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Quarterly ECONOMIC *Commentary*

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Outlook AND *Appraisal*

The decision of the Scottish people on 11 September to support the creation of a Scottish legislative Parliament with tax-varying powers is of historic significance. This expression of the people's will has ensured the eventual removal of the two-hundred year anomaly where Scotland is the only democratic country with its own legal system but no legislature of its own. Scotland will remain part of the United Kingdom with Westminster retaining responsibility for foreign affairs, defence and macro-economic stability, but the Scottish Parliament will be responsible for almost all other aspects of the business of government. The activities of the Scottish Parliament will therefore reach into almost every corner of Scottish life, not the least of which will be the economy.

In his Foreword to the White Paper the Secretary of State for Scotland, Donald Dewar, argued that "(w)ith its new responsibilities, the Scottish Parliament will be in a position to encourage vigorous sustainable growth in the Scottish economy." Indeed it has been suggested that a sense of frustration with the continuing lagging performance of the Scottish economy was the driving force which united the various groups that set up the Scottish Constitutional Convention (SCC) (Laramie and Mair, 1997). The SCC's proposals for a Scottish Parliament were largely followed by the new Labour Government in their White Paper to which the referendum was addressed. Yet, in the debate preceding the referendum, the economic issues that dominated were those relating to the financing of the Parliament and the impact of the tax varying powers. This was unfortunate because as Newlands points out "the economic possibilities of a Scottish Parliament ..... are not to be located with regard to the financing of Scottish public expenditure ..... but with regard to its impact on the rate of economic growth and development in Scotland" (Newlands, 1997, p.109). We believe that it is essential that a debate begins as soon as possible on the possibilities for a Scottish Parliament to improve the long-run economic performance of the Scottish economy. The debate is essential if the Executive and Members of the first Parliament are to move quickly and effectively to address Scotland's historic economic problems, particularly the poor performance of Scottish owned industrial activities, including low innovation and firm formation rates, leading to weak employment growth, high unemployment, and significant net outmigration of population.

We seek to make a contribution to this debate by highlighting where some of the economic possibilities for a Scottish Parliament might lie and by drawing attention to some key issues along the way.

A New Partnership

Scotland currently enjoys a significant decentralisation of administration, with the Scottish Office responsible for a large Budget of about £14.5bn and considerable autonomy to develop economic policy for delivery through Scottish Enterprise (SE), Highland and Islands Enterprise (HIE), Locate in Scotland, Scottish Trade International and many other agencies. The creation of a Scottish Parliament will add decentralisation of choice to the current devolved administration with the directly elected body responsible for all the present functions of the Scottish Office. It is reasonable to question whether this addition of democratic accountability to an already extensive range of devolved functions can make much difference to the impact of policy on the Scottish economy. Indeed, it was implicit in the "No-No" campaign that the Parliament was a flawed institution and so would be likely to damage economic performance. It is of course correct to point out that the quality of actors - the MSPs -, the nature of the powers conferred, and the financing arrangements, are all likely to affect the performance of the Parliament in relation to the economy. But there is no *a priori* basis for suggesting that devolution *per se*, tax varying powers apart[1], will be damaging to the economy. Indeed, the implication of the relevant theoretical economics literature (fiscal federalism) is that decentralisation of choice, with a parliament focusing on allocation and growth (see below), should raise regional welfare. The Scottish Parliament should be more able, and should perhaps be more willing, than central government to match its tax and spend decisions to the preferences of Scottish residents. The Parliament will be better informed about, and better able to reflect, individuals' preferences (Newlands, 1997). It will therefore have the potential to make better choices, from the point of view of the Scottish people, and institute an earlier rectification of poor choices, although the nature of the parliamentary process could mean that decisions are taken more slowly (Bryan and Hill, 1997).

The Parliament offers the opportunity to create a new partnership between government and the Scottish people for the benefit of the Scottish economy by strengthening networks of co-operation and by changing the rules and norms of behaviour (Newlands, 1997). The evidence from regions with successful economies and decentralised choice, such as the Third Italy, Baden-Wurtemberg in Germany, Rhone-Alpes in France and Catalonia in Spain, is that the performance of decentralised institutions linked to the institutionalisation of network structures favourable to innovation and collective learning, have been significant non-economic factors in the economic success of these regions. In addition, it is argued that the most successful areas place a high premium on trust, co-operation and social inclusion (Dunford and Hudson, 1996). It is not just growth that is the objective but "growth with development", where the benefits of growth are clearly seen to be shared widely throughout society. As a result, devolution of choice can, through partnership, lead to a more effective mobilisation of resources.

Old and New Policies

Newlands (1997) identifies four roles of government with respect to the economy: stabilisation of the macro-economy; distribution of income; allocation of resources to more efficient uses and the promotion of growth. There is a consensus amongst economists that the proper economic role for a decentralised government is to focus on allocation and growth, leaving the pursuit of the stabilisation and distribution objectives to central government. It is well known that markets fail to secure an optimal allocation of resources. This is principally because of the presence of externalities, or spillovers, which are not mediated through the market, resulting in too little private provision of those goods with positive spillovers and too much market provision where the externalities are negative. Moreover, the market may fail to deliver the socially optimal rate of growth because of information failures and/or because the present generation places a too high value on present consumption, thereby saving and investing too little at the expense of the consumption of future generations.

In providing services, the government seeks to correct the allocation of resources that would otherwise result from the operation of unfettered market forces. In Scotland today the provision of services is devolved to the Scottish Office and there are an array of policies to promote growth and development, principally through the activities of Scottish Enterprise and its associate agencies. Again it may be wondered whether the Scottish Parliament can improve on the achievements of the already devolved administrative structure. We have already noted that the Scottish Parliament is likely to be better informed, and more willing to satisfy the individual preferences of Scottish residents than the present decentralised administration of largely central government policies. But there is also good reason to believe that the Parliament will ensure the more efficient delivery of existing policies than the current governance arrangements.

One argument that was traditionally used against the decentralisation of choice is that there are economies of scale in the production of goods and services which justifies a central concentration of the production and delivery functions. However, Smith, S. (1996) points out that government today is much less involved with the production of public services, functioning instead more as a purchaser and regulator than as direct producer. The attainment of economies of scale are therefore less important to the decision on the appropriate spatial level of government. Moreover, given that modern government is more concerned with information processing activities than previously and given the evidence that such activities are subject to diseconomies of scale, with costs tending to rise more than proportionately with the size of government unit, the economic case for decentralisation has increased. Indeed, Smith argues that the costs of information processing are likely to be higher even when there is decentralisation of administration because of the need for at least some information transmission to London (Smith, S. 1996, p. 97). Further, a directly elected Parliament with legislative powers offers the prospect of a more effective control mechanism to: co-ordinate economic activity (Armstrong, 1997); ensure greater integration of the activities of the agencies responsible for economic development (Bryan and Hill, 1997); and constrain bureaucratic under performance (Smith, S. 1996). Hence, a Scottish Parliament should improve the delivery of existing policies and the efficiency of resource allocation within Scotland.

The advent of a Scottish Parliament also brings the prospect of new policies to address Scotland's economic problems. During the last twenty years there has been a recognition that policies which affect the supply capacity of the economy are necessary to enhance economic growth. Moreover, it is generally believed that many of these policies are better formulated and implemented in the regions and areas where the problems are located. In other words, there has been a movement in favour of supply-side policies which are "bottom-up" rather than handed "top-down" from central government. The development of Scottish Enterprise, the network of Local Enterprise Companies, Technology Transfer and Innovation Centres, Enterprise Development Centres, intermediate labour markets such as those typified by the activities of the Wise Group, and skill centres, are all examples of this trend. Yet the parameters governing the formulation of economic development policy and the activities of institutions charged with development are still set by central government. It is argued, for example, that despite much decentralisation, the strategy towards training in Scotland is largely determined by the priorities of the UK Government in London (Newlands, 1997). Under a Scottish Parliament this will surely change. Policies will be formulated which more directly reflect Scotland's problems.

Labour market policy will be able to reflect the greater incidence of long-term unemployment, lower participation rates and particular skill deficiencies in Scotland. Education policy will perhaps be more able to take account of the lower proficiency of Scottish school students in mathematics (Prais, 1997). Technology policy will be more able to remedy the low product innovation rate found in indigenous Scottish manufacturing firms (Roper *et al*, 1996). And there will be more scope for industrial policy to seek to address the implications of the ever increasing external control of Scottish economic activity, whether it be through takeover or inward 'greenfield' investments (Ashcroft and Love, 1993). Here the Scottish Parliament will want to build on the strengths of external ownership by encouraging higher local value added, increased local purchasing links, technology transfer, spin-outs, and networks, while at the same time minimising the threats, such as the loss or absence of key headquarters' functions: R&D, marketing and other key decision units.

The Scottish Parliament will also wish to formulate economic policies which capitalise on Scotland's existing economic strengths. Several scholars who have undertaken research in this area recognise that decentralisation of choice, while it may or may not be a necessary condition for improved economic performance, is not sufficient to promote a faster rate of economic development. A region's, or nation's, resource endowments, which embrace all of its general and specific assets and resources including its economic structure, are considered by some to be of crucial significance (Dunford and Hudson, 1996). While for others it is the processes that are driving economic change in the region that are critical (Haynes *et al*, 1997). This constitutes something of a truism but it highlights the need for the Parliament to be able to identify the key resources available to it, and to be aware of the processes that are driving economic change.

The Scottish economy has many strengths. The work of Scottish Enterprise to identify potential 'clusters' of sectoral and industrial development in Scotland is surely something the Parliament will want to encourage and develop. The latent potential in tourism, engineering, chemicals, higher education, film, publishing and the electronic media in Scotland, offer opportunities for creative policy intervention by the Parliament. And the strength and distinctiveness of the Scottish financial sector, particularly the banking sector, offers a range of policy opportunities which could be to the mutual benefit of both the sector and the wider Scottish economy (Dow, 1997).

But to capitalise on the strengths of the Scottish economy and deal with its weaknesses, the Parliament needs to be fully informed. There needs to be an improvement in the economic statistics and advice available to the Parliament. Despite the excellent work of Scottish Office statisticians and economists, the data currently available on the Scottish economy is inadequate for informed policy making. Key data are either absent, or imperfect while existing data sets are incompletely analysed. For example, we require more accurate, timely and frequent data on Scottish GDP and its principal expenditure components. Data on the labour market require extension and improvement, e.g. in the area of skills and other labour supply characteristics. There is an absence of adequate data on the service sector, particularly the financial sector. Little is really known about the structure, conduct and performance of industry in Scotland, including cost structures, profitability, R&D, innovation behaviour, start-up rates and ownership and control. More resources must be devoted to this area if we are to take full advantage of the economic policy making autonomy of the Scottish Parliament.

Furthermore, the Scottish Parliament will require a more developed source of independent economic advice than currently exists. Within the public domain the Secretary of State for Scotland receives economic advice from Scottish Office economists, and formally draws advice from outside government through the Scottish Economic Council and the Panel of Economic Consultants. The latter two advisory bodies meet infrequently and are inadequately resourced particularly to undertake research. We recommend that these two advisory bodies be replaced by a Scottish Economic Advisory Council (SEAC). SEAC should be modelled along the lines of the Northern Ireland Economic Council (NIEC)[2] but structured and resourced to reflect the particular nature of the Scottish economy. SEAC would contain 15 to 20 members, with at least 5 to 7 members who are independent economists with specialist knowledge relevant to the Scottish economy. The remaining members would be nominated from the community to reflect the interests of the social partners including business, the unions and the voluntary sector. SEAC would also be appropriately staffed with an independent chairman of considerable experience and stature, a professional economist as director and three or four other professional economists and appropriate support staff, including a secretary. The Council would meet monthly and would advise the Scottish Parliament on the development of economic policy. SEAC would discharge the advice function through: the publication of reports on aspects of the Scottish economy and related matters drawing on the expertise of Council members, SEAC staff research and pieces of commissioned research which would largely be of a synthetic or synoptic nature revealing relevant research findings and best practice from throughout the world; holding seminars designed to promote debate; and by the provision of comment and advice, through responses to invitations from the Parliament and other public bodies. The activities and proceedings of the Council would be open to public scrutiny to guarantee its independence, through its publications, its Annual Report and the public availability of its submissions.

A New Voice for Scotland

The creation of a Scottish Parliament offers the prospect of a new voice for Scotland in economic, and other, affairs. The legitimacy conferred by direct elections will allow the Parliament and its Executive to speak with authority on matters of significance to the Scottish economy. The Parliament will wish to influence the Scottish dimension of policies made in London and Brussels, through debates, committee investigations and active lobbying. In the EU, membership of the Committee of the Regions and the Economic and Social Committee should result in the Scottish viewpoint being listened to with greater interest and effect than with the present governance arrangements (Smith, N. 1996). The new voice of Scotland will also be heard to greater effect within Britain by non-departmental public bodies such as the Bank of England, the Monopolies and Mergers Commission, the Office of Fair Trading, the various regulators, and the BBC. The legitimacy conferred on the Scottish Parliament will ensure that there is a powerful voice to protest against any perceived harmful effects of EU and UK national policies. And it is a voice that will be seen and heard.

One corollary of the creation of a new centre of political decision making in Scotland with a powerful voice, is that there are likely to be some beneficial effects on the location of economic activity. Many private sector organisations will wish to be physically close to the Parliament to take advantage of economies of localisation. Some private sector headquarters functions previously lost to Scotland may return. Others may be attracted. Thus the existence of the Parliament in Scotland may serve to diminish, if not reverse, the trend to increasing external control. It will therefore provide a boost to specific policies that the Parliament might develop to attract new headquarters functions to Scotland.

A Qualified Freedom

We believe that the creation of a Scottish Parliament offers considerable opportunities for the Scottish economy. However, it would be a mistake to believe that the Parliament is a panacea for Scotland's economic problems. Much that happens within the Scottish economy is driven by forces outside the borders of Scotland. The macroeconomy will continue to be principally affected by the world financial and commodity markets, as well as the decisions of the UK Treasury, the Bank of England and, if Britain joins the European single currency, the European Central Bank. The Budget of the Scottish Parliament will reflect the UK economic situation and political considerations as well as Scottish conditions. Decisions affecting corporate activity in Scotland will still be taken in London, Frankfurt, Seoul, Tokyo, Paris and New York. Employment legislation, social security policy and administration, the regulation of the professions, many other regulatory functions, and transport safety, will still be determined by the UK Government in London. Trading and product standards, subsidisation limits, and competition law will still be set in Brussels.

Furthermore, the success of the Parliament will depend crucially on whether it can build support from, and harness the skills of, the Scottish people. In the words of Sir George Quigley, Chairman of the Northern Ireland Economic Council, at a recent seminar on decentralised government held at the University of Ulster, " the purpose of government is to provide strategic and hopefully charismatic leadership and thereby to enable the society to achieve its full potential, with all its members making their full contribution to, and sharing in the fruits of, economic performance. ..... The issue for every government is how to carry out that enabling function without locking the society into a state of dependency which enfeebles initiative and weakens the innovative, creative and problem solving capacities of the society. Institutions which are inappropriate or prone to malfunction can constrain economic performance." (NIEC, 1996, p. 210). The future members of the Scottish Parliament and its Executive would do well to heed his words.

Notes

[1] The assumption by many that the tax varying, and particularly tax raising, power will be damaging to the Scottish economy is seriously flawed. Simulations with the Institute's AMOS model suggest that if the Scottish workforce follow national bargaining outcomes i.e. don't push for higher pay in the face of the tax, rather than following local bargaining, then the impact of a 3p tax rise would raise output and employment as the extra government expenditures expand the economy by more than the effect of the reduction in worker expenditures due to the tax rise. (McGregor *et al* 1997)

[2] The Director of the Fraser of Allander Institute, Brian Ashcroft, is a member of both the Secretary of State for Scotland's Panel of Economic Consultants and the Northern Ireland Economic Council.

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