

# SCOTLAND'S ECONOMIC FUTURE POST-2014

## SUBMISSION FROM SIR DONALD MACKAY

### Structure and acknowledgements

#### Structure

- The recession
- The recovery and the labour market
- Childcare
- 'The Gleam in the North'
- The macroeconomic framework

#### Acknowledgements

In the course of making this submission I have asked many individuals and organisations for information and data. The response was always positive and unfailingly polite. I signal out three individuals because they are old colleagues and friends who have tried, not always successfully, to point me in the right direction. They are Professor Alex Kemp, Maitland Mackie and Bill Jamieson. They have all influenced my thinking on a range of topics, but each would want to emphasise that I don't always get it right. Donald MacRae is a more recent acquaintance but is always throwing new light on old and continuing issues. One day I may find the answer to his question - 'Scotland: Celtic Lion or Tim'rous Beastie?'

#### The recession

The recession over 2008-2012 was more severe and prolonged than any since the 1870s. The primary cause was the failure to control the public finances. This was compounded by the taxpayer funded support costs necessitated when a number of major financial institutions lost control of their balance sheets.

Figure 1.1 shows UK and Scotland GDP over the recession. Figure 1.2 throws new light on the recession from a different angle. The historical pattern has been that the Scottish economy went in to a recession or stop period earlier, and recovered more slowly than the UK economy. On this occasion Scotland entered the downturn later but began to recover earlier.

Figure 1.1

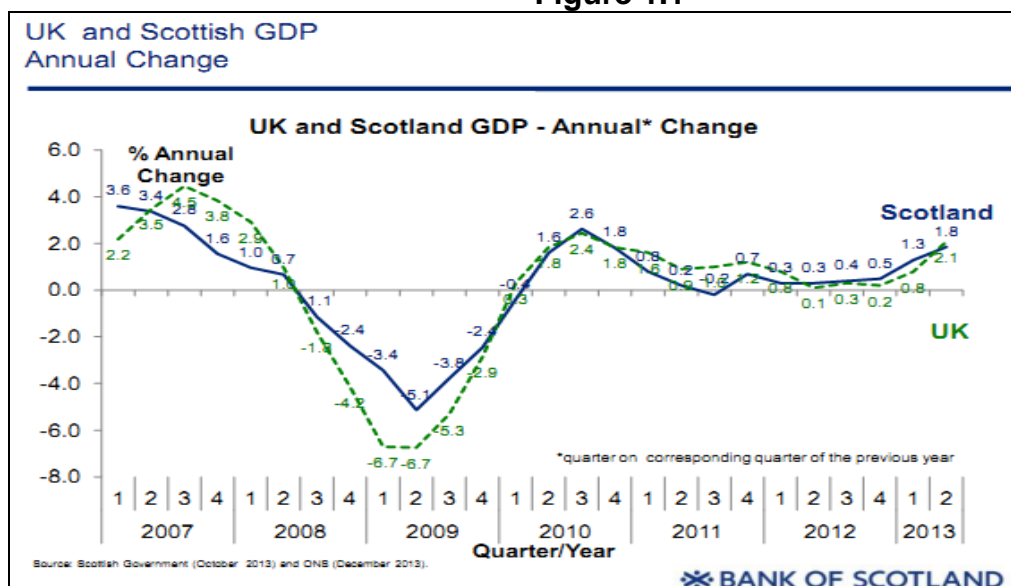
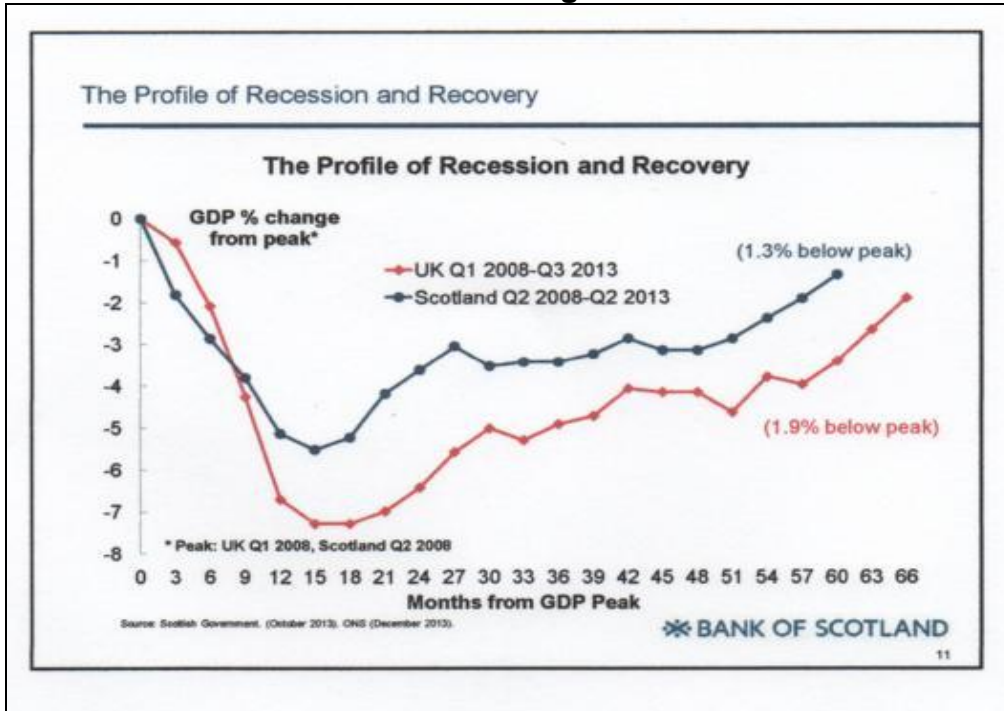


Figure 1.2



Over 2002-2008, public expenditure exceeded the Treasury forecast by some £166 billion. Total government debt rose from 29% of GDP to 40% in 2008 and, after the series of financial collapses, was still rising rapidly to reach 77% of GDP by end 2013. Despite all the talk of 'austerity', the UK stood out as a highly indebted country amongst the G20.

As in all previous recessions, the UK Government found it easier to cut public sector investment than public sector consumption, and its room to curb government expenditure was further eroded by the decision to ring fence some of the most important departmental budgets. Far from cutting 'too deep, too fast' total public sector debt continues to rise, although at a lower rate (from £160 billion when the Coalition Government came to power to an estimated £100 billion in this financial year). Interest payments on the national debt now exceed defence expenditure. On present trends it could even overtake public expenditure on education, although the evidence suggests that it should be able to reverse the rising tide in the next parliament.

Keynes suggested that a market economy could get stuck in a deep recession. To guard against this risk, fiscal policy should restrain the rate of growth of public expenditure when the economy is already growing at a good rate and run a deficit when the economy is growing more slowly. One of Gordon Brown's 'Golden Rules' was that the budget should be balanced over the cycle. This was an eminently appropriate rule that was honoured in the breach and not the observance. Government economic policy turned out to be pro-cyclical rather than anti-cyclical. The result was a boom based on rapidly rising public and private debt, followed by an even more spectacular bust.

All economists (myself included) did not anticipate the scale of the bust, but even fewer seem to understand the nature of the recovery which is now underway. Short-term modelling starts from the position that the economy is demand led. That is, it starts by forecasting what is likely to happen to aggregate demand and then predicts changes in GDP. Real incomes per capita have been falling through the recession

(although now stabilising) and it is difficult for the conventional forecaster to see how the economy is pulling out of the recession.

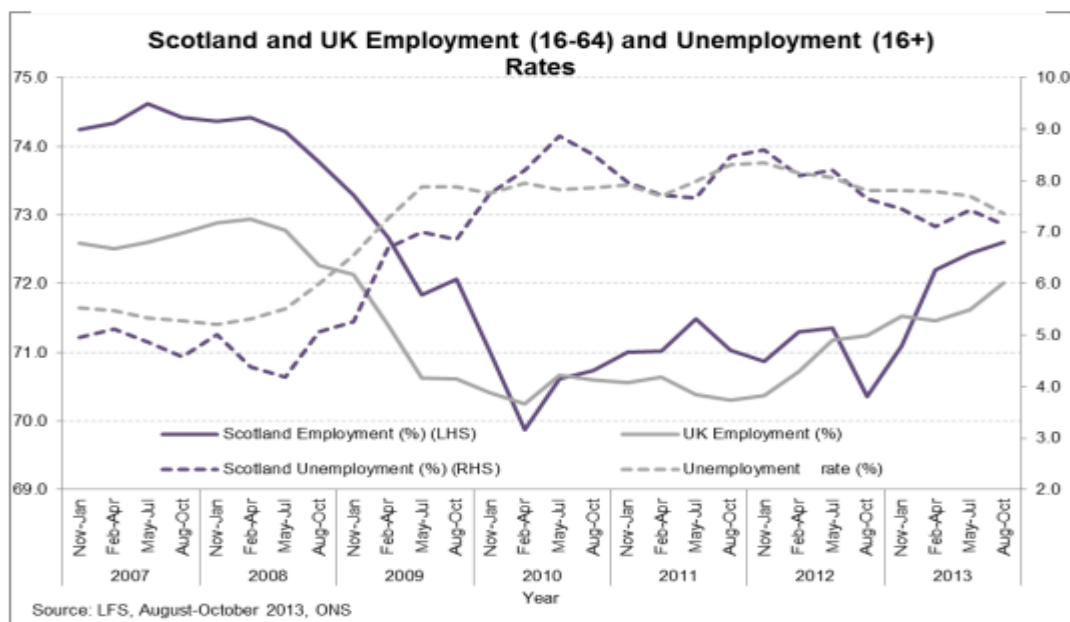
Keynes suggested that it might be necessary to '*socialise aggregate demand*' so as to guard against the economic and social costs of extreme cyclical costs which are always possible in a market based economy. In the extreme case it might even be necessary to undertake apparently wasteful activity to stimulate the economy in a deep recession. For example, the Treasury could bury bank notes in the ground, leaving private enterprise to dig them up and spend them, thus raising aggregate demand.

The trouble is that the UK Government was the main digger of a large fiscal hole prior to the recession, this including a significant measure of wasteful activity before the recession hit in 2008. To fund more public debt at an affordable cost, it had to convince the financial markets that it would bring public debt under control. In short, the Treasury had to stop digging.

### The recovery and the labour market

Many moons ago the French economist, JB Say, argued that supply creates its own demand. This is not true of all circumstances' but is highly relevant in many. This is very evident in the labour market, both in the long run and through the present cycle. Figure 2.1 shows that the 16-64 Scottish employment rate fell from 2008 and more quickly than the UK equivalent. From late 2012 the Scottish employment rate rises more rapidly, particularly toward the end of the period, and unemployment dips. A continued improvement is evident in the last quarterly data for September to November 2013. Further, Figure 2.1 does not capture the rising employment rate amongst males and females above what was the previously default rate of 65 and 60 respectively, nor is it easy to track the rapidly rising rate of self-employment.

Figure 2.1



Labour market flexibility is important to the performance of any economy. In a downturn it can help toward stabilising employment. In an upturn it can help push forward a more sustainable recovery. In the recent recession the fall in GDP was greater than the fall in employment over 2008-2010. There was, indeed, a cost of living crisis- real incomes were falling because money wages were static or

declining, as price inflation remained above the Bank of England target. This is what happens in a recession, particularly in a recession of this magnitude when it is evident that the government has to reduce the rate of growth of public expenditure.

Yet over 2008 -2010 many employers choose to '*hoard*' some labour against the day when they could respond to an increase in demand. This shows up as a reduction in productivity and profitability, but many employees stayed with the devil they know because they have no better alternative to hand. The bankruptcy of the alternative strategy was vividly demonstrated at Grangemouth. An employer who had invested heavily in Grangemouth and wished to invest even more heavily to reduce its cost base, was confronted by a union determined to play Russian roulette with the jobs of its own members. Fortunately its members were saved from this folly, which would have done immense damage to their own interests and those of the wider economy.

In Scotland the 16-64 employment rate bottomed out in Q3 2010 and has risen relative to the UK, particularly since end-2012. The unemployment relative shows the same improving pattern. A significant number of part-time employees and people on zero hour contracts have wished full time employment, but by 2013 male full-time employment was increasing more rapidly than part-time employment and this difference is even more marked for women.

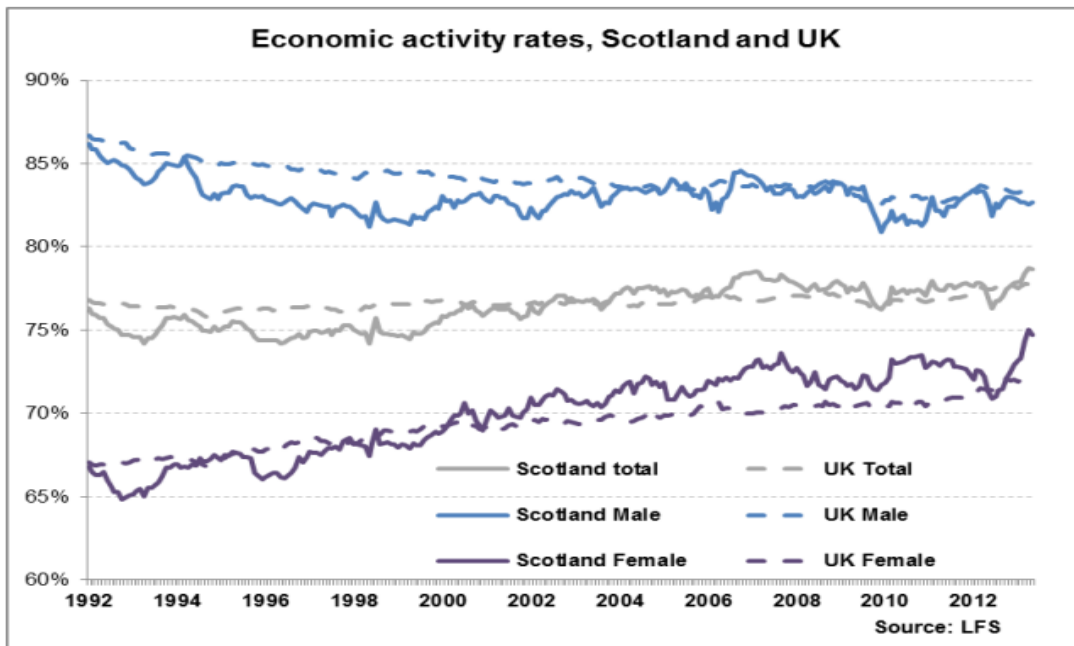
There is another change in the labour market which is not captured by the above discussion. There has been a steady rise in employment of men and women above what was the default retirement date. This is a predictable response to an increase in expected lifespan, accompanied by an increase in a longer, active retirement. People may work for a longer period because they enjoy the work they are doing, or to find another job with a different interest, or because they want more income or to meet new people.

Now take the argument that Scotland could not afford the same state pensions as the rest of the UK. Scottish incomes are 98% of the UK average, employment rates are higher, the unemployment rate is lower, Scots die at a lower average age after a shorter retirement period. Why, then, do the actuaries of the pensions industry believe that Scotland could not afford to match public pension for the rest of the UK? I suspect that, as my statistics lecturer used to say, '*extrapolation is a substitute for thinking.*' And error compounds over time if you start from the wrong set of assumptions!

Another sea-change has been the increase in self employment. For some this offers only limited relief with low incomes but for many others it can offer more stable income in a family setting. Technological change has improved the competitiveness of the self-employed and micro-businesses. It is self-evident in the city in which I reside and the place in the Highlands I call home, that people working from home and a low cost base, armed only with a mobile and a computer, adequate broadband and a sound base through education, training and learning by doing, can compete effectively in a wide range of economic activities.

But the major change in the labour market which has dominated all our lifetimes is that females have accounted for an increasing share of the labour force and Figure 2.2 shows that this has continued from 1992 and accelerates from 2012.

Figure 2.2



Nor is this simply a matter of numbers. A well educated and trained female labour force is increasingly competitive with male labour, including some of the highest paid occupations, such as law, medicine and accountancy. Females often receive lower hourly wages and salaries than males and often spend a lower proportion of their working lives in work, especially in the child rearing ages.

### Childcare

The flagship project proposed by Scotland's Future argues that a major extended system of childcare could increase female activity rates, employment and incomes, and generate additional tax revenues and employment incomes. The analysis of Section 2 shows that increasing female employment is part of the Zeitgeist of our time. Any competent labour economist will know the direction of change if the childcare proposed is enacted— female employment rates would rise with more women staying longer in the labour market, and income differentials between men and women would narrow. The issue will not be the direction of change but the speed of change.

No financially responsible Scottish Government would dare to implement the childcare proposals under the fixed block grant funding of devolution, unless they were prepared to take an axe to existing programmes when there was already strong downward pressure on the real value of the existing block grant. A January 2014 paper *'Childcare and Labour Market Participation-Economic Analysis'* sets out the reasoning behind the childcare proposals

**Figure 3.1**

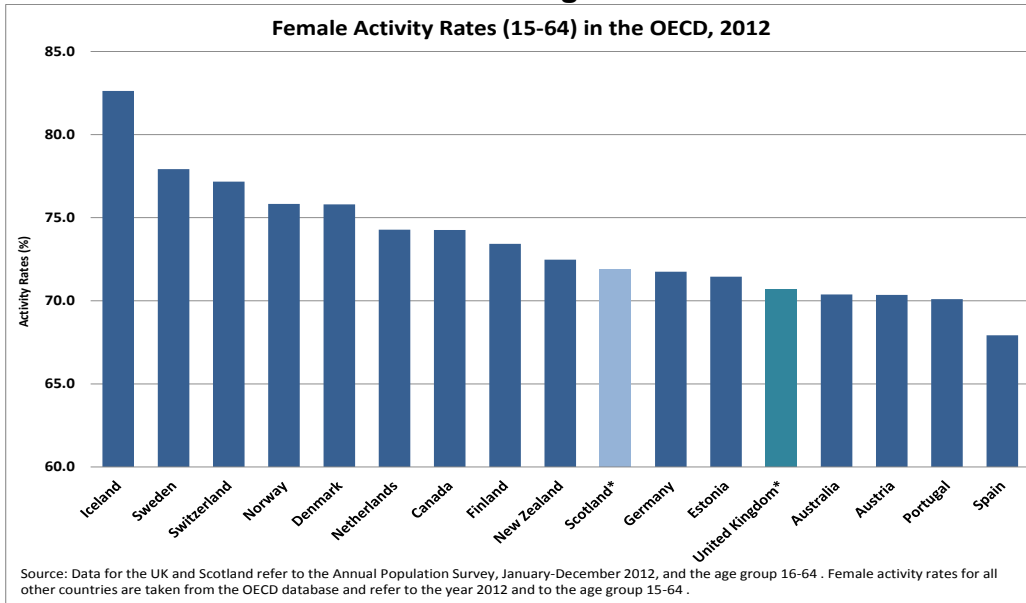
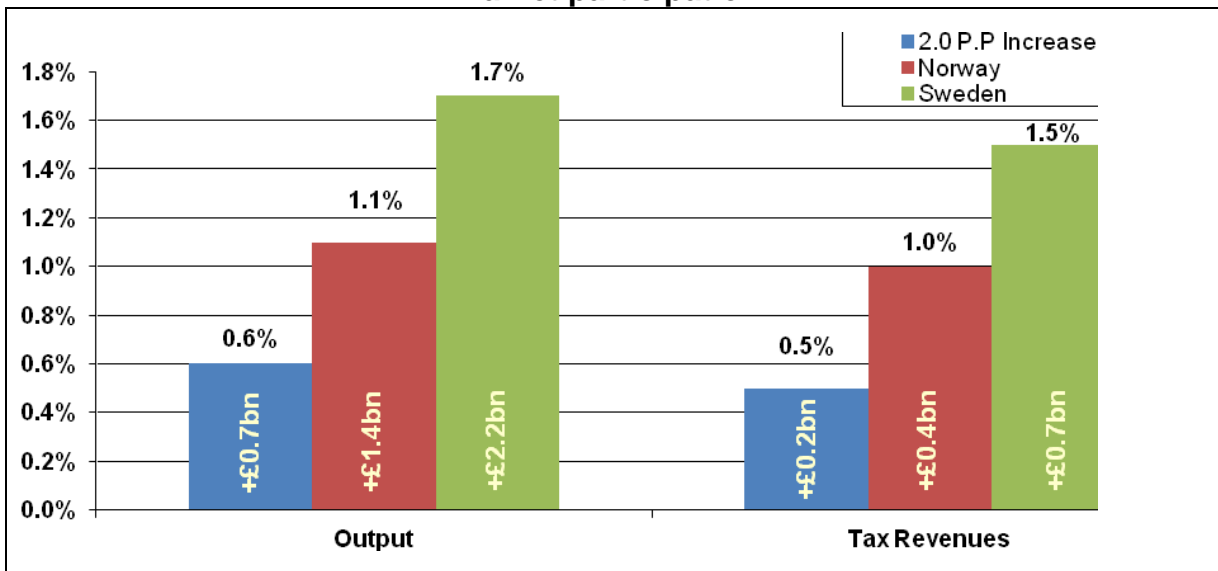


Figure 3.1 shows that the female activity rate in Scotland is below that of the smaller northern European countries which we fondly think bear similarities to our own condition – Iceland, Sweden, Norway, Denmark, the Netherlands and Finland-and two countries which have featured prominently in the Scottish diaspora – Canada and New Zealand. Figure 3.2 shows the anticipated change in incomes and tax receipts if the childcare proposals resulted in rising female activity rates. The full economic impact would take some years (say 5-10 years) toward the upper end of the range to match the Swedish outcome in female activity rates. But this how the supply side works –major change can only come if it has broad support, notice of the nature and the structure of the childcare system and the certainty that the early costs can be funded.

**Figure 3.2: Impact on the Scottish Economy of an increase in female labour market participation**



The Scottish Government already has the legal power to undertake a childcare programme of the scale and ambition proposed but, as there would be no automatic feedback to the block grant, any Treasury civil servant would regard it as unfunded and unaffordable. Nor would this judgment change under the Scotland Act. Its proposals would yield an additional £45 million, which is insufficient to offset the

likely future cuts in the real value of the block grant likely to result from the continued restraint which will be applied to all UK public expenditure for a considerable forward period.

The January 2014 paper estimates that the required expansion of childcare services would create some 35,000 jobs. The staffing of primary schools would tell you that most would be taken by women. The only plea I would make is that we should ensure that local people, non-profit making businesses and charities should be the driving force, rather than central or local government – if it is the latter it will not be much of a driving force. As the January 2014 paper puts it, *‘These impacts can be defined as demand-side. However, the greatest benefit for the Scottish economy will stem from the transformational supply-side impacts it could have.’* JB Say would have approved!

**‘The Gleam in the North,’ (Renewables)**

The title is taken from DK Broster’s novel of how the faint flicker of yet another Jacobite rebellion in the Highlands was snuffed out. Here I am considering a quite different proposition – whether renewables can provide a cost effective and reliable source of energy and thus contribute to the restructuring of the UK and Scottish economies which is so earnestly required and even more urgently needed.

In Scotland it is the conventional wisdom that Mrs Thatcher destroyed the industrial core - coal, steel, shipbuilding and marine engineering - of the Scottish economy. However, the start of the long-time decline can be traced back to the 1920s, were an acute concern to the (then) Scottish Office over the 1960s and 1970s, and, irony of ironies, was exacerbated in the 1980s by the higher exchange rate resulting from higher oil prices and increasing North Sea production. After the Conservative administrations of 1979-97, the Labour administrations of 1997–2010 fared no better. As Table 3.1 shows, the heartlands of UK industry –the Midlands, Wales, the North of England, Scotland and Northern Ireland - continue to exhibit a rapidly shrinking manufacturing base.

**Table 4.1: Manufacturing as a Share of Regional Gross Value Added, 1997 & 2011**

Region	1997	2011	% fall
West Midlands	27.5	13.8	-13.7
East Midlands	27.1	15.8	-11.2
North East	25.9	15.5	-10.4
Yorks/Humber	24.4	14.3	-10.2
Scotland	20.6	11.3	-9.2
North West	24.5	15.6	-8.8
N Ireland	21.6	13	-8.6
Wales	25.3	16.8	-8.6
South East	16.5	8.6	-7.9
East of England	19.4	12.3	-7.1



South West	19.2	12.3	-6.8
London	7.1	2.7	-4.3
UK	18.7	10.3	-8.4

(Source: FT December 24, 2013)

There is strong evidence that the present economic recovery will continue for the immediate future, but it is unlikely that present policies will deliver the required restructuring of the economy. The major part of the UK's industrial and manufacturing base has always lain north of the Severn/Wash axis and, if our manufacturing sector is to become more internationally competitive, that is where it will happen. An essential element in this will be a coherent energy policy and this has been lacking these last 30+ years. Even in the 1980s, when the UK recorded its last trade surplus due to peak North Sea production, it was evident that it would be desirable to plan for a future expansion of nuclear power. Yet only one new nuclear power station has been built since 1980 (Sizewell B) and the next scheduled completion date is Hinkley Point C in 2023. As the UK has lost its technological lead it will produce electricity at a much higher price than existing UK power stations. This is not to say that it should not be built, but simply to emphasise that the delivery will be well behind schedule and the energy supplied will be very high cost compared to our historic cost base.

Any classical economist would recognise that a sensible energy strategy for Scotland would be bound to look at renewables. After all, Scotland has the best natural resource (a long coast line and a small population, a location in the north east Atlantic, plentiful rainfall in the windiest country in Europe, with the strongest tidal stream) and also the acquired advantage of the business and skill base from developing and servicing the North Sea oil and gas fields off its coasts.

As of end 2013 Scottish electricity production was ahead of target with an impressive pipeline of projects under construction, with planning permission, or under consideration – and an active programme of testing and developing technologies for wave power and tidal streams. There is a view that the development of offshore wind power, tidal streams and wave power may lag the present timescale but there is still a strong belief that these sources will be contributing to electricity generation by 2020. Expectations are very similar to those evident in Aberdeen in the early 1970s – that the technical challenge was severe and the response time short, but that it could and would be met.

And in the meantime there is a need to consider how the increasing supply of renewable energy can be harnessed to provide a managed supply to final consumers. While Scotland has an excellent wind resource, it is self-evident that we cannot command the timing and strength of that wind. It is necessary to balance the variable supply of wind power with a storage system which can respond quickly to sudden and unpredictable changes in wind generated output. The obvious candidate is pumped storage of which there are four examples in the UK (Cruachan and Foyers in Scotland; Dinorwig and Ffestiniog in Wales). This has been used to help meet peak demand and has provided flexibility and reliability which has been important to the grid. However, no new pumped storage capacity has been required for some 30 years.

The situation will be markedly different when substantial additional amounts of wind power is delivered onshore by 2020. Pumped storage is the most effective means of



storing and, when required, rapidly releasing large supplies of electricity. But pump storage capacity on a sufficient scale is unlikely to be accomplished in present circumstances, because of a clear case of market failure.

What follows is a thumb nail sketch of how it may be possible to construct and commission a giant pump storage scheme by 2020, and why it may be sensible to do this via a managed utility. I expect that the approach sketched in below is broadly right, but it may be precisely wrong. It needs to be put through the wringer by the Scottish Futures Trust, the Green Investment Bank, the National Grid and SSE, to drive out error.

- SSE have consent for a 600MW Coire Glas pumped storage hydro scheme at Loch Lochy in the Great Glen. This compares with the capacity of Cruachan at 400MW
- Cruachan was the world's first pumped storage scheme which demonstrates this is a known technology, first applied in the Highlands
- The estimated construction cost of Coire Glas is £800 million with a construction period of five years
- The economics of pumped storage depend on pumping up water using electricity from the grid at low cost periods and then releasing the water to supply electricity to the grid at peak times
- The flexibility of pumped storage schemes make them capable of balancing the supply of wind power on a much greater scale than that possible at present. Market failure arises from the fact, that a managed utility would provide major benefits to energy producers, the grid and electricity consumers. However SSE could not expect to recover the costs of constructing and operating Coire Glas
- As onshore and offshore capacity builds up in the Highlands and Islands it will be increasingly difficult to balance a very unpredictable wind supply. The National Grid has already admitted that it has found it difficult to cope with some surges in wind power and, in May 2013, paid wind operators £2.6 million in "constraint" payments to avoid overloading the transmission network. For the UK these could amount to some £300million annually by 2020.
- The alternative to the above is that the grid should take the excess supply and use it, at no cost to the pumped storage scheme, to pump water up to Coire Glas's upper reservoir - where it would act as a huge battery to supply electricity to the grid at short notice
- Coire Glas should be used frequently, and for comparatively long periods, to balance the supply to the grid. This would provide an enhanced flow of income to service the debt of the managed utility.
- The economics of such a development would be assisted by locating substantial users of electricity close to the national grid. The possible projects are listed at p174 of the 2011 publication, *Scotland's Economic Future*, but my favourite project would be a new aluminium smelter at Invergordon.
- The last project failed because it was not possible to supply 24/7 electricity at a commercial price – the other UK aluminium production sites staggered on at worse locations. If this comes off then 'The Proclaimers' should be asked to add a new verse to their 'Letter to America' which hails 'Invergordon once more'.

- The two Scottish development agencies should be tasked with finding other energy-intensive businesses which would benefit from providing a larger and more balanced supply of energy.
- Strong candidates would be:
  - major manufacturing plants - offshore wind turbine and blade manufacturers, wave/tidal energy suppliers and engineering service providers
  - manufacturing/engineering plant and services for decommissioning and extracting oil and gas from increasingly difficult UKCS fields
  - offshore jackets and frameworks for wind turbines which will be very energy intensive
  - new port and harbour facilities to service offshore wind farms and oil and gas activity
  - heavy energy users, particularly chemicals and industrial biotech where the obvious candidate location is Grangemouth.

### **The macroeconomic framework**

The Canadian Governor of the Bank of England recently gave a master class in explaining that his role was that of a technocrat tasked to operate a currency union wished on him by politicians. The drift of his remarks suggested that he did not consider that the Eurozone was a good model to follow and that a continuing UK currency union required all the consenting parties to cede authority to a central authority and for the consenting parties to understand that they would have to act in a fashion which did not undermine the currency union itself.

We are not unfamiliar with this situation. Scotland has lived within a formal currency union since the Bank Charter Act of 1844 which, in effect, gave the Bank of England an effective monopoly of the note issue of commercial banks. Today, economists would regard the UK as an optimal currency area in which all the parties have ceded sovereignty to serve a wider interest. Scotland has enjoyed a currency union which has benefitted its constituent parts and we have all become wiser as to how to avoid a currency union which is dysfunctional i.e. the Eurozone.

The UK Government has recognised that, in the advent of Scotland voting for independence, the financial markets would expect the Bank of England to stand behind all UK debt. The Scottish Government have stated that it would wish to negotiate a population share of the UK balance sheet, debt and assets, and to stay within the currency union. This requires that the Scottish Government should operate within a framework which is as '*safe as the Bank of England.*'

I discuss below some quotations from the 2011 publication (*Scotland's Economic Future*) which are relevant to the current debate. The contributors did not necessarily believe that Scotland should remain within a formal currency union. However, I believe that a formal currency union, with established rules of conduct and supervision, would make it clear to all parties that, in this respect, we are '*better together,*' so long as we all observe the rules and the spirit of the joint enterprise which is a currency union.

Andrew Hughes-Hallett believes that '*adopting the currency and monetary policies of another country, but capital and financing links with a different partner outside the union... is a recipe for disaster. This speaks for staying with sterling....for as long as*

*the UK remains Scotland's dominant trade and investment partner. However, the case for fiscal independence remains unchanged.'*

He also considers that *'a properly functioning banking system with reliable credit/banking channels is an essential component in any monetary regime'....that this broke down... 'since the crisis in 2007 and needs to be restored' ...and... 'implies a local banking system, and a hand in its regulation, will be needed to make monetary policy effective.'*

John Kay suggests that the Scottish Government must guarantee the deposits of customers who bank with commercial and retail banks in Scotland, because these deposits are the base on which these banks can pyramid credit and provide loans to businesses and retail customers. This brings me to the crash and the role of the *'Scottish'* banks. First, when the crash came, the Bank of Scotland was a Scottish bank in name only. The author of its demise is apparent in the title of Ray Perman's book, *'Hubris: How HBOS Wrecked the Best Bank in Britain'*. And the Bank of Scotland had good claim to be the best bank in Britain, with a history stretching back to 1694.

The other major *'Scottish'* bank was the Royal Bank of Scotland, also with an illustrious pedigree, which had expanded spectacularly and with apparent success, until the crash of 2008 revealed a balance sheet riddled with bad debt. It was rescued, along with HBOS, at great cost to the taxpayer, because it was widely regarded as being *'too big to fail.'* John Kay remarks *'The premise that Scotland could not have handled the bailouts as the UK government did is correct. But the conclusion that this demonstrates the impossibility of independence is wrong. The Scottish government probably would not, and certainly should not, have done what the UK government did' ...but... 'the UK government should not have done it and certainly should not do it again'.* He concludes that *'neither a democratic society nor a market economy can contemplate private sector organisations which are 'too big to fail.'*

What Scotland needs are plain vanilla commercial and retail banks and not *'financial conglomerates driven by clashes of culture and conflicts of interest'* (John Kay). Banks headquartered in Scotland should use a subsidiary structure for their activities outside Scotland. Investment banks should depend on raising their own capital and the sensible use of their capital is the only guarantee of survival. The Scottish bank regulator should report to the Scottish Government and the Bank of England, and should be tasked with ensuring that the banking system in Scotland works within the rules and spirit of the currency union.

The Governor of the Bank of England has already commented on the business and cultural problems which have emerged in so many banking systems - *'while regulators will fix the mechanics of benchmarks in markets ranging from Libor to FX (foreign exchange), only private individuals and institutions can reform the behaviour which has made such changes necessary.'* This is true, but if you want a stable banking system you must insist that retail and commercial banks and financial conglomerates should be managed by different and independent institutions. And in the former, the regulator must ensure that the bonus structure does not encourage staff to sell products which are loaded against the interests of their customers.

Scottish banks should return to their strengths. Our investment banks should be boutique banks working with their own capital. If this is accomplished then the Governor's real problems may lie elsewhere. Despite pressure from all sides,

including Select Committees of the House of Commons, the City of London still does not get the point. It is unlikely that taxpayers will ever want to bail out *'too big to fail'* banks again. Investment and *'casino'* banking must take place in separate institutions raising their own capital. The Scottish Government should take the *'technical advice'* of the Governor and return to the banking culture and institutions which served her well through her history.

Turning to fiscal policy, an independent Scotland would inherit a substantial public debt and one which has been growing over time. Even in the best of worlds, that is continuing economic recovery, any sensible government would feel it necessary to continue to restrain the growth of public expenditure and to reduce the debt burden over time. Fiscal policy in Scotland would have to be consistent with that stance.

The fiscal situation facing Scotland, even given full recognition of the above, would be more comfortable than that of a rUK Government. The Government Expenditure and Revenue Scotland (GERS), on which much effort has been expended to ensure accuracy, shows that per capita tax receipts for Scotland are very close to those for the UK. When a *'geographical'* share of North Sea receipts are included, tax revenue per capita is 20% higher. The Fiscal Commission Working Group, comprising persons not used to being willing parties to error, calculated that, since 1980-81, Scotland has had an annual deficit for the UK of around 0.2% of GDP compared with a UK deficit of 3%.

The fiscal position inherited by an independent Scotland would be much more comfortable than that which would face a devolved Scotland with a fixed budget. Yet there is danger here that the opportunity might be wasted. This is not the time to day dream about building a Sovereign Wealth Fund from North Sea oil revenues. The time to do that would have been the 1980s. In present circumstances a greater fiscal freedom should be used for three key tasks – to provide ladders of opportunity, such as childcare, which allow people to attain a more self-reliant future, to provide a renewable energy supply and restructure the industrial and manufacturing base of the economy, and to pay down our national debt until it has reached a level that our children and grandchildren can live with.

Any future Scottish Government has to realise that while independence should give it some scope to build a stronger economy that could be easily dissipated by the *'bread and circuses'* approach which has characterised so much of economic policy in recent years. It should heed Adam Smith's warning - *'kings and ministers...are always, and without any exception, the greatest spendthrifts in the society. Let them look well after their own expence (sic), and they may safely trust private people with theirs.'*

And, for most of the time, ministers should walk on the supply side with Adam Smith and JB Say.