

IS THE GROWTH OF THE SCOTTISH ECONOMY THE “FIRST PRIORITY” FOR PUBLIC SPENDING IN SCOTLAND

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Introduction

The Scottish Executive, notably the First Minister, has frequently stated that the growth and development of the Scottish Economy is the first priority of government in Scotland. In the preface to the most recent version of the Framework for Economic Development in Scotland¹ the First Minister wrote:

“growing the economy is our top priority. A successful economy is the key to our future prosperity and a prerequisite for building first class public services and a Scotland of opportunity. Devolution has been good for Scotland but as a country, we need to be more productive and more competitive internationally, if we are to realise our ambitions”.

Faced with this claim, it is reasonable to ask if the actions of the Executive match these words and it was against that background that the Scottish Parliament Finance Committee conducted its recent Cross-Cutting Review of Public Expenditure on Economic Development in Scotland. The author of this paper was the committee’s advisor for that review and this paper draws on research which was undertaken for the committee. However, the views expressed here are solely those of the author and should not be regarded as representing the views of the committee – which can in any case be found in the committee’s report.² The views are personal and do not represent the views of Tribal HCH.

Public expenditure and economic development

The aim of this paper is to consider whether the actions of the Scottish Executive, specifically decisions on the level and pattern of public spending, have been consistent with the stated priority given to economic development.

There are various ways in which a government might try to pursue an economic development priority – by varying or reducing taxes, by altering any of the many laws which affect business activity, by attempting to alter international trade agreements, through the pursuit of particular macroeconomic policies, by subsidising certain activities (or withdrawing subsidies), by promoting competition and by spending money on activities which are believed to increase the productive capacity of the economy.

Even (or, perhaps, particularly) among any group of economists there would be lack of agreement as to which activities of government – or forms of public spending – increased the capacity of the economy to grow. Some might even argue that public spending was the least important way in which the economy’s growth could be promoted by government.

This paper does not aim to address the issue of whether public spending intended to support economic development is or is not effective or justified. That is, the paper does not consider whether or not economic growth in Scotland would have been higher had the level and structure of spending been different.

The issue of expenditure levels is, however, particularly relevant to any discussion of the activities of the Scottish Executive. The devolved administration in Scotland does not control many of the “levers” of economic policy listed above – it does not control macroeconomic policy, it does not set the framework of competition or of industrial or labour market regulation, it has little if any influence on trade agreements. The ability of the Executive to alter the taxation of business is minimal: the only business taxes it controls are Business Rates. The Executive has introduced one business taxation policy, the system of Rates Relief for Small Businesses – an initiative which provides very small firms with a rates abatement of a few hundred pounds per annum, the cost being fully met (possible over-met) by increased payments by larger firms.

What the Executive does, of course, control is the distribution of an “externally determined” level of public spending between a number of activities (notably health, education, transport, social housing and certain types of business subsidy). Given that the Executive is essentially a “spending” body, it is reasonable to evaluate its priorities with to respect its spending choices.

Trends in spending on economic development

There is no statutory or universally accepted definition of what constitutes expenditure on economic development but it is obviously impossible to conduct an analysis without such a definition. It is arguable that *all* public expenditure has some effect on the economy. At the most fundamental level it can be asserted that without elements of public spending – especially on a legal system and defence – the operation of a modern economy would be impossible: there

are goods and services that can only be provided in practice by the state.

From a macroeconomic perspective we may state that the level of public spending can, at least in the short term, influence the overall level of economic activity – though many economists would argue that the overall level of public spending has no impact on the long term growth of the economy. The level and pattern of public spending certainly affects the *structure* of the economy and the mix of goods produced if not the total value of output.

The issues touched on above – particularly the macroeconomic effects of public spending and the effects of the *size* of the public sector on the structure and performance of the economy are important topics in their own right but they are not the concern of the present paper. We are concerned with expenditure which has the *aim* of increasing the level of output and the rate of growth of economic activity. The intended effect may be to increase the level of economic activity at the level of the Scottish (or UK) economy or to increase activity in particular geographical areas or sectors. As discussed above, the paper does not consider whether these intentions are achieved or whether specific policies are well founded – the focus is on classifying spending by its *intended* or hypothetical consequences.

Economic development and public spending

Economic development can be defined as the process by which economies become increasingly productive and their populations become increasingly affluent. Thus expenditure on economic development is that expenditure which aims to increase the productive capacity of the economy – its ability to produce and sell goods and services. The usual economic rationale for such expenditure is rooted in the concept of “market failure” – which is the inability of the unaided market to produce, in certain circumstances, the socially optimal quantities of particular goods and services. With specific regard to economic development it may, for example, be argued that “left to themselves” firms will under-invest in skills, technology, research, marketing and so forth. Much economic development spending is thus concerned with encouraging companies to undertake such activity. Expenditure on incentives to encourage businesses to expand in certain areas is more difficult to relate to market failure - though it may be argued that the unaided market is failing to make use of unemployed but productive resources (i.e. unemployed people in certain areas).

A more problematic area is that of agricultural subsidies. It is certainly the case that subsidies to agriculture are intended to maintain economic activity which would be otherwise be likely to cease but it can also be argued that this is about supporting certain communities or maintaining a particular pattern of economic activity rather than increasing the overall output of the national economy. Indeed, it could be argued that some subsidies *reduce*

rather than increase national output by maintaining resources in relatively unproductive activity.

Other items of public spending are widely accepted as affecting economic development even though that may not be the main aim of the spending – education and transport fall into this category.

Spending levels and trends

The approach taken in this paper to the analysis of spending levels and trends is based on a division of public spending into three categories – Primary spending, Support spending and Spending un-related to economic development.

Primary spending is classified as that which has the *primary* purpose of encouraging or increasing the level of economic activity. Support spending consists of spending on those public services which have most significance to economic development

Tables 1 and 2 provide details of the specific elements of Scottish Budget spending which have been included in the first two categories listed above. A number of these expenditure elements have been switched between departmental budgets over the period of the data reviewed. So far as Scottish Local authorities are concerned, direct support to economic development is provided through activities which mirror those of the development agencies – mainly support of advisory services, provision of premises and promotional activities. These items are included in the category “Planning and Economic Development” in the Local Government Financial Statistics. This paper does not, however, analyse the “Whitehall” or local government spending over time.

Tables 3 – 5 provide details of expenditure (in real terms) by the Scottish Executive on the above categories of activity over the period since 11995.

Primary spend on Economic Development has fallen as a not only as a proportion of the Scottish Executive budget over the life of the parliament but absolutely in real terms. The evidence in relation to Support spend is more complex. Over the period 1997 -2005, Support spending as defined above grew by 56%. However, most of this growth was accounted for by increased support to public transport, increased spending on services for young people and grants to local authorities under the Education and Social Work budget. If these elements – which are tenuously related to economic development - are excluded, support spend grew by 35% over the period.

For the period 1999 – 2005 a slightly more detailed analysis of the data is possible. Over that period the overall Executive budget grew by 33%. Primary spend rose slightly (by 3%). The main spending “growth areas” were Rural Economic Development, Fisheries and Forestry. Expenditure on support to Innovation rose sharply in percentage terms, though the absolute amounts involved

were small. Recently, there has been a significant reduction in the take up of Regional Selective Assistance reflecting a reduction in inward investment in the manufacturing sector.

Over 1999 – 2005, support spending grew by 45% on the broad definition but by only 30% if public transport, young people's service and specific grants are excluded.

The concepts of Primary and Support spend used above are, of course, open to challenge and during the hearings held by the Finance Committee during its inquiry, such challenges were made.

For example, the Minister for Finance argued in his evidence that a very wide range of public spending – including for example spending on social housing – was supportive of economic development.

The Scottish Executive's economists argued that rather than analyse spending by departmental categories, it would be more appropriate to identify specific economic development objectives and then identify all the expenditure which supported those objectives. However, the Executive did not put forward any analysis on these lines and did not deny the very substantial practical and conceptual difficulties confronting this proposed approach.

Notwithstanding these criticisms, the main conclusions presented above remain robust. Over the period since devolution expenditure on activities which involve direct promotion of or intervention in economic activity has grown more slowly than is the case for public spending as a whole and much more slowly than spending on health. The implications of these patterns will be discussed below.

As we have seen, expenditure described as "support spending" has risen much more rapidly than has primary economic development spend but even within this category of spending it is not evident that economic development considerations are having a heavy influence on spending patterns. The most rapid spending growth has been in on items – such as public transport, increased spending on services for young people and grants to local authorities for Education and Social Work – which reflect social and possibly environmental priorities rather than economic development priorities.

Transport is a particularly telling example. Over the period since the creation of the Executive, expenditure on roads fell very sharply and has only recently regained the levels of 1997. In contrast, subsidies to public transport have increased four fold. There may be sound environmental and social reasons for increasing public transport subsidies but these reasons are not related to economic development.

At the Finance Committee hearings, the Minister for Transport stated that appraisals of road projects tended to show higher economic gains than did appraisals of other

types of transport project. Despite this, the transport programme has seen a marked shift away from road building. The Minister for Transport specifically stated that the project appraisal process:

"tends to show that roads projects have a higher benefit than do public transport projects, so one has to wonder whether we are carrying out the appraisal in the right way, if we believe in public transport, or whether we should be investing all the money in roads (14 December 2004, col 2124)."

The implication of these remarks is that economic development is being ranked below other priorities in driving the transport budget.

The role of FEDS

If one was seeking a mechanism to link economic development priorities and expenditure one might expect it to lie in or near to the Executive's Framework for Economic Development in Scotland (FEDS).

FEDS states that the management of the public finances will contribute to economic development by being efficient in its own right and by involving appraisal processes which accurately assesses the economic, social and environmental impact of projects and their value for money.

FEDS also identifies various key issues for business development – especially in relation to the promotion of competitiveness through innovation, skills development and entrepreneurship.

In relation to the areas defined here as support spend – what FEDS terms the economic infrastructure – the main priorities are said to lie in:

- Æ *the planning system and the role of the housing market;*
- Æ *the transport infrastructure;*
- Æ *school education;*
- Æ *lifelong learning;*
- Æ *the electronic infrastructure; and*
- Æ *the health system.*

FEDS states that "The Executive has a key responsibility in all of these matters, and a specific responsibility to identify the contribution that each makes to the fulfilment of the overarching economic vision. Indeed, the success of modern economies is closely related to the underlying progress in these areas".

However, while FEDS is a thoughtful and well-argued document it does not contain any real guidance on spending priorities. It is not possible to derive from FEDS any clear message as to where the Executive thinks that spending should be increased in relative or absolute terms. Thus the strong growth that has occurred in health spending over recent years may or may not be in part a reflection of the perceived importance of health care to

economic growth but there is, from available information, no way to establish readily to what degree the observed growth in health spending (up 55% in real terms between 1996 and 2005) is on services which will improve the health of working people.

The oral evidence from the Scottish Executive witnesses to the Finance Committee did not indicate that FEDS was playing a major role in shaping spending.

The balance between urban and rural spending

One area in which spending on economic development has clearly enjoyed a degree of priority is in rural Scotland. The greater part of the direct spend on economic development in Scotland (over £3000 million in 2002) – 60% - is on activities which mainly benefit rural areas (i.e. agricultural price support under CAP, forestry, fishing industry support, rural development and agricultural research).

If CAP expenditure is excluded, programmes focussed mainly on rural areas account for 47% of the expenditure – rural Scotland accounts for 27% of the Scottish population according to Scottish Executive statistics

It is clear that over the life of the Scottish Parliament, spending on rural economic development has risen by 88% in real terms while the budget of Highlands and Islands Enterprise has risen 10% in real terms. In contrast, the budget of Scottish Enterprise (whose focus is more on urban Scotland) has fallen by 20% in real terms and spending on Regional Selective Assistance (again, mainly of benefit to urban areas) has fallen by 50%.

Is the economic development priority reflected in Scottish Executive spending?

According to the Scottish Executive, and the first minister, the growth of the Scottish economy is the first priority of the Executive. The principal tool available to the Executive in pursuing that priority is the Executive's £23,000 million budget. Although issue of definitions are disputed, there is clear evidence that this priority does not impact strongly on the Executive's strategic spending choices.

Direct support to economic activity has not grown at all over the life of the devolved administration – except in rural areas which continue to gain a share of such spending which far outweighs their population and which is not transparently related to relative "need". Rural economic activity is important but it is not what will drive Scotland's economic future.

Spending on what FEDS calls the economic infrastructure has grown steadily but within that broad category of spending the fastest growth by far has been in areas with very limited impact at the margin on economic performance – public transport, health care and social programmes.

Transport provides the most striking example. Over the last eight years the transport budget has been shifted away from the activities with the clearest economic benefit – roads investment – towards public transport projects whose justification lies in environmental considerations and to subsidised fares, the case for which is essentially social.

There are possible alternative explanations of this pattern in the context of the Executive's assertion that the economy is its first priority. These are:

That other policy objectives – e.g. improving health or social housing or promoting social inclusion have, in fact, been higher priorities.

That the Executive considers that the level of direct economic development spending to be adequate Following from the above, that the Executive does not consider that increased spending on direct economic development activities (such as those of Scottish Enterprise) or on support spending intended to create economic benefits would in fact be effective in promoting economic development.

However, none of these arguments has been put forward by the executive and they are certainly not reflected in FEDS.

The most plausible conclusion is that the priority to economic development is not an effective priority. In practice, the executive has tended to act as one might expect from a body which is given a budget and told to spend it. It has distributed public spending in ways which it considered would meet with general public approval or which have served objectives (public transport, rural development) strongly supported by groups within the governing parties.

Endnotes

1. Framework for Economic Development in Scotland SE/2004/112 Laid before the Scottish Parliament by Scottish Ministers, September 2004.
2. Scottish Parliament Finance Committee Second Report 2005 Cross Cutting Review of Economic Development.

Table 1 Scottish Budget Primary Economic Development Expenditure

<i>Expenditure Category</i>	<i>Scottish Executive Expenditure</i>
Business Advice and Support	Scottish Enterprise Budget
Subsidies to Business Activity	Highland and Islands Enterprise Budget
	Included in SE and HIE
	Regional Selective Assistance /Other Grant Schemes
	Rural Development Expenditure
	Fisheries Support
	VisitScotland
“Generic” Promotion/Advertising of Scottish Business	Included in SE and HIE
	VisitScotland
Provision of Business Infrastructure	Included in SE and HIE
Support to Inward Investment	Included in SE and HIE
	RSA
Production Subsidies	Agricultural Subsidies
State Operated Business	Forestry
Industry Related Research	SERAD Research Support

Table 2 Scottish Budget Economic Development Support Expenditure

<i>Expenditure Category</i>	<i>Scottish Executive Expenditure</i>
Transport	Roads Construction and Maintenance
	Ferry Subsidies
	Highland and Islands Airport Subsidy
	Air Service Subsidies
	Rail Subsidies
	Subsidies to British Waterways
	Subsidies through Local Authorities
	Other Transport Subsidies
Education	Executive Expenditure on Schools
	Young Persons
	Student Loans
	Higher and Further Education Spending
	Culture, Heritage and Sport
	Specific Grants

Economic development is also supported by spending from Whitehall departments and by local authorities. This relates mainly to expenditure on “Trade, Industry, Energy and Employment” and “Agriculture, Fisheries, Food and Forestry”.

Table 3 Scottish Executive Primary Expenditure on Economic Development (£ million 2002-2003 prices)

	1996- 1997	1997- 1998	1998- 1999	1999- 2000	2000- 2001	2001- 2002	2002- 2003	2003- 2004	2004- 2005	2005- 2006
CAP	486	365	410	360	361	342	353	387	353	323
Rural Dev.	69	83	100	93	85	109	120	137	130	151
Agric Res.	100	88	89	89	89	91	93	116	126	90
Fisheries	44	42	36	35	34	37	41	47	40	43
Innovation Support	n/a	n/a	n/a	5.2	5.2	7.6	7.4	15.1	12.5	13
Scottish Enterprise	511	474	439	406	424	418	426	441	421	403
Visit Scotland	n/a	n/a	n/a	20.4	20.1	19.6	24.0	30.2	31.3	
Highlands and Islands										
Enterprise	68	71	70	70	74	78	79	79	75	73
Regional Selective										
Assistance	83	85	77	45	80	23	33	42	38	45
Forestry	0	0	0	33	44	46	45	50	48	48
Total Primary	1361	1208	1221	1156.608	1216.348	1171.228	1221.4	1344.285	1274.839	1189

Source: Scottish Executive

Table 4 Scottish Executive "Support" Expenditure (£ million 2002-2003 prices)

	1996- 1997	1997- 1998	1998- 1999	1999- 2000	2000- 2001	2001- 2002	2002- 2003	2003- 2004	2004- 2005	2005- 2006
Schools	35	71	95	83	81	119	144	161	194	188
Young Persons	30	80	108	149	170	200	79	107	133	147
Student Loans	493	505	554	567	595	620	567	554	527	509
Higher Education	624	624	584	647	675	733	734	737	748	764
Further Education	336	329	320	354	393	440	454	418	451	475
Specific Grants	19	21	20	133	213	248	183	162	182	267
Culture etc.	166	171	161	164	161	204	187	188	204	227
Other Enterprise and Life Long										
Learning	51	45	46	43	54	63	40	77	97	121
Roads	235	194	172	178	193	157	242	321	241	244
Ferries	18	31	33	34	33	36	26	27	25	25
Highlands and										
Islands Airports	19	17	9	17	25	20	24	22	20	20
Rail Subsidies	122	115	103	93	81	157	186	195	200	195
British Waterways	0	0	0	0	0	13	14	10	8	8
Local Auth. Subsidies	-6	-9	-5	-4	-4	-1	18	22	36	48
Other Transport	87	138	68	39	80	111	114	210	307	390
Total Support	2229	2332	2268	2497	2750	3120	3012	3211	3373	3628
All Spending	17439	16960	16926	17336	18081	19494	20407	21549	22264	23015

Source: Scottish Executive