

The challenge of Inclusive Growth for the Scottish economy

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Abstract

“Inclusive Growth” is the new approach to economic policy in Scotland. This Perspective summarises the thinking underlying this approach, including whether and how far it reflects a substantive change in policy. It suggests how the issues raised will frame economic policy in Scotland over the 2016-2021 Parliament, and underlines the importance of work based learning, as one example of how the Scottish Government is putting inclusive growth into practice. It concludes that a broad perspective is required to promote prosperity and address inequality in Scotland in an integrated way.

Key words: Scotland, inclusive growth, inequality, Scotland’s Economic Strategy, work based learning

1. Introduction and background

The ex-Head of the Research Department at the IMF, Professor Olivier Blanchard recently reflected on the response to the financial crash of 2007/08, and how economic policy makers should learn from the new facts about the economy. He argued that, in future, the task of governments and Central Banks should not simply be to use fiscal and monetary levers to fine tune an otherwise mostly stable economy. Instead a new approach should be built to avoid catastrophic destabilisation, as happened in 2007/08. To underpin this broader policy approach, he described a new approach to economics which takes the risks of destabilisation seriously. He urged an awareness that “*dangers lurk in dark corners*”, with a need for greater attention to those issues which have the potential to destabilise the economy. Some of these are well known, especially the financial sector and imbalances across the world economy, and others reflect the disruptive changes underway in the economy.

In a recent speech, Dr. Gertjan Vlieghe, External Member of the Monetary Policy Committee of the Bank of England, argued that “3 D’s” were increasingly important to monetary policy makers, namely debt, demographics and distribution of income. Moreover he says that many of the modelling tools used by central banks to assess the state of the economy “*imply that, by design, debt does not matter, there are no demographics and there is no distribution of income*”. His prescription going forward is to combine existing tools with the development of detailed analysis of underlying trends in the economy, including the “3 D’s”.

Professor Robert Gordon has identified a set of headwinds affecting the future of the world economy. His book, the [Rise and Fall of American Growth](#), published earlier this year starts with a disquieting claim, namely that “*the economic revolution of 1870 to 1970 was unique in human history, unrepeatably because so many of its achievements could only happen once*”. He foresees the prospects for continuing economic growth as much less than we have experienced, compounded by a series of headwinds, due to ageing population, a plateau in educational attainment, rising inequality and the need to repay household debt. Yet there is much we don’t know about the medium to long term prognosis for

the growth and stability of economic activity. The prospects for future economic growth are to put it mildly unclear. Edward Luce, in a recent Financial Times piece, described 3 distinct schools of thought;

- **“Digital optimists”** see huge opportunities for a digital industrial revolution. Their core argument is that the full productivity benefits of digital technologies have not yet been realised and the potential for disruptive innovation through networked information is enormous – and positive;
- **“Digital pessimists”** also see a prospect for huge changes in the use of machines, artificial intelligence and robots. Yet they mainly fear the potential destabilising and negative impact of jobs, incomes and human potential; and
- **“Digital-sceptics”** doubt the potential for continuing growth in productivity in the developed countries, even with digital technologies. Robert Gordon is the strongest proponent, and his pessimism has echoes in the concerns about so called “secular stagnation”. There are many forces at play here, including medium term weakness in aggregate demand as a result of the debt overhang and changed structure of personal spending. And there is the (conceptually different) problem of low levels of technological progress constraining future income growth. But for the average worker and consumer, the sceptics point to a much less positive future.

What is clear is that economic policy making is no longer (even if it ever was) a simple matter of steering the economy. Rather it requires a fundamental understanding of what is happening under the bonnet, whether the accelerator and brakes actually work and what skills we need to chart a course ahead. While there is a recognition that activist government will be required to deliver prosperity and reduced inequality, there remains strong disagreement over how this new agenda should be delivered.

2. A Scottish context

In its latest Economic Strategy, the Scottish Government committed itself to pursuing Inclusive Growth and marshalled an impressive set of studies to justify its new approach. The document seeks to provide *“an overarching framework for achieving the two mutually supportive goals of increasing competitiveness and tackling inequality in Scotland”*, and introduces 4 priorities of *“investment and innovation, supporting inclusive growth and maintaining our focus on increasing internationalisation”*.

A policy approach based on Inclusive Growth rests on 5 propositions, namely that:

- **Inequality of income is growing.** The Scottish Government note that income inequality among working age people increased faster in the UK between 1975 and the late 2000s than in any other country in the OECD;
- **The inequality of household wealth is more unequal than the distribution of income, and wealth inequality is increasing at a faster rate than income inequality;**
- **This inequality of income is constraining economic growth, and making the economy less stable.** This counters the common perspective that some inequality may be necessary to

create incentives to promote economic activity. Government Ministers quote a recent study by the OECD which concluded that rising income inequality in the UK reduced GDP per capita growth by 9 percentage points between 1990 and 2010;

- **Measures to address inequality can be growth-enhancing as well as inequality reducing**, which counters the common view that there is a simple trade-off between efficiency (and growth) and equity (and fairness);
- **High levels of income inequality are not linked to high economic performance or high human welfare.** Many northern European countries have achieved lower levels of income inequality than the UK whilst also performing better on key measures of economic performance (for example on the United Nation's Human Development Index (HDI) is a composite index based on indicators of life expectancy, educational attainment, and income).

This Perspective does not attempt to synthesise the huge research literature which underpins this narrative on economic policy. There are many excellent documents, which describe much of this story:

- Bell, Eiser and McGoldrick (2014) have prepared an excellent summary on the Income Inequality in Scotland, and what can be done about it;
- There are excellent book summaries of new approaches which have been published in recent years, especially books by Piketty (2104) and Atkinson (2014);
- There are many good summaries of the contrasting approaches to “distributional justice”. Some see income from economic activity as driven by human effort, skills and technology in the competitive economic marketplace. For a rigorous outline of this view, see Mankiw (2014). Others see market outcomes as the product of inheritance, societal “rules”, and luck, which increasingly reflect “market imperfections”, and the extraction of so called “economic rents”, rather than competitive forces. For a clear outline of this view, see Stiglitz (2011); and
- The previous two annual Economic Reports to the President, published by the US Council of Economic Advisers (2014, 2015) offer a sweeping, evidence-based assessment of the challenge of inclusive growth in the US.

This Perspective argues that, if we are serious about delivering on inclusive growth, we need to understand what is under the bonnet of the modern economy. For the vast majority, the jobs market is both the cause of inequality and the solution to it. Therefore, in order to achieve inclusive growth, we will need innovative approaches to economic policy. We will need new and better institutions to deliver them. And perhaps most of all, we need a greater depth of analysis of “what works at work”, to promote inclusive growth.

3. Why inequality of wealth matters so much

A combination of the financial crash in 2007/08 and an emerging new view of the economics of inequality is transforming our “big picture” perspective on the economy. And no-one is contributing more

to this reconsideration that Professor Thomas Piketty. His huge book, *Capital in the 21st Century*, has captured a mood.

Piketty has created a new grand narrative to explain the development of the economy, and he sees strong forces toward ever rising inequality of wealth and of income in future. His newest, and most powerful, contribution is to focus on ever-rising inequality of wealth. Piketty's pared down narrative of the last 200 years is a story of the rise, fall and rise again of the inequality of wealth. Indeed, the gap in wealth between rich and poor was large and rising in the 18th and 19th century, due to a combination of skewed returns from land and huge gains to the emergent business class during the initial stages of industrialisation. This was however undermined by the destruction of capital assets in the two world wars, particularly among the very rich, with a further loss in the real value of remaining savings by inflation. But, after reaching a historical low in the 1950's, the wealth gap between rich and poor started to rise again.

Piketty is not the first to observe a return to growing inequality of wealth. His profound insight is that this growth may reflect an inevitable force of capitalism. He identifies what he calls a Fundamental Law, namely that if the rate of return on wealth is greater than the rate of growth in the economy, then in simple terms the "rich will get richer". His economic model outlines how an ever growing inequality of wealth inevitably leads to a declining share in national income going to workers. His challenge to the economics profession is to take this "wealth begets wealth" process seriously, because it has no obvious self-regulating mechanism.

Piketty's work offers a fresh perspective on the post war period of economic growth in the west in the 1950s and 1960s. He sees the post war period of inclusive growth - where trends in economic growth and of inequalities of income and wealth reinforced each other, positively - as a fortuitous historical accident, rather than the norm. And he sees a major challenge in getting back to those trends without concerted government action. There are many doubters about his technical story, and those who see alternative explanations for growing inequality of wealth. And there are even more doubters about his solutions. But his perspective on the potential future risks of ever growing inequality has changed our collective perspective.

4. Why inequality of income has grown so much

Piketty's rich historical narrative fits with the trends in rising inequality of income. The facts are clear, albeit different across developed countries. The past 30 years has seen a huge increase in inequality of income within nations, especially the growth in the top 1% and the stagnation of median incomes. In parallel, global inequality between countries has actually narrowed over the last few decades, due to economic growth in countries like China and India.

There has been much focus on the rise of the super-rich. The average income of the super-rich in the US, defined as the top 0.1% of income earners, did not re-attain pre-WW1 levels until the late 1970s. (That's not a typo). Since then, average income of that group has grown by 7% per annum, which means their incomes roughly double every decade. The experience for the rest is the polar opposite – average incomes grew steadily after the war to around 1980, and have levelled off since.

Why has there been a U-shaped trend in income inequalities since WW2? The trend reflects globalisation, demographics, technological change underpinning economic growth, and changes in policies, behaviours and attitudes, particularly since 1979. While there are overlapping explanations, there are some identifiable trends; which have been well summarised by Coen Tuelings:

- **Globalisation has made the world flatter**, and political change has opened up much of Asia to accelerated economic growth. We have seen a dramatic increase in the global supply of labour, and free movement of capital and labour has led to huge changes in the location of economic activity and of global wages;
- **Changing technology has placed a premium on different skills.** Emergent technology has opened up new industries and closed the door on others. The outlook for jobs has been summarised by Andy Haldane, the Bank of England's Chief Economist. He said that *"technology may be the single most important force shaping the fortunes of jobs and wages"*. In general, as technology has advanced, people have become richer. And some professions and jobs have declined but more have been created. In the current period of disruption, the group that has benefited most are the highly educated and those with high cognitive skills, especially in sectors allied to digital technologies and computers. But there is a "hollowing out of the labour market", with massive benefits for some "superstars" and more modest returns for others. This effect is clearest among sport and media celebrities, bankers and the "super-manager" class of corporate CEOs. The benefits of growth appears to accrue to those who can harness digital technologies (i.e. can "complement computing power") and capture it in wages. But, on the negative side, there has been a decline in occupations that can be replaced by new technologies (i.e. can be "substituted by computing power") and labour has shifted into service professions, which are often non-tradeable internationally. Inequality will be greatest in parts of the economy where the super successful can gain huge returns (e.g. finance, entertainment, digital technology) and in economies with large shares of these sectors (especially the UK and USA).
- **The overall share of the economic cake going to workers is falling, with a greater share of the benefits accruing to profits.** A declining "Labour Share" is in fact one of the defining facts about western economies since the 1970s. At this stage it is not clear that this is the product of Piketty's focus on wealth. But it does appear to reflect changes in occupational structure and in the role of collective bargaining and union power in the economy. The trend away from statutory bargaining and wage setting seems to have reduced the share of economic gains going to workers. This suggests that measures to support minimum wages may not lead to reduced employment.

5. Scottish policy responses

So how is a policy focused on inclusive growth any different from the policy approach undertaken over the previous 15 years? An assessment by Marsh and Wakefield (2015) for the Scottish Parliament notes that, since 1999, there have been 8 economic strategies published by Scottish administrations. While all of have focused on raising productivity as the principal way to achieve long run economic growth, the

number of mentions of inequality has grown. The first strategy published in 2002 did not mention inequality, while the current document mentions inequality no less than 135 times. Yet, a simple word count is perhaps misleading, given the pre-2007 governments' separate and complementary publications on Social Justice. The difference between the economic strategies published by this Administration and former administrations before 2007 should not be exaggerated.

Nor should we be surprised by the very significant continuity in policy approach. The major challenge remains how best to raise productivity in the economy. The solution is not less economic growth, but more of the right type of economic growth. The simple arithmetic of compound growth means that delivering better economic growth for those disadvantaged in the economy remains crucial. As a thought experiment, the US Council of Economic Advisers asked "what if" the benign trends after WW2 had simply continued? They calculated what incomes would be like if the faster technological change and the shared growth in incomes (to 1973) and expanded labour participation (until male and female participation reached parity in 1995) had kept going. They found that average household incomes might have doubled on today's levels, with by far the major contribution coming from the benefits of faster economic growth, rather than from reduced inequality or higher participation. As the 2015 Report to the President makes clear, the inter-relationship between productivity growth, inequality of income and labour participation have driven our recent experience and will continue to shape the prospects for inclusive growth going forward.

Like the US experience, the Scottish Government's economic policy has responded to the changed political and economic environment around inclusive growth. Policies are increasingly reflecting this changed perspective. While promotion of economic growth remains fundamental, governments are increasingly careful not to promote growth which simply compounds the malign trends of rising inequality and increasing instability. Instead, the search is for growth policies, which match prosperity with structural reform to life chances and labour markets.

Fortunately, there is no simple trade-off between prosperity and equity. Instead, there is a huge middle ground of policies and social attitudes that deliver prosperity and equality. If trends in inequality partly reflect policies and social structures, then how can we develop a pro-growth social policy (and a pro-equality economic policy)? The Economic Strategy continues a very welcome emphasis on research, innovation and enterprise, and the imperative of raising export performance. It prioritises early years intervention, and childcare support, which will contribute both to expanding the working age population now and to developing the workforce of the future. And it recognises the skills challenges, both in formal education and in the workplace.

Most prominent in Scotland has been the Fair Work agenda, which focuses on workplace innovation and the concern that a neglect of effective "industrial relations" has undermined job satisfaction and productivity. Governments are now supporting labour markets to promote the interests of workers, and there is scope for companies to improve profitable outcomes by ever more education and better workforce utilisation.

Yet, the scope for Government to intervene is highly contested and bounded, and the changes in the responsibilities of the Scottish Government will throw these challenges into sharp relief. The scope for government actions are constrained on multiple fronts:

- **There is the “zero lower bound of monetary policy”.** In order to help the world economy out of the recession, western central bankers have resorted to historically low interest rates and unconventional monetary policies. This may continue for some time yet, and world interest rates are at very low levels. But there is little more that governments can do to boost growth through monetary policy;
- **There is an “upper ceiling of fiscal policy”.** The scope for Governments to spend more is deeply constrained. The financial crash and the resultant high levels of government debt have, rightly or wrongly, led to a view that welfare spending needs to be reigned in. Austerity policies, based on fiscal rectitude, have look likely to have made inequality worse;
- **There are limits on the scope for governments to “tax the rich”.** The accumulation of income and wealth by very successful individuals and corporations is an important tax base. Various income and wealth taxes are widely recommended, with a recognition that any negative impact on incentives may be minimal. But the opportunities for tax avoidance at national level blunts the effectiveness of such taxes, and limits the willingness of governments to introduce them;
- **The scope for measures to “compensate for market outcomes” through income transfers is highly contested.** The paucity of income and wealth of multiply disadvantaged individuals undermines their wellbeing and potential. One of the key features of the economy at present is the “jobs rich, wages weak” recovery which has increased in-work poverty. Over time, the welfare state is increasingly becoming an in-work support mechanism as much as an out of work support insurance. There is increasing interest in the idea of a “Basic Income” as an alternative to targeted welfare support;
- **The effectiveness and impact of labour market interventions, through the Living Wage and statutory Minimum Wages, need evaluated to ensure they work.** One of the most compelling recent contributions has been Professor Anthony Atkinson, who summarised 12 proposals to tackle inequality. His first was to advise that *“the direction of technological change should be an explicit concern of policy-makers, encouraging innovation that increases the employability of workers, notably by emphasizing the human dimension of service provision”*. The Scottish and UK Government are moving, albeit in different ways, to support higher and more widespread minimum wages. The Living Wage campaign has been actively promoting the benefits of raising wages alongside raising productivity in the workplace; and
- **The changing taxation responsibilities of the Scottish Government, through the new Smith Commission powers.** The further transfer of powers and responsibilities to the Scottish Parliament will mean that the composition of the income tax base will directly affect income tax revenues raised in Scotland. One key focus of the Fiscal Framework negotiations was on the appropriate procedure for calculating the reductions in the block grant to Scotland to offset the increased tax revenues

which will be raised directly in Scotland. The final deal reached between the Scottish and UK Governments means that, at least for the next 6 years, any differential growth in population between Scotland and UK will not affect the deductions made. However, any change in occupational structure and incomes will affect the income tax raised. This introduces, for the first time, a direct link between the income tax base in Scotland and revenue raised.

6. The importance of work based learning

The renewed importance being placed on work based learning illustrates the challenge of inclusive growth. Our economy is suffering for the lack of trained young people and our young people will suffer if they do not gain the right skills. The UK Government's "Productivity Plan" published in July this year said that *"The UK performs poorly on intermediate professional and technical skills, and is forecast to fall to 28th out of 33 OECD countries for intermediate skills by 2020"*. Employers see the benefits, but will need to regain the habit, of training our young people. While, as Sir Ian Wood put it his ground-breaking report on Developing our Young Workforce, *"Employers have lost the habit of employing young people"*.

A series of articles in the Fraser Economic Commentary have illustrated some of the challenges in labour market planning in Scotland. Gail Rogers and Kenny Richmond summarised the issues around "Job Polarisation", Graham Thom and Susan Mackay outlined the challenges on skills planning, and Robyn Millar, Sir Harry Burns and Alec Morton explained the interaction between demographics, economic activity and health. In this Commentary, Alan Sherry outlines the challenge of widening participation in higher education.

Looking forward, one of the key issues in labour market planning will be whether we have the analysis and policies that can find a route to inclusive growth. Skills Development Scotland are pioneering a renewed focus on work based learning, in the context of the 'Developing our Young Workforce' agenda. The Fair Work Convention is building a strategic approach to workplace innovation. These developments fit well with a strategic perspective on our changing labour market, and we should expect major developments in these areas in the coming period.

7. Conclusions

The challenges facing the Scottish economy are considerable. There are many headwinds – with a prolonged and reduced contribution from oil and gas activity, lower population growth than the UK as a whole and long term and well known structural features on private sector innovation and export performance. Yet, there is considerable scope for governments to pro-actively enable citizens to prosper, to make markets work better for citizens and to steer technological change toward lower inequality. Policy on innovation and growth needs to have an eye to inequalities, and social policy needs to acknowledge and work with the fundamental forces at work in the economy. This new agenda will pose a considerable challenge to the agencies and institutions of government, which generally take a focused view on their narrow statutory responsibilities. In future, a broader perspective is needed to promote prosperity and address inequality in Scotland in an integrated way. The need for new tools of policy and reformed institutions is at the heart of the Scottish Government's Economic Strategy – and success will depend on its effective delivery.

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