

Minute of the Fifth Meeting of the Council of Economic Advisers

26th & 27th January 2017

Bute House, St Andrews House, Edinburgh

Attendees

The following Council members were present:

First Minister, Nicola Sturgeon MSP (26th only)

Crawford Beveridge (Chair)

Sir Harry Burns

Professor Mariana Mazzucato

Jim McColl

Amanda McMillan

Professor Sir James Mirrlees

Professor Anton Muscatelli

Professor Sara Carter

Also present:

Cabinet Secretary for Finance and the Constitution, Derek Mackay MSP (26th only)

Cabinet Secretary for Economy, Jobs and Fair Work, Keith Brown MSP

Leslie Evans, Permanent Secretary, Scottish Government (27th only)

Liz Ditchburn, DG Economy, Scottish Government

Dr Gary Gillespie, Chief Economist, Office of the Chief Economic Adviser, Scottish Government

Mary McAllan, Director for Economic Development, Scottish Government (27th only)

Uzma Khan, (Acting) Deputy Director, Office of the Chief Economic Adviser, Scottish Government

Stewart Maxwell, Special Adviser

Brian Dornan, Deputy Head, Economic Policy Unit, Scottish Government

Kevin Brady, (Acting) Senior Economist, Office of the Chief Economic Adviser, Scottish Government

Annabel Arbuthnot, Assistant Economist, Office of the Chief Economic Adviser, Scottish Government

Purpose

This note provides an overview of the key points that were discussed during the fifth meeting of the Council of Economic Advisers. The meeting took place over the afternoon and morning of 26th and 27th January 2017.

Session 1 - 26 January 2017

Welcome

The First Minister and Chair of the Council of Economic Advisers welcomed attendees, and outlined the programme for the meeting.

Apologies had been received from Professors Frances Ruane and Joseph Stiglitz.

Update on Developments / Previous Actions

The Chair gave an update on developments since the last meeting in August 2016.

Since the August meeting, the Council's Report for 2015-2016 was published on the 14th October 2016. Council members had a call in November, which considered developments in the areas covered by the Annual Report. Council members also discussed development on each of the Councils work-streams and received an update on the Enterprise and Skills Review.

Since August, the Chief Economist had also one-to-one engagements with several Council members.

Several Council Members had also been involved in wider engagements in recent months. In particular, Anton Muscatelli, Frances Ruane and Amanda McMillan had contributed to the deliberations of the First Minister's Standing Council on Europe, which Professor Muscatelli chairs.

The Chief Economist gave an overview of wider developments since the August meetings, and highlighted on-going developments around inclusive growth.

Update on State of the Economy and Developments in the Public Finances

The Chief Economist gave an update on key developments in the Scottish and UK economies in recent months, as well as an outlook for the Scottish economy. Points that were raised included:

- The economy has remained resilient despite challenging internal and external conditions over the last 2 years.
- Economic growth has slowed below trend and relative to the UK reflecting specific sectoral issues in Scotland. There continues to be a growth differential with the UK.
- The labour market has remained resilient with high levels of employment, and unemployment remaining below its long run average. There were also signs of longer run changes to the structure and composition of the labour market
- The EU referendum result had prompted a monetary and fiscal response, although increased uncertainty was expected to impact negatively on growth during 2017 and 2018.
- Conditions were still challenging in the Oil and Gas sector, although there are tentative signs of increasing returns and activity.
- Outturn growth for Scotland for 2016 is forecast at around 1 per cent with a broadly similar outlook for 2017. UK growth for 2016 was forecast to be 2.0 per cent, and 1.3 per cent for 2017).
- UK growth performance would be contingent on expectations and the impact of changing terms of trade relating to EU exit, with impacts expected to begin materialising during 2017.

The following points were noted during the discussion on this topic:

- Members discussed trends in business investment in Scotland, particularly with respect to foreign direct investment. Members were interested in the

emerging data sources on business investment in Scotland, and discussed progress with initiatives designed to support business investment, such as the Scottish Growth Scheme.

- Members discussed trends in personal debt, noting that it is approaching pre-recession levels in the UK, as a share of disposable income. The declining savings ratios in both Scotland and the UK were also noted.
- Members expressed an interest in public procurement expenditure in Scotland as an instrument of policy, and shares of expenditure currently accruing to Scottish businesses.

The Cabinet Secretary for Finance and the Constitution provided an overview of developments in Scotland's public finances, with particular reference to the UK Government's Autumn Statement, and recent developments with the Scottish Government's Draft Budget for 2017-18. In particular, the Cabinet Secretary highlighted that this Draft Budget was the first where the Scottish Parliament had responsibility for setting rates and bands of personal income tax.

The role of the Budget Review Group was also highlighted. The Budget Review Group had been established to consider amendments to the Scottish Budget process, in order to ensure the process remained robust, and provided opportunities for parliamentary oversight and scrutiny, particularly in light of changes to the UK Budget process.

Scottish Government response to EU referendum result

The First Minister provided initial reflections on the emerging impacts of the EU referendum result, and provided an overview of 'Scotland's Place in Europe,' which was published in December 2016.

It was noted that predicted economic impacts from the referendum result had yet to emerge, partially as a result of monetary intervention from the Bank of England, a significant depreciation in the value of Sterling, and partly as the negotiation process was yet to begin in earnest. However, potential changes in the access to the single market and over freedom of movement between the EU and UK had the potential to create significant negative economic consequences for Scotland's economy.

The Scottish Government's position had been articulated through 'Scotland's Place in Europe', which argued for:

- The UK as a whole to remain within the European Single Market – through the European Economic Area – and within the EU Customs Union;
- In the event of the previous option being unavailable, that Scotland should retain access to the Single Market and retain some key benefits of EU membership, through a differentiated option for Scotland; and,
- The powers of the Scottish Parliament to be revisited and augmented, with consideration of three groups of powers: those 'repatriated' from the European Union in areas where the Scottish Parliament already has competence; powers repatriated from the European Union that should sit with the Scottish Parliament; and, broader powers that would be needed to support continued economic development in Scotland following Brexit, such as powers over immigration.

Professor Anton Muscatelli provided a brief overview of the work of the Standing Council on Europe, whose advice had contributed to the development of 'Scotland's Place in Europe'. The Chief Economist provided an overview of the economic analysis being undertaken on the impacts of the EU Referendum result on the Scottish economy.

The following points were noted during the discussion:

- Members emphasised the importance of scenario planning with regard to mitigating potential welfare impacts of the economic shock from the UK leaving the European Union.
- There was discussion of potential wider risks from aggressive deregulation in response to Brexit, and discussion of tax changes to act as a support to economic policy relative to other areas of the UK.
- Members discussed the available information on potential corporate outflows following the EU referendum result, and corporate contingency planning. It was recognised that Sterling's depreciation would act as a short run 'shock absorber', and support profitability for companies with earnings in overseas currencies.
- Members highlighted the importance of ensuring the general population, as well as businesses, were informed of the impacts of the EU referendum results.
- Concerns were expressed about the UK government's institutional capacity to deliver a successful exit from the European Union, and about the lack of engagement from the UK Government on areas of common interest, such as the Green Paper on Industrial Strategy.

Fiscal Matters

The Cabinet Secretary for Finance and the Constitution provided an introduction to this topic, which related to the Council's workstream on the Additional Rate of Income Tax. The Chief Economist presented an overview of existing data on the income tax base within Scotland, and the Scottish Government's published analysis on the potential behavioural impacts associated with a differential additional rate of income tax in Scotland. The relative uniqueness of Scotland's situation in relation to the rest of the UK within the evidence base was also highlighted.

The following points were noted during the discussion on this topic:

- Members commended the quality of the analysis undertaken by Scottish Government officials, recognising the importance of signalling and behavioural effects in impacting tax receipts and business behaviour.
- Members also noted the importance of residency rules in reducing avoidance behaviour. Parallels were drawn with the example of California and Nevada, particularly around residency arrangements, and sunset arrangements.
- Members were interested in exploring the structure, composition, sector of activity, and residency of the existing additional rate tax base in greater depth, where possible.
- It was recognised that this workstream pertained to a specific part of the income tax, and broader tax, landscapes within Scotland; Members

emphasised the importance of understanding the impact of changes in overall tax revenues from changes in specific tax rates.

- The broader impacts of relatively narrow tax decisions were considered, with the potential for tax changes to create wider signalling effects about the nature of the tax jurisdiction being recognised.
- The Chair requested that officials arrange a conference call for Members to discuss the operation of this workstream in greater detail.

Session 2 - 27 January 2017

Update on Inclusive Growth

The Chief Economist and Uzma Khan provided an update on developments relevant to the inclusive growth workstream. In particular, on-going work on the inclusive growth diagnostic was highlighted, including developments in the pilot with North Ayrshire Council and regional applications of the framework. These emphasised the importance of 'bottom up' approaches to inclusive growth analysis.

Officials also drew Council members attention to on-going international engagement, early work on an inclusive growth monitoring framework, and to the Programme for Government commitment for an inclusive growth conference.

The following points were noted during the discussion on this topic:

- Members highlighted digital infrastructure in particular as a constraint on inclusion and growth, along with uptake and use made of technology.
- Members discussed their wider work with inclusive growth applications, particularly work around Clyde Gateway and North Ayrshire.
- Members emphasised the importance of the private sector in contributing to inclusive growth, and the importance of policies like the Business Pledge in helping do so.
- Members discussed measurement approaches to inclusive growth, linked to the Council's previous work around measuring wellbeing, and highlighted the importance of the National Performance Framework in aligning behaviour across agencies and different parts of government.
- Members requested further information about the Apprenticeship Levy, and the approach being taken in Scotland around this.

Development Banks and Patient Capital

Professor Mariana Mazzucato gave a presentation to the Council on national investment banks, and their role in providing patient capital for infrastructure development, finance for high growth businesses, and in supporting strategic investments in innovation. Key points included:

- The role of the state in economic growth is wider than remedying market failures and 'levelling' the playing field. The state has a strategic role to play in facilitating economic growth, particularly through setting missions to guide and catalyse other economic actors.
- The public sector has historically undertaken and supported early stage investments in research and technology development, where risks are greatest.
- State investment vehicles have also performed important roles in providing counter-cyclical finance in recent recessions. International evidence and experience suggests they also play an important role in providing development capital for infrastructure; targeting investments in high-risk R&D, innovative start-ups, and lengthy innovations; and promotion of investments that help address complex societal problems.
- There are challenges relating to patient capital within the UK. Scottish and UK economies both have relatively low levels of gross fixed capital formation

as a share of GDP, particularly when compared against competitors, with public investment in transport infrastructure concentrated in London. UK domestic banks' share of lending allocated to non-real estate businesses has also declined over time.

- A number of bodies have proposed national investment banks as policy instruments for addressing these challenges, including the New Economics Foundation in a Scottish context. This work outlined proposals for what such an institution could look like, including its mandate, areas of activity, and governance arrangements. It also outlined practical issues (such as state aid, governance arrangements, sectoral classification, and HM Treasury accounting arrangements) that would be encountered in the establishment of such an institution.

The following points were noted during the discussion on this topic:

- The parallels with the experience of Scottish Water were explored. The Scottish Government had previously explored whether bodies like Scottish Water could issue bonds on the basis of the strength of their balance sheet. The ability to do so is constrained by HM Treasury rules, which would require a similar quantum of capital expenditure to be set aside on government balance sheets.
- It was noted that a number of other countries operate national investment institutions, and that the UK was a relative outlier in this sense. The Green Investment Bank had played a positive role in this regard, but Members were concerned by recent developments in this institution's status. Members' experience suggested investment by these had facilitated and encouraged private sector investment.
- Members highlighted the limitations to tax-based approaches to incentivise investment directly, through routes such as R&D Tax Credits.
- It was noted that recent experience, such as that of the Scottish Growth Scheme, suggested that HM Treasury might be willing to engage constructively on innovative approaches to provide finance for economic development, particularly in light of economic challenges created through the EU referendum result.
- It was noted that the UK Government owns a finance institution for international development purposes (the CDC), where there may be some parallels.
- Members recognised previous Scottish Government consideration of this issue, but felt that this was an avenue that should continue to be investigated, particularly in the context of the UK Government's Green Paper on industrial policy. With this in mind, Council members offered to provide an independent submission to the Green Paper consultation on this issue.

Industrial Policy in Scotland

The Cabinet Secretary for Economy, Jobs and Fair Work provided an overview of the Scottish Government's broad approach in the area of industrial policy. Council consideration of this issue was particularly helpful in the context of the UK Government's recent Green Paper on industrial policy, where the Scottish Government would be looking to engage proactively with the UK Government.

Brian Dornan, from the Scottish Government's Economic Policy Unit, provided Council members with an overview of Scottish Government's approach to different strands of industrial policy. The range of 'horizontal' economic policies were illustrated, while additional detail was provided on initiatives arising from the Manufacturing Action Plan, including developments around a National Manufacturing Institute for Scotland.

The following points were noted during the discussion:

- There is a need to go beyond existing manufacturing sectors and to look at potential opportunities in new areas of science. Members highlighted the example of the Blackett Review, which is exploring the potential of new scientific developments in areas like quantum technologies.
- It was important to appreciate that the Innovation Centres were not uniform, with some covering areas closer to the market than others, and to ensure funding approaches reflected differing circumstances.
- It was highlighted that the innovation landscape was sometimes fragmented within Scotland, with business having to draw links between different research institutions working in similar fields.
- The issue of finance for high growth companies was raised, with the suggestion that the issue was one of demand for finance, rather than necessarily one of supply. Members also highlighted that innovative companies have been penalised through the financial system since the financial crash.
- It was important to recognise the synergies across and between manufacturing and services, and develop strategy accordingly. Denmark's experience of green technology and services was cited as an example, where being known for having a dynamic policy environment had served to attract dynamic firms.
- With regard to attracting additional manufacturing capabilities, it was important to recognise what Scotland's unique advantages were, what subsectors it was most geared towards developing and specialising in, and where Scotland's 'offer' differed from initiatives like the Northern Powerhouse. Generating this understanding could help inform development of the National Manufacturing Institute.

Enterprise and Skills Review

The Cabinet Secretary for Economy, Jobs and Fair Work provided an update on developments in the Enterprise and Skills Review since the August Council meeting. Phase 1 of the Review had been published in October 2016, and had set out a range of actions to be taken forward. One significant strand of Phase 2 related to issues of governance, following the Phase 1 action relating to establishment of a strategic board. Work on Phase 2 of the Review was on-going, with reports due to be published by the end of Spring.

Mary McAllan provided an overview of the workstreams being taken forward in support of Phase 2 of the Review. The Review represented a significant and complex change programme in economic development support in Scotland, being taken forward at pace. There was a significant regional dimension to the work, drawing on inclusive growth approaches, and including the development of a South

of Scotland vehicle. Work on governance and Data was intended to support the agencies in working more closely together across Scotland, while digital was a theme common to each of the workstreams, with significant attention also being paid to internationalisation, learning skills and enterprise support.

The following points were noted during the discussion:

- Members agreed with the need for greater alignment across the agencies, and highlighted the importance of the structures underneath the new strategic board in determining its success. The importance of information sharing was highlighted, as current arrangements encouraged silo working.
- Members also emphasised the different organisational cultures across the agencies, and the need for awareness of these during the change process.
- Members expressed an interest in the learner journey workstream, with individual members expressing an interest in engaging further on this.
- Officials undertook to share more information on the Data workstream with Council members during the next conference call, as a prelude to a wider discussion on the robustness of economic data in Scotland.