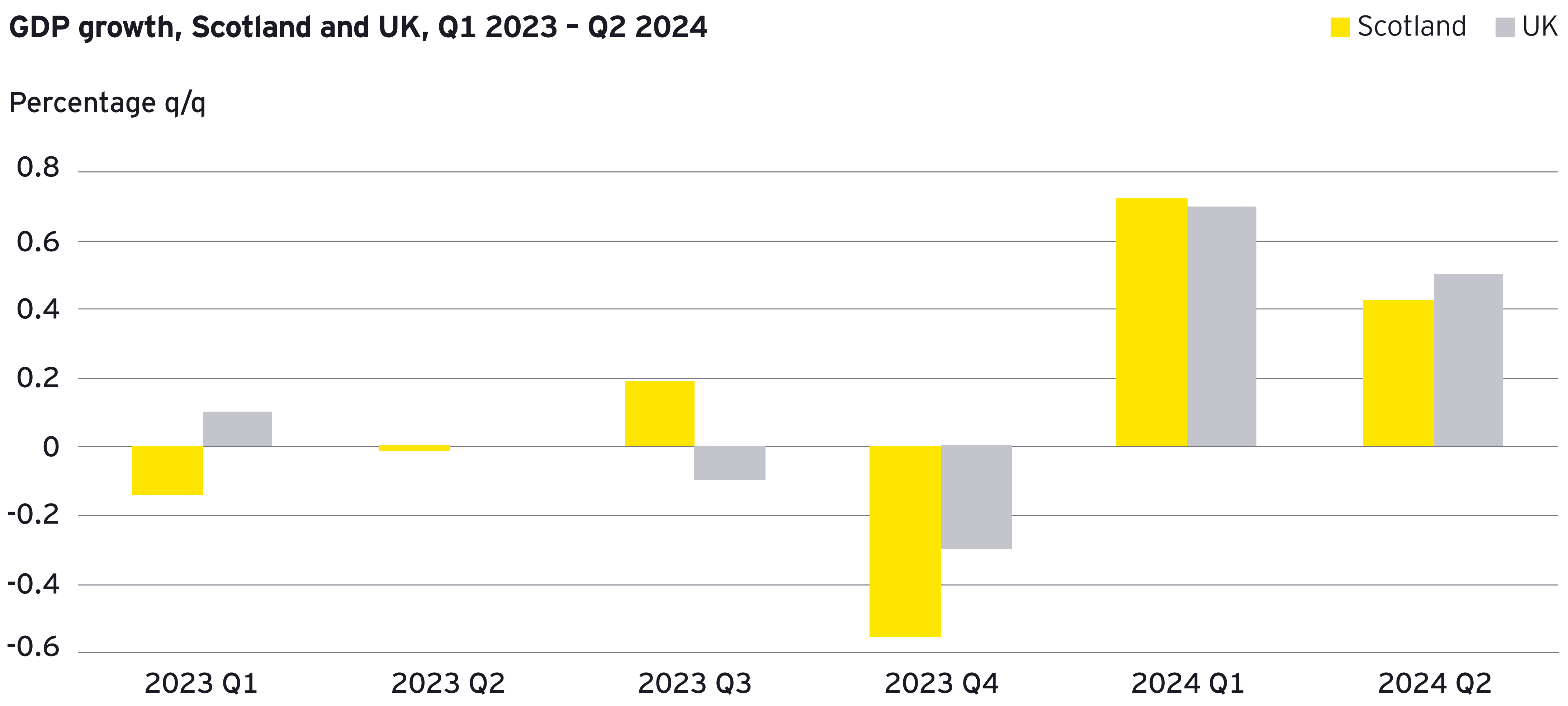
Scotland's economy continues to grow but the pace of the first half of the year may have started to fade

The latest quarterly GDP data confirm that the Scottish economy sustained relatively strong growth in the first half of the year, posting growth of 0.4% in Q2 2024 following expansion of 0.7% in Q1. The figure for Q1 was revised up from the 0.5% previously estimated. Growth so far in 2024 has been largely driven by expansion of service sector activity, with consumer-facing services showing particularly strong growth in Q1. Encouragingly, the production sector has also supported GDP growth across both Q1 and Q2, reversing the declining trend seen across most of 2023, as inflationary pressures eased and domestic demand improved.

The more volatile GDP monthly data show that Scotland's economy continued to grow at the start of Q3, with strong month-on-month expansion in July following a disappointing June, when poor weather affected hospitality and leisure sectors and some retail sales activity. However, the latest estimate for August shows that the pick-up in July was not sustained as key service sectors and manufacturing recorded a fall in activity. In the three months to August, Scotland's GDP grew by 0.1% compared to the previous three-month period, slower than the 0.4% growth recorded in Q2. Over the same period, the UK economy expanded slightly faster at 0.2%.

Despite the slight easing, Scotland's growth in the first half of the year came as inflation fell back to around the Bank of England's (BoE) 2% target, and real pay continues to grow ahead of inflation, offering support to Scottish household incomes. The BoE has also started its rate cutting cycle, starting with a 0.25 ppt cut in August and another in November, leaving Base Rate at 4.75%. Overall, Scotland's economic performance in 2024 has been broadly on par with the UK average and general economic conditions remain supportive for further growth this year.

GDP growth, Scotland and UK, Q1 2023 – Q2 2024



Source: Scottish Government/ONS

Autumn Budget brings mixed news for Scotland

After the election success in July, the new Labour government presented its first, and much anticipated, Budget in October. The main headline was the rise in taxes to fund day-to-day spending, principally the announcement that employers' national insurance contributions (NICs) would rise from April 2025. The Budget also included a tweak to the fiscal rules to allow increased investment to be funded by more borrowing. Plans for 2025 to 2026 include increased investment in school rebuilding and maintenance of the school estate. Long-term investment plans will be set out in the ten-year investment strategy coming in the spring. The Autumn Budget increased UK Government spending by around £70 billion a year, with around half covered by additional tax revenues and the rest funded through more borrowing.

The Chancellor announced an additional £3.4 billion for the Scottish Government, claiming that it was the largest real-terms increase in funding since devolution and it will receive £47.7 billion from the UK Government through the Barnett formula for 2025/26. The Scottish Government took emergency measures in September to help balance the budget, and in doing so highlighted areas that are likely to be key in its forthcoming Budget in December. Priorities among its spending plans will include public sector pay following the UK Government's acceptance of the Pay Review Body recommendations, and the fact that Scotland has a larger public sector relative to the rest of the UK. Recruitment freezes are already in place across Scottish Government for all but essential roles with the government looking to extend this. Other key spending areas will include healthcare, with Scottish Government committed to prioritise funding for the NHS, pledging investment and reform in health services while seeking efficiency improvements in the delivery of other public services. The capital budget also faces significant pressures, largely as a result of inflation. Commitments to infrastructure projects are therefore likely to be reviewed as the government seeks to balance its budget. The Scottish Government will also set their plans for devolved taxes for the coming year, with recent IFS analysis suggesting that the increases in Scotland's top rate of income tax (compared to the rest of the UK) may have reduced revenues. The Scottish Government has said it will publish its tax strategy setting out its medium-term ambitions for the Scottish tax system.

Following the Autumn Budget there was widely reported concern from Scottish business groups that the increase in employer national insurance and lower thresholds for contributions would make it more expensive for businesses to take on staff, and that this would affect future pay and hiring decisions. It is likely firms will try to pass on some of the extra cost by raising their prices, indeed results from the Scottish Business Insights and Conditions Survey (BICS) showed that in September 2024, 41% of businesses planned to increase prices to adapt to future increases in employment costs. Higher employment costs could also impact profit margins and reduce business investment. The BICS survey shows 35% would absorb higher employment costs within profit margins and 8% of Scottish businesses said they would reduce spending on investment. However, firms will also likely cut employment costs by slower pay rises and lower headcount. The same survey showed 16% of businesses would reduce employee numbers, and 9.4% said they reduce wage increases and the approach to adapt to higher contributions is likely to vary across different sectors of the Scottish economy and typically lower paying sectors, such as accommodation and food, said they are more likely to reduce headcount and pay to adapt than the economy wide average.

Growth across most sectors in Q2 but weather adversely affected construction and hospitality

There was positive news for the production sector in the first half of 2024, with output increasing in both quarters. Although Scottish manufacturing has had a few challenging years, with GVA from the sector falling by 3.2% in Q4 2023 and 10% below 2019 average output, it has since returned to growth. In the first quarter of 2024, manufacturing output grew by 0.9% which was sustained into the second quarter, with the rate of growth increasing to 1.5%. The expansion is from a low base, but records show that the sector last recorded two successive quarters of growth in 2021 Q4 and 2022 Q1. The recent improvement in manufacturing output coincides with the easing of inflationary pressures that particularly impacted the sector, including higher energy prices, raw materials, and employment costs, and amid improved domestic demand. But exports data implies that weak international demand has also weighed on the sector and recent data show no improvements, as Scotland's international good exports in real terms were down 7.6% in the year ending Q2 2024, compared to the previous year.

The goods exports figures go some way to explaining some of the sub-sectoral manufacturing performance. Food and drink is Scotland's largest manufacturing sector, accounting for 27% of manufacturing output. Output from food and drink has been volatile and given the production of whisky is a major component of demand, the performance of the sub-sector is no doubt linked to whisky exports. Data for the year ending Q2 2024 show that the export of drink was down 14% on the previous year. At the end of Q2 2024, output from the food and drink sector was 5.3% lower than the same quarter in 2023. Elsewhere, the export of road vehicles rose by 14% over the year to Q2 2024, and output from the transport equipment sector was 30% higher at the end of Q2 2024 than recorded in the same quarter a year previous, having grown by almost 11% in Q2.

While the manufacturing sector has shown consistent quarter-on-quarter growth in 2024 so far, the construction industry recorded declines across the last three successive quarters. Similar to manufacturing, the sector has faced significant cost pressures alongside high interest rates which have affected demand, but these pressures should be easing, but housing starts were down 14% in 2024 Q2, a more significant fall than seen elsewhere in the UK. This is likely cost-related but also linked to planning delays and a cut in funding for affordable homes. Anecdotal evidence also points to poor weather for some of the slowdown in construction activity in Q2. Higher frequency data provide a different perspective on construction activity, suggesting that activity picked up in May to a level that has been broadly sustained in consecutive months, indeed the sector grew by 1% in the three months to August.

Meanwhile, after a strong start to 2024, largely consumer-facing sectors were unable to maintain the growth recorded in Q1. Indeed, growth of 1.2% in wholesale and retail output in Q1 unwound in Q2, with output falling by the same amount. Accommodation and food and drink also suffered a decline in Q2, but its gains from Q1 mean that output remains higher than last year, and monthly data suggest activity bounced back in July. The same cannot be said for wholesale and retail, which remains well below its pre-COVID-19 level, and its pick-up in activity in July was not sustained and dipped again in August. Figures from the Scottish Retail Consortium, support the view that retail sales remain weak, estimating that year-on-year Scottish retail sales increased by just 0.1% in real terms in October 2024.

Indicative of strengthening economic conditions and a return to more normal travel patterns following COVID-19, the performance of the transport and storage sector has been strong so far in 2024. The sector posted growth of over 2% in both Q1 and Q2, and output in Q2 2024 is finally in line with the 2019 average following the COVID-19-related slump in activity. Elsewhere, the quarterly GDP data show that information and communication rallied, as did professional, scientific and technical services, with both growing by 2% or more so far in 2024. Although the monthly GDP data report output in both sectors dipping in August, this is likely a blip rather than the onset of sustained decline. It is also encouraging that finance and insurance activity has recovered some of the output lost over the last two years. The sector accounts for almost 8% of Scottish GDP, and output grew by an estimated 2.5% in Q1 and 0.3% in Q2, leaving the sector close to its pre-COVID-19 average.

Scotland's public sectors contribute over 25% of Scottish GDP compared to around 19% in the UK. Public sector activity in Scotland continued to expand in the first half of 2024, largely due to growth in health and social work, which grew by 0.6% in 2024 Q1 and 0.3% in Q2, as output from public administration and defence has fallen and activity in the education sector has levelled off.

Data for the year ending Q2 2024 show that the export of drink was down 14% on the previous year.

The labour market has cooled as employment demand softened and pay growth eased

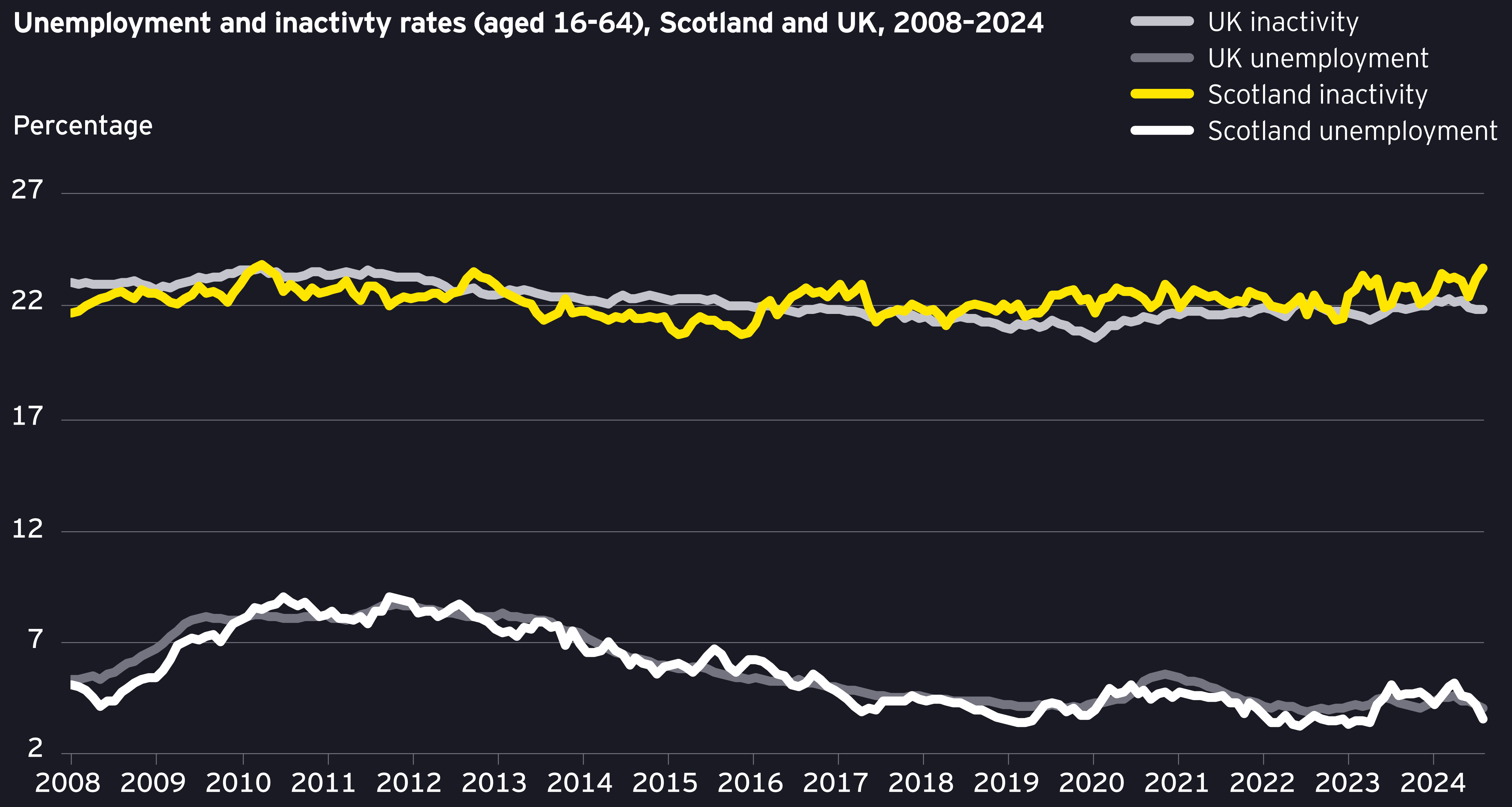
The latest ONS unemployment estimates suggest that the rate of joblessness in Scotland has fallen over the past quarter, with the unemployment rate at 3.5% in the July–September 2024 period, down from 4.5% in April to June 2024. The unemployment rate is now below the UK-wide figure. However, overall the labour market has continued to loosen – PAYE payroll employment has been flat this year with only small movements over the period. PAYE employment was 2.46 million in October, the same level as recorded in January at the start of the year. Meanwhile, median wages in Scotland are estimated to have grown by 6.2% in the year to October 2024, compared to 6.0% in the year to July 2024. The latest PAYE earnings data suggest that median annual pay growth in Scotland has dipped below the UK average in August, September and October of this year, in contrast to the pattern seen earlier this year.

Other labour market data supports the view that labour market conditions continue to cool. While the job advert index for Scotland remains higher in October 2024 than in most other UK regions and nations, apart from the North East and Northern Ireland, comparisons show that there has been a 30% decline in online adverts compared to October 2023, the largest difference of UK regions. The job advert index is also 5% down on the pre-COVID-19 average. However, despite weakening recruitment demand, it remains the case that a large proportion of Scottish employers are short of workers. In early October 2024, 25% of businesses with 10 or more employees reported a shortage of workers; a similar proportion to that reported in June 2024.

Any weakness in the demand for workers continues to be offset by the reduced availability of workers. Since COVID-19, the proportion of people who are working or looking for a job in Scotland has fallen. Ongoing issues with the ONS Labour Force Survey mean that less confidence can be placed on its measures of economic activity and inactivity, however, it remains the best source of such information. It suggests that the rate of economic inactivity in Scotland remains stubbornly high at 23.7%, 0.6% up on the previous quarter, and above the UK average of 21.8%. It is also almost 1% higher than for the same period a year previous. Again, caution needs to be applied to the interpretation of the available statistics, but data for the year to June 2024 suggest that 32% of the economically inactive population in Scotland are long-term sick, compared to the UK average of 28%.

Reducing levels of economic inactivity is key to supporting long-term growth in the UK and Scotland. Indeed, the government has launched a new Labour Market Advisory Board to reduce economic activity and help meet the government's ambition to increase the UK employment rate to 80%. As an example of the potential impact of increasing economic activity on the Scottish economy, the Office of the Chief Economic Adviser (part of the Scottish Government) estimated that a permanent 0.25 percentage point (ppt) increase in the economic activity rate relative to the baseline could boost GDP in the long term by around 0.1% – equivalent to additional GDP of £180 million a year (2024 to 2025 prices). The Scottish employment rate currently sits around 74%, below the UK rate of 75%, highlighting both the potential benefits but also the sheer scale of the ambition.

Unemployment and inactivty rates (aged 16-64), Scotland and UK, 2008-2024



Source: ONS

Consumer confidence is fragile, but businesses remain positive against signs of weakening activity

In Q3 2024, the Composite Consumer Sentiment Indicator was -0.2, having decreased by 2.6 points compared to the previous quarter. Four of the five components of the indicator fell over the quarter, including current and expected household finances, attitudes to spending, and expected economic performance. But consumers were more positive about current economic performance, which increased. Concerningly, however, consumers' expectations for the coming year are weighing the most on sentiment, and they now expect their household finances to deteriorate in the year ahead. Consumers' outlook on the economy remains positive but to a lesser extent than in the previous quarter.

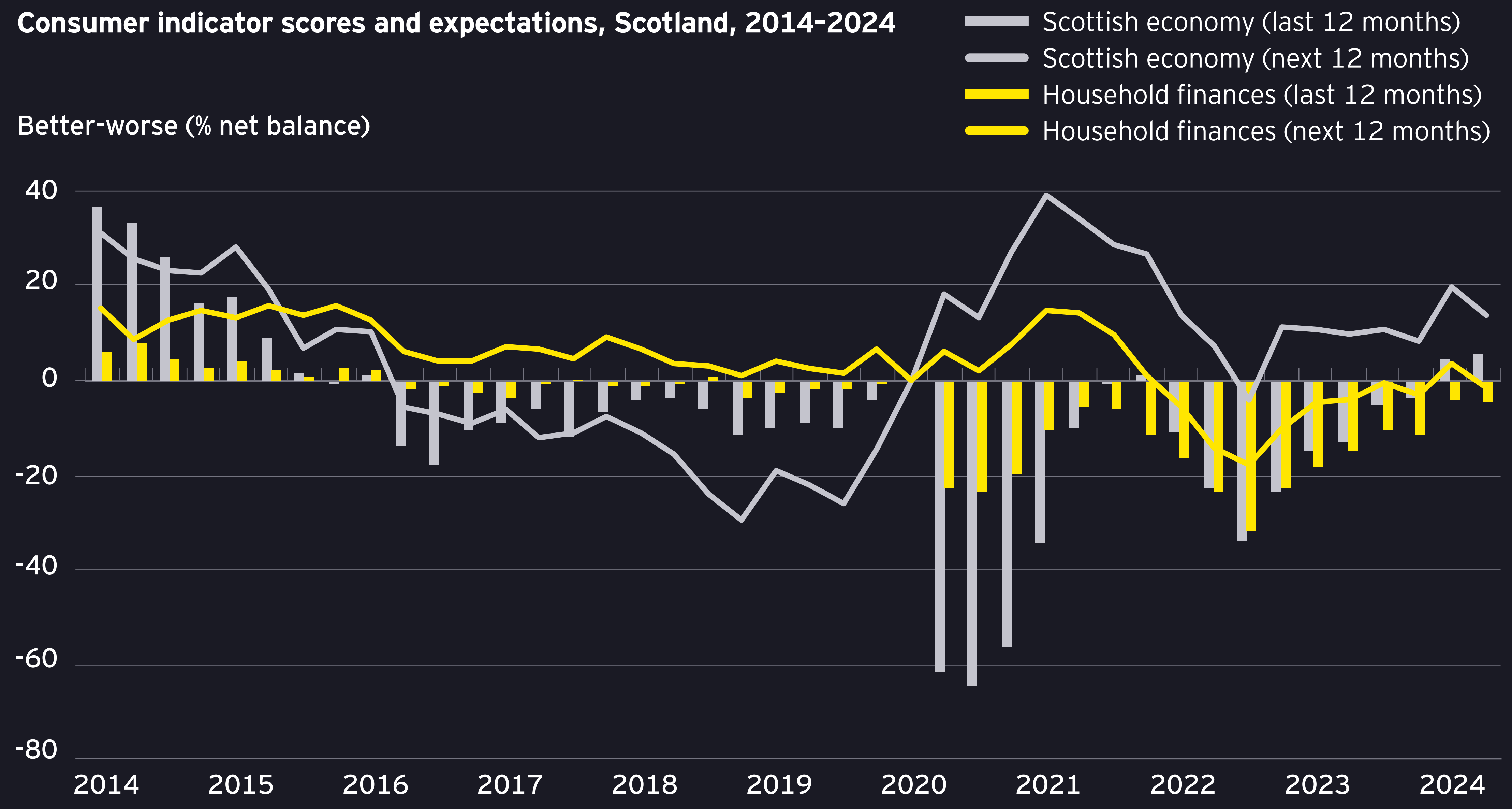
Business confidence has also eased, but it remains in positive territory. The latest PMI Scotland Business Activity Index for October at 51.3 shows that Scotland recorded growth in activity for the tenth consecutive month1. However, the three-month average for August to October at 51.7 is down 1.5 points from 53.3 in the previous three-month period, while the UK average remained flat at 52.7 over the same period.

Other evidence that business confidence may have eased comes from Scottish BICS for October, which found that 32.1% of businesses thought their business performance would increase over the next 12 months, down from 34.4% in June. Similarly, 6.8% of businesses expected performance to decrease, up from 6.1% previously. The Scottish BICS also reported that the largest concern for businesses is falling demand of goods and services, reported by 16.9% of businesses and up from 16.3% in June. Energy prices remain the main concern for 11.9% of Scottish businesses.

Investment is another indicator of business confidence. According to Scottish Government figures, the pace of investment growth moderated in 2023 following strong growth in 2022 and fell by 1.2% in Q2 2024. Meanwhile, the Scottish BICS for October reported that 15.6% of businesses plan to increase capital expenditure in the year ahead, compared to 16.3% in June. However, the proportion of businesses that plan to increase capital expenditure remains higher than the proportion that expect expenditure to decrease (10.2%).

1. A reading above 50 indicates growth, and the further above the 50 level the faster the rate of expansion indicated.

Consumer indicator scores and expectations, Scotland, 2014–2024



Source: ONS

Economic outlook

Scottish growth is set to slow to trend after the strong start to the year and will likely lag behind the UK

The signs that the pace of growth in Scotland is slowing more rapidly than the UK in the second half of 2024 means we expect Scottish GVA to grow by 0.7% this year, compared to UK growth of 0.9%. We continue to expect that low inflation and the continued recovery of household budgets and rising consumer spending will support growth through the rest of 2024, and that growth will be much stronger than recorded in 2023.

We expect that inflation will remain around 2% over the next few years and that the BoE will continue with its cautious approach to adjusting Bank Rate, which we think will fall to around 3.5% by the end of next year. However, falling interest rates will only have a modest impact on growth over the next couple of years as rates fall slowly, and many Scottish mortgage holders will fix to higher mortgage rates in 2025 and 2026, capping some of the effect of lower Bank rates. We expect that UK Government spending plans will limit growth prospects, but potential greater investment following the change in the fiscal rules in the Autumn Budget could boost growth above the central forecast view presented here.

Overall, we forecast that Scottish GVA growth will improve to 1.3% in 2025 and 1.4% in both 2026 and 2027 on the back of solid real income growth, improved sentiment, and looser financial conditions. However, we have revised down our forecasts from 2025 onwards following a large downwards revision to the saving ratio in 2024, meaning consumers are less able to reduce their savings than previously expected. Consumer expenditure forecasts are weaker as a result. The GVA forecast for the UK has also been revised down for the same reason but remains a little stronger than Scotland at 1.5% in 2025, 1.7% in 2026, and 1.6% in 2027.

However, the global economic backdrop could weigh on UK growth and broader geopolitical risks continue to pose a risk to the outlook. Continuing conflicts in the Ukraine and the Middle East could place upward pressure on energy, oil, food and transportation costs. In addition, the results of the US election could also result in material policy changes which impact global and therefore UK growth prospects.

Key economic indicator outlook, Scotland, 2020–2027, % year-on-year (unless otherwise stated)

	GVA	Personal disposable income	Consumers' expenditure	Population 000s	Employment 000s	Unemployment rate %	Migration aged 16–64 (000s)
2020	-12.0	-0.2	-12.6	5,413	2,760	4.5	12.2
2021	9.2	0.6	7.4	5,418	2,785	4.2	15.6
2022	5.6	-2.7	6.2	5,447	2,807	3.3	41.4
2023	0.2	1.4	-0.2	5,490	2,821	4.0	52.1
2024	0.7	3.7	0.7	5,536	2,860	4.2	43.9
2025	1.3	1.6	1.8	5,577	2,886	4.2	37.7
2026	1.4	0.5	1.6	5,608	2,899	4.2	35.4
2027	1.4	0.7	1.4	5,626	2,908	4.2	30.0

Source: EY ITEM Club. Note: GVA is chain linked 2019 prices. Personal disposable income and consumer expenditure are also 2019 prices. Unemployment rate is the ILO unemployment rate using Labour Force Survey data

Growth should be more balanced across sectors in 2025

Although we have downgraded our forecast for consumer spending, it remains a key driver of Scottish growth, and as household budgets continue to recover into 2025, we continue to expect largely consumer-facing sectors to benefit from an uplift in demand next year. This expectation should return retail and wholesale to meaningful growth in 2025, expanding by 1.6% compared to an expected outturn of just 0.1% this year. Similarly, accommodation and food should see activity pick up next year, and we expect it to be the second-fastest growing sector in 2025 (2.4%). However, while accommodation and food has already recovered COVID-19-related losses, the embattled retail and wholesale sector is not expected to return to 2019 levels until 2028, as retail volumes remain below 2019 levels and consumer spending on non-essentials will remain sensitive to prices into 2025.

The transport and storage sector is set to continue to expand through 2024, and the sector has the strongest forecast GVA growth for this year in our forecast at 4.5%. Alongside general economic growth, a key driver is air travel. Passenger numbers at Scotland's three main airports (Aberdeen, Edinburgh, and Glasgow) were up almost 10% in August 2024 compared to August 2023, handling 2.63 million passengers. The outlook remains strong, with rising incomes supporting tourism alongside growth in demand from other sectors. Still, growth will cool compared to the catch-up rates seen in recent periods and we forecast GVA growth of 2.1% in 2025, with growth expected to continue above the economy-wide average over the forecast horizon.

Despite recent improvements in growth in the financial and insurance sector in Scotland, we continue to expect output will decline on average in 2024 compared to 2023 but should expand in 2025, with the outlook strengthening in 2026 and beyond. However, the sector is expected to underperform compared to the wider UK and lag the Scotland economy-wide average. While Scotland continues to have a strong presence in financial services, particularly in Edinburgh, the share of UK activity has fallen since 2019 and this pattern has been seen elsewhere in other parts of the UK that, like Scotland are more dependent on retail finances and we expect competition with other regional financial centres both in the UK and internationally to increase in coming years. There could be upside risk to the outlook, and Scottish Financial Enterprise has set a target of the sector achieving GVA of £17 billion to £21 billion within 5 years, up from £14.3 billion in 2021.

We expect longer-term trends to continue to shape growth of the Scottish economy. Principally, we expect the success of key business services sectors to drive growth. Analysis of output at the end of 2023 compared to 2019 is striking. While total Scottish GDP was 2.5% larger in Q3 2023 than it was in 2019, output from professional, scientific and technical services was 18% larger, and information and communication was 26% larger. Administrative and support services was over 6% larger. These three sectors account for around 15% of Scotland's output, a share which is clearly growing over time. We expect these three sectors to continue to drive growth in Scotland's output, with each growing above the economy-wide average over the forecast period.

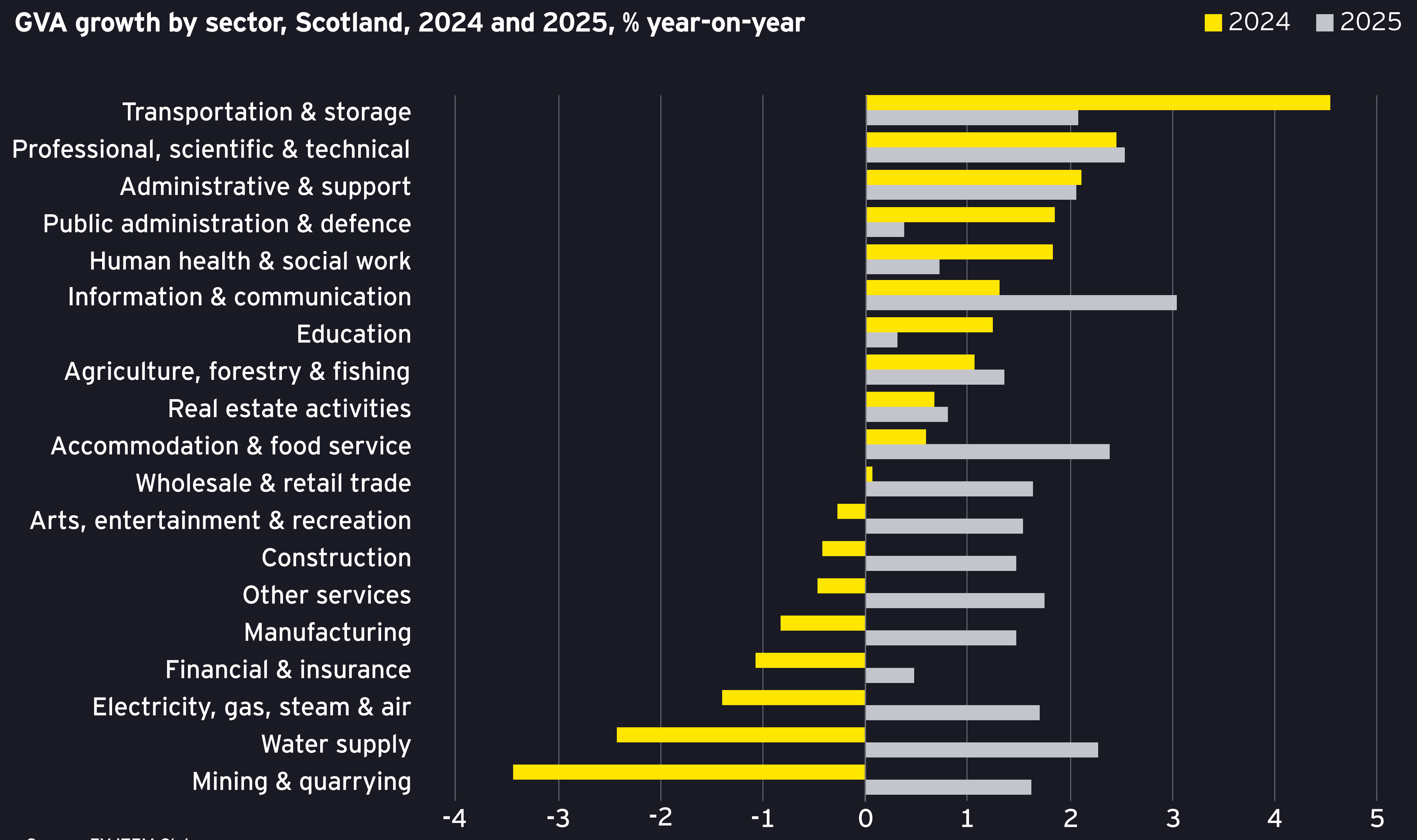
Despite the uptick in activity seen through the first half of 2024, we forecast that manufacturing output will decline on average in the year compared to 2023. Monthly data for August showed a 0.9% fall in sectoral output compared to the previous month, and goods exports appear to be weak. We anticipate that manufacturing output will return to growth in 2025, as domestic demand continues to recover alongside more buoyant international demand. Transport equipment is set to sustain growth over the forecast horizon, and prospects for refined petroleum, chemicals, and pharmaceutical products, and metals and machinery are above average, returning GVA growth of 1.9% and 1.6%, respectively, in 2025. The outlook for food and drink remains heavily dependent on the export of whisky, which as discussed earlier is still relatively weak. Whisky producers were also left disappointed by the increase in alcohol duty, which will see duty on alcohol, including whisky, rise in line with the level of the Retail

Price Index in February 2025. We forecast that the food and drink sector will grow by 1.3% in 2025 and 2026. Overall, we expect manufacturing output to expand by 1.5% in 2025 and 2026, before easing back to 1.1% in 2027, thereby dipping below the economy-wide average from 2027 onwards.

The outlook for construction is more positive, and we anticipate that lower borrowing rates, stable materials prices and increased demand should support a return to sustained growth. The Labour Party's stance on housebuilding and commitment in the budget for investment in infrastructure (although devolved in Scotland), and the UK and Scottish Governments' net zero ambitions, should all support the construction industry in coming years. We expect construction output to expand by 1.5% in 2025, rising to 2.0% in 2026.

The additional spending committed to the Scottish Government in the Autumn Budget includes about £1 billion a year for the NHS over the next two years. While our forecast was produced before the Budget was announced, we expect the health and social work sector to continue to grow over the forecast period and be a large contributor to Scotland's overall growth. We estimate the sector will grow by a relatively low 0.7% in 2025. However, the scale of the sector means that this growth is equivalent to 6% of Scotland's total GVA growth forecast for next year and as growth picks up in following years, the share attributed to health and social care is anticipated to rise over 14% of GVA growth in 2027. The larger budget committed to Scotland from Westminster could mean that more funds are directed towards public services in Scotland. In our forecast we anticipate that growth in public administration and defence will continue, but at a much weaker rate in coming years with growth of 0.4% in 2025 and 0.2% in 2026. Our view on education is slightly stronger at 0.3% and 0.5%, respectively, over the next two years, but this too is weaker than trend and considerably lower than the economy-wide average. This outlook could change when the Scottish Government sets out its spending plans in December, and spending on schools and healthcare is devolved. However, despite an increase in funds the reality is that public finances will remain tight and limit the scope of future public sector growth.

GVA growth by sector, Scotland, 2024 and 2025, % year-on-year



Source: EY ITEM Club

Stronger productivity gains limit future jobs growth but unemployment should remain low

As the shifting policy mix between monetary and fiscal policy offset each other to keep GVA growth near its trend rate, we expect employment growth to be steady over the forecast period. We think the unemployment rate will stabilise in Scotland around current rates, 4.2%, just 0.1 ppt above the UK rate over the same period.

Despite the relatively stable path for growth over the coming years, there will be a switch in its composition. Productivity growth is expected to recover a little further, settling around 0.9%, while employment growth is set to slow to just 0.5% per year between 2025 and 2029. Both these elements are slightly weaker than the UK forecast, with sectoral and demographic factors at play.

Both public and private investment is key to boosting UK and Scottish productivity. The increase in capital investment in the latest UK Budget relative to the previous administration is therefore a positive outcome, although as outlined previously the increased capital investment in 2025/26 is largely committed to improve the schools estate and unlikely to significantly boost UK productivity. Long-term investment, particularly in new technologies and promoting innovation is more likely to boost productivity and the government will set out their future plans in spring. In the face of a funding shortfall, the Scottish Government will have their own decisions to make on which capital projects to continue to back in their December Budget. Meanwhile, the UK Government is currently consulting on its industrial strategy, with a primary ambition of driving growth by focusing on eight 'growth-driving sectors' and fostering a pro-growth environment. Among the policy areas identified, people and skills is a key one, and is an area that Scotland tends to outperform the UK, at least in terms of the qualification levels of the population. High levels of economic inactivity have been identified as a drag on growth, and inactivity rates are higher in Scotland than the wider UK. Policies that result in immediate improvements in the health outcomes of the working age population could provide a more immediate boost to long-run growth in both Scotland and the UK.

Statistics released in October by National Records of Scotland (NRS) showed that Scotland's population was 5.49 million in mid-2023; this highest on record and 43,100 higher than a year earlier. With more deaths than births in the period, migration was the driver of growth, with two-thirds of people moving to Scotland originating from outside of the UK. However, population growth in Scotland, at 0.8%, is somewhat lower than the 1% growth recorded in England and Wales over the same period. The data also showed that population growth centred on Scotland's main cities with mild population decline estimated in some rural districts. We expect these trends to continue, with population growth in Scotland lagging the UK by around 0.2 ppts over the forecast period and much weaker demographic growth away from Scotland's major urban areas.

Alongside policy to tackle inactivity, the UK Government has pledged to "make work pay" and this includes the introduction of the Employment Rights Bill 2024–25. The new Bill includes a range of measures, including a statutory probation period for new employees and a ban on zero-hours contracts. The September 2024 wave of the ONS Business Conditions and Insights Survey found that around 72% of Scottish businesses employing 10 or more staff had a probation policy in place, but this varied greatly by sector. The same survey asked about the use of variable hours contracts and found that 30% of Scottish businesses used them, but the proportion in the arts, entertainment and recreation and accommodation and food services was double, with 60% of businesses in these sectors reporting their use. The proportion in health and social work, at 37%, was also considerably high. The survey suggests that sectors more dependent on temporary staff (like hospitality, entertainment, and possibly social care) are more likely to be affected by the Bill, which could exacerbate existing recruitment difficulties.

Sectoral employment growth is concentrated in health and key private services

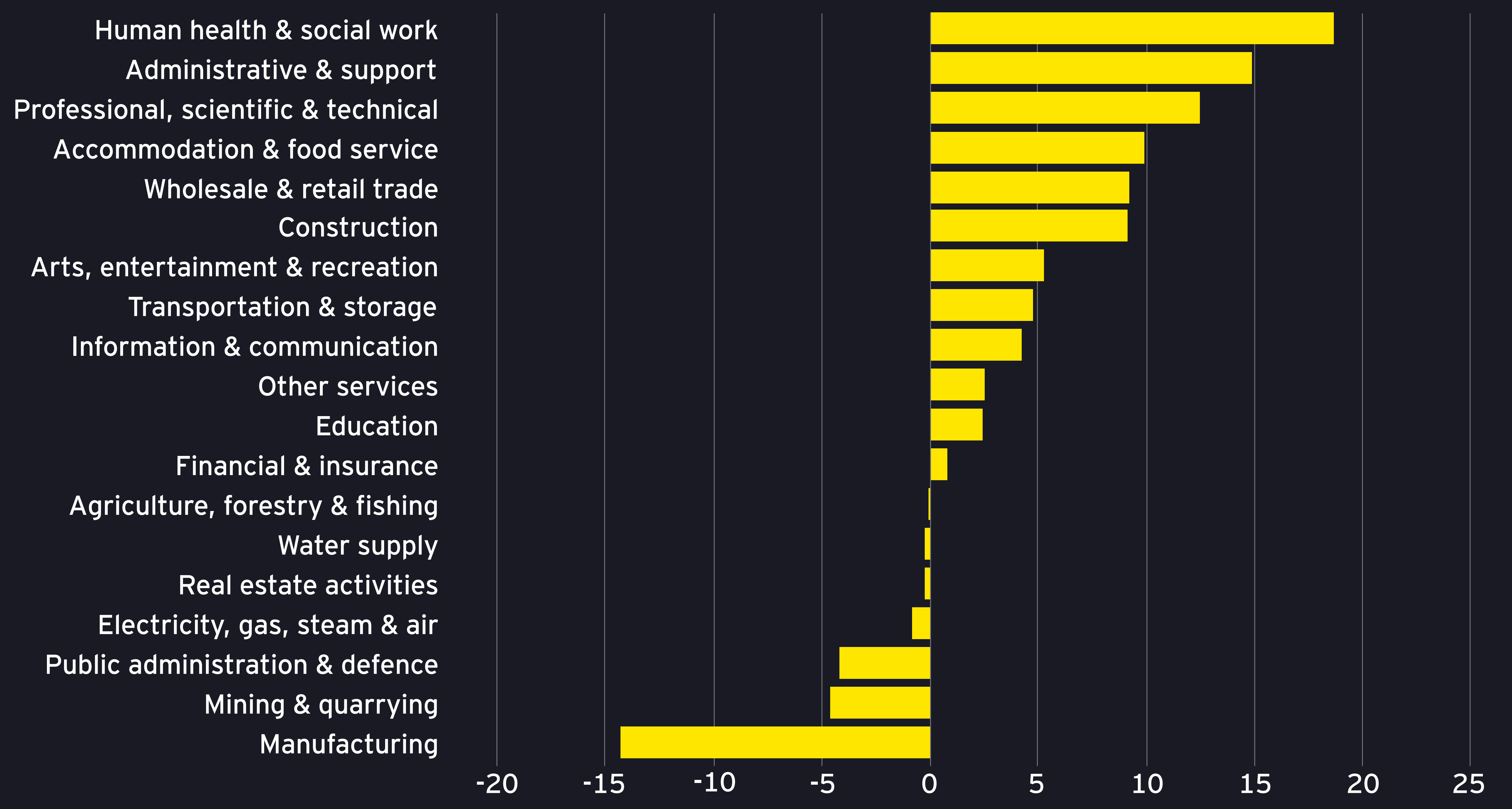
At the sector level, employment prospects largely reflect the pattern of expected output growth. We continue to expect short-term gains in mainly consumer-facing sectors, particularly over the rest of this year and into 2025. Retail and wholesale employment is forecast to grow by 1.3% in 2025, following growth of 1.0% in 2024. Similarly, employment in accommodation and food is expected to expand by 1.4% in 2025, following muted growth this year. However, employment growth in both sectors is expected to ease considerably from 2026 onwards. As demand for construction continues to grow, job creation in the sector is set to rebound next year, and the sector should add around 10,000 jobs between 2025 and 2029.

However, we continue to forecast a decline in manufacturing jobs as long-run trends in mechanisation improve productivity and reduce the demand for labour. We expect that the sector will shed a further 14,000 jobs between 2025 and 2029, or around 8% of the current workforce. Employment in mining in Scotland (which includes the extraction of oil and gas) is also expected to decline each year over the forecast horizon. We believe the continued decline of oil and gas employment is likely, given the Scottish Government's commitment to net zero and despite the recent discovery of 131 cubic feet of natural gas in the Selene prospect in the North Sea. Although believed to be commercially viable, discoveries like these are unlikely to shift the long-term decline of the sector.

Another sector expected to shed jobs over the forecast period is public administration and defence. This assumes that public finances will limit expansion of public services, which will likely lead to reduced employment over the long-term. However, with key aspects of fiscal spending devolved to the Scottish Government, the way it chooses to manage its finances over coming years could alter this outlook. Meanwhile, the strongest rate of employment growth is forecast for a part of the public sector, with human health and social work expected to create almost 20,000 jobs between 2025 and 2029. Employment growth is anticipated to meet the growing demand for health services, and funding remains in place for increased spending on the NHS.

The growth in private services activity will be the other main source of additional employment growth in Scotland, with administrative and support leading the way, followed closely by professional, scientific and technical services. These two sectors are expected to create 40% of Scotland's additional jobs between 2025 and 2029. Information and communication and transport and storage have seen rapid output growth in recent periods, and while we expect these sectors to exhibit strong output growth in coming years, we see greater opportunities for productivity gains. Both sectors should see their workforces expand by around 4%, adding over 4,000 jobs each. However, over the same period, output is forecast to grow by 9% in transport and storage and 14% in information and communication.

Forecast employment growth by sector: 2025–2029 (000s)



Source: EY ITEM Club

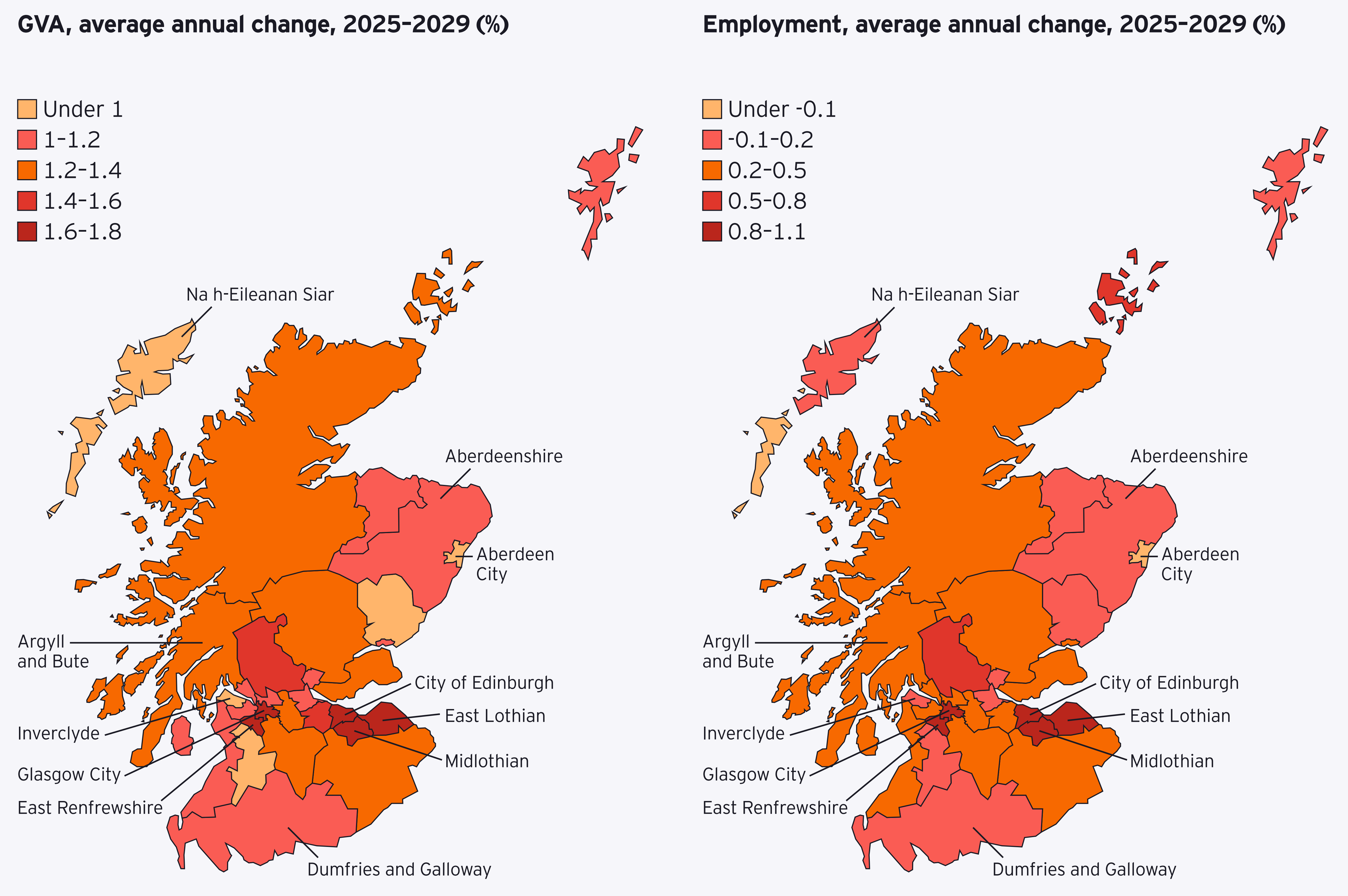
Future economic growth centred in and around Scotland's major urban centres

Growth prospects vary greatly across Scottish local authority areas, partly due to sectoral differences but also factors such as infrastructure, inward investment, demographics, and labour force skills. While we have upgraded our productivity assumption in the latest forecasts, population growth remains a key concern for Scotland's longer-term growth, particularly growth of the working-age population to maintain Scottish labour supply and support jobs growth. We forecast Scotland's working-age population will grow slowly, expanding by just 0.1% per year between 2025 and 2029. However, we also forecast that the working-age population will decline over that period in 21 of Scotland's 32 local authority areas, with decreases most pronounced in some of Scotland's rural and island areas, including Eilean Siar (-0.9% per year), Dumfries and Galloway (-0.7%), and Argyll and Bute (-0.7%). However, this is not just a simple mainland vs. islands or rural vs. urban story. Inverclyde, which forms part of Glasgow City Region, is expected to experience one of the highest rates of working population decline of 0.75% a year between 2025 and 2029. North Lanarkshire and South Lanarkshire, similarly, form part of the Glasgow City Region and are also forecast falling working-age population.

Urban areas that are more attractive to inward investment and more able to attract workers tend to have better prospects for future economic growth. Edinburgh stands out in this regard. According to the EY Attractiveness Survey, Edinburgh attracted the second highest number of Foreign Direct Investment (FDI) projects in the UK outside of London in 2023. Edinburgh also has a particularly high concentration of key private services activity such as financial and insurance services and information and communication, with tourism and hospitality also an important part of its economy. In the 2020–2023 period, Edinburgh had 350 high growth businesses, equivalent to 1.8% of all businesses, and greater than the Scotland-wide average of 1.1%. GVA in Edinburgh is expected to grow by 1.7% a year between 2024 and 2029, and will support the fastest rate of employment growth in Scotland at 1.1% per year over the same period. Neighbouring East Lothian and Midlothian districts that form part of the Edinburgh and South East Scotland City Region are also expected to grow rapidly. East Lothian's prospects are particularly strong, with average GVA growth of 1.8% per year between 2025 and 2029.

Glasgow is also expected to perform better than the Scotland average. Like Edinburgh, the city is attractive to foreign investment and sits fourth in the EY UK FDI project rankings for 2023, and it too has a high proportion of high growth businesses at 1.8%. Although it is less represented in some of the typically higher-value business services sectors, such as professional services and information and communication, compared with Edinburgh. Glasgow has a particularly large administrative and support services sector, a sector which includes activities such as recruitment and facilities management. The sector accounts for 12% of total employment, second only to human health and social work. Growth in these two sectors will contribute to the average jobs growth of 0.8% a year between 2025 to 2029, higher than Scotland's 0.5% growth rate over the period. Prospects across the Glasgow City Region are more mixed, with Glasgow and East Renfrewshire among the best performing districts in Scotland, while Inverclyde and South Lanarkshire are among the weaker performing districts.

Aberdeen City and neighbouring Aberdeenshire are forecast to continue to struggle. Aberdeen is one of the few local authority districts in Scotland to have fewer jobs in 2023 than in 2010. During this time, it has lost nearly 18,000 jobs, equivalent to 10% of its workforce in 2010, largely due to the ongoing decline in the locally important oil and gas industry. During the same period, employment in Aberdeenshire expanded by 7%, only slightly below the Scottish average of 8%. However, Aberdeenshire has a large manufacturing sector that is anticipated to decline in the future and against a backdrop of relatively weak average GVA growth of just 1.0%, employment is not expected to grow in the district over the 2025 to 2029 period.



Meanwhile, Aberdeen's prospects remain heavily tied to the oil and gas sector, and we forecast average GVA growth of just 0.8% a year over the next five years. However, prospects could improve if investment into Aberdeen is significant and effectively targeted. In support of this view, the city has been chosen to host the headquarters of Great British Energy, the UK Government's new company to invest in clean, UK-derived energy and backed by £8.3 billion in government funding over this Parliament. The move forms part of the government's plans to support clean energy in the North Sea and promote Aberdeen as Scotland's clean energy capital. As well as the Great British Energy, Aberdeen featured in the top 10 UK cities for FDI in 2023, attracting 13 FDI projects according to the EY Attractiveness survey. Indeed, ONS data show that almost 41,000 jobs in 2023 in Aberdeen were in firms with foreign ownership, equivalent to almost a third of total employment in the city. Aberdeen also had a slightly higher share of high growth businesses than the Scottish average. And with favourable demographic characteristics, the risks for Aberdeen's outlook are weighted towards the upside.

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