ECONOMY, ENERGY AND TOURISM COMMITTEE

AGENDA

35th Meeting, 2010 (Session 3)

Wednesday 15 December 2010

The Committee will meet at 9.30 am in Committee Room 2.

1. **Low Carbon Scotland - the draft report on proposals and policies (in private):** The Committee will consider a draft report to the Transport, Infrastructure and Climate Change Committee on the Scottish Government’s Draft Report on Proposals and Policies.

2. **Draft Budget Scrutiny 2011-12 (in private):** The Committee will consider a draft report to the Finance Committee on the Scottish Government’s Draft Budget 2011-12.

   *Not before 11.00 am*

3. **Council of Economic Advisers’ annual report:** The Committee will take evidence from—

   Sir George Mathewson, Chair, and Professor Hughes Hallett, Member of the Council of Economic Advisers.

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Clerk to the Economy, Energy and Tourism Committee  
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The papers for this meeting are as follows—

**Agenda Item 1**

PRIVATE PAPER  
EET/S3/10/35/1 (P)

**Agenda Item 2**

(to follow)  
EET/S3/10/35/2

**Agenda Item 3**

Council of Economic Advisers, 3rd Annual Report  
EET/S3/10/35/3

State of the Economy Report  
EET/S3/10/35/4
Scottish Council of Economic Advisers

THIRD ANNUAL REPORT

December 2010
## Contents

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chairman's Preface</td>
<td>1</td>
</tr>
<tr>
<td>Executive Summary</td>
<td>2</td>
</tr>
<tr>
<td>Chapter 1 Scotland’s Economic Progress</td>
<td>5</td>
</tr>
<tr>
<td>Chapter 2 Progress Against Purpose Targets</td>
<td>11</td>
</tr>
<tr>
<td>Chapter 3 Key Sectors</td>
<td></td>
</tr>
<tr>
<td>A. Overview</td>
<td>24</td>
</tr>
<tr>
<td>B. Financial and Business Services: Banking</td>
<td>26</td>
</tr>
<tr>
<td>C. Life Sciences</td>
<td>29</td>
</tr>
<tr>
<td>Chapter 4 Fiscal Responsibility</td>
<td>35</td>
</tr>
<tr>
<td>Chapter 5 Employment, Education and Skills</td>
<td>44</td>
</tr>
<tr>
<td>Chapter 6 Planning</td>
<td>51</td>
</tr>
<tr>
<td>Chapter 7 Chairman’s Retrospective</td>
<td>55</td>
</tr>
<tr>
<td>Chapter 8 First Minister’s Retrospective</td>
<td>57</td>
</tr>
<tr>
<td>Appendix Membership, Remit and Administration</td>
<td>59</td>
</tr>
</tbody>
</table>
Chairman’s Preface

The Council has been in existence over three of the most challenging years of recent times for the Scottish Government and for governments throughout the world. During this period we have met the First Minister and Cabinet Secretary for Finance and Sustainable Growth regularly, initially to provide our advice on implementing the Government Economic Strategy to achieve the government’s Purpose of increasing sustainable economic growth. However, as events have unfolded we have provided more immediate advice to the government on the financial crisis and its aftermath and on steering the Scottish economy out of recession. It has been three very interesting years.

During the meetings held this year, we have discussed and provided advice on such diverse topics as: pursuing greater fiscal powers; building connections between businesses and universities; life sciences; graduate employment; planning; banking; and the Independent Budget Review which was chaired by one of our members, Crawford Beveridge.

This, our Third Annual Report and the last in the current Parliamentary session, draws together these discussions, as well as those of 2008 and 2009, to reflect on the performance of the Scottish economy over the last three years.

The Report illustrates the themes that have driven our meetings, therefore we have devoted chapters to present our thoughts on progress made towards the Purpose targets and the challenges that face the key sectors that we discussed. We have continued to build on our advice related to seeking greater fiscal powers and have assessed the response to our recommendations on improving the planning system. We have also pulled together our discussions on skills, education and economic inactivity to present our key recommendations in these interlinked areas.

The final two chapters of the Report set out both my and the First Minister’s thoughts on the Council during this Parliamentary session. I have thoroughly enjoyed leading the Council over the past three years and reiterate my thanks to each and every member for their contribution.

Sir George Mathewson
Chairman
Executive Summary

Scotland's Economic Progress

1. The first chapter looks at the performance of Scotland over the three years that the Council has provided advice to the Scottish Government. The impact of the global financial crisis on Scotland is described, as is the resulting recession and subsequent deterioration in the fiscal outlook for many governments across the world. The future outlook for the Scottish economy is considered in terms of the possibility of fiscal responsibility and the strengths that have been shown by the key sectors.

Progress Against the Purpose Targets

2. This chapter provides an outline of progress made with each Purpose target over the past three years and provides a view on the outlook for each target.

3. The Council was created to advise the Scottish Government on developing and implementing its Government Economic Strategy. Over the past three years, the Council has provided advice on many of the Purpose targets and key sectors outlined in the Strategy. Progress towards achieving the Purpose has been slowed by global economic conditions, but the Council recognises that the Strategy is long-term and it will take time for policies to have an impact on the targets.

Key Sectors

4. As part of advising the Scottish Government on the implementation of its Strategy, the Council has provided advice on several of the key sectors over the past three years.

5. This chapter provides an overview of the key sectors discussed and their common themes. It provides more detail and recommendations on two of the key sectors discussed this year: life sciences and the banking aspect of the financial and business services sector.

6. The Council provides three recommendations on financial and business services, and four recommendations on the life sciences sector.

7. The Council recommends that the Scottish Government:

Recommendation 1: asks the Office of Fair Trading to review competition in the Scottish banking market.

Recommendation 2: seeks, through the outcome of such an investigation and other ways, to secure strong head office presences in Scotland in the banking industry.

Recommendation 3: seeks, by influencing the policies of the Westminster Government and to the extent possible, using the pressures and powers available to the Scottish Government, to secure an increase in trading with, and in competition for, the supply of banking services to SMEs in Scotland.

Recommendation 4: encourages a shift to life sciences sub-sectors with potentially higher productivity – possibly the agriculture, environment and veterinary, diagnostics, or industrial biotech (bio-manufacturing) subsectors, and re-evaluates priorities for diagnostic, testing and precision activities; and especially stratified or personalised medicine and the associated bio-informatics databases.


2 Third Annual Report of the Scottish Council of Economic Advisers
Recommendation 5: improves the financing of the trials, testing and development phase of innovations.

Recommendation 6: finds ways to encourage interactions between key sectors, e.g. life sciences and digital or IT, and matching of intellectual property.

Recommendation 7: considers changes in public procurement to favour new technologies and offer the possibility of an early order rather than a grant or subsidy.

Fiscal Responsibility

8. In past Reports the Council has considered how granting borrowing powers to the Scottish Government could help finance public infrastructure investment and recommended ways in which the Scottish Government could make best use of its current limited powers.

9. This chapter sets out what implementation of the Calman Commission proposals would mean for Scotland and then sets out a full fiscal responsibility framework along with mechanisms to ensure fiscal discipline.

10. The Council provides three recommendations for the Scottish Government to consider in relation to fiscal autonomy. The Council recommends that the Scottish Government:

Recommendation 8: seeks to obtain the tax powers outlined above, in order to be in a position to influence the rate of economic growth and employment.

Recommendation 9: engages the UK Government in negotiations to make the necessary institutional changes for this to be possible.

Recommendation 10: gives priority to obtaining the power to borrow; then to obtaining power over taxes that affect the rate of return on labour (national insurance, business taxes, research and development credits).

Employment, Skills and Education

11. Over the past three years, the Council has provided considerable advice on schools, universities, skills and addressing economic inactivity. This chapter draws together these discussions and outlines trends in employment, education and skills over the last few years.

12. The chapter sets out key policy challenges for the Scottish Government in these areas which include improving the employability of individuals; improving the quality of teachers in schools; and maintaining and developing world-class universities.

13. The Council provides six recommendations for the Scottish Government in these areas. The Council recommends that the Scottish Government:

Recommendation 11: more closely coordinates the arms of the Scottish and UK Governments with responsibility for employment and skills issues. In particular, the Council believes that closer alignment and coordination between Jobcentre Plus, careers services and Skills Development Scotland would bring about a more effective approach to improving labour market participation in Scotland. So too would greater Scottish autonomy in setting benefits policy. The Council believes that Jobcentre Plus employability services should be devolved to the Scottish Government and that further consideration is given to bringing benefits and skills policy together within Scotland.
Recommendation 12: puts greater effort into building local consortia consisting of representatives from the DWP, Jobcentre Plus, local government, NHS, Employers Federation, Skills Development Scotland, Chambers of Commerce and other key interested parties. The Council is convinced that the local partnership model is the most efficient way to design and manage the delivery of services to move benefit recipients into work.

Recommendation 13: ensures training and educational institutions pay attention to the subsequent employability of their students. The Council urges the collection and publication of statistics on students’ success in finding employment after graduation. Good quality careers advice for university graduates, coupled with short courses to enhance job-seeking and labour market skills, are likely to be cost-effective ways to tackle graduate unemployment.

Recommendation 14: undertakes development of metrics to measure teacher quality, in collaboration with professionals, in order to improve the quality of education in Scottish schools in cost-effective ways. The quality of teachers must be measured, good teachers must be recognised and rewarded, and ineffective teachers must leave the profession.

Recommendation 15: gives fresh thought to involving university students and their families directly in carrying the costs of Higher Education, preferably through a system of deferred payments. The alternative, in an era of extreme pressure on public resources, is likely to be unsustainable financial pressures on Scotland’s world-class universities.

Recommendation 16: given the international reputation of Scottish schools and universities, regards education at all three levels as part of the highly skilled services that Scotland markets to the global economy. The attraction of international students to Scotland, at every stage in their education, will raise the international profile and marketability of other sophisticated sectors of the Scottish economy.

Planning

14. The Council addressed the Scottish planning system in its First Annual Report and provided several recommendations for the government to consider.

15. In this Report, the Council revisits the planning system and assesses what progress the Scottish Government has made in implementing the recommendations from its First Annual Report. The key observation made by the Council is that significant and impressive progress has been made at the central government level but that at local government level planning policy has not developed. The Council suggests that financial incentives should be used to stimulate improvements at local government level.

16. The Council makes two recommendations to the Scottish Government in this area.

17. The Council recommends that the Scottish Government:

Recommendation 17: increases the pace of improvements in planning performance, particularly at the local authority level, through ensuring that there is a financial incentive for local authorities to commit to high quality developments. This could be achieved by rapid acceleration and development of the incentivisation models currently being piloted.

Recommendation 18: continues to work to ensure that the planning system acts as an enabler to development and focuses on development delivery, where it is vital for local authorities, government, agencies and the private sector to align activity.
Chapter 1

Scotland’s Economic Progress

INTRODUCTION

1.1 The Council held its first meeting in September 2007, and began with an overall review of Scotland’s economic performance over the past 30 years. In a comparison with the UK as a whole, the similarities are more striking than the differences. Scottish growth has averaged about 0.5 percent less than that of the UK, but income per head in Scotland is only marginally lower than that of the UK overall. Scotland’s position is therefore markedly different from that of Wales and Northern Ireland, both of which have substantially lower per capita income levels.

1.2 A partial explanation of Scotland’s lower growth of Gross Domestic Product (GDP) or Gross Value Added (GVA) is the country’s lower population growth. In the 1990s, Scotland’s population was actually declining, and the population decline was then projected to continue. Since 2003, however, this trend has been reversed, partly in consequence of a higher birth rate, but mainly as a result of increased net immigration.

1.3 The structure of the Scottish economy is also not markedly different from that of the UK. There is a widespread perception that Scotland is particularly dependent on public sector employment but this claim has little basis in fact. Per capita public expenditure on health and education, and on some other services, is around 10 percent higher in Scotland than in the UK as a whole. The proportion of workers employed in public sector activities, at 23 percent against a UK figure of 20 percent, reflects this difference. Scotland suffered from a sharp contraction in manufacturing employment and output immediately after 2000, mainly a consequence of apparent earlier success in attracting inward investment in electronics and related activities which then suffered disproportionately in the collapse of the technology boom.

1.4 The Scottish Government has drawn attention to the performance of other small states in Western Europe, many of which have outperformed both Scotland and the UK. With the exception of Portugal, all these countries have higher levels of output per head and generally faster growth than Scotland over the past 30 years.

1.5 The example of Ireland has received particular attention. The economic performance of Ireland in the decades following independence was very poor and the gap between Irish and UK living standards increased, but after EU accession in 1973 and particularly after 1986, Ireland rapidly narrowed the gap with European standards of living. Ireland was particularly successful in attracting inward investment and by the beginning of this century had overtaken the UK in GDP per capita (although the comparison is much less striking if gross national income is used as the benchmark because of the proportion of profits of foreign companies in Irish GDP).

1.6 In retrospect, however, there were difficulties around an unsustainable construction boom and unsustainable lending. The Irish experience illustrates both the opportunities and

1 Please note this excludes employment in the public sector financial institutions.
Chapter 1 Scotland’s Economic Progress

challenges available to small states in the European economy and has been – and will continue to be – a useful benchmark for discussion.

FINANCIAL CRISIS

1.7 When the Council met for the first time, the global financial crisis had just begun. It is now usual to date the beginnings of this crisis to the dislocation of wholesale financial markets which began in August 2007. But neither we, nor commentators generally, perceived the depth of the problem or the scale of the mistakes which had been made in the country’s largest financial institutions. The resulting financial crisis has been the dominant feature of the global economy in the years that followed and the near collapse of the two principal Scottish banks has been the most important development in the Scottish economy in that period. The optimism with which the Council began its task has been considerably restrained by the chilly external climate.

1.8 The basic cause of the financial crisis was the construction by many large banks around the world of highly leveraged balance sheets which included substantial volumes of assets based on complex securitisation products. As doubts about the value of these assets increased, the value of all assets which were liabilities of financial institutions became uncertain. Following the bankruptcy of Lehman Brothers in September 2008, wholesale credit markets simply dried up. The collapse of many large financial institutions across the world was averted only by state action to underpin these values, implemented through a combination of recapitalisation of balance sheets and the implicit and explicit guarantees of liabilities by major governments.

1.9 While the crisis was essentially one of the financial sector, the effect on general business confidence was severe. Attempts by banks to reduce leverage and restore capital values have had serious effects on the price and availability of credit, particularly to small and medium sized enterprises, which continues to the present.

1.10 As a result, UK GDP fell by around 4.6 percent in 2009 and in Scotland GVA fell by a similar amount. The data show a fall in Scotland through the recession which is marginally less than that for the UK as a whole. However, the treatment of financial services in UK output statistics is weak and the allocation to Scotland questionable. We are not inclined to attach any significance to these precise numbers or comparisons.

1.11 Both the UK and Scottish economies recovered somewhat in 2010. However it is unlikely that aggregate output will regain its 2008 level even in 2011 and it will be some considerable time before output reaches the levels which might have been anticipated if growth trends through to 2007 had been maintained.

1.12 The two principal UK banks headquartered in Scotland, Halifax Bank of Scotland (HBOS) and the Royal Bank of Scotland (RBS), which were recapitalised in October 2008, were also the two largest companies based in Scotland. The two banks were perceived in financial markets as vulnerable from the onset of the credit crunch in August 2007. Both banks had been aggressively expansionist in the previous decade. In particular, the growth of RBS, which successfully acquired and integrated the substantially larger National Westminster Bank, was a source of pride in the Scottish business community. RBS engaged in further acquisitions and in late 2007 completed the purchase of the large Dutch headquartered international bank ABN Amro.

1.13 The price paid for ABN Amro was extremely high and RBS persisted in the transaction even after the economic and financial climate had changed markedly in August
2007. ABN Amro was particularly active in trading the securitised products which were at the heart of the crisis while HBOS was particularly reliant on wholesale funding. Major rights issues in early 2008 temporarily strengthened the balance sheets of the two banks but this recapitalisation proved inadequate in the face of growing evidence of large losses in both trading and lending books and the freezing of credit markets following the Lehman Brothers bankruptcy in September 2008. RBS was recapitalised by the UK taxpayer, and HBOS merged into Lloyds Banking Group. Both RBS and Lloyds are now majority owned by the UK Government through an agency, UKFI.3

1.14 The problems of these banks had wide-ranging consequences for the Scottish economy. These consequences include loss of employment within Scotland, actual and potential erosion of high level corporate functions from Scotland, reduced competition in retail and corporate banking within Scotland and increased financing costs for individuals and businesses.

KEY SECTORS

1.15 The Council has, from the beginning, taken the view that the economic performance of a small economy depends on its ability to deploy competitive advantages in a limited number of sectors in a global marketplace. We have therefore given particular attention to sectors in which Scotland might have distinctive capabilities. These sectors are: creative industries; energy; financial and business services; food and drink; life sciences; tourism and universities.

1.16 The Council discussed the financial and business services, and food and drink sectors in its Second Annual Report. In this Third Annual Report, chapter 3 covers the life sciences sector and banking sub-sector of financial and business services, and also summarises the main conclusions and key themes across all the sectors discussed by the Council. We do not believe the long-term growth prospects for these industries are substantially affected by the macroeconomic events we have described above, with the exception of financial and business services, where the damage to Scotland’s two largest global companies plainly has substantially reduced the growth prospects of the sector. We acknowledge, however, that the financial services sector has other strengths and that those areas which have emerged relatively well from the crisis – such as insurance and fund management – may provide a continuing source of competitive advantage in financial services. We are also conscious that the higher education sector is particularly vulnerable in the face of the grim fiscal outlook for both Scotland and the UK and of the increasingly tight immigration controls of the UK Government, and believe that this may require wide-ranging policy reappraisal within Scotland.

PUBLIC FINANCES

1.17 Since 1978, overall public expenditure in Scotland has been determined by what is generally known as the Barnett formula. Broadly, the principle is that the allocation of funds to Scotland begins from an inherited base, which implies a level of spending per capita above the UK average. The formula then allocates to Scotland a population based proportion of the incremental public expenditure in England which is determined through

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3 UKFI was set up on 3 November 2008 to manage the government’s investments in financial institutions. Its overarching objective is to develop and execute a strategy for disposing of the investments in the context of protecting and creating value for the taxpayer as shareholder and as provider of financial support, paying due regard to the maintenance of financial stability and acting in a way that promotes competition.
negotiations between the Treasury and English spending departments. The allocation represents a block grant in respect of all devolved functions, in which health and education are by far the largest components of expenditure. The allocation to Scotland currently stands at around £30 billion. Benefits received in Scotland are paid on the basis of entitlements determined by UK Government policy while defence and debt interest are UK Government functions.

1.18 While the Barnett formula would seem to imply long-term convergence between per capita public expenditure in England and Scotland, little such convergence appears to have occurred. The formula involves separate allocations for current and capital expenditure, and the Scottish Government has no significant borrowing powers. PFI projects have generally been outside capital expenditure budgets, although of course the future costs are charged against current expenditure. Since a disproportionate fraction of such projects have been undertaken in Scotland, the growth of such commitments is a material constraint on future public expenditure in Scotland.

1.19 The institution of devolved government in Scotland in 1999 was followed almost immediately by a period of explosive growth in expenditure in England on the functions devolved to the Scottish Government. The result was very rapid growth in allocations of funds to the Scottish Government. These increased in real terms by 65 percent between 1999-00 and 2009-10, with most of the rise concentrated in the period before 2006.

1.20 The early years of devolution were therefore not conducive to the instillation of good habits of budgetary discipline. We do not comment on whether the additional money that flowed to Scotland was well spent: we would observe that government is often, perhaps mostly, about hard choices and during the initial years of devolution, the Scottish administration did not have to make hard choices. This background is particularly unfortunate in the light of the very hard choices that have to be made now that the overspending of the past decade in the UK is to be reversed. We agree with the view taken by the Independent Budget Review Panel that any demands that particular headings of expenditure be ring-fenced – i.e. maintained at the levels reached at the culmination of the period of rapid growth in expenditure – are unrealistic.

1.21 The UK Government’s commitment to ring-fence health expenditure in England gives a small measure of comfort to Scotland. Although growth of Scottish expenditure before 2010 was generally faster than growth of overall UK public expenditure, contraction in Scotland is likely to be at a similar rate to that of the UK. Nevertheless, the UK Government’s October Comprehensive Spending Review announced cuts of around three percent per annum in real terms in allocation to the Scottish Government between 2010-11 and 2014-15. The outlook for public expenditure is likely to be the dominant factor in the economic policy of the Scottish Government for the next five years.

1.22 The implications and options are discussed in some detail in the Independent Budget Review Report, published on 29 July 2010. The Review Panel, chaired by one of our members Crawford Beveridge, had the remit to provide the Scottish Government with a number of options that would allow savings of around £3.7 billion over the next four years. If all of the recommendations in the Report were to be adopted then savings of £4.3 billion could be achieved. Therefore there is flexibility in the choices to be made. The Report looked at capital spending, including the opportunity for saving additional capital if the status of Scottish Water was changed. It also considered some of the universal services provided in Scotland to see whether alternative policy choices might contribute considerable savings. Significant gains in public service efficiency have been achieved over the last four years, and the Report considered what levels of efficiency might be achieved in the next spending period. Finally, it considered public sector remuneration and the size of the public sector.
workforce, concluding that even if efficiency gains and policy changes took effect, there would still be a need to move to a smaller workforce over the coming four years.

**FISCAL REFORM**

1.23 The experience of the first decade of devolution has raised many questions about the overall fiscal framework in Scotland, and we share the nearly unanimous view that a reappraisal is necessary. We believe key elements in that reappraisal should involve the establishment of borrowing powers for the Scottish Government, a transition towards measures that would connect a substantial proportion of Scottish Government revenue to taxes raised in Scotland, and giving the Scottish Government the authority to make its own choices between current and capital expenditure.

1.24 Fiscal reform is important and desirable as a long-term measure, but does not allow us to escape the necessity for the painful public expenditure reductions that face the UK economy as a whole. In fact, our economic difficulties may make it appear harder to introduce reforms, but also more desirable. In the short-term, new budgetary arrangements within the UK will not make any additional resources available for public spending, although they may reallocate existing resources between present and future or between England and Scotland. But an environment in which the UK is experiencing an unsustainable budget deficit, and therefore faces the need to make large spending reductions, is not a favourable background for reallocations that would make additional funds available to the Scottish Government for current spending. But in the long-term, the gains will come from being able to shift the burden of taxes and pattern of spending to match Scotland's specific needs and growth aspirations.

1.25 The case for greater fiscal autonomy rests on the hope that in the long run, the result will be better management of public expenditure within Scotland, and that macroeconomic policies more directed towards specifically Scottish needs could be implemented in that framework and would give a stimulus to Scottish economic growth. Certainly, it is difficult to imagine that such management could be worse than the boom and bust practised by the UK Treasury over the past decade. The pattern of feast and famine has been and is likely to continue to be damaging to the Scottish Government and the Scottish economy.

**INEQUALITY ACROSS SCOTLAND**

1.26 The Council has been concerned from the beginning that the distribution of both prosperity and growth is markedly uneven across the Scottish economy. The urban/rural divide, which was for a long time a principal demarcation line in the UK and particularly in Scotland, is no longer central: most rural areas of Scotland, including the Highlands and Islands, have been performing relatively satisfactorily, in part as a result of successful development policies over several decades.

1.27 The main issue is the persistence of pockets of urban deprivation, principally located in the West of Scotland and to some extent in Tayside. On almost all economic and social indicators, the same small group of local authority areas diverges notably from other parts of the country. The difference in employment rates between the best and worst performing areas was around 20 percentage points in 2009.

1.28 Although that gap in employment rate had been narrowing in the relatively benign economic climate up to 2007, it has widened sharply – by six percentage points – in the two
most recent years. Broad measures of income inequality in Scotland, which had remained little changed, appear to have increased slightly in that time.

1.29 It is evident that the problem of urban deprivation in Scotland is deep-rooted, and that the affected areas are not only poor but more vulnerable to economic downturn. Although some individual initiatives have enjoyed success, these issues have not proved tractable in the face of a variety of policies over several decades. Policies depend on a mixture of benefit, employment and training strategies, some of which are devolved functions and many of which are not. We believe this is an area in which more devolution, not just to the Scottish Government itself but to local initiatives, is required.

CONCLUSION

1.30 A number of widely held illusions – about the ability of macroeconomic policies to limit the magnitude of economic cycles, about the strength of global financial institutions, and about the levels of public expenditure which could be sustained from existing tax rates – have been dispelled by the experience of the last three years. Output in Scotland is below, and is likely to remain below, extrapolations from past trends and so are earnings and employment. The outlook for the largest of the key sectors we have identified – financial services – is much less favourable than it appeared three years ago, and the fiscal outlook is grim.

1.31 Nevertheless, we remain optimistic about the long-term prospects for the Scottish economy. There are positive recent developments in several key sectors. New providers in the retail financial services industry, such as Virgin Money and Tesco Bank, are Scottish based, and some established firms which have weathered the crisis, such as Barclays Wealth and Nationwide, have announced expansion plans. So too have several companies in life sciences, such as Lombard Medical Technologies. Scottish firms continue to be successful in support of the oil and gas industry both here and overseas, and the Scottish Government believes there are many opportunities for Scottish business in support of renewable energy technologies. While the fiscal prospects remain a central, and depressing, issue, there are opportunities to achieve considerable efficiency gains across the public sector. This will be one of the principal challenges of the next four years.
Chapter 2

Progress Against Purpose Targets

INTRODUCTION

2.1 In Autumn 2007, the Scottish Government published its Government Economic Strategy which set challenging targets that were designed:

“to focus the Government and public services on creating a more successful country, with opportunities for all of Scotland to flourish, through increasing sustainable economic growth”.

2.2 Over the past three years, the Council has provided advice to the Scottish Government on how to achieve many of the targets. This chapter sets out the progress that the government has made towards meeting the targets, provides opinion on the likely path of progress towards each target, and summarises the Council’s advice in these policy areas. To set the past three years in context, the data where possible go back to 2000.

ECONOMIC GROWTH TARGETS

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<td><strong>UK target</strong></td>
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<td>2.3 UK annual GDP growth has been marginally higher than Scottish GDP growth during most quarters in the past decade. The onset of the recession saw Scottish growth perform relatively better, however early recovery in the UK was at a faster pace than in Scotland – over the year to 2010Q2, GDP in Scotland contracted by 1.7 percent whilst GDP in the UK fell by 1.5 percent. Recent data show that there is now a negligible gap between the GDP growth rate in Scotland and the UK as a whole: 1.3 percent in Scotland compared to 1.2 percent in the UK during 2010Q2. See Chart 1, below.</td>
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<td><strong>Small EU-Country target</strong></td>
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<td>2.4 The small independent EU countries identified in the Strategy as reference points were: Austria, Denmark, Finland, Ireland, Luxembourg, Portugal and Sweden. Annual GDP growth in the small EU countries exceeded the Scottish annual GDP growth rate in the majority of quarters over the past decade. Again, during the economic downturn, GDP growth was relatively better in Scotland and the growth gap between Scotland and these countries became negligible. However, recovery in the small EU countries (in aggregate) has been stronger than in Scotland which has resulted in the gap in annual growth rates widening in recent quarters. See Chart 1, below.</td>
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Outlook to 2011 and 2017

2.5 Whether Scotland matches the UK growth rate in 2011 will depend on the relative strength of its recovery from recession. Of more immediate concern is the level of growth in Scotland and the UK over the next five years, as fiscal consolidation and continued tight lending conditions for both consumers and businesses will act to weaken the strength of the recovery throughout the UK. Given the openness of the UK and Scottish economies, the strength of the recovery in key trading partners will also have an important bearing on the speed and sustainability of the recovery.

Chart 1  Gap Between Scottish and UK and Small EU Annual GDP Growth Rates, 2001Q3 to 2010Q2

Source: Scottish Government, ONS, OECD

2.6 A key determinant of the Scottish performance compared to the small EU-countries over the period to 2017 will be the relative size of the long-term impacts of the recession on trend growth rates in these countries and in Scotland.

Policy Considerations

2.7 The Council considered the 2011 UK target in its First Annual Report and recognised that achievement of this ‘will mainly be determined by global macroeconomic factors over which the Scottish Government has little influence’ (paragraph 3.12). Recent events have shown this to be the case. However, the Council recognised that the longer-term target to 2017 would additionally be determined by microeconomic factors where Scottish Government policies could have some impact. In its First Annual Report the Council recommended that the Scottish Government strengthen the comparative advantage of Scotland’s businesses and also invest in public-sector infrastructure.

2.8 The Council recognises the work that the Scottish Government has carried out to identify challenges in its key sectors and there is now a need to work to tackle these

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4 http://www.scotland.gov.uk/Publications/2008/12/04092147/0

12 Third Annual Report of the Scottish Council of Economic Advisers
challenges. The Council provided recommendations to improve Scotland’s comparative advantage in some of the key sectors in its Second Annual Report, and chapter 3 of this Third Annual Report also focuses on life sciences, banking, and provides an overview of commonalities across all key sectors.

2.9 As a result of its Economic Recovery Plan, the Scottish Government has accelerated capital expenditure to help mitigate the detrimental effects of the recession. With expected constraints on public finances in the future, the Scottish Government now needs to find new ways to encourage the private sector to invest, in order to achieve the growth required to make progress towards the 2017 target.

**PRODUCTIVITY TARGET**

To rank in the top quartile for productivity against our key trading partners in the OECD by 2017.

2.10 Improvement in productivity is key to long-term economic growth and improved living standards. This target represents a significant challenge for Scotland.

**Progress to date**

2.11 Scotland’s productivity performance continues to lag behind that of many of its competitors. In 2008, the latest year for which comparable data are available, Scotland was ranked at the top of the third quartile (17 out of 31 countries). However, as can be seen in Chart 2 below, there is little difference in productivity levels between Scotland and those countries ranked in the second quartile.

![Chart 2 2008 GDP Per Hour Worked (USA=100)](source: OECD, ONS)

To rank in the top quartile for productivity against our key trading partners in the OECD by 2017.

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2.12 In order to move into the top quartile, Scotland would have to surpass the productivity performance of Germany, assuming no other relative changes. Although Scottish productivity growth rates are currently greater than those in Germany, accelerated productivity growth would be needed to achieve this target as, historically, productivity levels in Scotland have been lower: for example, 86 percent of German levels in 2008. Furthermore, if Scotland does not improve its productivity growth rate it may be overtaken by countries currently ranked closely below it.

Outlook to 2017

2.13 It is Scotland’s relative performance in the face of the current economic downturn that will determine its progress against the target. In previous recessions, the removal of less efficient firms from the economy, and the reallocation of assets toward more productive firms, has tended to improve average productivity levels. The speed of this adjustment is determined, in part, by the relative flexibility of labour and product markets. To date, the size of the labour market adjustment in Scotland has been greater than in many of our competitor countries (in particular, Germany), which could be expected to narrow the gap in productivity performance.

2.14 However, there are also significant risks arising from the current recession to the drivers of productivity in Scotland. For example:

• business investment has fallen considerably during the downturn – data for the UK shows that business investment declined by 16 percent during 2009;
• constrained credit conditions may prevent investment in research and development (R&D) and discourage business start-ups. Although the latest corporate sector statistics show an increase in the number of enterprises over the two years to March 2010 driven by small start-ups;
• the deterioration in labour market conditions may reduce human capital levels, particularly if some workers become disengaged from the labour market – over the year to the three month period July to September 2010 the number of people aged 16 to 64 defined as being economically inactive has risen by 8,000;
• some merger activity may reduce levels of competition, for example, in the financial services sector; and
• the forthcoming measures to reduce levels of public sector investment across the UK may also constrain future productivity – the October Comprehensive Spending Review forecasts government net investment (at the UK level) will decline from £59.5 billion in 2010-11 to £43 billion in 2014-15 (2010-11 prices).

2.15 The extent to which such issues may impact disproportionately on Scotland relative to our competitor countries, and therefore on achieving the target, is very unclear at present.

Policy Considerations

2.16 The Council has had several discussions about the Scottish Government’s productivity target and sees improvements in productivity as being possible only through sustained long-term strategies, such as investment in human capital and restructuring towards more higher value-added activities. The Council has reported on productivity in each of its previous Annual Reports, making a number of recommendations now being taken forward by the Scottish Government.
POPULATION TARGET

<table>
<thead>
<tr>
<th>Purpose Target</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU-15 Population target</td>
<td>To match average European (EU-15) population growth over the period from 2007 to 2017. Supported by increased healthy life expectancy in Scotland over the period from 2007 to 2017.</td>
</tr>
</tbody>
</table>

**EU-15 Population target**

2.17 The population targets recognise the importance of population growth as a key contributor to, and consequence of, a more vibrant society and a more dynamic economy. Population growth that leads to a larger working age population has the potential to increase the size of the economy.7

2.18 In recent decades, population growth in Scotland has lagged that of many of our EU-15 competitors, contributing directly to the gap in economic growth rates between Scotland and elsewhere. For example, higher population growth in the UK accounted for approximately 50 percent of the gap between Scottish and UK economic growth over the last decade.

**Healthy Life Expectancy target**

2.19 Healthy life expectancy (HLE) is an estimate of how long the average person might be expected to live in good health. Improving HLE will increase the number of people in work (and their productivity) and allow people to work longer. It will minimise drag on the economy by reducing the economic and social costs of poor health.

**Progress so far**

**EU-15 Population target**

2.20 The latest population estimates, published by General Register Office for Scotland in April 2010, allow for analysis of the first two years of progress against the population growth target, over the period from the baseline year of 2006-07 to 2008-09. Over this two-year period the EU-15 population has grown by 1.12 percent, whilst the Scottish population has increased by 0.97 percent over the same period.

2.21 For Scotland to have matched EU-15 growth over this period, the Scottish population would have had to increase by an additional 8,000 people compared to the estimated growth (49,800) over the period. This 8,000 can be viewed as the current deficit on the target, which, as the target is cumulative over the 10 year period 2007 to 2017, will have to be addressed over the remaining eight years.8

**Healthy Life Expectancy target**

2.22 Levels of HLE for women and men have been gradually increasing since 1980. In 2008 HLE for women was 70.8 years, whilst levels for men were 68.1 years. Average levels of healthy life expectancy increased by 0.5 percent between 2007 and 2008. However, recent trends show that HLE is not increasing as fast as life expectancy which means that greater numbers of people are likely to spend more years in poor health. This has negative implications for their capacity for employment and consequently for Scotland’s economic growth and ongoing costs to public services.

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7 It should be noted however that if participation is to be maintained or increased as the population increases, which will contribute to economic growth, there may be tensions between achieving the population target and the productivity target (depending on the relative skills mix, and therefore average productivity, of the new workers entering the labour market).

8 The majority of this gap is due to Scotland’s lower population growth rate in 2007-08.
Outlook to 2017

**EU-15 Population target**

2.23 It is estimated that Scotland needs to grow its population by approximately 24,000 people per annum over the period 2007 to 2017, if it is to meet its population target.9

2.24 The latest population projections indicate that Scotland will experience relatively low levels of projected natural change (births minus deaths) over the period of the target. This is in contrast to many of our competitors in the EU-15 who have experienced significant levels of natural change in recent years – in particular, France, Ireland, United Kingdom, Finland and Denmark. As a result, these countries will be able to rely on natural change to drive population growth over the period of the target, even if inward migratory flows decline. Therefore, the key impact of the recession on progress against the population target will be the relative impact on net migration flows to Scotland compared to the countries of the EU-15.

**Healthy Life Expectancy target**

2.25 If the recent trend of gradually increasing HLE continues then it is likely that the 2017 target will be met. However, rising unemployment as a result of the economic downturn, may damage physical and mental wellbeing, and reduced spending power may have adverse effects on the quality of food consumption. Furthermore, the economic climate and tight public sector finances may divert resources and attention away from the necessary sustained approach to health promotion and addressing upstream causes of poor health.

**Policy Considerations**

**EU-15 population target**

2.26 Annual levels of population growth are determined by net migration levels and natural change. As annual population growth in Scotland has been predominantly driven by net migration in recent years, with negative levels of natural change until 2007, the Council considered net migration levels in its Second Annual Report.

2.27 In meeting the target, while levels of natural change will be important, these are determined by trends in fertility rates and life expectancy which take considerable time to have a significant impact. Over the target period (2007 to 2017) therefore, change in net migration is likely to be the main determinant of success.

2.28 Since 2004 Scotland has received a relatively high share of EU Accession countries (A8) migrant flows compared to the UK as a whole. However, there has been a considerable fall in registrations from migrant workers from the A8 since mid-2008 (mirroring trends in the UK as a whole). Economic conditions are a key determinant in migration decisions and the Council expressed the view that emphasis on meeting this target should take account of the global recession. The Council also highlighted the significant risk to delivery of the target, particularly as many of our competitors in the EU-15 are forecast to experience greater natural growth, driving up population levels even if inward migratory flows decline.

2.29 In terms of policy response, the immigration system itself is reserved which limits the extent of policy interventions that can be made by the Scottish Government, though it is

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9 This analysis is informed by the latest EU-15 population projections, produced by Eurostat. See: http://epp.eurostat.ec.europa.eu/portal/page/portal/population/data/database
engaging with the UK Government in this area. In order to promote higher net migration to Scotland, the Council recommended that the Scottish Government commission research to explore factors affecting migration decisions so that policy can be grounded in good evidence.

**Healthy Life Expectancy target**

2.30 The key policies to address healthy life expectancy are to address the social determinants of health and underlying cause of health inequalities, and to improve the contribution of the NHS. While the Council did not focus specifically on this area, it recognised the importance for Scotland of maintaining momentum in the prevention of poor health and improving HLE in the face of tight public finances.

**PARTICIPATION**

To maintain our position on labour market participation as the top performing country in the UK.

To close the gap with the top five OECD economies by 2017.

2.31 Improved labour market participation is a key driver of economic growth. Increasing the number of people in employment adds to the productive capacity of the economy and makes better use of human capital potential. It also improves the standard of living of those moving into employment and supports a more equitable distribution of the benefits of growth.

**Progress so far**

**UK Target**

2.32 Until very recently, Scotland had the highest employment rate in the UK.

**Chart 3**  
**Employment Rates (16 to 64) in the Four Countries of the UK, 1998Q3 to 2010Q3**

Source: Labour Force Survey, Seasonally Adjusted data, Office for National Statistics
Chapter 2 Progress Against Purpose Targets

2.33 However, as can be seen from Chart 3, above, Scotland has lost its lead by a small margin, coming second to England which has an employment rate of 71.2 percent compared with Scotland’s 70.7 percent in 2010 Q3.

Organisation for Economic Co-operation and Development (OECD) Target

2.34 The employment rate in Scotland in 2009, using the European age definition (15 to 64), was 70.6 percent, 1.6 percentage points lower than the previous year. Between 2008 and 2009 the gap in employment rates between Scotland and the country with the fifth highest rate (Netherlands in 2008 and Denmark in 2009) increased from four percentage points in 2008 to 5.2 percentage points in 2009.

2.35 In 2009, the top performing OECD countries, as shown in Chart 4, were Iceland, Switzerland, Denmark, Norway and the Netherlands. There is little difference in employment levels between many of the countries ranked close to fifth in the OECD, which results in many countries moving places between years.

Chart 4 International Employment Rates (15 to 64 Population), 2009

Source: OECD, Annual Population Survey

Outlook to 2017

2.36 Most OECD countries witnessed growth in their employment rates in the five years leading into the recession (2003 to 2008), however, there have been considerable variations in the rates of growth. The effect of the recession in many OECD countries at the end of that period is likely to have an effect on trend rates and Scotland’s relative position. This will depend on the relative strength of Scotland’s recovery as noted above.

Policy Considerations

2.37 The Council considered the participation target in its First Annual Report and thought the OECD target to be particularly challenging. The Council highlighted several key factors that have a major impact on Scotland’s participation rate. These included: (i) the ability and willingness of individuals to get sustainable employment, influenced by the benefits and pension regime for example; (ii) specific challenges faced by some groups such as lone
parents and those with drug or alcohol problems; (iii) employer demand for labour determined by economic growth and entrepreneurship; and (iv), the value and effectiveness of training and education.

2.38 The Council recognised that the responsibilities for addressing these factors are divided between different levels of government, with benefits and pensions policy in particular being reserved to the UK Government. The Council’s key recommendation was to resolve tensions between Scottish and UK policy responsibility and implementation so that a consistent welfare environment would support increased employment rates.

COHESION

To narrow the gap in participation between Scotland's best and worst performing regions by 2017.

2.39 The benefits of economic growth should be enjoyed across the whole of Scotland. At present differences in income, participation and growth across Scotland act as a drag on collective economic performance and potential. By addressing the low participation rates of our worst-off regions, the economic potential of all Scottish people will be better utilised. This will reduce the cost of poor performance that otherwise impacts on the whole of Scotland.

Progress so far

2.40 The employment rate in Scotland varies considerably by local authority area. The difference between the three best and three worst performing local authority areas has generally reduced over the last 10 years.\(^\text{10}\) However, the difference increased by 5.8 percentage points between 2008 and 2009.

Chart 5 Percentage Point Difference Between the Employment Rates in the Best Three and Worst Three Performing Local Authorities, 2001 to 2009

Source: 2001-2003 data are taken from the Annual Labour Force Survey. Data from 2004 onwards are taken from the Annual Population Survey. The data for 2004 onwards are based on the calendar year whereas data prior to this is based on seasonal years (Mar-Feb) so there is a discontinuity in the series.

\(^{10}\) In 2009, the three best performing local authorities were Orkney Islands, Shetland Islands and Highland. The bottom three local authorities were Inverclyde, North Ayrshire and Glasgow.
2.41 This change was driven by increases in the employment rates of the top three local authorities and decreases in the employment rates of the bottom three who, among others, continue to face challenges as a result of the current economic conditions.

2.42 Increasing the employment rate in the bottom three local authority areas to the Scottish average (in 2008) would, based on 2008 population levels, require nearly 48,000 additional working age people to be in employment.

**Outlook to 2017**

2.43 As with participation, the outlook for cohesion over the next few years and beyond will depend on the strength and sustainability of the Scottish recovery and on how different parts of Scotland respond. If the impact of the recession is stronger in the worst-performing areas – as has historically been the case in recent recessions, particularly in employment terms – then the gap with the best-performing areas can be expected to widen. It is not clear how rapidly different areas may be able to recover in employment terms and therefore whether uneven employment impacts will affect the medium-term target.

**Policy Considerations**

2.44 The Council briefly discussed cohesion in its First Annual Report and recommended that the government assess whether there is an appropriate weighting of resources to, and within, Glasgow allocated to employment issues. This has become more relevant since the onset of the recession, in light of the indications that the gap between other local authorities and Glasgow may be widening.

2.45 As with the participation target, the role of UK Government benefits and training policies, and the actions of key agencies such as JobCentre Plus will affect employment rates in different parts of Scotland. However, perhaps more critically, local delivery mechanisms are critical in this target as is the need to look critically at the relative effectiveness of different intervention mechanisms.

**SOLIDARITY**

To increase overall income and the proportion of income earned by the three lowest income deciles as a group by 2017.

2.46 The healthy development of our society depends on reducing inequalities and sharing the future benefits of growth among people and communities. Unlocking the economic potential of all individuals will support economic growth by increasing labour market participation and by removing the personal and social costs of poverty.

**Progress so far**

2.47 Between 2007-08 and 2008-09, total income received by Scottish households increased from £73 billion in 2007 to £74 billion in 2008 (in 2008 prices). However, the proportion of income received by those in the bottom three deciles remained at 13 percent so the income gap between the richest is broadly unchanged. See Chart 6.

**Outlook to 2017**

2.48 The Scottish Government cannot achieve this target alone, but is reliant on a coalition across the public, private and third sectors. Resource constraints will be an issue
for all sectors, and there is the additional risk to the most vulnerable (for example those who are unable to work) from pressure on the key public services on which they rely.

2.49 No progress has been made on raising the relative income level of the bottom three deciles over the last 10 to 15 years – tackling the long-term drivers of income equality is something that does not happen quickly but rather happens over several generations.

**Policy Considerations**

2.50 The Council has not yet had an opportunity to have a full discussion on solidarity and possible policy responses. The Council is aware of the Scottish Government’s ongoing work to maximise income, and to overcome barriers to work, but recognises the need for more targeted interventions to help those in the bottom three deciles.

2.51 As with cohesion, a key driver is the tax and benefits system which is largely reserved. However, the Scottish Government can have an impact on employment opportunities, education and training as routes out of poverty. The Scottish Government can also influence the UK Government on benefits and pensions reform.

**Chart 6** Proportion of Total Equivalised Income Going to the Bottom Three Income Deciles (Scotland), 1998-99 to 2008-09

![Chart 6](image)

Source: Department for Work and Pension's Family Resources Survey, Households Below Average Income datasets

**SUSTAINABILITY**

To reduce emissions over the period to 2011.

To reduce emissions by 80 percent by 2050.

2.52 The quality of Scotland's environment and natural heritage is a key asset and source of competitive advantage. Consequently, protecting and enhancing Scotland's biodiversity and landscape for future generations is central to Scotland’s current and future competitiveness, and to its long-term sustainable growth. A critical element of this is climate
change, not just because it poses a particular threat to Scotland, but also because there is a
global imperative to address the issue. By reducing emissions Scotland will make a valuable
contribution to addressing climate change.

**Progress so far**

2.53 In 2008, Scottish greenhouse gas emissions, including international aviation and
shipping, and adjusted to take account of trading in the EU Emissions Trading Scheme,
were 21.2 percent lower than in the 1990 base year. Between 2007 and 2008 such
emissions reduced by 3.7 percent. See Chart 7.

**Chart 7 Scottish Greenhouse Gas Emissions, Showing the Effect of
Incorporating Net Effect Trading in the EU Emissions Trading System**

![Chart 7](image)

(2): Figures include removals from land use, land use change and forestry.
Source: AEA Energy and Environment

**Forecast to 2011 and 2050**

2.54 Although data will not be available until 2013, the Scottish Government is confident
that the 2011 target will be met due to the significant downward trajectory in emissions since
1990 and given the fall in economic activity due to the recession.

2.55 The Committee for Climate Change (CCC) was asked by the Scottish Government to
assess the appropriateness of the 2020 interim target on the path to 2050. The 2020 target
is to reduce emissions by 42 percent from 1990 levels and achieving this would set Scotland
on the right trajectory to meet the 2050 target. With a global deal, the CCC believes that the
42 percent interim target would be challenging but achievable and hence Scotland would,
with significant effort, be able to be on track to meet the 2050 target.

**Policy Considerations**

2.56 The Council considered the 2011 emissions target in its *First Annual Report* and
believed this would be achieved given the trajectory from 1990 and the evidence provided by
the Scottish Government which indicated that sufficient renewables capacity would be
installed to help meet it. The Council recognised that the 2050 target would be much more difficult to achieve as it will require an annual rate of reduction averaging more than three percent and provided recommendations to help achieve this target.

2.57 The Council welcomes the *Report on Policies and Proposals*, published as a requirement of the Climate Change (Scotland) Act, which sets out how the Scottish Government intends to achieve 42 percent emissions reduction by 2020, on the pathway to 2050. The transition to a low carbon economy represents a major economic opportunity for Scotland, and the business efficiencies which will be required to change the way we use energy, and to use it more efficiently, can contribute to wider business innovation and productivity.

**CONCLUSION**

2.58 This chapter has provided an overview of where Scotland now stands in terms of the targets sets in the *Government Economic Strategy*. Clearly, there has been a remarkable change in the global economic environment since 2007, when these targets were set. While the global recession makes some targets easier to achieve, it ultimately increases the challenges of achieving more of the specified targets. Nonetheless, the Council is of the view that the focus of the targets, and especially the time horizon out to 2017, remains correct. Furthermore, in the Council’s view, it is important for the Scottish Government to have this longer-term focus, especially in the current environment.
Chapter 3

Key Sectors

A. OVERVIEW

3.1 The Council of Economic Advisers’ original mandate in 2007 was to recommend ways in which the Scottish economy’s rate of economic growth could be improved. The subsequent economic crisis in 2008-09 has made achieving this target particularly difficult in the short run. However, a long-term improvement requires structural change. A structural change in the economy means making interventions either to improve the economy’s competitiveness by lowering production costs/unit labour costs; or to raise productivity growth rates across the board so that prices rise slower than elsewhere; or to alter the industrial mix of the economy so as to increase the share of high tech/high value added production in the economy’s total output.

3.2 Standard results from studies of economic growth show that, to increase growth rates, a government needs to offer tax incentives (for example, reductions in business taxes, corporation tax, depreciation allowances or R&D credits) targeted at business activities in order to increase investment and new business formation; or to find ways to increase savings, public or private, to the same end; or to increase the rate of employment or the rate of productivity growth for the average employee. Under current arrangements the Scottish Government has no control over tax rates or tax allowances and tax credits. These are reserved matters, as are national insurance contributions and other costs imposed on employment. It also has no control over factors that would produce an increase in savings or easier credit, and limited influence over the growth and quality of the working age population. Therefore, the only lever available for improving growth is to increase productivity: either across the board, with an eye to reducing prices relative to elsewhere, or by raising the share of high productivity industries in the economy as a whole.

3.3 To that end, the Council undertook two studies of productivity and innovation and conducted reviews of three key sectors (life sciences, financial and business services, and food and drink), the details of which can be found either elsewhere in this Report, or in the Council’s two earlier Annual Reports. The purpose of this chapter is to summarise the main conclusions and common themes across the key sectors that the Council has reviewed.

3.4 The life sciences sector is the smallest of the key sectors, but is of particular interest because of its strong growth potential. However, like the economy itself, it suffers from an imbalance in activity between subsectors, which manifests itself in slow productivity growth. The sector would benefit from reducing its dependence on drug discovery and increasing its share of other activities. Second, there is some concern over the lack of cooperation between universities/researchers and commercialising firms. This is a problem for several key sectors, and possible solutions were discussed in the Second Annual Report. However, it appears that the real difficulty is to find investors to support the trials and development stage which, in the life sciences case, is long and inherently risky. Various ways of shortening the trials period and de-risking it are possible. Third, there are evident synergies between life sciences and other high value activities (IT, agribusiness, environment, energy) which may provide opportunities to form deeper and more robust industrial clusters.

3.5 The financial and business services sector covers fund management, insurance and general business services. It is often characterised by back office functions for high value added firms whose operations are mostly located elsewhere. This raises a general
difficulty: the government’s growth target can only be realised if the high value added parts (and head offices in particular) can be attracted to, or retained in, Scotland. Unfortunately, the crucial elements of competition and regulatory policy are reserved to the UK Government and the European Commission, with the Scottish Government’s role effectively limited to moral suasion, lobbying and setting a vision. The Scottish Government could seek to influence competition and regulatory policy, in particular using its voice in Brussels to limit the constraints of the Scotland Act. The banking sector itself has suffered from the financial collapse of 2008-09 without the Scottish Government having the means to regenerate the sector. However, it should be possible to refocus on asset management, insurance, custodial banking, wealth management, and business banking. Similarly, the proposed Scottish Financial Research Institute would provide research and expertise as a catalyst for a revived financial cluster in Scotland, as well as better links to the university and business education sector.

3.6 **Food and Drink** is a large sector, especially the drink/whisky subsector which enjoys very high value added (five times more than food processing). The food sector is fragmented with low productivity and low margins because of the strong market position of the main buyers (UK supermarkets). With competition and regulation policy being reserved or subject to EU rules, there is little scope for the Scottish Government here, except to promote premium and niche foods and supply marketing assistance (where management skills seem to be lacking). There is, therefore, a case for targeting support to specific activities rather than offering general support, and also a case for providing support to firms that need to consolidate or scale up. The drink sector, by contrast, grows quickly and is highly productive, but it employs few, and the main producers are not only foreign owned, but are also often foreign registered. This means the high value added typically accrues to another economy. Since this is a consequence of an EU ruling that allows a distinction between brand and production, it would pay to review and change (together with the UK Government) the tax and cost conditions that have made foreign registration worthwhile.

3.7 In summary, the areas where government action would be helpful are promotion (marketing), education and research, facilitating financial assistance for small firms, and influencing regulation.
B. FINANCIAL AND BUSINESS SERVICES: BANKING

3.8 In the summer of 2007, RBS led a consortium in a contested bid for the Dutch based global bank ABN Amro, and persisted with this bid even after the dramatic change in the mood of wholesale financial markets in August 2007. The acquisition price was high, while ABN Amro had itself been a particularly active participant in trading in the securitised products which were at the centre of the market collapse. It would become clear that RBS itself had very considerable exposures to these products.

3.9 In 2008, RBS engaged in the largest ever issue of equity capital on UK stock markets but this fresh capital proved wholly inadequate. After the Lehman Brothers bankruptcy in September 2008, the bank was successively recapitalised by the UK taxpayer. Currently, 83 percent of total share capital (and 68 percent of voting share) is owned by the UK Government and managed by UKFI on its behalf.

3.10 HBOS, particularly dependent on wholesale funding, was correspondingly vulnerable to the disruption of these markets in 2008. Like RBS, HBOS had substantial exposure to structured products and had, in addition, been particularly aggressive in its pursuit of corporate lending, especially in the property sector. Facing collapse in October 2008, the bank agreed to be acquired by Lloyds TSB. The UK Government used its statutory power to block the reference to the Competition Commission which the Office of Fair Trading (OFT) had recommended. The resulting Lloyds Banking Group is also majority owned by the UK Government (41 percent of total share capital) and managed on its behalf by UKFI.

3.11 In 2007, RBS and HBOS were, by some margin, the two largest businesses headquartered in Scotland. They were also the two principal institutions providing banking services to individuals and SMEs based in Scotland. The damage done to the Scottish economy by both the crisis of 2007-08, and its effect on these banks, has several aspects:

• the loss of headquarters functions from Scotland;
• the loss of employment opportunities due to consolidation of activities within Scotland or transfer of activities from Scotland;
• a reduction in competition for bank customers in Scotland; and
• general damage to the reputation of the financial services sector in Scotland.

3.12 The Council has been concerned from its inception by the steady erosion of headquarters functions from Scotland. This erosion is potentially damaging because the disappearance of senior functions and posts and the individuals who might hold these posts or discharge these functions may reduce the vitality of the Scottish economy and Scottish society more generally, and because firms are more likely to invest and to locate high value added activities in places close to their corporate headquarters. As these functions and positions have been lost – most recently, for example, by the acquisition of Scottish and Newcastle and the Grampian Food Group by multi-nationals – the primary countervailing force in the last decade had been the international expansion of RBS.

3.13 At best, RBS will emerge from the financial crisis as a slimmer organisation, shorn of many of its international activities. The interests of the Scottish economy would probably be best served if RBS were to be refloated as a single organisation, but this decision is now principally in the hands of UKFI. The Lloyds Banking Group, in its evidence to the Scottish

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11 UK Financial Investments Limited (UKFI) has published its annual report and accounts for the year ending 31 March 2010 at: http://www.ukfi.co.uk/publications

12 UKFI was set up on 3 November 2008 to manage the government’s investments in financial institutions. Its overarching objective is to develop and execute a strategy for disposing of the investments in the context of protecting and creating value for the taxpayer as shareholder and as provider of financial support, paying due regard to the maintenance of financial stability and acting in a way that promotes competition.
Parliament’s Economy, Energy and Tourism Committee, reiterated its commitment to Scotland. It is the parent company for a number of eminent Scottish companies and brands. Bank of Scotland and Scottish Widows will be flagship brands from now on, with Bank of Scotland operating as its high-street branch and business bank in Scotland, and Scottish Widows operating as its life and pensions brand throughout the UK. The Mound in Edinburgh is the Group’s Scottish Headquarters and will be the Registered Office for the Group as a whole. The Lloyds Banking Group will continue to hold AGMs in Scotland. Nevertheless, the Head Office of Lloyds Banking Group is situated in London.

3.14 The problems of RBS and HBOS have had significant impact on employment within Scotland as a result of the slimming of the operations of these banks, the reduction of overlap between activities through the merger of HBOS with Lloyds, and disposals imposed by the EU. Some of these losses will be compensated by gains of market share of competitor banks.

3.15 RBS and HBOS are the leading Scottish banks with a market share for Personal Current Accounts of 20 percent to 30 percent for RBS and 40 percent to 50 percent for the combined share of Lloyds and HBOS. For SME banking, 2006 figures show that the market share in Scotland is 30 percent to 40 percent for RBS and 40 percent to 50 percent for the combined share of Lloyds and HBOS (30 to 40 percent for HBOS alone). Their retail banking activities faced competition from Clydesdale Bank (owned by the National Australia Bank Group) and Lloyds (which achieved a significant presence in Scotland through its acquisition of TSB), HSBC and Abbey (now Santander) have expanded their activities in Scotland as a result of the crisis, but foreign banks that had increased their lending to SMEs prior to 2007 have largely withdrawn.

3.16 In Scotland, however, these banks had a very small share of the SME market. The Icelandic banks which failed in October 2008 did not have a “High Street” presence but mainly provided internet banking to UK customers. Other “foreign” banks appear to have reduced their share of the UK lending market since 2007. The most important new entrant to the UK banking market is the Spanish bank Santander. This bank may be expected to develop its banking activities in Scotland following its purchase of the English branches of RBS.

3.17 The Council is seriously concerned about the state of the banking market for SMEs in Scotland. There is a significant UK-wide problem resulting from the EU pressures on banks to increase their capital and the future of lower base rates to be translated into lower borrowing rates. The problem is aggravated in Scotland by the reduction in effective competition in the market. A recent report published by the Scottish Government on SME Access to Finance suggests that the market shares of the top four banks in Scotland are estimated to be around 94 percent.

3.18 Some of the principal new players in the market are Scottish based. Tesco Bank has announced that it will offer a full banking service including mortgages and small business banking, but these products have not yet been rolled out. Virgin Bank, which has its headquarters in Edinburgh, currently has over 2.5 million customers and offers credit cards, savings and investment, and general insurance products. It acquired Church House Trust in January 2010, apparently with the intention of developing its banking activities.

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15 Scottish Government (2009) http://www.scotland.gov.uk/Topics/Economy/access-finance/report The four banks comprise Santander (Abby and Alliance and Leicester), Lloyds Banking Group (Lloyds and HBOS), Clydesdale and RBS (RBS and Ulster)
3.19 The overall result is a significant reduction in competition in the Scottish retail banking market, as was recognised in the OFT recommendations. The competition directorate of the European Union has used its powers in relation to state aid to impose a number of conditions on those banks across Europe which accepted financial support from their own governments but the forced disposal of RBS branches in England (to be acquired by Santander) has had only a marginal impact on competition in the Scottish market. Of more significance perhaps will be the divestment by Lloyds Banking Group required by EU State Aid rules. This offers the opportunity to create a stand-alone Scottish headquartered bank, should a purchaser wish to do so.

3.20 It is at this time impossible to judge what impact, if any, the well publicised travails of the major banks have had on the wider reputation of Scotland in financial services. However, there is no evidence of loss of business by Scottish firms engaged in insurance and savings business, or asset management, as a result of these reputational effects. There will be consequences for these firms, and more substantially for those activities which provide services to financial businesses, as a result of the contraction of the Scottish banks.

RECOMMENDATIONS FOR THE SCOTTISH GOVERNMENT

3.21 The Council recommends that the Scottish Government:

Recommendation 1: asks the OFT to review competition in the Scottish banking market.

Recommendation 2: seeks, through the outcome of such an investigation and other ways, to secure strong head office presences in Scotland in the banking industry.

Recommendation 3: seeks, by influencing the policies of the Westminster Government and to the extent possible, using the pressures and powers available to the Scottish Government, to secure an increase in trading with, and in competition for, the supply of banking services to SMEs in Scotland.
C. LIFE SCIENCES

BACKGROUND

3.22 Life sciences is the smallest of the key sectors in the Scottish economy in terms of turnover. But it is a sector with high growth rates, especially when measured in terms of employment growth and the creation of new businesses, and one which offers levels of productivity and value added that are higher than average.

EVIDENCE BASE

3.23 In 2007, the life sciences sector, spanning manufacturing, R&D as well as indirect activities, contributed GVA of £1.5 billion, equivalent to 1.6 percent of Scotland’s total GVA; experienced turnover of £3.2 billion; and employed 28,900 people in the Scottish economy.\(^{17}\) The sector has a productivity level (GVA per employee) which is approximately 10 percent higher than the Scottish average.\(^{18}\)

3.24 The attractiveness of life sciences as a key sector lies in its growth potential. In 2010Q1, output in the sector was 21.7 percent higher than in 1998Q1. Output in the overall Scottish economy grew by 17.8 percent. Life sciences, therefore, grew 0.2 percent faster than the rest of the economy in terms of value added.\(^{19}\) Over the same period the number of employees in life sciences grew by 63 percent and rates of new business start ups grew 0.25 percent faster each year than in other parts of the economy.\(^{20}\)

3.25 However, productivity growth has been disappointing. Output per employee, while higher than elsewhere in Scotland, has not increased significantly between 1998 and 2007, which means that productivity itself has grown two percent slower than the Scottish average in this sector. Part of the explanation is that much of the activity in life sciences is R&D, drug discovery or clinical trials, while the production and marketing of the product (after the research is completed) takes place in a different company, often outside Scotland. This is typical of “pre-revenue” businesses. If R&D is labour intensive, then output/value added per employee will appear lower if the production it enables takes place in a different firm and/or in a different economy. This is illustrated by comparing figures for other industries: productivity in Scottish manufacturing (a typical revenue business) is 50 percent higher than in life sciences, while in services (where there is little R&D activity) productivity is 25 percent lower.\(^{21}\)

3.26 There has also been a shift in the structure of the industry, which has affected productivity growth. Life sciences contains seven subsectors: pharmaceuticals (18 percent by value added); agricultural, environmental and veterinary (two percent); diagnostics and medical devices (23 percent); professional services (21 percent); supply firms (23 percent); contract research (nine percent); and biotech (three percent).\(^{22}\) The productivity levels in these sub-sectors vary, with output per head in the pharma and agricultural subsectors (where research is completed) being £22,000 to £30,000 higher than the Scottish average in 2006; but with biotech and contract research (where research is still underway) at £2,000 to £6,000 below (see Table 1). If there is a shift in the balance of activity from high productivity/revenue to low productivity/pre-revenue sub-sectors (say from pharma, to biotech and contract research), then the labour productivity growth rate will inevitably fall.

17 Source: Matched Scottish Enterprise data (matching a list of life sciences companies with SIC codes).
18 Scottish average defined broadly excludes the financial sector and some of the public sector.
19 Scottish Quarterly GDP Index: Sector definitions based on SIC code classification.
20 Source: Matched Scottish Enterprise data.

Third Annual Report of the Scottish Council of Economic Advisers 29
3.27 However, year-by-year productivity figures are often highly unstable because the timing of employment changes seldom matches the more steady changes in output growth or value added. The figures for 2007 (Table 1, below) illustrate this problem very well. In the absence of long run of productivity growth figures by subsector, it is doubtful if we can draw any reliable conclusions about the growth potential of the sub-sectors from Tables 1 and 2. It would be better to rely instead on the earlier “revenue generating” vs. “pre-revenue” distinction to show where growth and productivity growth potential of the sector lies instead.

### Table 1  Productivity Differences for the Life Sciences

<table>
<thead>
<tr>
<th>Core sector</th>
<th>GVA per employee, minus Scottish average (2006)</th>
<th>GVA per employee, minus Scottish average (2007)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pharma</td>
<td>£29,858</td>
<td>£41,608</td>
</tr>
<tr>
<td>Agriculture, environment</td>
<td>£22,719</td>
<td>£3,991</td>
</tr>
<tr>
<td>Diagnostics and medical devices</td>
<td>£5,950</td>
<td>£2,243</td>
</tr>
<tr>
<td>Contract research</td>
<td>-£1,919</td>
<td>£1,924</td>
</tr>
<tr>
<td>Biotech</td>
<td>-£5,904</td>
<td>£20,915</td>
</tr>
</tbody>
</table>

| Suppliers and business services  |                                               |                                               |
| Professional services           | £180                                          | £10,092                                       |
| Supply firms                    | -£1,205                                       | -£3,914                                       |

Source: Matched data of Scottish Enterprise list of life sciences companies with Annual Business Inquiry

3.28 Employment in the life sciences sector has grown by around 11,000 employees or 63 percent between 1998 and 2007, compared to 7.5 percent for Scotland as a whole. But this was unevenly spread across sub-sectors, and in some cases from a very low base, as the following table shows:

### Table 2  Employment Growth in the Life Sciences Sector in Scotland

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Diagnostics and medical devices</td>
<td>117 percent</td>
<td>3,400</td>
</tr>
<tr>
<td>Pharma</td>
<td>-55 percent</td>
<td>-3,300</td>
</tr>
<tr>
<td>Contract research</td>
<td>164 percent</td>
<td>2,300</td>
</tr>
<tr>
<td>Biotech</td>
<td>500 percent</td>
<td>1,000</td>
</tr>
<tr>
<td>Agriculture, environment etc</td>
<td>150 percent</td>
<td>300</td>
</tr>
</tbody>
</table>

| Suppliers and business services |                                               |                                               |
| Supply firms                    | 93 percent                        | 3,700                                   |
| Professional services           | 119 percent                      | 3,700                                   |

Source: Scottish Government and Scottish Enterprise

**POLICY CONSIDERATIONS**

**Skills, business structure and location**

3.29 Life sciences is a key sector because it exploits Scotland’s comparative advantage in higher education and capacity for advanced research. The links with the universities, and the fact that R&D in higher education is more productive than elsewhere in the UK (and

23 Ibid.
24 Scottish average broadly excludes the financial sector and some of the public sector.
proceeds at twice the rate of business R&D), coupled with a highly educated workforce, mean that this is an important advantage to exploit. Scotland is now host to the second largest life sciences cluster in the UK, the third largest in Europe and is usually rated as one of the top five in the world.25

3.30 The pattern of employment creation is interesting. Scotland ranks, along with the South East and East, as one of the three dominant locations for life sciences companies in the UK, and employs roughly three times as many as any of the other regions. Yet the growth in employment of the past decade has all been in Scotland, Wales, Yorkshire and the South West.26 That suggests life sciences firms are cost sensitive, possibly lifestyle sensitive, as far as location decisions are concerned — provided the necessary specialised services, research facilities, and access to world class academic personnel and pools of knowledge can be assured. To develop the life sciences industry we need sufficient instruments to preserve/extend the cost advantage over other regions.

Investment

3.31 Access to investors and finance is crucial for the development of the life sciences sector and has proved to be the weak point in Scotland. There are two issues:

- capital to set up and run the companies concerned; and
- sufficient finance to run the R&D projects, in particular for the long clinical trials and testing phase before any product can be commercialised.

3.32 Investment for the setting up and running of life sciences companies seems to have been inadequate. Figures for 2005 to 2008 have remained fairly constant despite the rapid growth of the industry in that period (10 percent per year). And at £20 million to £30 million for an average of 40 deals per year, it amounts to raising less than £1 million of financing per firm on average.27 It would pay to think of schemes to increase the flow of investment funds, either directly (such as a small levy on successful firms to help future start ups; or tax breaks for firms that undertake R&D, or for knowledge workers), or indirectly via concessionary terms or guaranteed purchases for the product if it is successfully developed and marketed.

The availability of finance

3.33 A recurring complaint has been that there is a lack of coordination and common purpose between the universities, commercial firms and supporting agencies: that is between the principal source of innovation ideas and those that can implement or commercialise them. Chapter 3 of the Council’s Second Annual Report sets out some of the many reasons for this.

3.34 This complaint assumes that innovation, discovery and development is a two part process – between the researchers/innovators and those who commercialise and develop the market – which functions poorly because neither side has the incentive to act or cooperate as the other would wish or finds necessary.

3.35 The reality is more complex. The process is in fact in three parts: research/discovery; trials, testing, development; commercialisation and production. The greatest difficulty is in obtaining finance and investment for the middle phase. It was reported to us that it is comparatively easy to obtain finance for the first (research) stage, typically in the £2 million to £4 million range, especially with the use of university or research institute facilities and

26 Scottish Enterprise (2009), op. cit.
27 Scottish Enterprise (2009), op. cit.
academic expertise. It is also easy to raise finance/investment from venture capitalists or existing life science firms for the third stage, typically £50 million and up, once the trials are complete, development work done and it is clear that a viable product is on the way. But it is very hard to get the middle stage, perhaps £5 million to £10 million, financed. If companies fail to find financing at any stage, it is likely they will be sold out of Scotland and the expertise, as well as employment and value added, lost. This is not a problem which is peculiar to Scotland: the same complaint came just as forcefully from innovators in the US and the rest of the UK.

3.36 The reason is fairly clear. The middle stage takes a long time to complete (perhaps ten years in the case of drugs), and contains all the risk that a) the new product will fail in trials, b) will have unexpected side effects, c) will ultimately fail. It is, therefore, hard to assess what the expected rate of return on such an investment might be. It is also subject to asymmetric information in an area where no-one can know the truth before the trials begin: the inventor will maintain the product to be excellent until proved wrong, and the producer that it brings potential liabilities until proved otherwise. As a result, potential investors are reluctant to put up funding unless either the process is shortened, or the product de-risked.

3.37 The difficulty appears to be the alignment of inventors with commercialisers. There are various ways to do this more effectively:

- The first is to shorten the trial period, reduce the risks, or broker a more symmetric and reliable supply of information to both parties. Since this needs to be done on a proper scientific basis, it might best be done in the form of the “Oxford model” outlined in the Council’s Second Annual Report. This would bring the inventors and financiers together, with neutral information and a pooled system of intellectual property rights. Edinburgh’s Bioquarter and the developments in Dundee would be natural candidates.
- The second is to establish new priorities within the sector in order to shrink the middle phase. Since drug discovery and pharmaceuticals are the most risky, and need the most exacting trials, this implies moving away from big pharma towards biotech, agricultural-environmental, diagnostics and devices, and personalised medicine. This will be controversial since it is generally perceived that big pharma (if successful) brings higher returns. But it is not clear that it also implies higher expected returns.
- A proper review of how the contracts between inventor, investor and producer are written and priced might be a more effective way to increase the incentives for all parties to participate.
- Similarly, the pricing for contracts on output: for example concessionary pricing for those who supported a particular project, or a guaranteed supply at a certain price. Since this is likely to involve the NHS, or other agencies in markets that are highly regulated (agriculture, environmental), it provides a mechanism for indirect support from those agencies and may induce other financiers to take part as a result.
- In the US, university contracts are increasingly used to finance the middle stage. This is unlikely to happen in the UK. But a strategy of forming clusters around one big player (for example providing specialised services for the NHS in the case of life sciences) would make an alternative strategy.

3.38 The areas that might be prioritised are: diagnostics; precision measurement; imaging, testing and instrumentation; stratified or personalised medicine techniques with the necessary databases; agri-bio and enviro-bio; services with a medical dimension (medical and bio-engineering, medical-legal, medical-IT). Industrial biotech, in particular, is predicted to grow by 37 percent a year over the next five years.28

Inter-industry collaboration

3.39 The paragraph above shows there is also clear potential to exploit spillovers between key sectors. This implies a new strategy for how industrial clusters should be put together. A strategy to favour such inter-sector collaborative ventures would make it easier to: reach critical mass; increase economies of scale; obtain investment and a range of specialised services; provide some protection for head office functions; and widen the exploitation of Scotland’s scientific base. Examples might be:

- clinical/translational medicine, supporting collaboration and innovation through the Translational Medicine Research Institute and Scottish Academic Health Sciences Collaboration; and
- enhancing Scotland’s strength as a centre for stem cell and regenerative medicine.

3.40 Clustering like this would have the valuable effect of pooling intellectual property rights, which can result in important spillovers when a particular idea/technique is matched with another from a different field. Outside a cluster this is unlikely to happen, but inside there can be big payoffs. A central register of intellectual property could facilitate such matching.

NHS purchasing strategies

3.41 A recurring concern is that the NHS purchases little of the life sciences sector’s output. Those responsible for NHS purchasing argue that they always choose the most cost effective option available. However, the problem is a serious one from the economy’s point of view. The NHS is not only the largest domestic purchaser; it is also a monopoly purchaser. If a company finds no local purchasers for its product, but can sell into other markets abroad, it is likely to leave Scotland and move to where its market is. The production, employment, and potential for future investment is then lost to Scotland. NHS purchasing is therefore important for anchoring life sciences firms in the economy. From that perspective, when firms say “don’t give us a grant or subsidy, give us an order” it represents an important opportunity to give firms the evidence to show investors that they will stay in business.

3.42 Given the above, changes in procurement that are medically justified, offer new technologies, and offer the possibility of an early order (with a government indemnity if necessary) rather than grant or subsidy, would be useful. Similarly, contracts to sell the product could be written to contain price discounts, or guaranteed supplies at an agreed price, to those who supported the product’s development or where there is a monopoly buyer.

Anchoring and tax incentives

3.43 A major concern is the need to anchor successful firms in the Scottish economy given the inevitable temptations to relocate in other markets. This is not an issue if a firm is locked in an effective cluster with access to academic research and research facilities. The cost in externalities lost would be too high. The important features to include here are access to the research infrastructure, first class academic personnel and labs, databases (especially genetic databases), stratified medical records, and other specialised services. Another example would be investing in a nationwide genetic database so that Scotland becomes the location for developing personalised medicine procedures. Life sciences clusters need to be put together to contain these things.

3.44 Ideally, we should be able to use the tax system to encourage the life sciences sector’s development. This might involve an extension of corporation tax credits for
developing or using new intellectual property, and for undertaking R&D. Finally the licensing agreements or pricing policies which underlie those new firms/techniques might contain clauses that reduce taxes on products that use Scottish technology.

3.45 It is not clear that tax incentives can be offered under current arrangements – which is another reason the Council believes more devolution of fiscal levers is necessary. As things stand, the only weapon is public procurement, for procedures as well as drugs or equipment.

RECOMMENDATIONS FOR THE SCOTTISH GOVERNMENT

3.46 The Council recommends that the Scottish Government:

**Recommendation 4:** encourages a shift to life sciences sub-sectors with potentially higher productivity – possibly the agriculture, environment and veterinary, diagnostics, or industrial biotech (bio-manufacturing) subsectors - and re-evaluates the priorities for diagnostic, testing and precision activities; and especially stratified or personalised medicine and the associated bio-informatics databases.

**Recommendation 5:** improves the financing of the trials, testing and development phase of innovations through any of the methods suggested in paragraph 3.37.

**Recommendation 6:** finds ways to encourage interactions between key sectors, e.g. life sciences and digital or IT, and matching of intellectual property.

**Recommendation 7:** considers changes in public procurement to favour new technologies and offer the possibility of an early order rather than a grant or subsidy.
Chapter 4

Fiscal Responsibility

4.1 The Council’s original remit, in 2007, was to find ways to increase the rate of long-term economic growth in Scotland; and to advise on how such policies could be used to overcome the persistent underperformance of the economy over the past 35 years. That remains the remit.

4.2 The Scottish Government currently faces the challenge of supporting economic activity in the face of severely constrained public finances. This has opened up the debate with the new UK Government over how much autonomy Scotland should have in order to address challenges. This means we have to draw a clear distinction between a funding formula in which ministers are held accountable (in a narrow accounting sense) for raising and spending a defined stream of money, versus a financing regime which gives the Scottish Parliament the capacity and the responsibility to raise and spend those sums of money which they think would most improve the performance of the economy and the standard of living of its citizens.

4.3 Many commentators have criticised the strategy currently used to finance the Scottish budget, both the block grant system and the small amount of fiscal autonomy devised in the Calman Commission report. This chapter sets out to identify what level of autonomy would best suit the Scottish economy, and the institutional changes needed to support that arrangement. The Council’s conclusions are in line with those of the Steel Commission: that significantly more fiscal powers should be transferred to Scotland.

EVIDENCE BASE

4.4 The Council’s responsibility is to find a financing regime that will secure growth and jobs. Simple funding mechanisms, such as a block grant or the Calman tax assignments, cannot give the Scottish Government the capacity to improve the economy on a systematic basis. Instead they are a means to secure Scotland a given stream of funding.

4.5 The options available more broadly are: block grant funding (such as the Barnett formula); tax assignment schemes (including apportioned taxes); partial fiscal autonomy; fiscal federalism; and full fiscal responsibility.

4.6 The current Calman proposals would imply a very small amount of autonomy, were it not for the fact that spending will be tied to fluctuating revenues defined by others (thereby reducing the opportunity for independent decision making). Moreover, since these proposals are impossible to implement as they stand, the implemented version is almost certain to operate by apportioning taxes (previous UK Government White Paper, 2009). The original instructions from the Calman Commission were to consider full fiscal autonomy (the example of the Basque-lands was given), fiscal federalism, and the implications of the Steel Commission report in 2006. But after six months, those options were ruled out of consideration. This chapter therefore brings fiscal devolution (fiscal responsibility) back into the range of possible choices.
Chapter 4 Fiscal Responsibility

Partial Fiscal Autonomy

4.7 At present, Scotland faces a dilemma. The existing block grant system has been widely criticised, not least by the UK Government.29 On the other hand, the Calman proposals appear to be unworkable as they stand because they require information on future tax revenues that no policymaker can possibly have; and because, by denying borrowing for current activities, they contain no mechanism to reconcile contractual spending (most of the budget) with variable revenue flows – which is to invite an eventual breakdown. Thus the Calman proposals retain the very defect that led the Commission to reject the possibility of allocating North Sea revenues to the Scottish budget. But any attempt to fix these problems (for example by using Treasury forecasts of future tax revenues), is likely to introduce three further difficulties: new grounds for quarrels between the UK and Scottish Governments, a long-term deflation bias, and a loss of devolution.30

4.8 There is an additional problem, generic to this kind of partial fiscal devolution. Since taking office, the new UK Government has announced that it will raise the tax-free allowance on income tax to £10,000 – to be funded by increases in Employee National Insurance revenues and in the rate of Capital Gains Tax on non-business assets. This will alter the balance of taxation in the economy and reduce the revenues raised from income taxes. That would have a major impact on the finances of the Scottish Government should the Calman proposals be adopted. The Calman regime assigns part of the revenues generated by income taxes in Scotland to the devolved government. As a result, the new tax allowances will reduce the revenues from income tax and, consequently, the funding available to the Scottish Government since the replacement National Insurance and Capital Gains revenues will go straight to the UK Government, not to Scotland. However, no such effect will be observed in the rest of the UK since, by construction, the loss in income tax revenues will be compensated by increases in these other tax revenues.

4.9 The problem is that changes of this kind imply a retreat from devolution. If Scotland is to continue to meet her obligations, the Scottish Government would have to raise its own tax rates to compensate for changes made in England each time this happens. The only way out is for the Scottish Government to seek greater autonomy (more taxes under its control) since the problem is caused by not having assigned any other taxes to compensate in Scotland. In other words, a small amount of autonomy will automatically generate new pressures for greater autonomy.

4.10 Another way out would be to grant autonomy in setting the rules governing the operation of a tax (the tax bands, thresholds, allowances, and changes to the tax base itself). But if nothing is done, alterations in the burden of different UK taxes will always change the finances available to the devolved government. One can attempt to resolve this problem with a series of ever more complicated technical fixes to the remaining grant (Barnett bypasses) to ensure the outcomes are revenue neutral. But that would take us straight back to a system where the effective revenue flow is determined by the underlying block grant, and devolution is meaningless. In addition, greater uncertainty and arbitrary political judgements would surround the financing of Scotland’s devolved administration, with more quarrels to damage the performance of the Scottish economy. It is hard to imagine such a regime being open, transparent and verifiable.

30 A deflation bias because income taxes grow slower than the other sources of revenue that drive the spending allocations that make up the block grant, and because historically income tax forecasts have overestimated actual outcomes - so too much will be taken off the grant in lieu of own resources. A loss of devolution because spending decisions will be driven by what someone else says you can spend based on the status quo, not what you might have to spend by improving the economy’s performance.

36 Third Annual Report of the Scottish Council of Economic Advisers
Efficiency and Political Accountability

4.11 Generally, the Council suggests that more devolution is better than less, for two reasons. First because a wider devolution is better as a matter of system design (internal diversification to stabilise revenues; insurance against unrelated UK policy changes); second because it creates a responsibility for creating a better economic performance, as well as accountability in a legal sense. Since both are desirable, more is better than less. But questions remain. How do we attain greater economic efficiency? Legal accountability alone creates no responsibility for efficiency. And what are the spillovers for the economies in the rest of the UK? Are they consistent with the overall UK macroeconomic framework?

Fiscal Responsibility

4.12 There is an extensive literature on the economics of fiscal decentralisation, or “fiscal federalism”, starting with the work of Musgrave in the 1950s and Oates in the 1970s. The conclusion of that literature is that decentralisation, hence fiscal responsibility, typically leads to better economic performance – both in theory and in practice. The argument is usually put in terms of economic efficiency: decentralisation provides an efficient way to correct various forms of market failure, ensure an equitable distribution of resources, and stabilise regional economies and employment. To deny that, one must show that a single, centralised, monolithic government could or indeed would succeed in maximising social welfare across all regions out of a sense of benevolence, despite the electoral pressures and special interests in a multi-region democracy.

4.13 In practice, where there are regional differences in structure or resources, or in the way economies respond to shocks or policy changes, or a region’s position in the cycle, it would be very hard – if not impossible – for any one government to come up with one set of policies that satisfied everyone in the sense of maximising wellbeing. Different regions will require different solutions to suit their particular circumstances.

4.14 It would be doubly difficult if central government:

• has less precise information on local needs/conditions or if its policies are helpful in one place but have adverse spillovers on another;
• is less accountable because of political distance from the regions; or
• is subject to special interest groups because of the electoral calculus of majority rule.

4.15 As a result the provision of public goods and stabilisation of employment would be inefficient, and the performance of the regional and aggregate economies below potential.

4.16 This argument is sufficient to demonstrate the classic “decentralisation theorem” of Oates (1972): that in multilevel government, each level (including central government) will maximise social and economic welfare within its own jurisdiction. That would necessarily provide a higher level of economic and social welfare than can be gained in a regime in which central government provides a uniform set of policies and public goods for all – since regional policymakers could always replicate the central government’s common policies, had they wanted to do so. That is the case for devolved fiscal policies: decentralising will always produce better outcomes for all, including the central government (subject to not devolving so far as to create serious diseconomies of scale in the delivery of public services).

4.17 The standard response has been to say that the same result can be achieved by a common set of policies plus a set of lump sum transfers (subsidies, grants, side payments) to each region, chosen to allow the same local outcomes. That, of course, is true: but it reproduces the Barnett grant system that has been used until now. It also means that grants may have to be more generous in some regions than in others; and it imposes no
accountability on those who raise the grants, or on those who spend them. Moreover, if the grants are to respond to local conditions, and if there are structural or cyclical differences, or more accurate information at the local level, or if central government finds itself constrained, then we will have to ask regional governments to decide on those grants for themselves – giving rise to even less accountability and even more perverse incentives.

4.18 It would be better to make regional governments raise and spend their own revenues. They are then accountable to their own electorate and must bear the pain of their spending decisions; but can still profit from more precise information on local conditions, differences, preferences, with some protection from blocking coalitions elsewhere. The result would be more effective policies: higher growth and higher employment than is possible under a grant or assigned taxes.

POLICY CONSIDERATIONS

4.19 That, essentially, is the case for fiscal responsibility. The remaining question is to decide how far autonomy should go. Regional governments will recognise that they have a limited ability to influence local employment or prices, or play an active stabilisation role, or borrow. The central government should therefore retain a defining role in coordination, monetary stability, stabilising the economy; and also in competition policy and financial regulation (albeit subject to representation from Scotland).

Allocating Policy Instruments and Responsibilities

4.20 This argument suggests a natural way to allocate policy instruments between central and regional governments. The power to tax immobile factors, property and natural resources (including North Sea oil) should be allocated to regional governments. They should also set user fees, benefit taxes and spending; have the power to raise income, sales, corporate or business taxes, and the social security taxes that affect mobile factors, production costs and competitiveness; also control spending on health, education, police and justice, infrastructure, R&D, innovation, and development. These are all instruments that affect productivity growth in the short and long run; and hence unit labour costs, employment and the cost of doing business. Unusually, taxes on mobile factors are included here because the ability to set taxes equal to the marginal cost of providing services at the regional level is necessary if households and firms are to choose locations that provide the most efficient level of services – and to give governments a direct incentive to supply those services efficiently.

4.21 By contrast, “framework policies” that affect monetary conditions, price stability, financial stability, taxes/spending for income or resource redistribution, competition and regulation policy, mechanisms for internal/external coordination, and commercial policy (tariffs, trade barriers, exchange rates) are better left with the central government. This allocation of policy instruments has been made according to comparative advantage for the objectives of regional and central government respectively.

Size of government

4.22 This type of allocation emphasises the importance of creating “own sources” of finance in a devolved system. A regime that relies on grants or tax assignments provides a fatal incentive to expand public spending programmes beyond efficient levels by pressing the centre to shift more in their direction, or to expand the common debt issue to allow that to

31 There is a case for allocating regulation in a single UK market (such as competition policy, or for banking and financial services) to the UK level, but regulation of a natural monopoly to the Scottish Government (as in Northern Ireland for gas and electricity).
happen. The prospect of an easy bail-out, or guarantees for local debt issues, would have the same effect. Creating own sources overcomes that problem by passing responsibility and accountability on to regions.

4.23 There may be a concern that these arrangements could lead to an expansion of government, with overlapping or conflicting functions at different levels. This will be minimised if policies and responsibilities are chosen according to comparative advantage. In that way the distortions and inefficiencies that might otherwise arise from excess fiscal competition will be kept below the inefficiencies which appear with central financing. In practice, it appears that this tendency to larger government is weak and depends on the form that devolution takes, not its existence. In fact where decentralisation is built around raising taxes (as in fiscal responsibility), it is typically associated with smaller government. But where it is financed by transfers or grants, as now, there is a tendency to larger and less efficient government.

**Fiscal Responsibility in Practice**

4.24 It is now possible to set out a fiscal framework that contains more autonomy, but with institutional links to central government to maintain coordination, to allow risk sharing, and to align Scotland’s fiscal policies with the framework policies of the UK Government. But by maximising its resources, Scotland can increase accountability and realise the efficiency gains. Supporting institutional measures to extend risk sharing, monitoring and fiscal oversight are then needed to bring credibility and stability to the system.

4.25 The Council emphasises that the scheme that follows is a fiscal system which falls short of what had once been agreed by the UK Parliament in the Irish Home Rule Bills of 1912-13. It is consistent with the recommendations of the Steel Commission (2006), but supplies the necessary detail with respect to institutions, tax allocations, tax codes, and financial flows.

4.26 We start from the example of the Basque-lands and Navarre which operate very successfully in Spain. These areas pay the Spanish central government about nine percent of their revenues as “rent” for common services: defence, security, foreign and diplomatic service, central administration, contributions to Spain’s EU dues and debt servicing. In 2008-09, a comparable sum for Scotland would mean a contribution of £6 billion to the UK Government. To this we add another one percent of GDP in solidarity funds to allow the UK Government to make its own redistribution and stabilisation payments. These funds mirror the UK’s own payments to the EU budget for solidarity purposes.

4.27 Power over the remaining taxes/expenditures would then be allocated to the Scottish Government: that is those noted in paragraph 4.20, but also include a share of VAT; any other sales taxes; capital gains and inheritance taxes; fuel tax; social security; payroll taxes/nonwage costs (to give Scotland some control over her own competitiveness); “cap and trade” (including auctions under the EU-ETS) and environmental taxes; financial market levies; council tax; tax concessions; operating surpluses of statutory bodies; and the smaller taxes (stamp duty; alcohol, tobacco and vehicle duties; passenger duties; etc). New taxes might include landing fees for natural resources on the Australian model, or licence fees for electricity generation (currently held by the Crown Estates but not credited to or accounted for in Scotland).

4.28 It is further proposed to adopt sensible practices on safeguarding social security through hypothecated policies, as happens in other European countries to ensure stability and to define the rents payable to the UK Government, and the contributions to a central

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grants commission (see paragraph 4.31). Pensions will continue to be paid out of a common national insurance fund, as now.

4.29 Finally we stress the important feature of fiscal autonomy is that it transfers to the Scottish Government the means to control the tax base and exemptions, just as much as tax rates and tax bands as a way to expand the revenues and scope of the devolved taxes. Note also that automatic transfers (that is, additional risk sharing elements) are built in to stabilise the economy via the central budget and the grants commission (see paragraph 4.31).

Supporting institutions

4.30 Institutional support is necessary if Scotland is to realise the gains of greater responsibility. Devolution reduces the inefficiencies that stem from a centralised one-size-fits-all set of policies, and so improves economic performance. But it may create conflicts in the form of free riding; or spillovers that damage performance elsewhere if not restrained by regional governments or the central government. Consequently, devolution is at its most effective and the gains from autonomy largest, when there is diversity (of structure, circumstances, preferences) and when the spillover effects of local action are small. Since central government has a comparative advantage in imposing coordination, discipline, and setting the general thrust of policy, the best way to realise those gains is to create a decentralised scheme with small grants to, or rents from the regions; with institutions designed to secure both coordination and the gains of accountability.

4.31 We suggest a UK Grants Commission, as mentioned briefly in paragraphs 4.28 and 4.29. This would be a device to assure the UK Government that Scotland is operating in a macroeconomic framework which is consistent with the rest of the UK, and would prevent Scotland doing anything that might otherwise distort, destabilize or damage the UK economy and its regions. The Commission would have three functions:

- **partnership and coordination**: to ensure the UK continues to operate as a social and economic union; and that the underlying regional/national policies are consistent and mutually supportive.
- **economic and political**: that there is a mechanism that defines effective roles for the Scottish and UK Governments; that there is an explicit redistribution mechanism between regions if needed, and also a central budget to provide automatic risk sharing transfers that are short-term and reversible.
- **a UK monetary fund** to distribute any payments/loans/grants to or from the centre as described in the debt management section below.

4.32 The Grants Commission would contain an Economic Policy Forum, with representatives (one each) from the UK and each devolved government, to reach agreed decisions on matters of joint interest or to resolve conflicts in the overall macroeconomic framework. The Forum would have authority to recommend changes to the economic policies of any of the constituent regions. Such recommendations would be advisory and non-binding by majority, or binding with unanimity, and would include discussion of potential retaliations in cases of severe disagreement.

Fiscal discipline

4.33 There are four mechanisms to ensure that fiscal discipline is maintained with the advent of devolved fiscal responsibility:

- increasing the accountability of the regional governments through greater autonomy;
• risk sharing transfers found in fiscal autonomy. This will depend on the existence of a central budget and automatic transfers to/from that budget (see paragraphs 4.24, 4.29, 4.31);
• enforceable limits on the size of any deficit or debt; and
• an independent fiscal policy commission charged with the oversight and monitoring of the government’s fiscal plans.

4.34 Increased accountability points to fiscal responsibility as the appropriate regime. It depends of course on the policymakers’ concern for reputation. A funding collapse would suggest that the regional government had failed and would leave them accountable to the censure of the voting public – the more so the more autonomy has been granted. Discipline therefore calls for more autonomy rather than less, backed by some visible restraint/punishment mechanism.

4.35 Risk sharing transfers depend on the existence of a central budget and automatic transfers to/from that budget. Risk sharing also flows from the cross-border ownership of stocks, bonds or other income sources; and from cross-border lending and credit. So there will always be some risk sharing in an integrated market for capital and financing. However, the presence of the central government raises a new problem: moral hazard, the perception that excessive deficits will be bailed out or otherwise “insured” by loans from central government. Moral hazard blunts the incentive to maintain fiscal discipline, in particular to shrink deficits in good times to prepare for bad times. For that reason, it is better to have regional stabilisation, rather than central insurance and soft budget constraints. That is, it is better to have more extensive devolution, rather than a centrally determined system.

4.36 The third mechanism is enforceable limits on the size of fiscal deficits and debt. In the Euro-zone, the problem with such limits has been two-fold. First, they have proved difficult to enforce. Second, our ability to monitor deficits in real time to detect significant deteriorations is very limited. Early releases of deficit figures, and the data necessary to strip them of their cyclical components, are so imprecise that the ability to detect violations reliably is only achieved after four years; too late to take any corrective action or to induce such actions through the threat of fines. It is better to focus on debt limits.

4.37 A debt target is useful for many other reasons. First, debt is what has to be financed and what causes default risk. Second, the debt burden is better defined: what has and needs to be borrowed is known to the markets since they hold the paper. Third, debt is a moving total of past deficits and represents the structural position we need to monitor. Fourth, debt is a stock and not a flow. That means it is persistent, which will make policymakers forward looking in their plans and, by extension, make their plans more credible – or at least more easily tested for credibility. In particular, persistence gives them an incentive to restrict debt in order to preserve freedom from financing constraints in the future.

4.38 An effective monitoring agency needs to overcome two defects in the existing monitoring schemes; first that they are automatic and partial, and second they are purely backward looking. They do not imply any pressure to modify fiscal plans in the light of future problems. To get round that, we need an independent Fiscal Policy Commission. This Commission would have the responsibility to review the fiscal outlook for Scotland, the revenues likely to be available, the current structural position and the likely consequences of current spending policies, including changing demography and pension costs.
An Excessive Debt Protocol

4.39 The Council proposes the following enforcement mechanism:

• the UK and Scottish Governments jointly operate a UK monetary fund as above;
• the debt targeting system should be set up as a debt target value and an upper boundary; and
• the space between the target and upper boundary should be divided into three ranges.

4.40 If the debt target was set at 45 percent of GDP, and the ceiling at 60 percent, the excessive debt protocol ranges would be from 45 percent to 50 percent; from 50 percent to 55 percent; and from 55 percent to 60 percent. The first range would be the range of normal fluctuation. If the debt ratio entered the second range, Scottish fiscal authorities would be placed on the watch list and subject to comment and advice from the Fiscal Policy Commission. Any support from the Grants Commission, or advice from the Fiscal Policy Commission, would now become conditional on improvements being made. If the level of debt entered the third debt range, this would trigger public warnings. Finally, if Scotland’s debt ratio rose above 60 percent, all guarantees would be lifted. Debt management and refinancing would become subject to the full discipline of the markets. The Scottish budget would be required to follow rules set out by the Fiscal Policy Commission until the 60 percent limit was regained and held for a year.

Advantages of fiscal autonomy for the UK and for Scotland

4.41 This scheme is predicated on the value, to UK Government, of a Central Grants Commission, of saving money by abandoning Barnett, of savings achieved by reallocating spending decisions, of creating a better economic performance (and hence a lower burden on the UK budget), and of significantly increasing the degree of financial accountability in the Scottish Parliament. This is a constitutional arrangement with gains for both sides.

4.42 Practical experience shows how much can be gained from this kind of arrangement. Spain’s autonomous regions, with a similar regime to that described here, show GDP per head to have grown relative to the non-autonomous Spanish average: from 25.9 percent to 29.3 percent above that average in Navarre, and from 19.3 percent to 34.2 percent above it in the Basque-lands, between 1995 and 2009. Thus both regions were always richer than the Spanish average, but they have become increasingly so since the present system of fiscal autonomy was introduced. In fact, for the Basque-lands the additional GDP per head has increased by 77 percent in that period.33 In the same period, unemployment in those regions fell to nearly half the Spanish average and has stayed there. And the Basque-lands had an AAA credit rating, while Spain itself was rated AA. Recent work in the American Economic Journal shows that, for OECD countries, a 10 percent reduction in corporation tax (or the factors that reduce that tax liability, such as R&D credits or payroll taxes) typically increases the investment rate over two percent; increases the number of entrepreneurs from three to five per 100 population; and raises company registrations by 20 percent.34 These are all examples of what fiscal responsibility can deliver in practice.

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33 “Spanish Regional Accounts”, Institute of National Statistics, March 2010
RECOMMENDATIONS FOR THE SCOTTISH GOVERNMENT

4.43 The Council recommends that the Scottish Government:

**Recommendation 8:** seeks to obtain the tax powers outlined above, in order to be in a position to influence the rate of economic growth and employment.

**Recommendation 9:** engages the UK Government in negotiations to make the necessary institutional changes for this to be possible.

**Recommendation 10:** gives priority to obtaining the power to borrow; then to obtaining power over taxes that affect the rate of return on labour (national insurance, business taxes, R&D credits).
Chapter 5

Employment, Skills and Education

BACKGROUND

5.1 The Council has devoted considerable attention to the interlinked issues of future skills requirements and the implications for education. It held discussions on Scotland’s schools and universities; and on employment, particularly graduate employment. This chapter draws together some of the issues that emerged from these discussions and the reports that summarised their conclusions.

5.2 The importance of the issues of education, skills and employment were all recognised by the Scottish Government in setting Purpose targets for assessing the impact of its Government Economic Strategy. However, all are areas where policy is likely to take effect only over several years. The lifetime of the Council has been too short to hope to see definitive and lasting changes in any of the areas.

5.3 In the course of its discussions, the Council has made a number of suggestions for policy in all three areas, some of which have been accepted by the Scottish Government. The deteriorating climate for employment and public spending makes it essential that the government pursues well-targeted and demonstrably effective policies in all these areas, avoiding short-term measures that may ultimately be expensive and ineffective.

EVIDENCE BASE

Employment

5.4 The past three years have seen a deterioration in the outlook for Scottish employment, largely because of factors outwith the influence of the Scottish Government. In addition, while labour market participation has been higher in Scotland than the rest of UK since May 2004, with the exception of two quarters, there has recently been a dip.

5.5 From the mid 1990s, Scotland's employment rate steadily increased, reaching a peak of 74.9 percent during the second quarter of 2007, and overtaking England. Since then it has fallen – to 70.7 percent in the third quarter of 2010 – slipping slightly behind England. Over the 12 months between the third quarters of 2009 and 2010, the gap between the employment rates of Scotland and England widened by 1.3 percentage points.

5.6 Compared with the top five Organisation for Economic Co-operation and Development (OECD) countries, Scotland’s performance has also worsened over the lifetime of the Council. The employment rate in Scotland, using the European age definition (15 to 64), was 70.6 percent in 2009, which is 1.6 percentage points lower than the previous year. Compared to the other countries in the OECD, Scotland has moved from 10th position to having the 11th highest employment rate. Between 2008 and 2009 the gap in employment rates between Scotland and the country with the fifth highest rate (Netherlands in 2008 and Denmark in 2009) increased from four percentage points in 2008 to 5.2 percentage points in 2009.

5.7 Scotland’s unemployment rate is now above that of the UK. In the three months to September 2010, Scotland’s unemployment rate rose to 8.5 percent compared with a UK

35 Based on the headline measure of those aged 16-64.
average of 7.7 percent. Unemployment in Scotland increased by 6,000 over the three months to September, whereas unemployment in the UK as a whole fell by 9,000 in the same period.

5.8 The Scottish Government also set a Purpose target for social cohesion, arguing that a narrower spread of unemployment among regions would both limit the potential drag of underperforming regions on the economy as a whole, and release public resources to invest in other parts of the economy. The difference between the three best performing local-authority areas and the three worst fell between 2001 and 2005, and then stabilised. However, the difference increased by 5.8 percentage points between 2008 and 2009. This has been driven by declines in the employment rates of the bottom three local authorities which have been especially affected by the economic downturn.

Education and Skills

5.9 The Government Economic Strategy identifies Learning and Skills as one of five Strategic Priorities that are essential for economic growth. The Strategy also notes that Scotland’s education and skills are not translating into higher productivity or better economic performance. In its first two Annual Reports, the Council considered education both at school and at tertiary level, taking as its starting point the importance of improving the stock of human capital and, through it, economic growth.

5.10 In terms of attainment – as measured by the examination system in each country – Scotland has shown little or no improvement since devolution, whereas each of the other parts of the United Kingdom has seen improvements, particularly England. Attainment data for the last year of compulsory education show that England, which lagged Scotland in 1998-99, had caught up with and overtaken Scotland by 2006-07. This relative improvement has come about through a considerable improvement in the English results, while those for Scotland have remained largely unchanged. Both Wales and Northern Ireland have also seen improvements over the period, although they have not been as dramatic as those for England.

5.11 At the same time, international studies show that, whereas Scotland’s overall position is quite high, in recent years it has either stood still or declined, in relative terms. A view of the performance of Scotland’s schools in an international context can be gathered from looking at a number of indicators of the performance of students in maths and science. The evidence, reviewed in the Council’s Second Annual Report, suggested that Scotland holds only the middle ground across the range of OECD countries.

5.12 In international terms, OECD data suggest that average spending per pupil in Scotland is above the OECD average for both primary and secondary schools. In other words, the shortcomings of Scotland’s education are not the result simply of under-spending on teachers and schools.

5.13 In addition, there is some evidence to suggest that Scotland’s levels of spending per pupil are high relative to other parts of the United Kingdom, vary greatly among local authorities, and are not clearly correlated with levels of achievement. A study in 2009 by the

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36 CPPR: http://www.gla.ac.uk/media/media_133107_en.pdf
38 See David Raffe (2008) for a commentary of the OECD Review of the quality and equity of schooling in the Scottish system.
Centre for Public Policy for Regions\(^39\) found that spending per pupil in Scotland appeared high relative to England, Wales and Northern Ireland. Indeed, the Centre found tentative evidence to suggest that spending per pupil might be anything from 23 percent to 82 percent higher than in the rest of the United Kingdom.

5.14 Within Scotland, even taking the mainland alone, spending per pupil varies by more than ten percent from the country’s average. Whereas some of this difference might be explained by sparse populations or high levels of local deprivation, much of the variation across local authorities is difficult to explain. The Centre cited as an example the fact that Stirling has above-average attainment results but is in the bottom three spenders per pupil.

5.15 In terms of the direction of spending on schools, there has been considerable financial investment in teachers in Scotland since devolution, and an even faster increase in ancillary staff. Between 2002-03 and 2008-09, spending on teachers increased by almost 30 percent, while expenditure on “other employees” rose by 60 percent. The Council has concluded that the challenge facing Scotland is to use resources more effectively in education, rather than to increase spending.

Universities

5.16 In terms of the share of the population that has higher education, Scotland comes 13th of the 31 OECD countries.\(^40\) However, the proportion of the Scottish workforce holding a university degree is almost exactly the same as the UK as a whole, and the UK is below the EU and OECD averages for graduates as a proportion of the workforce. Scottish participation rates in higher education are boosted by the unusually high proportion of the workforce with post-school, sub-degree level qualifications such as HNDs and HNCs. Put simply, Scotland has one and a half times as many people with HN qualifications as the rest of the UK, but has the same skills at higher levels.

5.17 Scottish universities receive proportionately more of their funding from public sources than English ones do, because tuition fees for Scottish students are paid by the government-backed Student Awards Agency for Scotland. They may thus be more vulnerable to national reductions in public spending. A recent Freedom of Information request by NUS Scotland found that eight universities were planning cuts in student numbers of up to 18 percent, amounting to 2,000 students in the 2010-11 academic year.\(^41\)

5.18 Scotland’s universities appear to be slipping down the rankings in one of the most widely used global league tables. In September 2010, the Times Higher Education World University Rankings placed only one Scottish university, Edinburgh University, in the world’s top 100, ranking it at 40th out of the world’s 200 best universities. Thanks partly to the use of a new methodology, it fell from joint 20th last year. The University of St Andrews fell from joint 87th in 2009 to 103rd, while Glasgow University dropped from 79th to 128th.

Graduate employment

5.19 The Labour Force Survey for July to September 2010 shows that there has been an increase in graduate unemployment to 4.1 percent, up 0.7 percentage points since 2009. This rate is lower than the English and UK averages (of 4.7 and 4.5 percent respectively). Graduate unemployment has increased more slowly in Scotland than unemployment of those without degree qualifications (up 1.5 percentage points between 2009 and 2010).

\(^{39}\) Centre for Public Policy for Regions, “Spending on School Education”, October 2009. Available at: www.cppr.ac.uk/media/media_133107_en.pdf

\(^{40}\) OECD Education at a glance: http://www.oecd.org/document/52/0,3343,en_2649_39263238_45897844_1_1_1_1,00.html

\(^{41}\) http://www.heraldscotland.com/news/education/axe-set-to-fall-on-scotland-s-universities-1.1024572
5.20 There is evidence to suggest that graduates are finding it more difficult to gain graduate level employment. For the period July to September 2010, the proportion of degree-holders in Scotland working in graduate level jobs was 67 percent. This has fallen by one percent since 2009 (when 68 percent of degree holders were working in graduate level jobs) and four percent since 2007 (when 71 percent worked in graduate level jobs). The proportion of graduates working in non-graduate level jobs was 16.7 percent, which is similar to the average level of the previous four years. The remaining 16.4 percent of graduates were in unemployment or economic inactivity, the highest figure in five years.

POLICY CONSIDERATIONS

Key policy challenges identified by the Council

5.21 In terms of generating employment, the Council accepts that Scotland as a small open economy is to some extent subject to forces beyond its control. The overall demand for labour has ebbed with the international recession. However, the government can and should influence factors affecting employability of individuals, and it is on these that the Council has concentrated its discussions.

5.22 Among the factors influencing the willingness of individuals to look for work and of employers to recruit them are the availability of welfare benefits and the extent of the “benefits trap” which provides more income to people out of work than in it; the pension regime, which may deter older workers from seeking employment or employers from recruiting them; job-related skills, including levels of numeracy and literacy; affordable childcare; and health.

5.23 Scottish earnings are below average for the United Kingdom, but not by much. In 2009 adult median gross weekly full time earnings in Scotland were £473.60, compared with a national median of £488.70. This places it 4th among the 12 countries and regions of the UK, though it should be noted that earnings differ considerably by type of occupation.

5.24 Although earnings levels vary by region, welfare benefits vary much less across the UK, with the result that the gap between earnings and benefit levels diminishes in regions with lower than average earnings. That may, in turn, have an impact on the regional prevalence of a “benefits trap”.

5.25 The Council has been conscious of the need to pay special attention to the few areas of particularly high social deprivation and low productivity, especially in parts of Glasgow. It emphasises the need for the employment services to work effectively to improve the functioning of the labour market. It is essential that employment services are well integrated with other Scottish services providing job advice and information, and that strong links exist between business communities and educational institutions. It will be important to use communication technologies imaginatively to build these links and to make sure that job market data is up-to-date and fully available to those who are helping job seekers.

5.26 In terms of workplace skills, there is a strong link between employability and education. Educational qualifications have a major impact on the likelihood of having a job. Working-age people with no qualifications or low-level qualifications have significantly lower employment rates and higher unemployment rates. Under half (47.6 percent) of working-age people with no qualifications are employed compared to 86.6 percent of people with degree-level qualifications. In 2009, the Annual Population Survey estimated that there were 36,000 young people aged 16 to 19 not in education, employment or training, representing

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42 Based on traditional working age definition of 16-59 for females and 16-54 for males. The data covers the period January to December 2009, before the introduction of changes to the female state pension age in 2010.
13.8 percent of that age group. The size of this group decreased significantly between 2005 and 2008, but then increased in 2009 by 5,000 (two percentage points). The proportion of young people not in education, employment or training remains high by international standards.

5.27 The Council has extensively discussed ways to improve the quality of education provided by schools and universities. In the case of schools, the Council does not believe that broad and substantial salary increases are likely to improve teacher quality, if they are not linked to output targets at teacher level. The international literature strongly suggests that reducing class size alone has a limited impact on student outcomes. The Council is also doubtful of the value of curriculum changes unless well-grounded, appropriately piloted, well managed and strongly led. The Council is particularly anxious to see work undertaken to develop and expand the Chartered Teacher Programme, thus developing a system that rewards excellence. An opportunity exists to rejuvenate Scotland’s population of teachers and to raise quality, because some 38 percent of teachers will reach retirement age in the next ten years and more than 50 percent of head teachers will reach retirement age in the next seven years.43

5.28 The Council argues that the government should not ignore the potential to develop education for export as a valuable sector of the Scottish economy, at both school and university level. Of the 32,000 students in independent schools in Scotland in 2009, 1,469 came from overseas. But the concentration is much higher in boarding schools, where 22 percent of pupils came from abroad.44 The Scottish Council of Independent Schools says that the number of international boarding pupils has been increasing gradually in recent years. Overall, the total turnover of the private school industry in Scotland is of the order of £200 million a year.45 As for universities, some 20 percent of students come from overseas, and Scottish universities collect some £181 million a year in international fees. University students from outside Europe feed an estimated £172 million into Scotland's economy in other spending. Recent research by Universities Scotland concluded that for every three overseas students in the country, one job has been created.46 The expansion of education as an export sector will require that Scotland retain its current reputation for high-quality education at both school and university levels, and in both public and private sectors.

5.29 Turning to higher education and its impact on employment, the Council has expressed concern at the scale of funding required to retain world-class universities, given the scale of the cost and the other demands on limited budgetary resources. The Council realises that this is not just a Scottish challenge. But ultimately, the Scottish Government needs to confront the funding issues that have led, south of the border, to the creation of Lord Browne’s review. At present, it is not clear that the absence of tuition fees has encouraged more students from poor homes to attend university in Scotland. Indeed, a report from Universities UK published in September showed that only 28.1 percent of students in Scotland in 2008-09 were from lower social economic groups such as shop workers, compared to 32.4 percent for England and 32.5 percent for Wales, where tuition fees apply.

5.30 The Council notes that the structure of Scottish universities is monolithic, but the quality and character of university education varies widely. There is a big difference in provision between the older universities and the newer ones, which mainly offer vocational courses and put less emphasis on academic research. One possible policy suggested by the

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44 Scottish Council of Independent Schools
45 This is calculated as 32,000 x £6,000 as rough average fee
46 Universities Scotland.
See: http://www.universities-scotland.ac.uk/index.php?mact=News_cntnt01_detail.0&cntnt01articleid=34&cntnt01returnid=24
Council would build on the strengths of the standard four-year honours degree courses offered in Scotland by considering a two-tier approach, similar to that in the US, with the first two years resulting in a broad, stand-alone qualification and the second two years providing an additional, specialised qualification.

5.31 Such a policy would also develop local institutions so that they can build on existing diversity to promote locally-available courses and provide an entry route into higher education to students who require more teaching support than is found in traditional universities. The overall aim would be to develop a system that would provide a more flexible university sector with greater breadth of education.

5.32 Sustaining high quality education at both school and university level would, in and of itself, create opportunities for graduate employment. But given Scotland’s demographic prospects, the expansion of the education sector in Scotland will depend on attracting more students from outwith Scotland to study at its secondary and tertiary institutions.

5.33 In terms of improving job opportunities for graduates, the Council is reluctant to give priority to a group which has suffered less than others in the recession. However, graduates represent a greater stock of human capital than non-graduates, and the country, through subsidies to universities, has also invested more in them. The Council believes that schemes to subsidise internship programmes and work placements are unlikely to be good value for money and prefers instead the development of policies to promote networking and job-search skills.

RECOMMENDATIONS FOR THE SCOTTISH GOVERNMENT

5.34 The Council recommends that the Scottish Government:

Recommendation 11: more closely coordinates the arms of the Scottish and UK Governments with responsibility for employment and skills issues. In particular, the Council believes that closer alignment and coordination between Jobcentre Plus, careers services and Skills Development Scotland would bring about a more effective approach to improving labour market participation in Scotland. So too would greater Scottish autonomy in setting benefits policy. The Council believes that Jobcentre Plus employability services should be devolved to the Scottish Government and that further consideration is given to bringing benefits and skills policy together within Scotland.

Recommendation 12: puts greater effort into building local consortia consisting of representatives from the DWP, Jobcentre Plus, local government, NHS, Employers Federation, Skills Development Scotland, Chambers of Commerce and other key interested parties. The Council is convinced that the local partnership model is the most efficient way to design and manage the delivery of services to move benefit recipients into work.

Recommendation 13: ensures training and educational institutions pay attention to the subsequent employability of their students. The Council urges the collection and publication of statistics on students’ success in finding employment after graduation. Good quality careers advice for university graduates, coupled with short courses to enhance job-seeking and labour market skills, are likely to be cost-effective ways to tackle graduate unemployment.

Recommendation 14: undertakes development of metrics to measure teacher quality, in collaboration with professionals, in order to improve the quality of education in Scottish schools in cost-effective ways. The quality of teachers must be measured, good teachers must be recognised and rewarded, and ineffective teachers must leave the profession.
Chapter 5 Employment, Skills and Education

**Recommendation 15:** gives fresh thought to involving university students and their families directly in carrying the costs of Higher Education, preferably through a system of deferred payments. The alternative, in an era of extreme pressure on public resources, is likely to be unsustainable financial pressures on Scotland’s world-class universities.

**Recommendation 16:** given the international reputation of Scottish schools and universities, regards education at all three levels as part of the highly skilled services that Scotland markets to the global economy. The attraction of international students to Scotland, at every stage in their education, will raise the international profile and marketability of other sophisticated sectors of the Scottish economy.
Chapter 6
Planning

BACKGROUND

6.1 The Council first addressed issues within the planning system in Scotland in its First Annual Report. Its recommendations in this area asked the Scottish Government to:

• financially incentivise local authorities to promote and facilitate sustainable development projects;
• change the culture of planning and reform the planning system so that it contributes to increasing sustainable economic growth; and
• set out that a central purpose of the planning system is to facilitate good quality outcomes.

6.2 This chapter looks at the recent reforms made by the Scottish Government; the progress made in implementing the Council’s recommendations; and provides further policy considerations for the government.

EVIDENCE BASE

6.3 Since the Council first discussed planning in September 2007, steps have been taken to change the planning system, in order to improve its contribution to sustainable economic growth.

6.4 Reforms to the planning system include:

• removing the requirement for two tiers of development plans across the whole country. Instead, strategic development plans are now only required for the four largest city regions, focusing on significant cross-boundary land and infrastructure issues.
• placing a statutory duty on planning authorities to update their development plans every five years. The purpose of this duty is to ensure the plans provide an up-to-date framework for investors and communities, reflecting current development issues and opportunities. Previously there was a policy target to update plans every five years, but in April 2009 only a third of plans were less than five years old.
• simplification of the process of examination for all draft development plans by the Scottish Government. This has cut costs and replaced the more resource intensive and confrontational formal inquiry process. The new examination process is around 50 percent faster than the old style local plan inquiries.\(^{47}\)
• launching the e-planning system in April 2009. This is an £11 million investment in efficiency and innovation. It is estimated that 18 percent of all planning applications are now made online though the ePlanning Scotland website which significantly exceeds the first year projected take up of three percent;\(^{48}\) and a wide range of planning information is now available online.
• improvements to the appeal process to ensure a more proportionate process. The key improvements were the removal of the automatic right to be heard, passing responsibility for the method of hearing (written submission, hearing or inquiry) to the Reporter. In the four years prior to 2008-09, only seven percent of appeals dealt with by the Scottish Government through the written submission process were concluded in

\(^{47}\) Scottish Government
\(^{48}\) ibid
less than 12 weeks. By 2008-09 this increased to 27 percent and in 2009-10, 86 percent of such cases were dealt with in less than 12 weeks.\footnote{ibid}

- appeals against the refusal of planning permission for some local scale developments are now dealt with by Local Review Bodies (formed by local elected members) rather than Scottish Ministers. Performance in the first six months has shown the same success rate as when appeals were dealt with by Scottish Ministers, and there is anecdotal evidence that there is growing confidence in this very significant change.
- the number of planning cases being referred to Ministers has been substantially reduced to enable greater focus on matters of national interest.
- introduction of a new process for pre-application consultation for national and major developments in 2009 to increase awareness of proposed developments. This enables communities to share their views on proposals, and gives prospective applicants the opportunity to address misunderstandings and negative issues before the proposal is finalised. Initial indications from planning authorities are that the new process has improved the quality of some applications and contributed to fewer objections being received at the planning application stage.
- publishing the Second National Planning Framework (NPF2) in June 2009, along with an action plan which identified 80 actions for all partners involved in delivery. Many elements of the NPF2 strategy will be implemented without public sector investment. However, where projects are heavily dependent on public funding, the severe pressures on government budgets will make delivery challenging.
- introducing the hierarchy for planning has ensured greater focus is now given to processing applications of major and national significance.

6.5 The percentage of local applications decided within two months remained at around 62 percent from 2008-09 to the end of the financial year 2009-10. Following bedding in of the reforms outlined above, the first quarter figures for 2010-11 showed an improvement to 67 percent. 27 out of the 34 planning authorities showed a performance improvement for local applications in this three month period.

6.6 The percentage of major applications decided in under four months declined from 39 percent in 2008-09 to 27 percent in the period August 2009 to March 2010. In part this reflects changing definitions, for example prior to August 2009, 10+ houses were classed as a major application, now it is 50+ houses. But it also reflects decisions being reached on the backlog of applications. Subsequently, in the first quarter of 2010-11, the rate of decision increased to 32 percent.

**PROGRESS MADE WITH COUNCIL RECOMMENDATIONS**

6.7 In response to the recommendation to financially incentivise local authorities, the Scottish Government examined the option of tax increment financing (TIF). TIF is a means of funding public sector investment infrastructure judged to be necessary to unlock regeneration in an area, and which may otherwise be unaffordable to local authorities. It uses future additional revenue gains from taxes to finance the borrowing required for public sector infrastructure improvements that will, in turn, create those gains.

6.8 The Council understands that the Scottish Futures Trust is now actively engaged with three local authorities (City of Edinburgh, North Lanarkshire and Glasgow City) helping or having helped them to develop suitable business cases. Only proposals that can give suitable evidence of delivering value for money and appropriate additionality will be considered for the pilot stage. Scottish Ministers gave provisional approval on 28 September 2010 for the City of Edinburgh Council to progress with the Edinburgh Waterfront TIF pilot project.

\footnote{ibid}
6.9 Additionally, the Scottish Government and COSLA are working together on a proposed business rates incentivisation scheme to be introduced by 1 April 2011. The aim of the scheme is to encourage local authorities to maximise their non domestic rate income from existing businesses and to grow their tax base through increased business development and new start ups. Options which would allow local authorities to retain a proportion of the business rates they collect in excess of an agreed target are currently being considered.

6.10 The Council strongly supports the introduction of TIF and the business rates incentivisation scheme to replace the current system whereby the business rates income is pooled centrally by the Scottish Government and then redistributed back to local authorities based on their population shares.

6.11 Related to the second recommendation made by the Council, the Scottish Government and COSLA jointly launched the common statement Delivering Planning Reform in October 2008. This initiative was endorsed by key stakeholders and is intended to strengthen the contribution that the planning system has made to increasing sustainable economic growth, through a range of non-statutory initiatives and culture change. All the commitments are now either completed or underway, and the government regularly monitors progress. Agency engagement with the new system has been generally positive, with significant improvements made in their approach to engaging with planning authorities and developers on planning applications and development plans.

6.12 The Scottish Government’s Economic Recovery Plan sets out what is being done to ensure the planning system helps the Scottish economy return to sustainable growth. The economic downturn presented fresh challenges for the planning system, particularly related to development viability and the instability of the private house-building industry. Guidance on the use of planning agreements related to the provision of infrastructure has been revised and updated to highlight the need to consider market conditions and promote the use of staged or deferred payments to minimise the impact that contributions have on development. In addition, work is underway with Scottish Development International to ensure that the planning system does not act as a barrier to inward investment opportunities that will have a positive impact on growth.

6.13 Related to the third recommendation of the Council, the government launched the Scottish Sustainable Communities Initiative to promote the creation of well-designed, low carbon communities in order to present a practical example of facilitating good quality outcomes. The government also published information and guidance within Designing Streets, aiming to apply the principles of good design to new streets in residential areas. The government has worked with a development company and the local authority to create an exemplar of good street design. The project resulted in a new masterplan for a proposed residential development called Polnoon, in East Renfrewshire, which provides a good practice model for the translation of good design principles into actual development. The findings of a review of Architecture and Design Scotland are also being implemented to ensure that all of its activity is geared towards securing better outcomes.

6.14 The Council welcomes the significant progress that has been made with the planning system by central government – the process is now quick and clear. However, this is in contrast to generally slower progress in planning reform at local authority level, as demonstrated by recent statistics on the pace of decision-making, although latest statistics show some improvement, which is to be welcomed.\textsuperscript{50} Some planning authorities have

\textsuperscript{50} In 2009/10, the number of planning applications decided by Scotland’s planning authorities decreased by 14.5 percent against a 7 percent reduction in the number of applications received. The percentage of local applications decided within two
implemented wide changes to the planning system recently but this is not yet fully visible in the planning statistics. The consistency of improvement so far across Scotland urgently needs to be addressed.

POLICY CONSIDERATIONS

6.15 The Council understands that, in early 2010, the Scottish Government completed its Scotland-wide audit of development activity to determine what issues were blocking development. Key findings were:

- significant effects on development viability resulting from the changes in the funding landscape for private house building and commercial property development;
- potential benefits to developers and the wider economy of a more proactive approach to enabling developments by local authorities and other public sector bodies; and
- the need for effective partnership working between public and private sectors, including potential funding arrangements, use of development brokerage and revised ways of securing developer contributions in the current economic climate.

6.16 There remain issues with variability of performance across the planning system. Performance figures for 2009-10 show that the planning authorities’ speed of decision making is poor when compared to statutory timeframes, although there has been recent improvement. Some authorities are, however, developing positive approaches to working with the development industry, for example Highland Council and City of Edinburgh Council, but there are still issues with lack of flexibility by authorities and authorities not fully addressing the new economic climate and challenges of development funding.

6.17 Resourcing of planning authorities is often cited as an impediment to more effective planning service delivery. The Council understands that the government recently ran a consultation on resourcing a high quality planning system which promotes further discussion of performance and resources, including alternative models of service.

RECOMMENDATIONS FOR THE SCOTTISH GOVERNMENT

6.18 The Council recommends that the Scottish Government:

Recommendation 17: increases the pace of improvements in planning performance, particularly at the local authority level, through ensuring that there is a financial incentive for local authorities to commit to high quality developments. This could be achieved by rapid acceleration and development of the incentivisation models currently being piloted.

Recommendation 18: continues to work to ensure that the planning system acts as an enabler to development and focuses on development delivery, where it is vital for local authorities, government, agencies and private sector to align activity.

months increased only marginally whereas the percentage of major applications decided in under four months declined. The definitions of ‘local’ and ‘major’ developments for the purposes of the statistics were adjusted during 2009/10 to meet new statutory definitions introduced through planning reform. See:

http://www.scotland.gov.uk/Topics/Statistics/Browse/Planning/Publications
Chapter 7
Chairman’s Retrospective

7.1 When the Council of Economic Advisers was convened in 2007, we were asked to advise the First Minister directly on the Scottish Government’s principal objective of increasing sustainable economic growth. The individuals tasked with filling this remit have made the Council one of exceptional depth and commitment.

7.2 Council meetings have been uniformly distinguished by vibrancy and depth of discussion fuelled by the hard work that has gone into the research by both members and officials. Members are owed a great deal for the time and effort that has gone into analysis of the highest quality. There has been active debate on issues that are particularly pertinent to the economic and social challenges that Scotland faces, such as: fiscal responsibility; banking; energy; the recession; and public spending cuts. The Council has always operated under the premise that an open and frank discussion is the norm. It is our belief that this approach leads to stimulating and innovative approaches to solving some of the major challenges which the Scottish economy, and society more generally, faces. However, given the scale of the challenge with which we are presented, achieving a consensus is not the goal as much as exploring new ideas and presenting frank advice directly to government leaders. As I made clear at the launch at the outset, advisers advise; it is elected governments who must govern.

7.3 One area where the Council has had clear consensus is that it sensible for the Scottish Parliament to have more fiscal responsibility. Over the last three years, public finance has been increasingly in the public debate as the world has gone through a deep global recession. The Council has been clear that Westminster has not always been the model of fiscal responsibility (a point widely acknowledged) and that regardless of who is in office it is critical in principal and in practice for the Scottish Parliament to be more responsible for the revenue side of the balance sheet as well as the expenditure side. Council members have pointed out that the UK is the only country in the OECD that does not allow borrowing at the sub-national level, and the incongruity of local authorities being able to borrow while the Scottish Parliament cannot is illogical and counterproductive. We also believe that any constitutional change must be in the direction of making Scotland more economically competitive and must allow for clear lines of accountability, not merely complicated cosmetic accounting changes. Members gave evidence to the Calman Commission to this effect and note that the final recommendations being pursued fail on both counts.

7.4 On energy, we all agree that Scotland has diverse energy sources and there need be no fear that the lights will go off. We also all agree that there is an obvious benefit to Scotland of the further development of alternative energy sources – as set out in the report carried out for the Scottish Government by Wood Mackenzie. That said, there is no one consensus view of the long-term energy strategy for Scotland. Indeed, debates like this to determine the right mix for each country are happening around the world. No doubt in depth research on the best way to capitalise on our energy sector here in Scotland will continue to be undertaken by the Energy Advisory Board.

7.5 The Council has written three Annual Reports covering a wide variety of topics and presented some challenging recommendations to the government to help it implement its long term Strategy. For example, the Council recognised the planning system in Scotland has serious flaws and urged the government to commit to changing the culture within it to ensure that planning outcomes are focussed on facilitating sustainable growth. There is still
a long way to go, particularly in local authorities. One solution is to put in place financial incentives for local authorities in line with what the Scottish Government wishes to achieve.

7.6 The Council has also discussed issues that have come to light during the past three years such as the significant reduction in competition in the Scottish retail banking sector resulting from the financial crisis, and the imminent public spending cuts.

7.7 Due to the nature and scale of the challenge, progress and impact will not be felt in many areas that the Council has advised on for sometime, though this is to be expected due to the long-term strategic nature of it’s advice.

7.8 In general, because of political necessity, discussion and debate is prematurely exposed to public examination and this interferes with and alters the development of policy. I would add that the function of the Council is not that of an Executive. Members do not pretend to know what policies fall within the bound of political possibility. It is for us to step in and suggest policy improvements - the decision and task of implementation falls to the Scottish Government.

7.9 I would like to offer my thanks to First Minister and Mr Swinney for bringing the Council together providing opportunity for an independent voice to debate the issues that Scotland faces. I would also like to offer my substantial thanks to the other members of the Council for their time, advice and commitment over the past three years and the hard work they have undertaken both at and between meetings preparing meeting papers, Reports and attending meetings and functions in their capacity as Council members.

SIR GEORGE MATHEWSON
Chapter 8
First Minister’s Retrospective

8.1 In the context of the Scottish political environment, Scotland's Council of Economic Advisers has been a ground-breaking development. For the first time since devolution was achieved in 1999, the Scottish Government brought together a group of renowned business leaders and economists, who not only have outstanding expertise and knowledge around the Scottish economy, but also have an exceptional track-record of success in the international environment; which is vital in an ever increasing globalised economy.

8.2 When we first came to power in May 2007 we made our central ambition clear: to create a Scotland where everyone had the opportunity to flourish; and we were committed from day one to delivering this ambition by increasing sustainable economic growth.

8.3 Our immediate task was to articulate this vision to the people and businesses’ of Scotland; that's why our first priority was to develop the Government Economic Strategy. This set out our approach to increasing sustainable economic growth, presenting challenging targets and highlighting the outcomes that we as a government, would like to see delivered for the people of Scotland.

8.4 The Council was an invaluable resource which helped shape our thinking around the development of this Strategy. Not only was it a critical sounding board for our thoughts, it also contributed views which helped to develop and shape our thinking on what our priorities should be. Ultimately, this process delivered the over-arching strategic direction for this government and our associated agencies.

8.5 Not long after we delivered the Strategy we were presented with the greatest challenge that the Scottish economy has faced for a generation. As a result of a global financial crisis, many of the world’s leading economies, some of which were our major trading partners, plunged into recession. Scotland’s businesses faced an extremely difficult trading environment which threatened their long-term future. However, by having the Council in place, with several leading businessmen and academics in a position to offer sound strategic advice, we responded swiftly to this highly challenging situation.

8.6 Indeed, with the help of the Council, who emphasised the need to respond to this crisis quickly, we launched our Economic Recovery Plan (ERP), which was first published in January 2009. The principals of our ERP are aligned to the recommendations of the Council and are wholly consistent with our long-term strategic objectives around increasing sustainable economic growth. For example, we recognised that infrastructure spending was critical to coming through this recession; as such we accelerated our capital spending, which is essential if we are to meet our growth aspirations, a policy which the Council strongly supported.

8.7 The overall economic environment in which we are operating continues to be extremely challenging; however, we have come out of recession and although the path to sustained success will be difficult, we feel that we have the right policies in place to deliver long-term growth to the Scottish economy, which is our primary objective.

8.8 In order to deliver this long-term vision we have sought the Council’s expertise and advice. Our Government has responded positively to the Council’s recommendations; which have energised our approach in numerous areas. This has included areas like planning,
where we are working to ensure that decisions are made quickly, and also on key opportunities for growth like renewable energy. The Council recommends that Scotland should further strengthen our global position by utilising our existing resources and boosting our comparative advantage; which will ultimately result in a sector which the rest of the world looks on with envy.

8.9 We are matching our ambition with action, to make Scotland a European leader in innovation and deployment of low carbon energy. We are embracing the energy-related opportunities presented by Scotland’s world leading climate change targets, ranging from Scotland’s leading position on carbon capture and storage to our fabulous renewable energy potential. At present Scotland has over 3.8 GW of installed renewable capacity. We are making excellent progress towards the 2011 interim target for renewables to generate the equivalent of 31 percent of gross electricity consumption. Industry estimates suggest that there is over 7 GW of renewable energy capacity already consented, under construction or awaiting construction, in addition to the 3.8 GW already installed. With this progress, we have now increased our target for 2020; for renewable sources to generate the equivalent of 80 percent of Scotland’s gross annual electricity consumption.

8.10 Of course, we continue to strive to maximise the economic opportunities from our existing policy levers; however, ultimately, we believe that if Scotland is to reach its undoubted potential, additional fiscal responsibilities will be required. The Council has been a crucial sounding board, both on a theoretical and practical basis, for how we should progress this further. Indeed, the Council has recommended that we should have greater borrowing powers which would allow us to not only finance public infrastructure but also allow Scotland to determine the appropriate split between current and capital expenditure, depending on our prevailing economic context.

8.11 The Council’s engagement on this debate has been invaluable in helping my ministers and I develop our thinking on what is the most appropriate course of action. Indeed, the Council has further developed its position around how Scotland would deliver greater fiscal responsibility, ensuring that the Scottish Parliament is as responsible for raising revenues as spending them. Fiscal responsibility is a position which not only we as a government sign up to but also one on which many business leaders, academics and individuals from across the political spectrum are engaged.

8.12 Moving forward, due to the challenging nature of the spending review, the Scottish economy will continue to face difficult economic circumstances. However, I am confident that both our ERP and our Strategy give us a clear direction as we work to foster sustainable economic growth for the benefit of all the people of Scotland. This Council has been an invaluable source of advice, expertise and challenge in developing these strategies to help Scotland tackle these tough times and I would like to thank all involved for their commitment and effort towards making Scotland a country of which we can all be proud.

FIRST MINISTER
Appendix

Membership, Remit and Administration

MEMBERSHIP

- Sir George Mathewson, Chairman
- Crawford Beveridge, CBE
- Frances Cairncross, CBE, FRSE
- Professor Andrew Hughes Hallett
- Professor John Kay
- Professor Alexander Kemp, OBE
- Professor Finn Kydland
- Jim McColl, OBE
- Professor Sir James Mirrlees
- Professor Frances Ruane
- Lord Smith of Kelvin

REMIT

The Scottish Council of Economic Advisers was established in June 2007 to advise the First Minister directly about the best way to increase sustainable economic growth in Scotland.

The Council’s work is focused on delivery of the Scottish Government’s Purpose as set out in the Government Economic Strategy:

“To focus the Government and public services on creating a more successful country, with opportunities for all of Scotland to flourish, through increasing sustainable economic growth.”

ADMINISTRATION

Since it was established the Council has met ten times. Detailed information relating to the administration of the Council of Economic Advisers, including the minutes of all meetings, can be found on the Scottish Government website.51

51 The website of the Council of Economic Advisers can be accessed via:
http://www.scotland.gov.uk/Topics/Economy/Council-Economic-Advisers
State of the Economy Presentation

Dr Andrew Goudie
Chief Economic Adviser
30th November 2010

This presentation outlines recent developments in the global, UK and Scottish economies. Updates will be provided on a quarterly basis in February, May, August and November.

To view previous State of the Economy presentations please visit the following link: http://www.scotland.gov.uk/Topics/Economy/economic-situation/state-of-economy

Data on the Scottish economy, including comparisons with other countries, can be found in the Economic Pocket Databank: http://www.scotland.gov.uk/Topics/Economy/Factfile/PocketDatabank

Feedback and comments on this presentation can be provided using the email address below.

Economist-WebGroup@scotland.gsi.gov.uk
Summary of Key Conclusions

Recent Global Economic Developments

- The global recovery continued into the second half of 2010 but significant divergences persist across the global economy. While emerging and developing economies are driving the pick-up in global output, advanced economies continue to experience a more modest recovery.
- Concerns that the growth in output in the US economy is losing momentum prompted further monetary policy stimulus by the Federal Reserve.
- In Europe the recovery has been particularly uneven, with strong growth in certain economies such as the UK and Germany, while others such as Greece and Ireland struggle to emerge from recession. Indeed the recovery in the UK during 2010 has been above market expectations.
- There have been renewed concerns over the sovereign debt position of a number of Euro Area economies, with Ireland seeking financial assistance from the EU and the IMF.

Recent Scottish Economic Developments

- Scottish GDP rebounded strongly in Q2 2010 with growth of 1.3%, the fastest quarterly growth since Q2 2006. This was reflected in positive growth in production, services and rapid growth in the construction sector which expanded by 10.4% over Q2 2010.
- However, revisions to the GDP data suggest that the recovery in Scottish output at the turn of the year was weaker than previously estimated, with a modest decline in GDP in Q1 2010.
- Conditions within the Scottish labour market remain challenging as unemployment continued to increase in Q3 2010. Although the pick-up in employment levels suggests that unemployment may soon stabilise, this may start to rise again as the fiscal consolidation reduces public sector employment.

Future Prospects – Global Economy

- The global recovery is expected to continue into 2011, with growth driven by emerging and developing economies. Advanced economies are forecast to experience a more modest recovery, with unemployment levels to remain significantly above pre-recession levels.
- Heightened downside risks remain for advanced economies as a sustained recovery is dependent on addressing both internal and external imbalances.
- In addition, sovereign debt concerns in the Euro Area and the ongoing debate over currency valuations provide an uncertain backdrop to the global recovery.
Future Prospects – Scottish Economy

- The latest independent forecasts predict a modest recovery in Scottish GDP, with output expected to remain broadly flat over the second half of 2010 before the recovery gains further momentum in 2011 where GDP is expected to grow by around 2%.
- With many of Scotland’s key trading partners expected to experience a modest recovery, it will be a challenge to rebalance the Scottish economy away from domestic demand toward investment and exports.
- Reductions in public spending will impact on both the public and private sectors of the Scottish economy in the coming years, although a number of factors will influence the scale of the impact.

Risks to the Recovery

The risks to the recovery in the Scottish economy remain significant as a number of key uncertainties persist. These include:

- The strength of the recovery in the UK, given the significant inter-connections between Scotland and the rest of the UK.
- The impact the UK Government’s fiscal consolidation will have on the Scottish economy. Although it may be beneficial for some parts of the UK, uncertainty remains as to whether other parts of the UK such as Scotland may be disproportionately affected.
- A key challenge will be to rebalance the Scottish and UK economies away from domestic demand towards business investment and exports. This rebalancing will depend on credit conditions improving – particularly for SMEs – and the strength of recovery in our key overseas trading partners such as the Euro Area.
- While conditions in the Euro Area remain turbulent and growth is expected to be modest in the coming years, Scottish businesses will need to increasingly focus on parts of the global economy such as East Asia which are predicted to perform strongly.
- Not only will new export markets create opportunities for Scottish firms, but so will the emergence of new industries such as renewables. Although these benefits may accrue in the long term, they provide opportunities for Scottish firms to develop competitive advantages in growth industries of the future.
Recent Developments in the Global Economy
Multi-Speed Recovery Continues

The global economic recovery continued into the second half of 2010 with growth slightly stronger than previously predicted. This was driven by emerging and developing economies, particularly in East Asia, who have returned to pre-recession rates of growth.

Within advanced economies the recovery has been particularly uneven. While the recent quarterly GDP data have remained particularly volatile, within advanced economies the performances can be broadly grouped into three distinct categories:

1. Within Asia many advanced economies have experienced a strong return to growth, benefiting from the pick-up in global trade, and are now back to pre-recession levels of output;

2. The US is close to recovering the output lost during the recession, but the pace of the recovery is slower than expected and employment growth has remained muted; and

3. Japan, Euro Area and the UK remain significantly below pre-crisis levels of output and rely to some extent on foreign demand supporting the recovery. Within the Euro Area, significant divergences continue with some economies struggling to emerge from recession.

1 IMF Economic Outlook, October 2010
Output Remains Volatile

While the global recovery has proceeded throughout the year, there has been significant volatility in quarterly GDP growth rates which has made it difficult to draw firm conclusions over the sustainability of the recovery in certain economies. Such volatility is common during recovery phases and is likely to be amplified due to the scale of the global recession.

Over the past six months there has been increasing concern over the pace of the recovery in the US economy and the possible implications this may have for the global economy. Following strong growth in the final quarter of 2009 and the first quarter of 2010 of 1.2% and 0.9%, US GDP growth has slowed with growth of 0.4% and 0.6% in Q2 and Q3 2010 respectively.

This slowdown in growth, coupled with concerns over the high levels of unemployment in the US, prompted the US Federal Reserve to undertake a further round of quantitative easing in a bid to accelerate the pace of the recovery.

Within the Euro Area, the strong growth in Q2 2010 of 1.0% - driven by the fastest quarterly growth in Germany since reunification of 2.2% - was subsequently followed by a weakening in the pace of recovery in Q3 2010 in which GDP expanded by 0.4% over the previous quarter. Despite this slowdown in quarterly growth, output in the Euro Area remains 1.9% up on the same quarter in 2009 and close to the Euro Area’s pre-recession annual trend rate of growth.
However the growth figure for the Euro Area masks significant divergences within the currency area as although economies such as Germany and France have continued to recover, a number of peripheral economies are still struggling to emerge from recession. For example, GDP in Greece fell further in Q3 2010 and output in Ireland continues to experience extreme volatility, with the latest GDP figures for Q2 2010 reporting a quarterly contraction of 1.2%.

The UK economy – which emerged from recession slightly later than other G7 economies – has performed strongly throughout 2010 and has exceeded market expectations. GDP expanded by 1.2% in Q2 2010 and this was followed up with growth of 0.8% in Q3 2010. This growth has primarily been driven by the rapid expansion in output in the construction sector, particularly in Q2 2010, and the return to growth of the service sector.

In terms of the expenditure components of UK GDP, the breakdown for Q3 2010 highlights that the expansion in output was broad-based, with domestic and government consumption along with investment expenditure contributing to growth. In addition, external demand has started to make a positive contribution to UK GDP growth after imports exceeded exports for the first half of 2010. At this stage it is unclear whether this marks the beginning of a rebalancing within the UK economy from domestic & Government demand to external demand.

**Contribution to Quarterly UK GDP Growth**

<table>
<thead>
<tr>
<th></th>
<th>Q1 2010</th>
<th>Q2 2010</th>
<th>Q3 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Household Consumption</td>
<td>0.0</td>
<td>0.4</td>
<td>0.2</td>
</tr>
<tr>
<td>General Government Consumption</td>
<td>0.2</td>
<td>0.2</td>
<td>0.1</td>
</tr>
<tr>
<td>Gross Capital Formation</td>
<td>1.1</td>
<td>0.6</td>
<td>0.2</td>
</tr>
<tr>
<td>Net Trade</td>
<td>-0.7</td>
<td>-0.1</td>
<td>0.4</td>
</tr>
</tbody>
</table>

Source: ONS

To date, the recovery in UK business investment has been modest and the level of business investment remains significantly below pre-recession levels. Many reasons for the slow recovery in business investment have been cited, including uncertainty over the future economic outlook and the difficulty in obtaining affordable finance.
Growth Stronger than Surveys Suggest

Throughout the recession, business surveys such as the PMI have tended to broadly track the shape of the performance in UK GDP (albeit with a slight lead). However since the end of Q1 2010, business surveys have indicated that UK firms have perceived a weakening in the recovery of economic activity. This weakening has not yet been borne out in the official GDP statistics, which report that the recovery gained significant pace in Q2 2010, and continued to perform well into Q3 2010.

Although business surveys are a valuable and timely indicator of the business environment, business survey results are a qualitative indicator of whether activity in the sample has risen or fallen. Therefore surveys are not directly comparable to official statistics, but instead are a quantitative indicator of by how much actual output produced by businesses in the economy has changed. In addition, the samples used by business surveys and official statistics will differ significantly. This may suggest that official statistics may be capturing strength in parts of the economy that the surveys have not picked up.

The disconnect between official and survey statistics, however, may also just be a reflection of the uncertainty that remains over the shape of the recovery. In a recent speech by Charles Bean, the Deputy Governor of the Bank of England, he conceded that although official statistics are the ‘bedrock’ on which bank policy rests, they rarely provide a perfect picture and a range of indicators, including business surveys, are utilised when making policy decisions. These differences between sources of data on the UK economy make it hard to gauge the underlying strength of the recovery.
Unemployment Persists Despite Recovery in Output

Throughout most advanced economies, the fall in output during the recession was closely followed by a rise in unemployment as firms reacted to the decline in demand by reducing staffing levels. Although in many cases the rise in unemployment was less than what would usually be associated with a decline in output on the scale experienced, the level of unemployment in the G7 is still some one and a half times above pre-recession levels (compared to GDP which is only around 4% below pre-recession levels).

In addition, while many of the G7 economies have been out of recession for around a year and a half, most have experienced only a stabilisation in their level of unemployment.

Traditionally unemployment is a lagging indicator as it usually recovers after economies have returned to growth. However even in countries such as Canada and the US where the level of output remains close to pre-recession levels, there has yet to be a marked improvement in unemployment levels. This has placed increased urgency on the need to accelerate the recovery so that unemployment levels start to decline. The notable exception is Germany which has experienced broadly stable levels of unemployment throughout the downturn and subsequent recovery.
Divergences in Monetary Policy

The multi-speed recovery in the global economy is reflected in divergences over the monetary policy stance across countries. Where the recovery has been strongest, such as in Australia, Canada and China, central banks have begun tightening monetary policy through increasing interest rates so as to mitigate the future rise in inflation.

By contrast, for some economies the debate has focused on whether additional monetary stimulus measures are required in order to support economic activity and prevent deflation. In the US where the economy has showed signs that the recovery may be starting to lose momentum, the US Federal Reserve announced on the 4th November 2010 a new programme of quantitative easing worth $600bn (£373bn).

The buying of long-dated government bonds is expected to support the economy through: (1) reducing the cost of borrowing as buying government bonds increases their price and lowers their yield, or the interest they pay out, which in turn puts downward pressure on interest rates across the economy; (2) inflates asset prices as investors will look to buy other assets such as equities given the lower yield on government bonds; and (3) increases lending as the proceeds from bond purchases by the central bank will increase the amount of money that banks have available to lend to businesses and individuals.

However, there is a degree of uncertainty over both the timing and scale of the impact of this unconventional monetary policy instrument, with the Bank of England highlighting that it will take time to fully assess the extent to which quantitative easing has stimulated nominal spending in the UK.
Capacity Utilisation Puzzle in the UK

Within the UK there has been significant debate over whether the Bank of England’s quantitative easing programme should be extended beyond its current level of £200bn. Indeed the minutes of the most recent Monetary Policy Committee (MPC) meeting revealed a three way split in voting over the future direction of monetary policy.

At the heart of the debate over the monetary stance in the UK is the size of the output gap in the UK – the difference between actual output and potential output – as this is a key determinant of the underlying inflationary pressures within an economy. For example, if firms are operating at full capacity then they will be more inclined to raise prices so they can obtain greater return from their output. On the other hand, if there is spare capacity there is greater scope for output to rise without putting upward pressure on prices.

Unfortunately the output gap is not something which can be observed as it is extremely difficult to accurately measure the potential output within an economy, particularly after a recession which may have reduced the productive capacity of firms.

There are a number of different methods for estimating the output gap in the UK which at the moment present a wide range of possible values for the size of the output gap. This makes it difficult to accurately gauge the underlying inflationary pressures in the UK. For example, surveys indicate that capacity utilisation in UK

Surveys of Capacity Utilisation in the UK

Source: Bank of England
firms has increased significantly since the recession, suggesting that the degree of spare capacity in the economy has narrowed.

By contrast, the data on labour market productivity within the UK suggests that there is a significant degree of spare capacity in the economy. The reduction in hours worked has been proportionately smaller than the reduction in output, resulting in a fall in productivity during the UK recession. Although there has been a pick-up in productivity within the manufacturing sector, both manufacturing and service sector productivity remains significantly below productivity levels had the pre-recession trend continued. This suggests that firms have a significant degree of spare capacity (i.e. have scope to increase the amount of output produced per hour worked).

However, the key uncertainty centres on whether the productive potential for firms has been permanently affected by the recession. This could occur through the loss of expertise when reducing employment levels or through the scrapping of capital equipment which was too expensive to maintain during the recession. In addition, any structural change within the economy brought about by the recession may also alter the underlying productive potential for the economy.

Given that it is too early to accurately assess the impact of the recession on the structure of the UK economy – as traditionally any restructuring tends to continue throughout the recovery phase – it is extremely difficult to accurately judge the degree of spare capacity in the UK economy. This adds to the uncertainty over the future outlook of inflation within the UK and makes it difficult to judge whether the next move by the Monetary Policy Committee is to loosen monetary policy so as to prevent inflation from undershooting the 2% target rate or tighten monetary policy so as to prevent inflation from overshooting the target rate in the medium to long term.
Inflationary Pressures Remain Low

Inflationary pressures in the global economy remain low relative to pre-recession rates particularly in advanced economies. For example, in the US inflation is close to 1% and has prompted much debate over the threat of deflation if the pace of the recovery does not accelerate.

Although inflation in the UK has been persistently higher than the Euro Area and the US during the recovery, with inflation remaining at or above 3% throughout 2010, this has mainly been due to the rise in VAT in January 2010 following the temporary reduction in the VAT rate to 15%, and the increase in import prices as a result of the depreciation in sterling.

In many parts of the UK economy the pricing pressures remain weak. For example, the growth in average weekly earnings has persistently been below CPI inflation since the middle of 2008. In other words, people have on average experienced a reduction in their earnings in real terms. This will have had a knock-on impact on retailers by constraining the degree to which they can increase their prices.
The main concern is that with UK inflation remaining above the UK Government’s 2% target rate since December 2009, this may have affected expectations for future inflation. Inflation expectations by households and companies are important as they will partly determine inflation in the medium term.

For example, if a worker expects inflation in the future to remain around its current level of 3.2%, this would impact the amount he or she would demand in terms of a pay increase. Similarly, if companies expect future inflation to be around 3.2%, they will be more willing to offer a pay increase, all other things being equal, of close to 3.2%. This action would place upward pressure on future inflation in the UK economy.

Consequently, the Bank of England regularly monitors inflation expectations to ensure that they remain close to the UK Government’s 2% target rate. The latest evidence shows that despite the persistence of inflation above 2% throughout 2010, inflation expectations remain at levels that appear broadly consistent with inflation being around the target in the medium term.
Currencies and Global Rebalancing

The announcement that the US has taken forward a further round of quantitative easing (so-called QE2) has led to a depreciation in the value of the dollar as investors price in higher expected future inflation. Although this depreciation may be beneficial to the US in terms of boosting export competitiveness, this was not the prime reason the US took forward QE2, which is principally designed to boost domestic demand within the US.

This depreciation has had implications for foreign economies with flexible exchange rates as it has led to an appreciation in their currency against the dollar, potentially leading to a fall in export competitiveness and perhaps more crucially, an inflow of capital as investors seek returns on currency investments. Emerging economies, who have so far recovered relatively well from the global recession, are faced with a risk of overheating as this ‘hot’ money is invested in their economies, potentially leading to the emergence of asset bubbles, particularly in property markets. Evidence so far implies that many emerging economies have intervened to buy foreign currency to keep their exchange rate low or imposed taxes on foreign capital inflows to try and remove some of the danger from large scale capital inflows.

However, the impact of QE2 on foreign economies is not entirely negative. If this new round of monetary easing in the US is successful, demand in the US should increase. As the US is the world’s largest economy, an expanding US economy is generally good news for global demand, and QE2 could therefore be expansionary on a global scale. A faltering US recovery would have more than likely led to a further slump in global demand.
In addition, the US is not the only country who is influencing the currency situation. China operates a fixed exchange rate which is believed by many to be currently set too low, a strategy designed at protecting export-led growth. Indeed China’s economic growth strategy is dependent on keeping their exchange rate competitive.

Crucially, these low exchange rates in China and emerging economies have been in part blamed for the existence of global imbalances which formed the foundation for the emergence of the conditions that ultimately led to the financial crisis towards the end of 2007. These imbalances were a consequence of a build up of current account surpluses in countries such as China due to booming export sales. These surpluses were recycled as purchases of US Government bonds, allowing the US to keep interest rates low and fuelling a credit boom in the West.

The emergence of this so called ‘currency war’ only highlights the continued need for global rebalancing. Global demand needs to shift away from indebted developed countries towards more spending in the developing and emerging world. This needs to happen both in terms of a rise in domestic demand in emerging economies and an increase in their real exchange rate.

There is a danger that the ‘currency war’ could escalate to the point where the defence of export markets leads countries to resort to protectionism in order to protect domestic markets from aggressively priced imports. This would equate to the breakdown of global economic cooperation and would certainly depress global trade and stifle global production, adding a further threat to the recovery.

However, the consequences of the continuation of global imbalances is also a major threat to the global economy as it has the potential to lead to the re-emergence of the conditions that led up to the recent international financial crisis. Current account imbalances have narrowed as US demand has fallen through the recession, but once demand recovers, it is thought that the imbalance will re-establish itself to the same degree as before the crisis. Without a conscious global effort, it is difficult to see how these issues will be resolved.

The G20 summit in November 2010 failed to reach a substantive agreement on how to reconcile the issue of imbalances, but agreed a set of vague “indicative guidelines” by which internal and external imbalances could be assessed.
During the recession, many countries adopted fiscal stimulus measures to support spending in the economy. As these countries have come out of recession, many are looking to improve the public finance position with a combination of tax rises and spending cuts. In some countries, this will not equate to an actual fall in government consumption, but public spending is forecast to grow by a substantially smaller amount in OECD countries over the next few years compared to recent experience. However, there is a risk that lower growth in government consumption and higher taxes may depress domestic demand.

In addition, in a number of countries the weak state of the public finances necessitates a more severe consolidation. A number of small peripheral European countries, such as Ireland, Greece and Portugal have come under intense market pressure to put the public finances on a sustainable footing, to the extent that the planned reductions in government expenditure and tax increases are forecast to lead to a fall in domestic demand. There is a risk that the cumulative impact of consolidation measures in OECD countries may weigh down on global demand in the years ahead.
Global Financial Sector Recovery and Reform

In October, the IMF released their most recent Global Financial Stability Report (GFSR). This made clear that while the situation in the financial sector continues to improve, the debt crisis in the peripheral Euro Area has hindered the financial sector which remains a drag on the recovery of the wider economy.

The IMF concedes that although private and sovereign balance sheets will continue to strengthen as the general economic environment improves, downside risks from a weakening in the macroeconomic recovery in some regions, sovereign financing pressures and the knock-on effect this has on bank funding mean that the financial recovery is far from secure.

Estimates of bank write-downs between 2007-10 have been revised down since the IMF’s last GFSR in April 2010 from $2.3 trillion to $2.2 trillion, with three quarters of this debt thought to have already been realised. Although encouraging, banks are far from resting on a secure footing. One important factor to consider is that in the next two years banks need to refinance nearly $4 trillion of bank debt and close consideration will therefore be needed as to how and when government support for the industry is removed.
More importantly, the regulatory reform agenda remains unfinished. Although most countries agree that reform is needed to safeguard against future crises, there is little agreement over how matters will be resolved.

The Basel Committee on Banking Supervision which consists of representatives of banking supervisory authorities and central banks from the G20, issued a consultation document in December 2009 setting out proposals for reforming the regulatory framework. Following this period of consultation, it announced on the 12th September 2010 a new set of capital requirements for financial institutions (often referred to as Basel III).

The most significant change announced in September 2010 was the raising of the amount of ‘core capital’ (common stock holdings and retained earnings) as a proportion of total assets that a bank must hold. The new regulations increase this ratio from 2% to 4.5% and also introduce a ‘conservation buffer’ of 2.5% in addition, raising the total capital requirement to 7%. These changes will be phased in from 2013 to 2019.

The purpose of this new legislation is to ensure that banks are able to better absorb losses in periods of financial and economic stress. These new regulations were ratified at the G20 meeting on 11th and 12th of November 2010 and, although a positive step in global cooperation on bank regulation, there remains many issues around addressing systemic risk in the global financial sector that have not yet been addressed.
Concerns Over Euro Area Continue

The potential for a sovereign debt crisis in the Euro Area re-intensified in recent weeks, with bond yields rising considerably in Ireland, Greece and Portugal, in some cases to record highs.

The main reason that concern is increasing is the emergence of data which indicates that the austerity programmes have been less effective than hoped at addressing the deficit. For example, Portugal’s deficit actually rose over the first nine months of 2010, prompting the parliament to approve an even more severe austerity budget at the start of November 2010. However, the plans have adversely impacted on the macroeconomic performance of the countries in question. As the table indicates, peripheral euro-area countries are struggling to show signs of a robust recovery.

**GDP Growth in Peripheral Euro-Area Countries**

<table>
<thead>
<tr>
<th></th>
<th>Q1-2009</th>
<th>Q2-2009</th>
<th>Q3-2009</th>
<th>Q4-2009</th>
<th>Q1-2010</th>
<th>Q2-2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ireland</td>
<td>-2.8</td>
<td>-0.1</td>
<td>-0.3</td>
<td>-2.5</td>
<td>2.2</td>
<td>-1.2</td>
</tr>
<tr>
<td>Italy</td>
<td>-2.9</td>
<td>-0.3</td>
<td>0.4</td>
<td>-0.1</td>
<td>0.4</td>
<td>0.5</td>
</tr>
<tr>
<td>Greece</td>
<td>-1.6</td>
<td>-1.1</td>
<td>-0.3</td>
<td>-0.2</td>
<td>0.1</td>
<td>0.2</td>
</tr>
<tr>
<td>Portugal</td>
<td>-1.8</td>
<td>0.6</td>
<td>0.3</td>
<td>-0.1</td>
<td>1.1</td>
<td>0.3</td>
</tr>
<tr>
<td>Spain</td>
<td>-1.0</td>
<td>-0.3</td>
<td>-0.5</td>
<td>-0.8</td>
<td>-0.8</td>
<td>-1.8</td>
</tr>
</tbody>
</table>
Additionally, a comment made by the German chancellor Angela Merkel in late October 2010 in which she suggested that a future system to rectify debt crisis should force private shareholders to take a greater proportion of the costs, appears to have unsettled the markets, despite the fact that the new system would not be introduced until 2013 and would only apply to new shareholders after this date.

The main concern at the moment appears to be focussed on Ireland and in particular the sustainability of the Irish banking sector. The intense speculation that the Irish Government would seek financial assistance from the international community came to a head on the 21st November 2010 when the Irish Prime Minister formally requested the support of the European Union and the International Monetary Fund (IMF). Following discussions, details of a €85bn support package was announced on the 28th November 2010 which included €50bn aimed at bolstering Ireland’s public finances, €10bn to be used to recapitalise Ireland’s banks and €25bn as a contingency fund should further assistance for the banking sector be required.

There are a number of different channels through which the current situation in Ireland could affect the performance of the Scottish and UK economies. Firstly, UK banks through their direct exposure to Ireland’s banking sector may suffer further losses either as a result of outright default by borrowers or through further falls in asset values. The UK banks’ exposure to the Irish banking sector is estimated at around 6% of UK GDP (around £100bn).

Secondly, given that Ireland represents Scotland’s 6th largest overseas export market, accounting for around £960m or 7% of total overseas exports from Scotland (7.6% for the UK), the weaker performance of the Irish economy could adversely affect Scottish exports.

Thirdly, the financial support offered by the UK Government to Ireland will have an impact on the public finances (although these loans given to Ireland should be paid back in due course).

More generally, events in Ireland have prompted renewed concern over the possibility of a sovereign debt crisis developing in the Euro Area. The fiscal positions of Portugal, Spain and now Belgium have come under increased scrutiny. It is possible that these developments may act to dent confidence within the Euro Area and result in a slower recovery. This would have a serious impact on both the Scottish and UK economies as a slower recovery in our largest overseas trading area would make it more difficult to secure an export-led recovery.
Summary of Recent Developments in the Global Economy

- The global recovery continued into the second half of 2010 but significant divergences persist across the global economy. While emerging and developing economies are driving the pick-up in global output, advanced economies continue to experience a more modest recovery.

- Concerns that the growth in output in the US economy is losing momentum prompted further monetary policy stimulus by the Federal Reserve.

- In Europe the recovery has been particularly uneven, with strong growth in certain economies such as the UK and Germany, while others such as Greece and Ireland struggle to emerge from recession. Indeed the recovery in the UK during 2010 has been above market expectations.

- There have been renewed concerns over the sovereign debt position of a number of Euro Area economies, with Ireland seeking financial assistance from the EU and the IMF.
Recent Developments in the Scottish Economy
Sharp Bounce-Back in Scottish Output in Q2 2010

Output in the Scottish economy bounced back strongly in Q2 2010 with GDP growth of 1.3% over the previous quarter, the fastest quarterly growth since Q2 2006. However, the fragile nature of the recovery was highlighted in revisions to data for the end of 2009 and the start of 2010, with Scottish GDP experiencing growth of 0.1% in Q4 2009 before contracting by 0.2% in Q1 2010 (the previous estimate was growth of 0.3% and 0% in Q4 2009 and Q1 2010 respectively).

Therefore the trough in the Scottish GDP series now occurred in Q1 2010 rather than in Q3 2009 as previously estimated, with Scottish GDP down 5.8% compared to its pre-recession peak. This compares to a peak to trough fall in GDP of 6.4% for the UK.

This volatility in the quarterly GDP data is commonplace during the recovery phase, as has been witnessed for other advanced economies, as much of the growth during the early stages of recoveries tends to be driven by temporary factors such as the rebuilding of stock levels by firms or the return to activities which were placed on hold during the recession. Consequently, this may result in a sharp bounce-back in output over a short period of time. This has been apparent in countries such as Germany (2.2% in Q2 2010), Japan (2.4% Q2 2009) and the US (1.2% in Q4 2009) and makes it difficult to gauge the underlying strength of the recovery.
Growth Driven by the Construction Sector

The strong quarterly growth in Scottish output over Q2 2010 was driven by the construction sector which experienced growth of 10.4% compared to the previous quarter. This was the second consecutive quarter of growth in the construction sector and the level of output within the sector has now returned close to pre-recession levels.

Following two quarters of falling output around the end of 2009 and into 2010, output in the Scottish production sector grew by 2.5% over Q2 2010. Meanwhile, the loss of output in the service sector in Q1 2010 was regained in Q2 2010 with growth of 0.3%, driven by growth in real estate and business services.

Despite the quarterly growth in Q2 2010, output from all the main sectors of the Scottish economy remains down over the year with the exception of the agriculture, forestry & fishing sector. More generally, the sectoral performance over the past year in Scotland has been broadly in line with the UK as a whole (again with the exception of the agriculture, forestry & fishing sector).
Improvements to Scottish GDP Series

The publication of the Scottish GDP figures for Q2 2010 on the 20th October 2010 incorporated a number of major improvements to the methodology in the way the Scottish Government assesses changes in output in the Scottish economy. This was the culmination of a wider programme of work under the Scottish National Accounts Project\(^2\) (SNAP) to improve not only the accuracy of existing economic statistics on the Scottish economy but also to develop new indicators on the performance of the Scottish economy.

The most significant development in the Scottish GDP series was the benchmarking of historical time series data to Input-Output GVA weights. As this led to revisions in the Scottish GDP time series, it is helpful to explain the background to these changes.

The quarterly publication of Scottish GDP in basic prices, also referred to as GVA, relies on the assumption that the rate of change in output is strongly correlated to the rate of change in GVA. As GVA is a function of output less inputs, in producing the quarterly estimates on this basis the underlying assumption is that the ratio of output

\(^2\) [www.scotland.gov.uk/snap](http://www.scotland.gov.uk/snap)
to GVA is fixed. In the short term, this assumption is an accepted national accounts convention.

The ratio of output to GVA will, however, tend to drift in the longer term as industries change in structure, efficiency, and different components of inputs and outputs experience different levels of price inflation. As more data become available after the period in question, it becomes possible to compile other measures of GDP based on expenditure and income methodologies.

The Office for National Statistics compile three main measures of GDP for the UK each quarter which incorporate more data at each publication and successively balance the estimates to improve accuracy. These are then benchmarked to the annual Blue Book exercise which contains Supply-Use analysis of the economy as this is generally accepted as the most settled and complete picture, providing the most accurate estimates of national GVA around a year after the end of the period of reference.

The component GDP series for Scotland are annually chainlinked with others to form aggregate series using GVA weights but this process only partially counteracts the drift between output and GVA. The publication for the first time of a robust consistent time series of Supply-Use analysis for the period 1998 to 2007 provided the necessary raw data to benchmark the output measure for Scotland against the fully balanced Input-Output GVA estimates. These tables also provided updated weights for the subsectors of the economy and the GDP output measure now incorporates weights for 2005, 2006 and 2007. This new methodology makes the Scottish GDP estimates more consistent with the Office for National Statistics estimates for the UK economy.

The fully balanced measures available from Supply Use Analysis incorporate a much more complete picture of the economy at the time of compilation. The benchmarking process allows the series to be presented with the quarterly resolution of the output measure, but provide greater consistency and accuracy in the long term. The output measure at the time of publication provides a robust estimate of the direction and size of the growth of GVA. However, as it is the only measure of real terms growth for Scotland, the index is often also used for very long-run analyses. The process of benchmarking means that longer term analysis can now be carried out on a significantly more robust basis.

As benchmarking was introduced for the first time in October 2010, and the exercise incorporated the 10 years time series of Supply-Use analysis, the revisions were larger than will routinely be the case in future benchmarking exercises.
Increase in Labour Market Participation

Despite moving out of recession in Q4 2009, conditions in the Scottish labour market continued to deteriorate at the end of 2009 and into 2010 with a decline in employment and an increase in unemployment. However since the end of Q1 2010 there has been a general movement of people from economic inactivity into the labour market, with some securing employment whilst others seek employment.

This trend has resulted in an increase in employment levels in Scotland coinciding with a further increase in unemployment. The latest data for Q3 2010 reports a continuation of this trend, with an increase in employment of 21,000 while unemployment also rose by 6,000 compared to the previous quarter as 20,000 more people moved into the Scottish labour market.

Overall, the Scottish unemployment rate continued to rise, reaching 8.5% in Q3 2010. Although the rate of increase has started to moderate in recent months, the trend has diverged from the whole of the UK which has experienced a broadly stable unemployment rate of just under 8% for the past year and a half.

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3 The labour market charts on pages 29 – 32 are based on the rolling 3-month average.
The rise in unemployment in Scotland has broadly followed a similar path compared to what the UK economy experienced during the recession in the 1980s. By contrast, the smaller rise in unemployment in the UK experienced during the recent recession appears to be more in line with the rise in unemployment during the UK recession in the 1990s.

The diagram below highlights the total movement within the Scottish labour market since unemployment started to rise in the three month period March – May 2008. Therefore despite a movement of people back into the Scottish labour market since the end of Q1 2010, there has still been an increase in economic inactivity in Scotland since unemployment started to rise.

![Change in Unemployment Rates (16+ population)](image)

Note: Lines refer to the UK unless stated
Pick-up In Employment

The employment rate in Scotland has improved since the end of Q1 2010, rising by 0.7% points to reach 70.7% in Q3 2010 with an extra 29,000 people in employment. This pick-up in the employment rate has closely followed the trend for the whole of the UK, with the UK employment rate rising to 70.8% in Q3 2010.

The increase in employment in both Scotland and the UK has been predominately driven by a rise in part-time employment. For example, in Scotland full-time employment decreased by 61,000 over the year to the end of Q3 2010 whereas part-time employment increased by 28,000. Therefore despite the recent improvement in employment in Scotland, average income levels are still being affected by the recession as a greater number of people still find it difficult to secure full time employment.

The main sectors of the Scottish economy which experienced an increase in jobs over the year to June 2010 include transport, storage & communication and the construction sectors, with an increase of 20.8% and 6.3% respectively. Other parts of the economy, such as manufacturing and finance, real estate and business services, experienced a decline in the number of jobs over the year to June 2010.
Employment During Previous Recessions

Since the start of the recession, the decline in the level of employment within Scotland has broadly followed the trend experienced for the UK during the recession in the 1980s and 1990s. However, data over the past six months suggest that the period of declining employment – as experienced during the 1980s and 1990s recession – may not be as protracted during the current recovery phase, as employment levels appear to have stabilised and improved more rapidly than in previous recessions.

There has been a divergence between the degree to which employment levels in Scotland and the UK have been affected during the recent recession, with a higher and longer period of decline in Scotland. For example, the Scottish employment rate fell by 5.1% points since its peak prior to the recession, whereas the UK employment rate only fell by 2.5% points from its previous peak.

This sharper decline in employment in Scotland may partly reflect the period of strength in the Scottish labour market relative to the whole of the UK prior to the recession. The Scottish employment rate peaked at close to 75% towards the end of 2007 while the peak UK employment rate was around 73% before it started to decline. Therefore half of the difference reflects the superior starting position. However, it does not necessarily explain why employment in the UK stabilised and recovered slightly earlier than in Scotland. This may be due to differences in both the timing and the speed of the recovery in Scotland relative to the UK.

Note: lines refer to the UK economy unless stated  
Source: ONS
Retail Sales Growth Continues

Following a pick-up in retail sales growth in Scotland in 2009, data for 2010 shows that growth has continued, albeit at a slightly weaker pace. Growth fell in Q1 2010 (likely to have been due to a combination of the rise in VAT back to 17.5% and the impact of the adverse weather at the start of this year) but since then, the sector has seen continued signs of recovery.

Over the course of the recession, Scottish retail sales have performed relatively well despite the rise in unemployment, pressures on incomes and tighter credit conditions. Indeed, both over the year and since the Scottish economy entered recession, retail sales in Scotland have grown more strongly than for the whole of Great Britain.

However, the performance of the retail sector is extremely sensitive to earnings growth, and the continued weakening of the labour market in Scotland is a key concern for the sector going forward.

Meanwhile, the Scottish Retail Sales Consortium has reported that in October 2010 Scottish retail sales growth had weakened with growth of 1.4% compared to the same month in the previous year. The growth came entirely from an increase in food sales, with non-food sales falling by 1.1% over the year.

Source: Scottish Government

Scottish Manufactured Exports Remain Subdued

Since the pick-up in global trade in the second half of 2009, the performance of Scottish manufactured exports has remained subdued. Although Scottish manufactured exports grew by 0.6% over Q2 2010, they remain down 2.5% over the year and are still close to the trough in exports experienced in Q2 2009 following the collapse in global trade flows.

A stronger recovery in Scottish exports may have been expected given the depreciation of Sterling which has remained around 25% below its pre-recession level since towards the end of 2007. This could have lowered the relative price of Scottish overseas exports, thereby making them more competitive. However, with profit margins remaining tight on domestic sales, there is evidence that exporters have been increasing margins rather than reducing the foreign currency price in order to boost profitability.

The Scottish export sectors which performed strongest over the year to the end of Q2 2010 are drink (up 10.1%), wood, pulp, paper, publishing & printing (up 8.4%) and chemicals, coke, refined petroleum & nuclear fuels (up 5.0%).

Separate statistics published by HMRC report slightly stronger growth over the year to the end of June 2010, with the value of Scottish exports up 5.3%.

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5 Agents’ Summary of Business Conditions, March & July 2010, Bank of England
Scottish House Prices Remain Below Peak

House prices in Scotland appear to have remained relatively flat over the past year, and remain between 3% and 15% below their peak, according to data from Halifax, Nationwide and DCLG. The same data sources report a similar picture for the UK as a whole, although house prices in the UK have recovered from a deeper trough.

Data from Nationwide and Halifax for Q3 2010 point to a slight deterioration in prices over the quarter but data from DCLG pointed to a rise in prices. This conflicting data highlights how difficult it is at the moment to determine the direction of house prices.

Data from the Council of Mortgage Lenders for Scotland suggest that the value of loans for house purchase has increased since the start of 2009. However, the value of total loans in Q2 2010 was over 50% below the level of Q2 2007. While a fall in the value of mortgages could be expected to some extent given the fall in house prices, the number of mortgages approved is also down, with over 55% less mortgages approved in Q2 2010 than Q2 2007. This is consistent with UK wide data from the Bank of England and may imply that transactions are being constrained by access to finance.
Credit Conditions Remain Tight

Credit conditions in Scotland and the UK have improved a little over the past year, although the annual growth in net lending to businesses remained negative. The stock of lending to business is currently around 3% lower than it was 12 months ago. Although for UK firms overall there has been a fall in lending, data shows that for large businesses conditions have improved. The Bank of England Regional Agents have noted that both credit availability and the cost of bank credit for large corporations have eased.

Large firms can also raise funding by issuing debt or equity. Although issuance has fallen back in 2010, compared to 2009 when it rose to very high levels, net issuance has remained stronger in 2010 than in the years running up to the financial crisis. In addition, it appears a wide spectrum of firms are utilising the market to access funds with 40% of firms issuing corporate bonds in 2010 doing so for the first time. In contrast, smaller businesses that are more dependent on bank finance continue to have difficulty accessing finance, according to the Bank of England. The Scottish Government has commissioned an update in its Access to Finance Survey for SMEs, with the results due to be published early next year.

Lender’s responses to the latest Bank of England’s Credit Conditions Survey suggest that secured credit availability to households has not changed significantly through 2010 and that there has been little significant change in the cost of new borrowing. The survey also indicated that demand for mortgages had fallen in Q3 2010. The availability and cost of unsecured lending has yet to show significant signs of improvement following large-scale tightening in 2008 and 2009.
Summary of Recent Developments in the Scottish Economy

- Scottish GDP rebounded strongly in Q2 2010 with growth of 1.3%, the fastest quarterly growth since Q2 2006. This was reflected in positive growth in production, services and rapid growth in the construction sector which expanded by 10.4% over Q2 2010.

- However, revisions to the GDP data suggest that the recovery in Scottish output at the turn of the year was weaker than previously estimated, with a modest decline in GDP in Q1 2010.

- Conditions within the Scottish labour market remain challenging as unemployment continued to increase in Q3 2010. Although the pick-up in employment levels suggests that unemployment may soon stabilise, this may start to rise again as the fiscal consolidation reduces public sector employment.
Future Prospects
Business Sentiment Remains Uncertain

Following a global improvement in business sentiment through 2009, a divergence between the US and the Euro Area has appeared in the second half of 2010. In the US the decline is likely to reflect the slowing down of the recovery over this period, which has been borne out in official figures. The tick up in confidence in the last couple of months may in part reflect expectations of a restart of quantitative easing.

In the Euro Area, despite a small fall in April 2010 at the time of the escalation in concern over the debt position of certain countries in the Euro Area, economic sentiment has continued to improve. This probably reflects the continued economic strength of large Euro Area countries, such as Germany.

In Scotland, evidence on business optimism remains mixed. The Scottish Chambers Q3 2010 business survey reported a fall in optimism across all sectors reported in the survey, including manufacturing, construction and tourism. However, CBI Scotland and Scottish Engineering posted more positive optimism figures. This divergence suggests that perceptions over future conditions in Scotland remain uncertain.
Scottish Surveys Point to Weakening Economic Outlook

Scottish business survey evidence has pointed to a slight weakening in the Scottish recovery in the second half of 2010.

In the manufacturing sector, the Bank of Scotland PMI survey which had previously pointed to robust recovery in the sector, actually reported a slight fall in output in September 2010 and no change in October 2010. However within the engineering sector, evidence from the Scottish Engineering Quarterly Review reported an extremely good outturn in Q3 2010, with output volumes at their highest level since 2006.

The Scottish Chambers of Commerce also reported a deterioration in new orders in Q3 2010 compared to Q2 2010 in the manufacturing sector. In addition, it reported a fall in new orders in every sector of the economy which it surveys. In particular, the construction and retail sector performed poorly over the quarter.

In terms of the performance of the service sector, the Bank of Scotland PMI survey reported a slight decline in output in September and October 2010 and the Lloyds TSB Business Survey reported that business in the sector saw output falling over Q3 2010. The majority of firms surveyed by Lloyds TSB expect conditions to remain roughly the same over the next six months.
The latest Bank of Scotland Index of Leading Indicators report\(^7\), which combines a series of economic indicators such as business optimism, new car registrations, consumer confidence and new orders, reported that the recovery in the Scottish economy is set to peak in Q3 2010 before slower growth in Q4 2010 and into 2011. The main reason for this slowdown is weaker consumer confidence.

![Bank of Scotland - Index of Leading Economic Indicators](http://www.lloydsbankinggroup.com/media/pdfs/bos/2010/11910pressrelease.pdf)

However, the Bank of Scotland Index of Leading Indicators does report that business confidence is growing in Scotland. Overall, the report indicates that growth in output in the Scottish economy will be low towards the end of 2010 and into 2011.

Global Recovery Expected to Continue

The IMF predicts that the global recovery will continue over the second half of 2010 and into 2011 with growth strongest in developing and emerging economies. It reports that many emerging economies have coped much better with the global downturn by virtue of their strong trend growth and avoidance of financial excess and are therefore well placed to benefit as the global recovery gathers pace.

Advanced economies are expected to experience a slower recovery as many continue to address imbalances, both internal and external, within their economies. These imbalances include the strengthening of private sector demand in advanced economies to mitigate the consolidation in the public sector; and external rebalancing with an increase in net exports in trade deficit countries, such as the US, and a decrease in net exports in surplus countries.

The IMF expects the growth of the G7 economies to remain modest in the short-term, with the Euro Area in particular predicted to experience a weak recovery. With strong growth forecast for Germany, the average for the Euro Area masks significant divergences within the currency block as peripheral economies such as Greece are expected to experience a slow recovery as they implement austerity measures to address their fiscal position.
Modest Recovery Predicted for the UK

There is a general consensus on the pace of the recovery in the UK, with GDP expected to grow by around 1.7% in 2010 before accelerating to around 2% in 2011. Although this is broadly in line with the OECD’s forecast for the G7, this is still below the UK economy’s historic 30-year average annual growth rate of 2.5%.

The Office for Budget Responsibility (OBR), which now has responsibility for publishing UK growth and public finance projections for the UK Government, released their latest forecasts for the UK economy on the 29th November 2010. UK GDP is now predicted to grow slightly stronger in 2010 than at the time of the Emergency Budget in June 2010, with growth of 1.8% compared to the previous forecast of 1.3%. However, weaker growth is now expected at the start of 2011 – mainly due to the rise in VAT to 20% in January – with the OBR predicting that UK GDP will grow by 2.1% in 2011. Over the medium term, the OBR expects UK GDP growth to accelerate to 2.6% in 2012 and 2.9% in 2013.

The main drivers of growth in the UK are still expected to come from domestic consumption, investment and net trade, as government expenditure makes a negative contribution to UK GDP growth in the coming years as a result of the fiscal consolidation. There has been much debate over whether the strength of the private sector recovery will be able to sustain the growth in GDP over the coming years against the backdrop of sharp reductions in public spending.
**Contributions to UK GDP Growth (percentage points)**

<table>
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<tr>
<th></th>
<th>2010</th>
<th>2011</th>
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<tr>
<td>Inventories</td>
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<td>Net Trade</td>
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<td>0.9</td>
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<td><strong>GDP</strong></td>
<td><strong>1.8</strong></td>
<td><strong>2.1</strong></td>
<td><strong>2.6</strong></td>
<td><strong>2.9</strong></td>
</tr>
</tbody>
</table>

Source: OBR, November 2010

One key factor, highlighted by the Bank of England in their November 2010 Inflation Report, which will determine the strength of the recovery in the UK in the coming years is whether conditions in the global economy remain favourable. Part of the necessary rebalancing of the UK economy requires a greater contribution to come from exports. Since the late 1990s, the UK’s trade deficit has continued to widen as imports exceeded exports, particularly in relation to goods rather than services.

However, following the 25% depreciation in sterling since towards the end of 2007, there is evidence that this trend has been halted as the export-import ratio of goods has remained broadly stable. By contrast, over the past two years UK service exports have declined sharply. This has been driven by the decline in exports of financial services in which the UK specialises. At this stage it is difficult to judge whether this is a temporary trend as a result of the international financial crisis, or whether this marks a permanent reduction in exports from the financial services sector.

Overall, the latest forecasts published by the Bank of England in their November 2010 Inflation Report highlight that the Monetary Policy Committee (MPC) believe that the UK economy will recover slightly more strongly than predicted back in August 2010. Indeed, despite previous criticism for being too optimistic, the MPC’s growth forecasts for the past year have actually slightly underestimated growth in the UK economy. With annual growth of between 2.5% and 3% predicted over the next two years, the MPC’s forecast remains at the upper end of the forecasting spectrum for the UK.
Modest Recovery in Scottish Output

Forecasts for the Scottish economy continue to show that the recovery is likely to remain modest in 2010, with GDP growth predicted to be around 1%. The recovery is expected to gain momentum in 2011 with growth of just below 2%.

However some forecasters are predicting a more gradual recovery in Scotland, with the latest forecasts from the Fraser of Allander Institute (FAI) predicting that Scottish GDP will only grow by 1.1% in 2011. This gradual recovery is forecast to result in higher unemployment in Scotland and for a more prolonged period of time than previously forecast. FAI now expect Scottish ILO unemployment to peak at 10.7% in 2010 and Claimant Count to peak in the same year at 5.9%.

The Ernst & Young Scottish ITEM Club are forecasting a stronger recovery in Scotland, as Scottish GDP is expected to grow by 2.1% in 2011 and 2.4% in 2012. Whilst recognising the significant downside risks to the recovery in Scotland, the ITEM Club highlights that the strong pick-up in orders in the engineering sector and the potential boost to productivity as a result of the recession may lead to a stronger recovery.

Like FAI, the ITEM Club predict that the growth in output in the Scottish economy will not result in a marked improvement in conditions in the Scottish labour market as net employment is predicted to increase by only 6,000 by 2012. Indeed they highlight that it may be 10 years before employment in Scotland returns to pre-recession levels.
Risks to the Recovery

Despite the global recovery proceeding, previously identified risks remain valid and continue to generate considerable uncertainty over the economic outlook. These risks remain skewed on the downside as a number of factors may weaken the strength of the global recovery, such as:

- Continued turbulence in the financial sector;
- Impact of the fiscal consolidation;
- The persistence of high unemployment; and
- The threat to increased trade protectionism following the debate over currency valuations.
Continued Turbulence in Financial Markets

Conditions in the international financial system were turbulent throughout the first half of 2010 as concerns intensified over the sovereign debt position of a number of Euro Area countries. Although the package of measures introduced by the EU in May 2010 eased fears over a sovereign debt crisis spreading in the Euro Area, there remains considerable uncertainty over whether certain countries in the Euro Area will be able to service their sovereign debt in the coming years.

More generally, while the health of the global banking system has improved as banks have made further progress in writing-down bad debts associated with the financial crisis and have rebuilt capital ratios, the banking system remains heavily reliant on government or central bank support and is susceptible to further shocks. In addition, with a significant amount of debt requiring refinancing in the coming year, this will be particularly challenging as wholesale markets remain in disrepair.

Furthermore, although the approval by the G20 of the so-called Basel III proposals for increasing the capital gearing ratios for banks, a number of key shortcomings in the regulation of the global financial system still need to be addressed. In particular, the ability to deal with systemic risk within the system whereby the collapse of one large bank can quickly spread to problems for other banks.

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8 IMF Global Financial Stability Report, Oct 2010
Impact of Fiscal Consolidation

Despite differences in the pace and scale of the fiscal consolidation, governments across nearly every advanced economy will rein in public sector spending and raise taxation in order to address the budget deficits which widened significantly during the global downturn. There has been much debate over whether this action will threaten the recovery and perhaps lead to a double-dip recession, or whether the recovery in private sector output will be strong enough to drive the recovery.

At this early stage in the period of fiscal consolidation, it is too early to accurately gauge what the impact of the fiscal consolidation will have on the global recovery. The IMF notes that the fiscal policy stance is likely to prove contractionary for most economies in 2011, although the precise extent is difficult to determine\(^9\).

Research by the IMF into previous periods of fiscal consolidation in advanced economies suggests that fiscal tightening by 1% of GDP has typically caused a 1% decline in domestic demand after two years, with around half the effect on real GDP usually offset by higher net exports. However, it is debatable how much past experience helps to inform what is likely to happen in the coming years given the unique nature of the current circumstances in the global economy. For example, with nearly all advanced economies set to undergo a period of fiscal consolidation, it will be difficult for all economies to experience a rise in exports.

\(^9\) IMF World Economic Outlook, Oct 2010
The UK Government published its Comprehensive Spending Review (CSR) on the 20th October 2010 which set out the spending plans for the next four financial years. Overall, there was no significant change to the fundamental path of fiscal adjustment to that outlined in the June 2010 Emergency Budget, with total public sector expenditure (TME) planned to fall by 3.3% in real terms between 2010-11 and 2014-15.

However, total UK departmental spending is forecast to fall by 11.2% in real terms between 2010-11 and 2014-15, with capital spending forecast to decline by 29% over the same period.

The impact of the CSR on the UK public finances was published in the updated projections by the Office for Budget Responsibility (OBR) on the 29th November 2010. Their projections for both the UK cyclically adjusted current budget deficit and net debt remain broadly in line with the previous projections published at the time of the June 2010 Emergency Budget.

The OBR expects the UK public sector net debt to increase from 60.8% of GDP in 2010/11 to a peak of 69.7% in 2013/14, before beginning to fall. The cyclically-adjusted current budget balance is forecast to move from a deficit of 4.7% of GDP in 2010-11 to a surplus of 0.5% of GDP in 2014-15.

For Scotland, the CSR announced plans to reduce the Scottish Government Departmental Expenditure Limit (DEL) spending to £28.5 billion in cash terms by 2014-15. This represents a real-terms cut of 11.3% between 2010-11 and 2014-15, equivalent to an average annual reduction of 3.0% in real terms over the four year period. The CSR resulted in a cut in the Scottish Government’s real capital spending power of 36% by 2014-15 compared to 2010-11.
Details of how the Scottish Government will handle this sharp reduction in its budget were published in the Draft Budget for 2011-12\(^\text{10}\). This includes an update of the analysis previously published by the Scottish Government’s Chief Economic Adviser into the potential medium to long-term pressures on the Scottish Government Budget arising from the possible spending cuts planned by the UK Government.

Assuming a return to spending growth consistent with the wider UK economy by the end of the period of spending cuts, the analysis shows that it could take until 2025-26 for the Scottish Budget to return to 2009-10 levels in real terms – an adjustment period of 16 years. This implies a cumulative real terms loss of approximately £39 billion from the base year of 2009-10.

Although adjusting the assumptions behind this analysis alters the year-on-year changes in Scottish DEL, it does not change the key underlying message that we are unlikely to experience a return to the current levels of public spending in Scotland for a considerable period of time. This will have a knock-on impact on the provision of public services in Scotland and the Scottish economy.

\(^{10}\) http://www.scotland.gov.uk/Publications/2010/11/17091127/23
Potential Impact of Fiscal Consolidation on the Scottish Economy

The Fraser of Allander Institute (FAI) published\(^{11}\) updated projections on the impact of the UK Government’s fiscal consolidation on the Scottish economy following the announcement of the CSR. In addition to analysing the impact of the reductions in public sector employment, the analysis also assesses the potential spill-over effects onto the private sector. This second effect stems from the fact that public contracts are often an important source of income for private sector companies, while public sector wages fund a significant amount of consumer spending in the economy.

The FAI model, based on an 11% real reduction in the Scottish Budget by 2014-15, produces results for two different scenarios. The first scenario assumes that prices and wages in the economy are fixed. As a result, reductions in departmental spending lead directly to a reduction in the demand for goods and services in the Scottish economy, with employment expected to fall significantly.

The second scenario allows prices to be flexible, which results in wages and prices responding to changes in demand in the economy. Under such a scenario, any reduction in employment will be mitigated by downward pressures on prices and wages. As inputs into the production process (such as raw materials and labour costs) become relatively cheaper, this has the potential to improve competitiveness and boost private sector activity. Such effects could serve to limit the worst effects of the reductions in demand. As a result, this “crowding in” may offset some of the job losses.

Both scenarios predict significant job losses in Scotland. However, the more flexible wages and prices are, the less will be the impact (see table opposite). Although there remains a significant amount of uncertainty over the potential impact of the reduction in the Scottish Government’s budget, the analysis highlights that the greater the extent to which wage pressures can be managed, the less the impact will be on employment. Furthermore, the exact impact will be dependent upon how the spending cuts are implemented, such as decisions over the balance between investment and current (consumption) expenditure.

Separate analysis by the Ernst & Young Scottish ITEM Club estimate that around 40,000 public sector jobs in Scotland may be lost by 2015.

\(^{11}\) http://www.strath.ac.uk/frasercommentary/

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</tr>
<tr>
<td>Total Change</td>
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Source: Fraser of Allander Institute
Concerns over Continuation of High Unemployment Rates

With the exception of Germany, most developed countries have seen a rise in unemployment over the recession, with levels of unemployment remaining significantly above pre-recession levels.

A continuation of unemployment at high levels would either imply significant productivity increases (as firms are able to produce output with fewer workers), or a reduction in the supply capacity of the economy (as firms permanently produce lower output than prior to the recession).

The longer unemployment continues, the more adverse the impact on the future supply potential of the economy as redundant workers lose skills which firms may need in the future to expand capacity.

A continuation of high unemployment also has implications on the demand side, as a lower number in employment equates to lower income per household and therefore lower household consumption.

In total, the implications on both supply and demand of high unemployment are likely to reduce overall output in an economy, with the impact increasing the longer the situation continues. That is why many governments have increased their efforts in recent months to boost employment levels so that persistently high unemployment does not act as a drag on future growth.
Threat to Global Trade from Protectionism

The debate over the valuation of currencies, particularly between the US and China, has raised concern that governments across the global economy may resort to protectionism by imposing barriers to trade to protect domestic economies.

Although specialisation enables countries to increase trade and wealth within the global economy, not every country will benefit and therefore it can often lead to trade protectionism. This can take many forms such as manipulating the value of a currency in order to ensure that a country’s exports remain competitively priced in the global economy.

However, coupled with fears over subdued growth and high unemployment in a number of countries, policy makers and international organisations such as the World Trade Organisation (WTO) are concerned over the potential for the introduction of more explicit barriers, such as tariffs and import quotas, spreading through industrialised countries to protect growth in domestic economies.

Protectionism is implemented for short term gain, but is likely to reduce both imports and exports for countries which impose it. Trading partners will retaliate with their own form of barriers, therefore reducing the export opportunities of those countries who originated the policy, with a cumulative impact of a reduction in world trade. This experience in the 1930s is thought to have been one of the contributing factors behind the spread of the Great Depression.
Summary of Future Prospects

Global Economy
- The global recovery is expected to continue into 2011, with growth driven by emerging and developing economies. Advanced economies are forecast to experience a more modest recovery, with unemployment levels to remain significantly above pre-recession levels.
- Heightened downside risks remain for advanced economies as a sustained recovery is dependent on addressing both internal and external imbalances.
- In addition, sovereign debt concerns in the Euro Area and the ongoing debate over currency valuations provide an uncertain backdrop to the global recovery.

Scottish Economy
- The latest independent forecasts predict a modest recovery in Scottish GDP, with output expected to remain broadly flat over the second half of 2010 before the recovery gains further momentum in 2011 where GDP is expected to grow by around 2%.
- With many of Scotland’s key trading partners expected to experience a modest recovery, it will be a challenge to rebalance the Scottish economy away from domestic demand toward investment and exports.
- Reductions in public spending will impact on both the public and private sectors of the Scottish economy in the coming years, although a number of factors will influence the scale of the impact.