Purpose

This note provides an overview of the key points that were discussed during the eighth meeting of the Council of Economic Advisers (CEA), which took place on the afternoon of 2nd May 2019.

Welcome

The Cabinet Secretary for Finance, Economy and Fair Work and Chair of the CEA welcomed attendees to Panmure House and outlined the agenda for the meeting.

The Chair and the Cabinet Secretary both extended a special welcome to Tim Ng, Chief Economist at the New Zealand Treasury, and Benedikt Arnason, Director General at the Icelandic Government, who both travelled to Edinburgh for the Wellbeing Economy Governments Group Policy Labs on 1st and 2nd of May.

The Chair noted a number of the group were unable to attend and extended apologies from the First Minister, Professor Sir Anton Muscatelli, Professor Joseph Stiglitz, Professor Mariana Mazzucato, and Julia Unwin.

Update on Developments

The Chair gave an update on developments since the previous meeting in December 2018.

The Council had a conference call in March 2019. During the call, the Council discussed various aspects of the Council's work themes, including developments around the Export Growth Plan and the Wellbeing Economy Governments Policy Labs, in addition to the No Deal Brexit Analysis carried out by the Office of the Chief Economic Adviser, and developments around the Scottish National Investment Bank.

Since the December meeting, the Chief Economist also had one-to-one engagements with members of the group including a phone call with Joseph Stiglitz to update him on council activities, a meeting with Marianna Mazzucato in London and a meeting with member Julia Unwin which covered the Council's remit.

Several Council Members have also been involved in wider engagements in recent months. Anton Muscatelli continues to chair the First Minister's Standing Council on Europe and is also taking forward a review, commissioned by Mr Mackay, on the economic impact of Scottish Universities and how we can maximise the contribution Universities make in working with industry; Sara Carter continues on the Enterprise and Skills Strategic Board; and Mariana Mazzucato has continued to be involved in developments around the Scottish National Investment Bank. The Chief Economist also attended a presentation delivered by Mariana Mazzucato at the Scottish Government in March, on the mission-orientated approach for the Bank.

The Chief Economist thanked members for their contributions throughout the year.

Update on Brexit: Current Issues

The Cabinet Secretary for Finance, Economy and Fair Work provided members with an update on developments around Brexit. It was noted that the withdrawal date for the UK leaving the EU has been extended to 31st October 2019, with the option to leave earlier if a withdrawal agreement is agreed.

The Cabinet Secretary highlighted the First Ministers continued efforts to engage with the Prime Minister to reach a compromise, and reiterated the Scottish Governments' stance on Brexit which is predominantly to remain in the EU, or in the event Brexit does go ahead, to remain in the Customs Union and Single Market.

It was also noted that there needs to be recognition Scotland is being taken out of the EU against its will and that, as recently set out by the First Minister in parliament on 24th April, Scotland should be given the option to choose to remain in the EU via a second referendum on Scottish independence, and that legislation to allow a second referendum is currently being set.

It was also highlighted that the risk of a disorderly no deal Brexit has been delayed and that Scotland has had reassuring economic indicators in the face of Brexit. However, the default option still remains to leave the EU without a deal and therefore, the risk of a no deal Brexit and the associated risks to the economy could emerge again. In particular noting the risk to GDP from falling output linked to investment, consumption and trade (falling exports), a decline in the labour supply which will impact skills, and ultimately increasing rates of poverty.

It was noted that given the risk of a no deal remains on the table, the Scottish Government will continue to prepare for such a scenario, referencing the preparations the Scottish Government have carried out in relation to transport, food security, and support for businesses in preparing for a no deal. However, it was noted that the Scottish Government cannot fully mitigate the full impact of a disorderly No Deal brexit.

Work Theme Review – Part 1

The Chief Economist provided members with a brief overview of the progress of Resilience and Wellbeing Work Theme, which currently encompasses the Scottish Governments work in establishing the group of Wellbeing Economy Governments (WEGo) and deliver of Economic Policy Labs.

WEGo is an initiative led by the Scottish Government to deepen understanding of, and better embed in practice, the concept of economic wellbeing. Formally launched at the OECD world forum in November 2018, the group consists of the Governments of Scotland, Iceland and New Zealand.

The group held their first Economic Policy Lab on 1st and 2nd May in Panmure House. The session focused on Wellbeing Measurement Frameworks, Sustainable Tourism and Natural Capital, and Child Poverty and Predictive Analytics.

The Chief Economist, Tim Ng (Chief Economist at New Zealand's Treasury) and Benedikt Arnason (Director General at the Icelandic Government), and Carrie Exton from the OECD took part in the Policy Labs alongside various officials from across Government, as well as Jim McColl, Professor Sir Harry Burns and Crawford Beverage of the First Minister's Council of Economic Advisers.

The First Minister delivered the welcome address at the opening session, alongside the Prime Minister of Iceland, Katrin Jakobsdottir, and Carrie Exton from the OECD, who delivered a presentation on the different approaches to wellbeing among OECD countries.

The Chief Economist, Tim Ng, and Benedikt Árnason shared their reflections from the meeting, noting the productive discussions which emerged from the sessions and the positive sentiments from those who attended. In particular, they highlighted the common challenges their countries are facing in firstly mainstreaming Wellbeing across Government using performance frameworks, data and budget processes. That Wellbeing is multi-faceted but the economy and the outcomes achieved have a key role alongside broadly social and environmental policy. The discussion of the tourism industry, in each country, highlighted similar challenges in terms of economic, social and environmental outcomes and the opportunity for sharing practise and collaboration to tackle these challenges. Finally, they reiterated their commitment to the group and their future ambitions, including the potential expansion of the group.

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

- Members were content with the progress of the group, noting how wellbeing frameworks can act as a medium to enhance communication and collaboration between government departments and agencies to deliver wellbeing.

- Members noted how well the group has been received internationally, and that the policy labs provide a platform to connect experts from the respective governments involved and to strengthen Scotland's international networks.

- Members noted the challenges around moving from measurement to the delivery of wellbeing across society, and in particular noted the valuable opportunity to learn from New Zealand's innovative wellbeing budgeting approach.

Economic Performance

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:

- Scotland's economy has grown at a stable pace in 2017 and 2018, in line with the UK, continuing a pattern of stronger growth underpinned by stronger confidence and activity in the oil and gas sector and its supply chain, and stronger global growth and lower Sterling supporting export growth.

- Scotland's labour market continues to perform strongly with unemployment falling to its lowest rate on record and employment at its highest rate on record, with full-time work driving employment growth and labour market tightness reflected in improving nominal wage growth.

- Labour productivity has also strengthened in 2018 reflecting a combination of stronger growth and a fall in average weekly hours worked.

- Brexit uncertainty continues to weigh on consumer and business confidence and investment resulting in a reallocation of resources to contingency planning and stockpiling.

- Brexit uncertainty has not impacted fully on economic performance yet. However, there remains a significant downside risk to growth from a disorderly Brexit alongside a slower global growth outlook.

- Independent growth forecasts for Scotland remain around 1% - 1.2% in 2019 assuming some form of smooth Brexit transition. However, a disorderly no-deal Brexit remains a risk that could push the Scottish economy into recession.

Members were also provided with an overview of the recent analysis carried out by OCEA on the degree of vulnerability of Scotland's places, rural economy, and communities to a no-deal Brexit, the aim of which is to enable the development of appropriate policy responses and actions to the impacts of a no-deal.

An index was created to visually represent the ranking of communities according to their potential vulnerability. A combined socio-economic approach was used, providing insight across a range of indicators and drivers that may influence the ability of a local area and its communities to withstand disruption to its economy.

The index shows that most, if not all, Local Authorities are likely to be vulnerable to the impacts of no-deal. Overall, rural areas are the most vulnerable to a no-deal Brexit. However Urban areas and cities are more highly exposed in terms of the vulnerability of their workforce due to the dependency on EU workers and the number of jobs exposed to EU-intensive export industries.

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

- Members noted that the divergence in the level of employment between Scotland and the rest of the UK is widening, with Scotland continuing to outperform the rest of the UK.

- Members noted that the tightness of the labour market is negatively impacting on the ability of some sectors and businesses to fill vacancies, and that this could worsen due to a fall in the supply of labour, owing to a decline in EU citizens in the labour market as a result of Brexit.

- Members noted the increased levels of stockpiling among businesses to cushion against Brexit, highlighting that the increased stockpiling could have ripple effects across the economy if Brexit does not go ahead.

- Members considered the oil price collapse in 2015 and how this corresponded to a fall in the value of exports due to the fact Scotland is an exporter of technical services to support the oil and gas sector.

Work Theme Review – Part 2

The Chief Economist provided the Council with an update on Scotland's Export Growth Plan, which was published on 1st May. The purpose of the plan is to drive a significant increase in the value of Scotland's exports as a proportion of GDP by providing an evidence based action plan for growth. The Council were provided with an overview of analysis which reviewed Scotland's export performance and identified potential opportunities for export growth in key sectors, businesses and markets.

The Chief Economist gave an overview of the analysis the key sectors, businesses and markets targeted. The analysis indicates that the following sectors are the key target sectors to boost Scottish export performance: Food and Drink; Engineering and Advanced Manufacturing; Life and Chemical Sciences.

Out of the 11,000 exporting businesses in Scotland, the top 500 companies account for 80% of Scotland's total exports. Increasing the value of the exports from those 500 companies by 50% would increase overall exports by £13bn, whereas increasing the value of exports from the remaining 10,500 exporters by 50% would increase overall exports by less than £3bn. It was also noted that the top 100 companies are experienced exporters with the skill and capacity to enter new markets. The analysis suggest that it is the next cohort of around 400 companies, which contribute around 20% of export value, where there is significant potential for improved performance with the right support.

The analysis also categorized markets based on their immediate versus longer-term priority, and on the whole indicates that established markets are the immediate priority, while emerging markets provide longer-term opportunities for increasing export performance.

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

- The Cabinet Secretary for Finance, Economy and Fair Work highlighted the successful launch of the export growth plan at the National Economic Forum on 1st May which had an audience of around 1,500 businesses, and noted that the plan has been received well by businesses.

- Members noted the importance of internationalisation for enhancing the resilience of the economy, and provided positive feedback regarding the plan's focus on where to target efforts to boost exports as a share of GDP, which has remained relatively static.

- Members noted that the degree of intervention required varies widely across businesses and the potential for successful exporting businesses to support those which have not yet entered, or are in the early stages of entering, the export market.

- Members noted that, contrary to expectations, the analysis on the whole indicates that established markets are the key target markets, however, noted the importance of monitoring emerging markets for potential targeting.

- Members noted the high degree of uncertainty surrounding Brexit and the potential negative impacts this could have on exporting businesses.

Update on Public Finance

The Cabinet Secretary for Finance, Economy and Fair Work noted the successful approval of the budget on 21st February, noting its focus on education, the economy and the environment, and the challenges in introducing spending plans in times of such uncertainty resulting from Brexit.

The budget added £90 million to the local government budget and made additional commitments including on local taxation: on council tax increases, the transient visitor levy, and the work place parking levy. The Cabinet Secretary noted the shift in public opinion on environmental issues and the need for the government to facilitate the transition to a low carbon economy while maintaining public services.

It was highlighted that the funding outlook continues to be dominated by UK Government policy decisions such as austerity and Brexit and that consequently the Scottish budget has seen a real terms reduction to the resource block grant over the past decade, making it necessary to tighten public spending. However, it was highlighted that the Scottish Government have taken action to mitigate against this where possible, using tax powers to protect public services while ensuring Scotland is as prepared as possible for exiting the EU.

The Cabinet Secretary stressed there should be no detriment to public finances as a result of Brexit, noting that while the Scottish Government has contingency plans in place in relation to Brexit, there has been a lack of clarity from the UK government in relation to funding streams to mitigate any negative impacts on public finances.

The Cabinet Secretary highlighted the upcoming spending review, which provides an opportunity to review every aspect of the budget, and noted that the Scottish Government are taking a whole of systems approach.

Work Theme Review – Part 3

Members were provided with an update on the progress of the Council's competitiveness work theme, which currently focuses on the analysis of the behavioural effects of divergences in income tax rates between Scotland and rUK.

Since the Council were last updated in December 2018, an assessment of new micro data from the Survey of Personal Incomes and a review of new literature has been carried out, exploring as far as possible the whole tax base to reflect the expanded remit of the competitiveness work theme beyond top rate taxpayers.

However, there have been no significant developments in the evidence base since December that may requires a review of the Council's previous advice.

It was also highlighted that the analysis is limited until new outturn data are released, and that the work will be developed further over the coming months, with a further update to the Council provided in Autumn 2019 to inform the budget 2020-21.

The Chief Economist highlighted the importance of the social contract and how the provision of local or national amenities are an important factor to consider when assessing the behavioural responses to income tax changes.

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

- The Cabinet Secretary for Finance, Economy and Fair Work reiterated the importance of a strong evidence base on the behavioural impacts of income tax differences between Scotland and rUK and the associated impacts on the economy, to inform future tax decisions in Scotland and to support the Scottish Government to have a progressive tax system, which maintains Scotland's competitiveness, sustains revenues and protects public services.

- Members discussed the social contract and how the provision of local or national amenities such as public services and free tuition fees can contribute towards reduced rates of crime, unemployment and health related issues, benefiting public finances and making Scotland a more desirable place to live and, in turn, impacting on the perceived negative effects of changes in income tax.

- The Cabinet Secretary noted that there are benefits to living in Scotland that offset tax differences with rUK and requested these to be demonstrated.

- Members were interested in the potential to measure the affect of rate increases on higher rate payers

- Members noted the role which the structure of the tax system has to play in reducing inequality, including negative income tax. Members also noted the potential role of Universal Basic Income.

- Members noted that the legal minimum requirement for pension contributions was raised by the UK government and enquired whether this change combined with the higher top rate tax has had a negative impact on businesses. It was noted that the combined effect of these changes has not been assessed, however no evidence has yet emerged which indicates businesses have been negatively impact by the higher top rate tax.

- Members agreed to continue the work investigating the behavioral responses to differential tax rates with further analysis to be reprted back on later in the year.

Update on Scotland's Centre for Regional Inclusive Growth

The Deputy Director of Economic Strategy provided the Council with an update on Scotland's Centre for Regional Inclusive Growth (SCRIG). The Council were last updated on SCRIG in December last year.

SCRIG was established to drive improvements in inclusive growth outcomes by deepening the understanding of 'what works' in regional and local economic development and improving the use of these insights in policy and decision-making. The aim is to achieve this by providing local authorities with the tools to identity their unique constraints to inclusive growth and align local and national strategies.

The Deputy Director gave a brief overview of the recent activity of SCRIG.

SCRIG has recently worked with Economic Development Association Scotland (EDAS) to run an inclusive growth 'Community of Practice' that brings together a range of public, private and third sector practitioners working to deliver inclusive growth across Scotland. The first phase of this work delivered 4 events around Scotland with 130 attendees across the events. A bank of case studies are available on the Community of Practice site covering employability, community engagement, and community benefits.

SCRIG has also established a Regional Inclusive Growth Research Network hosted by Policy Scotland at the University of Glasgow, which held its first meeting in March 2019. Academics from universities across Scotland attended and have committed to working together to advance our understanding of inclusive growth and how it can be delivered through policy.

It was noted that initial feedback on the website was received, which is in the process of being implemented. The importance of enhancing the accessibility of the tools/metrics was also highlighted, so as to better empower local authorities to address their inclusive growth constraints.

Update on Scotland's National Investment Bank

The Chief Economist updated members on the progress of the Scottish National Investment Bank. The Council were last updated during the conference call in March on the introduction of the Bill to parliament and the resourcing of the Bank.

The Chief Economist highlighted the continued involvement of Council member Professor Mariana Mazzucato in developments around the Scottish National Investment Bank, noting her visit to the Scottish Government in March to deliver a session on how to establish a mission-orientated approach for the Bank. Professor Mazzucato delivered a public session alongside a private masterclass with the bank staff. It was noted that both of these sessions were received well.

The Chief Economist raised the issue of HM Treasury Dispensation, noting that the Scottish Government are continuing to engage with HM Treasury regarding the required derogation to enable the Bank to carry cash balances between financial years. The Chief Economist also noted that a State Aid notification for capitalisation of the Bank is being prepared for the European Commission to consider. The UK Government has indicated that its intended approach to State Aids will be similar following Brexit, and as such the intended approach to meet the legal requirements of state aid will not change substantively in the short term.

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

- Liz Ditchburn, the DG for Economy in the Scottish Government, noted that there has been a considerable amount of enthusiasm and interest from across sectors to support the Bank and in particular noted the positive relations which have been established between the Bank and Scottish Enterprise.

- Members highlighted the importance of maintaining the Bank's mission-orientated focus and discussed how this approach ties in with Scotland's wider institutional landscape.

- Members noted the issue of State Aid approval and discussed the potential for external finance as an additional source of leverage for the Bank.

Update on Scotland's National Manufacturing Institute

The Chief Economist provided an update on the progress of Scotland's National Manufacturing Institute, following the conference call in March during which members requested an update on what the Scottish Government is doing to support manufacturing activity.

The First Minister launched the Manufacturing Action Plan in February 2016 which sets out an action plan to work with industry to deliver initiatives to boost productivity and stimulate innovation and investment in Scottish manufacturing to boost global competitiveness. This includes eight thematic workstream and a proposal to establish a Scottish National Manufacturing Institute (NMIS).

It was noted that in December 2017 the location for institute was announced as Renfrewshire and the University of Strathclyde as an academic partner. Funding of £65 million for NMIS has been announced; £48 million from the Scottish Government and £8 million from Strathclyde University. The aim is to complete building work in two phases, with phase 1 expected to be completed in 2021.

Additional funding of £8.9 million was announced for the Lightweight Manufacturing Centre, which will open in temporary accommodation close to the permanent site and is expected to start delivering initial projects in 2019.

The Chief Economist noted there has been significant engagement with tier 1 companies who are involved in the design of NMIS. There have been 321 companies identified for targeted engagement by University of Strathclyde and SE with some input from HIE and SDS. A report on further demand assessment covering an additional 87 companies through SE account managers and SMAS practitioners has also been completed. Aerospace announced they had become a Tier 1 member of the Lightweight Manufacturing Centre on 11 March.

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

- The Cabinet Secretary for Finance, Economy and Fair Work noted the valuable industry, public sector and political leadership which the Strategic Leadership Group, co-chaired by the Cabinet Secretary and the Rolls Royce Director of Global Manufacturing, has provided to NMIS, and highlighted that there has been a high degree of enthusiasm for the initiative.

- Members noted the value of manufacturing services, and were interested in the idea of taking a more integrated approach to manufacturing by actively increasing synergies between a range of disciplines and fields such as economics and academia, to enhance product development.

- Members noted the need to ensure the support offered by NMIS does not focus solely on large, globally established businesses, but actively targets a wide spectrum of businesses including SMEs.

- Members highlighted the widespread potential economic benefits of the National Manufacturing Institute, noting in particular the potential to boost to Scotland's competitiveness.

Other Business

The Director General of Economy noted the Climate Change Committee's advice which was published earlier that day (2nd May), to set a new target of net zero emissions for Scotland by 2045. This is in place of the current target of 90% emissions reductions by 2050. It was noted that the First Minister accepted this advice, and has lodged an amendment to the Climate Change (Scotland) Bill.

It was noted that significant economic and societal change will be required to achieve the net zero emissions target and the Council were asked to consider the nature, pace and scale of the required transition going forward.

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

- Members considered various alternative sources of energy including the harnessing of excess wind energy to produce hydrogen or ammonia, and the use of these as a source of fuel.

- Members noted the importance adopting a broad approach to tackling climate change, which enhances communication with a wide range of stakeholders.

- Members noted that the required transformation presents a vast array of economic opportunities across businesses and sectors and considered where these opportunities lie, including renewables, exports and job creation.Finally it was agreed that this would be a topic for a fuller discussion at a future Council meeting.

Attendees and Apologies

The following Council Members were present:

Crawford Beverage (Chair)

Professor Sir Harry Burns

Professor Sara Carter

Craig Clark

Jim McColl

Also Present:

Cabinet Secretary for Finance, Economy and Fair Work, Derek Mackay MSP

Liz Ditchburn, DG Economy Scottish Government

Alyson Stafford, DG Exchequer, Scottish Government

Dr Gary Gillespie, Chief Economist, Directorate for Chief Economist, Scottish Government

Uzma Khan, Deputy Director, Office of the Chief Economic Adviser, Economic Strategy, OCEA, Scottish Government

Joanne Briggs, Economic Adviser, Economic Strategy, OCEA, Scottish Government

Alison Lang, Assistant Economist, Economic Strategy, OCEA, Scottish Government

Apologies:

Professor Joseph Stiglitz

Julia Unwin

Professor Marianna Mazzucato

Professor Anton Muscatelli