

SCOTLAND'S ECONOMIC FUTURE POST-2014

SUBMISSION FROM THE STUC

Economic sectors, regulation, trade, labour markets

1 Introduction

The STUC appreciates this opportunity to contribute further evidence to the Committee's important inquiry. We would encourage the Committee to read this submission in conjunction with our **A Just Scotland** papers¹ which cover key issues such as the macroeconomics of independence, the public finances, welfare and inequality. Although the arguments are not repeated here, it's important to stress that the success of Scotland's future economic development will be determined at least in part by the macroeconomic framework in which it operates.

2 Economic outlook

The OBR's latest Economic and Fiscal Outlook published alongside Budget 2014 makes for depressing reading on the UK's longer-term economic prospects. Real GDP per capita will not reach its pre-crisis peak until 2017; employment per capita sometime thereafter. While revising upwards growth forecasts for 2014 and 2015, the OBR revised down its forecast for the remainder of the forecast period. Of more concern is the composition of this growth:

- Exports will improve but the increase will not be sufficient for net trade to make *any positive contribution* to GDP growth over the forecast period;
- The supply side measures announced in the Budget (enhanced export finance support, higher investment allowances etc) will make *no positive contribution* to GDP growth – not for the first time the OBR is forecasting stronger business investment over the forecast period. But even on best case scenario, business investment will not reach pre-crisis levels till 2017 – still nowhere near sufficient to bridge the gap with high productivity nations;
- The consumer will continue to drive growth with consumption funded by a falling savings ratio rather than strong income growth (although real incomes are anticipated to start growing in 2014 and remain positive over the forecast period);
- House price inflation will continue to outpace income growth and *household gross debt to income will spring back to pre-2008 levels by 2018*; and,
- Real hourly earnings will not exceed 2008 levels till at least 2016 (given this is a forecast for average hourly earnings it's reasonable to assume that median wages will take even longer to achieve pre-recession levels).

The above does not paint a picture of a fairer and more equal economy or one more resilient to systemic crises. It does however closely resemble the model which

¹ A Just Scotland, Second Report, STUC <http://www.ajustscotland.org/files/Report/AJS2%20final.pdf>

collapsed so spectacularly in autumn 2008. The prospects for genuine 'rebalancing' (from financial services to manufacturing; from London and the South East to the nations and regions of the UK; from debt funded consumer spending to net trade) of the UK economy look bleak.

3 *Scotland's Economic Future*

The STUC is concerned that if Scotland wants to advance a new approach to economic development - one that's genuinely distinct from the UK model - *many of the things that would have to change are not even being addressed in the debate about Scotland's constitutional future*. For example, the White Paper has nothing of substance to say on structural reform of the banking sector, corporate governance reform, incentive-distorting executive pay or how patient, committed finance might be more effectively channelled to growing firms. Or, in short, how Scotland might overcome the UK's endemic short-termism is simply not being discussed.

The referendum debate also has a tendency towards facile comparisons with other nations and often naive proposals on which policies Scotland might pick and choose from elsewhere. As Michael Keating notes in his evidence to the Committee, this approach ignores the 'internal coherence' of the policy framework in other nations. What works in Germany or Denmark works because it's integrated into a specific economic, social and cultural context; what John Kay calls the 'embedded market'. Scotland may be able to replicate institutional structures but it can't transplant the norms and obligations that render them effective in other nations.

4 *The Labour Market*

The Scottish labour market is currently struggling to emerge from the 2008/09 recession and the prolonged period of stagnant growth that followed. Although headline employment and unemployment rates compare favourably with the UK as a whole and with OECD nations in general, these headline rates obscure worrying trends.

The unemployment rate remains significantly higher and the employment rate significantly lower than pre-recession. Yet more worrying is the collapse in real wages for nearly all workers and the rapid shift to low-wage, insecure forms of work. Underemployment stands at 240,000 and there are 130,000 fewer full-time jobs than in 2008.

There isn't space within this submission to provide the Committee with comprehensive analysis of the current state of the labour market and future trends but the STUC is of course happy to elaborate on any issue of interest.

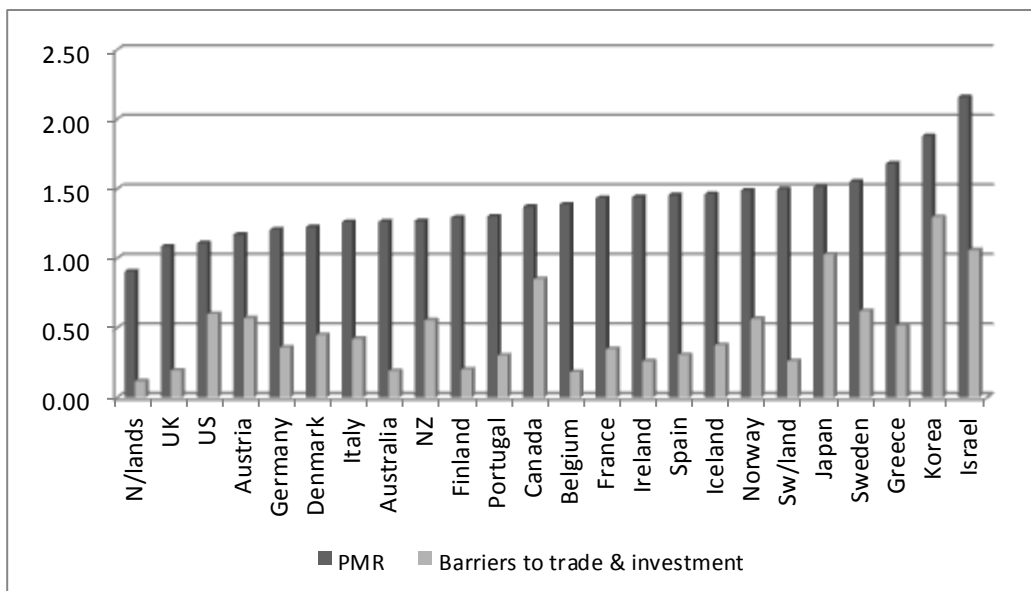
Suffice to say that over the longer-term, Scotland, in common with all other advanced nations, is likely to face significant challenges in providing decent employment opportunities for all its citizens. The rate of capital biased technological change is forecast to increase rapidly (the 'rise of the robots') and many cash rich corporations apparently struggle to discern decent investment opportunities; a problem that predates the crisis. Sectors, such as social care, which are likely to grow significantly in employment terms, are currently characterised by poor quality

employment. Boosting women's' participation to rates achieved in the best performing nations is another key long term challenge.

5 Regulation: is Scotland a (too?) 'good place to do business'?

It is important to quickly dismiss the oft-repeated claim that the Scottish economy is held back due to high-costs generated by tax, regulation and bureaucracy. Any recourse to comparative analysis produced by the international institutions provides a very different perspective: the World Bank currently ranks the UK 10th out of 189 countries on its ease of doing business rankings and the OECD currently ranks the UK as the second least stringently regulated product market in the developed world (the international institutions do not assess Scotland separately):

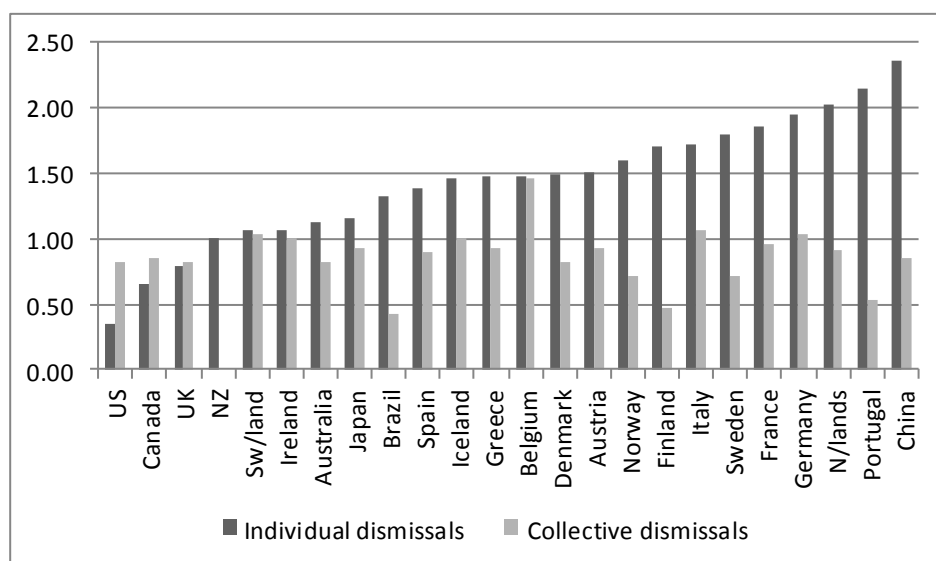
Table 1 Product Market Regulation and Barriers to Trade and Investment, OECD, 2013



Source: OECD indicators of Product Market Regulation 2013 (US data 2008)

Interestingly, as table 1 shows, the UK also has barriers to trade and investment lower than the OECD average and significantly lower than nations with higher manufacturing and exports shares of GDP such as Germany, Japan and Sweden. The UK's labour market is also very lightly regulated:

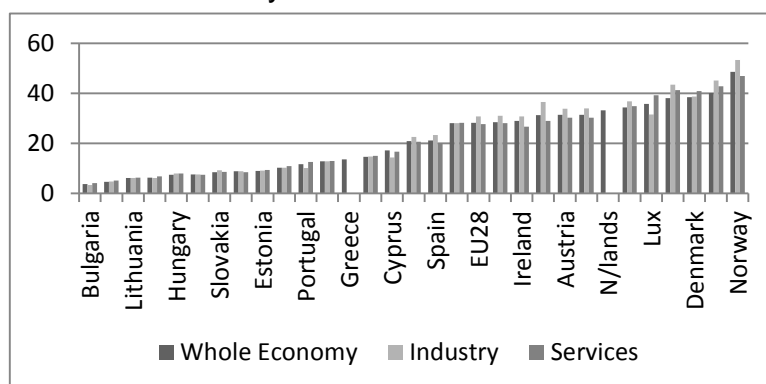
Table 2 Protection of permanent workers against individual and collective dismissals, OECD 2013



Source: OECD indicators of Labour Market Regulation 2013

Eurostat data published only last week confirm that one of the consequences of the low-road competitive strategies facilitated by comparatively low regulation has been to drive down wages in the UK:

Table 3 Hourly Labour Costs in Euros in the EU 28, 2013



Source: Eurostat, hourly labour costs (wages and salaries and non-wage costs such as employers' social contributions) in EU 28, March 2014.

Regulation is a public good; a necessary and unavoidable component of any modern advanced economy. The financial crisis and the horsemeat scandal are recent examples of why this is the case. Government at all levels has to try much harder to understand the negative consequences of persisting with an approach to economic development which prioritises low levels of product and labour market regulation.

The White Paper signals a new approach to regulation of the labour market, has little to say about a general approach to product market regulation and proposes that a combined economic and competition regulator should be established post-independence. *The STUC will happily engage in a discussion about how the regulatory environment can better protect and enhance the welfare of Scotland's workers. However the new approach to economic and competition regulation is a concern: it is a model that risks embedding groupthink and a narrow approach to efficiency. Competition should be the responsibility of a separate regulator.*

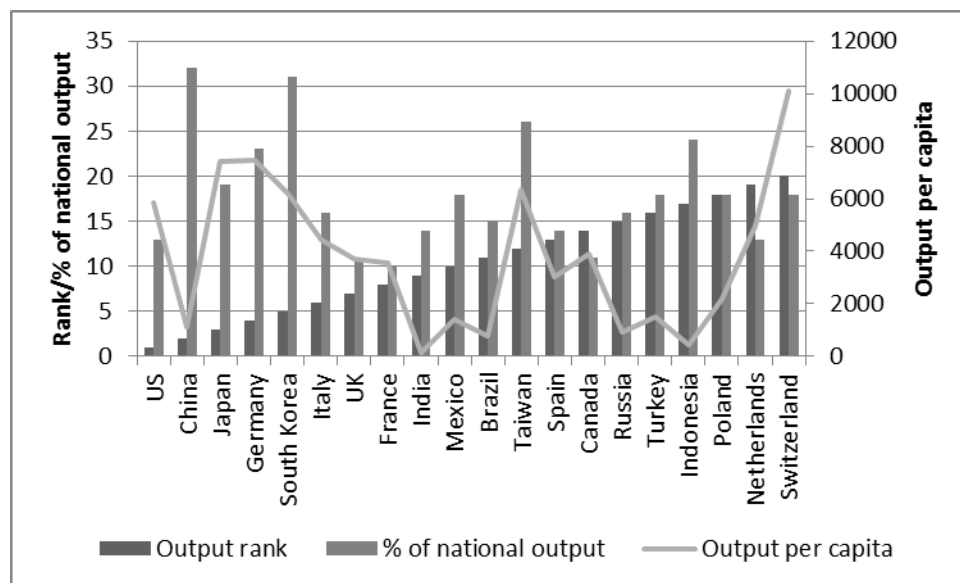
6 Manufacturing

Boosting manufacturing's share of total economic activity is now a priority of Government at all levels; it is a key component of the economic policy set out in the White Paper and the Chancellor reiterated his support for the 'makers' at Budget 2014.

It's important to stress that manufacturing's share of total economic activity has declined in all advanced nations but the UK is commonly assumed to have fared particularly badly in this regard. In 2011, out of 237 countries in the world, the UK ranked:

- 7th in terms of manufacturing output at (\$233 billion).
- 26th in terms of manufacturing output per head (\$3,700).
- 108th in terms of manufacturing output as a share of national economic output (11%).

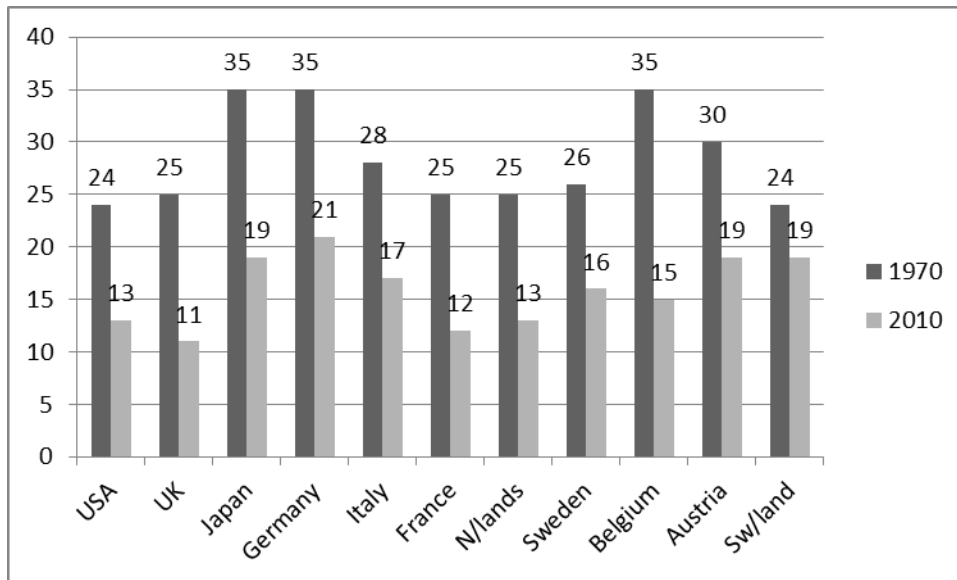
Table 4 World's 20 biggest manufacturing nations by output in 2011



Source: UN Conference on Trade and Development
Output per capita, \$US in 2005 prices using 2005 exchange rates

Over the past four decades the UK has undoubtedly experienced a sharper decline in manufacturing output and employment than most other advanced nations yet the extent to which this is the case is often exaggerated:

Table 5 Manufacturing output as % of GDP



Source: International comparisons of manufacturing, House of Commons Library, January 2014

Scotland tends not to feature as a separate entity in international comparative literature. But with manufacturing accounting for only a slightly greater share of all economic activity (around 12%) in Scotland compared to the UK as a whole (around 11%), UK data can be considered a decent if imperfect proxy for Scotland.

The STUC argues there is no simple answer to the UK's relatively poor performance on manufacturing. Rather the explanation is to be found in the confluence of a number of factors: lack of political support, endemic short-termism, the '*imperial overhang*' (UK firms, used to exploiting captive markets, were wholly unprepared for, and unable to deal with, globalisation) and a complacent attitude to ownership and control.

The STUC strongly supports efforts to boost manufacturing's share of employment and output (we're less confident on the former given the rate of manufacturing productivity growth) and welcomes the new found enthusiasm for the economy's 'makers' now manifest at all levels of Government. Yet, this enthusiasm has yet to translate into hard edged policy recommendations. The White Paper has warm words but little of substance to say on manufacturing and industrial policy. Curbing the current short-termist business culture should be the priority but, again, the White Paper has nothing to say in this regard. The trajectory of UK policy will only further embed short-termism.

The day one impact on Scottish manufacturing of a yes vote in the independence referendum - i.e. the immediate closure/migration of workplaces and loss/shifting of jobs – is likely to be limited. Whisky production cannot migrate from Scotland

(although bottling is always a concern). Skills and agglomeration effects in many sub sectors will make employers wary of rash action. It's difficult to see why firms in, for instance, vehicle manufacturing, chemicals or textiles would immediately up sticks on the basis of a yes vote if they're satisfied that the business environment will remain just as accommodating as it is at present.

Nevertheless, there is a potentially severe impact on the defence manufacturing sector and its supply chain where many jobs are reliant on contracts directly procured by the UK Government.

7 *Key sectors/industrial policy*

The Scottish Government's current key sector demand led approach to economic development has much to commend it but the STUC believes that it is insufficient to meet the needs of all Scotland's citizens. It ignores the needs of those sectors where most people actually work and fails to deliver on a spatial basis.

The following priorities for developing a more effective economic development strategy are relevant under all constitutional scenarios:

- **Realism:** Industrial policy isn't easy, obvious or straightforward. It is difficult, the payoffs are uncertain and long-term and some investments are bound to fail. Government can expect to receive little if any credit for the successes of industrial policy but it certainly won't avoid scathing criticism for its failures.
- Policy will benefit from a dose of **precision**: where do manufacturing, industrial and economic development strategies/policies begin and end? The potential for damaging confusion is high and that's where the White Paper seems to lead. If industrial policy is to achieve anything at all then a minimum requirement is that people should know what's being talked about.
- Industrial policy **mustn't only focus only on external constraints on production** – too many companies (whole sectors?) operate inferior and/or damaging business models. Such models may succeed in providing the quarterly growth in earnings demanded by the City while, for instance, actively reducing the systemic capacity to replicate the skills the firm/sector needs to sustain and improve production. Even if government got its supply side interventions exactly right, Scotland's private sector manufacturers could not and would not morph into a Caledonian Mittelstand overnight.
- **Supply chains**, and the power relations which define them, must be core to any successful strategy. Think of supermarkets and food processors. A handful of very powerful monopsonistic buyers forcing prices down prevent the type of patient investment in skills and capital equipment necessary for the supplier to thrive in the long-term and for the worker to enjoy a decent workplace experience.
- **Geography** – Scotland's current national economic development framework doesn't translate very well to local level. Strategies which aim to use local assets to engage with Scotland's key sectors and grow the local business

birth rate are highly orthodox but doomed to failure. Many areas have no such assets and creating more marginal under sized poorly performing enterprises is likely to reduce rather than increase local employment. A 'foundational' approach will involve using every tool at Government (at all levels) to drive up the economic and social return from sectors like the privatised utilities, supermarkets and retail banking. National action (e.g. living wage) will also be necessary to drive up private sector employment standards and returns to the local economy.

- **Building a new financial system** that supports the productive economy rather than actively undermining it: this pivotally important issue is ignored in the White Paper and the prospects for effective reform at UK level have rapidly diminished. The Scottish Government's recent banking strategy paper is very weak. There's simply no point promoting a new approach to industrial policy while continuing to treat finance as a priority sector i.e. promoting growth in the sector as an end in itself. This is bad not just for the economy's productive sector but also for equality and democracy. *It is difficult to see a way forward that doesn't involve a greater role for new public industrial development and investment institutions.*
- **Innovation** policy and industrial policy should be developed and implemented as intimately as possible. It was a mistake for the Scottish Government to recently publish a joint entrepreneurialism and innovation strategy thereby further embedding the notion that private entrepreneurs are always and everywhere the key driver of innovative change.
- Adopt a more realistic approach to the role of **very small firms**. As Mazzucato² notes, 'the majority of start-ups end up as marginal, undersized, poor performance enterprises that can drive down profits, increase factor prices for high-potential firms, confuse investors and fail to generate benefits commensurate with the amount of public support they receive'.
- **Funding:** industrial policy is potentially expensive and Scotland already spends much more than rUK on direct economic development. Corporation tax cuts are expensive and could – if paid for by removing allowances which favour manufacturing – actively undermine the purposes of industrial policy. It's also essential that the Government captures at least some return from its investments to reinvest back into the system.
- **Ownership and control:** the regulatory landscape could be tweaked to *make foreign takeovers more difficult*. Any such proposal will inevitably be met with the cry of 'protectionism'; one of economics' great debate-killing tropes. As other European countries demonstrate, it is entirely possible to play a full role in the global economy while not making it as easy as the British do to purchase indigenous firms. It's unlikely that enhanced devolution would

² Financing Innovation and Growth: Reforming a Dysfunctional System, Finance Innovation and Growth project (FINNOV), European Commission 2012

provide additional powers in this respect and it's an issue on which the White Paper is silent.

8 *Conclusion*

Ubiquitous use of the term 'economic levers' suggests a certainty in the relationship between constitutional powers and economic outcomes which simply doesn't exist. Successful long-term economic development – especially for a small, open economy in an increasingly globalised world – is just very difficult. While Scotland's economic future depends on the quality of decision making the most important determinant of economic success will continue to be the state of the global economy. Even if a future Scottish Government made perfect policy choices, bad things would still happen to the economy.

However, also entirely possible that constitutional change – enhanced devolution or independence – could help precipitate radical change in Scotland's business culture. With the judicious use of new powers it's possible to see a new manufacturing and innovation eco-system developing in which firms can grow organically with committed – public and private – funding partners. As investment horizons widen, management and policymakers may start to see the benefits in an approach which works for employees, communities, suppliers and customers as well as shareholders.

But achieving this culture change will not be easy. It is essential that advocates of enhanced devolution and independence start to properly flesh out how additional powers can be used to this effect. To do so, they will have to start engaging with areas of policy that the debate has thus far ignored

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