Introduction

This book asks how to improve growth in a small economy, specifically growth in advanced industrial regions and nations which also have a commitment to social justice and sustainability. The case study is Scotland. To paraphrase Adam Smith, one of the country's most famous sons, the task is to identify sources of new wealth for old nations. The challenge of understanding what makes economies grow, and how governments can help or hinder, is hardly new; but contemporary challenges provided the impetus for this book. First, how do the long-standing EU members compete after the Union's enlargement in 2004? Secondly, what forces drive growth in small economies, whether a sovereign state or a region? This question is particularly pertinent now Europe has a common monetary policy and growing pressures for greater fiscal coordination, and is relevant everywhere because of the impact of globalization in intensifying competition with much lower cost locations. For these reasons, there is a renewed interest in what local levers can affect growth. Our contributors focus on Scotland but their policy prescriptions demonstrate just how general are the political economy challenges for any advanced, industrial region.

Aims of the Book

We asked the contributors to consider three themes. The first is simply *growth*: what enhances and what limits the growth rate? The second is *opportunity*: in a small country like Scotland, with just over five million people and an essentially social democratic political consensus, what is the nature of the trade-off between growth and fairness, and can its terms be improved? The third theme is *governance*: how can the productivity of the public sector be improved and how can a consensus for policy change be developed and implemented?

The book regards the need for a specific commitment to growth as a policy priority in Scotland, where recent growth rates have been mediocre in international terms (see Chapter 1). Such a growth priority has wide relevance in many developed economies exhibiting sluggish performance in the recent past. All now face the challenges posed by ageing, static or declining populations and the ever-rising demand for better public services and superior infrastructure. Improving growth is important to managing the trade-offs inherent in the popular desire for both low taxes and high-quality services. In Scotland, as elsewhere in Europe, there is a strong social democratic aspiration for the policy process to deliver fairness in economic outcomes. How can both improved allocative efficiency and redistribution objectives be addressed in a small economy highly sensitive to factor flows in a world of ever-increasing capital and labour mobility? These dual aims of growth and opportunity raise pressing questions of governance. How can limited public funds be used more efficiently and what political and administrative structures help rather than hinder economic performance?

By focusing on the three challenges of faster growth, improved opportunity and better governance, we are not denying that there are many other pressing issues confronting public policy. However, achieving higher sustainable growth by increasing the resources available would ease many other policy challenges, both social and environmental. This book is a contribution to creating a renewed climate of ambition for public policy. We aim to spark a debate about the use of microeconomic instruments. Structural economic reform in the European Union and elsewhere may find that its best hope lies at the regional level, where significant powers have been devolved.

Inevitably, given its ambitions, there will be inappropriate emphases, misperceptions and errors of judgement in this book. However, all the authors are eminent academic economists known for applying their analytical insights to the policy realm. Most of our contributors are based outside Scotland, a choice which reflects a desire to ensure the analysis both drew on international evidence and stepped outside partisan domestic sensitivities and prescriptions. We invited them to apply their external perspective to challenge the received wisdom within Scotland about the right economic strategies.

The Growth Process

The issues at stake in the developed world are less urgent than those in the developing world, but nevertheless small improvements in productivity and growth can make a big difference to the quality of life in a small economy such as Scotland. However, neither economics as a discipline nor this book offers an easy answer to the question of how the long-term growth rate can be raised. The more complex but richer appreciation of the growth process in modern economic theory considers improvements in growth as self-reinforcing. Central elements in the growth process include innovation, investment, human capital, the institutional context and ‘social capital’ (i.e. the network of relationships and institutions, both formal and informal, underpinning the organization of the economy), openness to trade, and incentive structures created by government policy.

How these all fit together is another matter. Certainly, increasing returns to scale and spillovers mean the specifics of place and time play an important part. They also mean that economies are subject to virtuous and vicious circles. This places a greater emphasis on aspects of culture, political institutions, social norms and even historical accidents.[1] But it also makes it much harder to draw simple policy conclusions. The old machine metaphor, of policy levers to change the economy’s gear and getting the engine ticking over faster, has been abandoned to rust by the side of the road.

[1] There is a voluminous recent literature on growth. A classic theoretical statement is by Romer (1986); an overview is given by Aghion and Howitt (1998).

Instead, the focus is on policy as a means of coordinating collective behavioural change such as encouraging more entrepreneurial attitudes or convincing people of the desirability of extra years of education and workforce training. Government intervention in the growth process can therefore be best understood in terms of either promoting market efficiency or redressing the consequences when markets fail (Balls et al. 2004, Chapter 1). Encouraging competition is an example of the former, while an example of the latter is the provision of tax credits when the social return to investment in R&D is higher than the private return due to external spillovers. Policy makers need to set incentives to influence the behaviour of key groups and individuals, creating a collective commitment to national economic priorities and setting a framework where fear of failure does not hinder innovation.

The importance of ideas in stimulating growth in advanced economies also creates new policy challenges. While economies have always depended on knowledge, adding value now depends more heavily than in the past on intangibles including the exploitation of human capital, tacit knowledge and personal networks. The 'knowledge economy' has entered the lexicon of policy without economists having provided a full account of why and exactly what role 'knowledge' per se plays in growth (Coyle 1996; Quah 2002). Even so, it is apparent that in some countries at least, trend growth rates have increased due to the importance of information and communication technologies (OECD 2003). The growing body of evidence suggests investment in human capital, investment in new technologies, and international openness all play an important role. Case studies also point to important aspects of organizational change (Brynjolfsson and Hitt (2000, pp. 23–48) offer a survey).

The processes underpinning economic growth are becoming better understood, particularly the importance of achieving behavioural change in a specific historical, geographic and institutional context. But one corollary of this is that economic policy needs to be viewed as less technocratic and more 'political'. In practice, good policies need to be persuasive to many thousands or even millions of individuals, with incentives set appropriately, rather than winning over a handful of senior politicians and officials. Thomas Schelling suggested many years ago that the ideal for effective policies was the traffic light, a self-enforcing convention (Schelling 1976). The role of government is to establish the convention but not to enforce individual compliance, which is rewarded automatically. Growth theory has come around to effectively the same conclusion about policy design, recognizing the importance of incorporating appropriate incentives in policies and the importance of the incentives faced by the policy makers and politicians themselves.

The chapters that follow demonstrate considerable consensus among the contributors about the issues that need to be tackled. But a natural concern[2] is whether politicians are willing to pursue structural reforms in the face of opposition from powerful vested interests. Resistance to change is likely to be stronger in circumstances where any adverse consequences of a failure to act are unclear, and when the available evidence can be interpreted in conflicting ways.

[2] Often raised in the seminars held by the authors in Scotland in 2003–04.

Recent Irish experience suggests that achieving sufficient consensus for radical action is important in improving growth (Alexander 2003). However, a robust debate is required to crystallize the choices and the implied trade-offs associated with different policy options. Achieving a balance between conflict and consensus goes to the heart of effective leadership. Political leadership must ensure that policies are shaped by evidence, and then harness the best available expertise in both the public and private sectors to secure the implementation of reforms. Those regions and nations which are able to engage both public and private sectors successfully in a common purpose will have a head start.

Why Scotland?

Scotland is a country of just over five million people who have recently acquired political autonomy over their domestic affairs from the rest of the UK (nearly 60 million people in total) and are also part of the newly enlarged European Union (455 million). This recent policy autonomy makes it an excellent case study. There are lessons for many small, developed economies in its recent experience and current challenges.

In common with other parts of Western Europe, Scotland, with its impressive industrial and intellectual history, has known considerable past economic success. Such legacies can be both inspiring and debilitating. Indeed, a challenge for the new Scottish Parliament, created in 1999, is how to reconcile past splendours with contemporary mediocrity. As Paul Krugman notes in Chapter 2, Scotland's 'first wind' created such a powerful legacy that it has been hard to muster the momentum for a second and now a third wind. However, the new Parliament's powers offer the scope to implement fresh policy proposals, stimulating widespread interest in the regional growth and productivity performance.[3] The next few years therefore mark a window of opportunity to steer the economy onto a higher path.

This book draws on a series of seminars commissioned by the University of Strathclyde's Fraser of Allander Institute and funded by 13 Scottish businesses, entrepreneurs and foundations. Many Scots share an aspiration to combine the American spirit of enterprise with the European commitment to solidarity. In the seminars a number of the contributors noted complacency, contentment with a satisfactory underperformance and the absence of a single-minded strategic intent on the part of the policy elite in Scotland. This contrasts with many successful small nations and regions. Other participants detected an appetite among many Scots, in all walks of life, for an effort to create a nation which, although small, is both 'smart' and 'successful' (to borrow the phrase chosen for the Scottish Executive's 2001 policy document, *Smart, Successful Scotland*). The desirability of creating a consensus about the economy's future direction is recognized by a wide swathe of Scottish society. Yet Scotland's economic concerns are far from unique. How to thrive locally in the global economy lies at the heart of the policy challenges facing all small advanced economies.

[3] The powers and responsibilities of the Scottish Parliament are listed in the appendix.

The European Context

Many of the lessons in this book therefore have wider applicability. For example, many central and eastern European economies are still experiencing the difficulties of transition, with extensive public ownership and an over-reliance on traditional manufacturing industries. The accession of many of these economies to the EU in 2004 suggests that conventional policy formulations, such as competing for foreign direct investment (FDI) in leading sectors, cannot possibly work in every case. The Irish success in convergence after joining the EU might well turn out to be a strategy viable only in its specific historical context. With more competing locations and presumed limits on the quantity of FDI, other regional economies in the new Europe will need to assess carefully their own chances of attracting inward investment, its character and the nature of potentially beneficial spillovers.

Many aspects of the Scottish experience chime with other parts of Western Europe, particularly the devolution by central government of many of the instruments of structural economic policy. All of the major countries of the EU15—Germany, Italy, Spain, Britain and France—have opted for greater subsidiarity in domestic affairs, whether it be the fully fledged federalism of Germany or the more cautious, uneven decentralization in Italy. This is of particular interest in the context of the Lisbon Agenda, the economic priorities identified by EU leaders at their summit in Lisbon in June 2002.[4] They committed the EU to becoming the world's most competitive and dynamic knowledge-based economy by 2010. Yet it is already apparent as the mid-point review in 2005 approaches that Europe is in fact falling further behind the US.

Progress on structural reform has been agonizingly slow, arguably because the process failed to address the political framework needed to introduce difficult economic reforms. A recent report prepared for the European Commission by a group of experts led by André Sapir (2003) offers this concise statement of the problem:

> Faster growth is paramount for the sustainability of the European model, which puts a high premium on cohesion. Sustainability is nevertheless under threat from rapid developments in demography, technology and globalisation, all of which increase the demand for social protection. Failure to deliver on the commitments of the Lisbon Agenda would endanger the present European contract and could lead to its fundamental revision, thereby threatening the very process of European integration. Fortunately, however, technology and globalisation, like enlargement, also hold the potential for faster growth throughout Europe.

Sapir's report emphasizes decisions taken at the EU and national levels, with the regional dimension of Europe's structural reform agenda rarely noted.[5] This is

[4] See http://europa.eu.int/comm/lisbon_strategy/index_en.html.

[5] In addition, although both national governments and the Commission have produced a plethora of reports on the Lisbon Agenda, member governments are not obliged to present to their national parliaments a coherent overview of how they plan to meet the targets.

particularly disturbing given that more balanced regional growth can lead to faster overall national growth (Balls et al. 2004, Chapters 1 and 5). Moreover, the Sapir report dwells on a number of measures which do lie in the hands of the Scottish Executive and other regional European governments. Many of the powers needed to deliver structural reforms rest with regional rather than national authorities. Finding the right balance between competitiveness and cohesion, the needs of the economy and those of society and the environment, goes to the heart of the debate taking place in many small European countries and regions, which may be politically autonomous but are increasingly tightly woven into the fabric of the European and global economy.

The Structure of the Book

The book begins with a chapter offering non-Scottish readers an overview of the political economy of Scotland. The chapter was written by the editors along with Jo Armstrong and John McLaren, making up the team which ran the Allander Series. An overview of Scotland's political and constitutional past provides the context for an analysis of recent economic performance and policy. The remaining chapters are arranged in three parts corresponding to the themes of growth, opportunity and governance.

Part 1: Growth

In Chapter 2, Paul Krugman sets out the analytical framework with a discussion in the light of recent theories on growth and economic geography of the challenge of raising the trend growth rate in a regional economy such as Scotland. He examines the distinctive characteristics of regional growth. Unlike growth in a large economy such as the US, the EU or large nations—where, of necessity, the primary market is domestic and growth is driven by productivity gains—regional growth is more export-dependent. Hence, a region's overall openness to international markets matters. However, in small economies the attraction of significant flows of mobile capital and labour can stimulate a rapid rate of growth whatever the domestic productivity performance.[6] Exploiting this opportunity can lead to spillovers which can snowball in a virtuous circle of growth. But this requires a deep understanding of a regional economy's competitive advantages and how they might be exploited to generate factor inflows on a big enough scale. Key areas of potential advantage include higher education to ensure the availability of a skilled labour force, the quality of life (for the same reason) and public infrastructure. Securing domestic productivity improvements, whether by encouraging spillovers from FDI or by direct attempts to improve the efficiency of domestic industry, cannot be neglected if growth is to be sustained.

[6] Ireland is a case in point. Location, tax incentives, macro-stability, a favourable exchange rate and labour availability together stimulated the attraction of US multinationals which fuelled the Celtic Tiger phenomenon. Yet the domestic economy still faced huge productivity challenges concerning research, innovation and structural reform.

The other chapters in this part turn to the specifics of policies that could help Scotland achieve faster growth. William Baumol addresses enterprise and innovation, emphasizing the need to tailor policies to the varying roles played by both large and small firms and by other institutions, notably universities and government. Scotland's record on entrepreneurship and innovation is relatively weak, and the institutional capability of the economy to innovate lags competitor economies. Baumol puts the spotlight firmly on microeconomic instruments such as investment in basic research, corporate R&D, the provision of finance, competition and patenting policies, and education and training. He also echoes Krugman on the importance of openness to technology, ideas and people from overseas—a lesson for small economies too rarely understood at the regional level. He therefore stresses the need for the Scots to become skilled imitators as well as excelling at 'blue-skies' research. This may be particularly relevant in economies such as Scotland where the capabilities of the corporate sector to undertake R&D and innovate appear weak.

In Chapter 4 Edward Glaeser looks at the role of the major cities in attracting the skilled workforce needed for economic growth. He notes that for knowledge-intensive activities there has been an increasing concentration in cities—unlike the pattern in manufacturing where the trend has been dispersal to cheaper, less-congested areas or relocation overseas. The message is clear: if future economic success depends on attracting knowledge-intensive activities, then those economies wishing to compete effectively will have to offer successful city regions where people want to live. Increasingly city regions are competing to attract and retain talented people and businesses. Glaeser crystallizes the choice: does Glasgow want to be a Boston or a Detroit? He argues that Scotland's urban core has managed the transition from traditional manufacturing to services reasonably successfully, but a fresh approach is now required. Edinburgh and Glasgow need to operate as one city region to achieve the scale necessary to succeed in the global marketplace. Attracting skilled workers requires: providing education and amenities to grow the skilled workforce; tackling urban social problems without driving the better-off elsewhere; making affordable housing readily available; and managing the inevitably growing use of cars in cities. He characterizes his prescriptions as 'sun, skills and sprawl'. And if sun is too often absent, as in Scotland, the greater the importance of skills and sprawl.

In the final chapter in this part, Paul Hallwood and Ronald MacDonald turn away from structural policies to look at an issue with great political salience in Scotland, as in many other regional polities, namely the characteristics of an effective financing mechanism for regional governments. Hallwood and MacDonald start with an analysis of what recent economic theory suggests about how to align revenue and expenditure powers across multiple tiers of government in order to maximize allocative efficiency and growth without jeopardizing macroeconomic stabilization or redistribution objectives. They then examine how other states have approached these challenges. They conclude that the asymmetric nature of devolution within the UK (expenditure but not taxation) and institutional considerations may have limited the potential efficiency gains. They suggest a different equity/efficiency trade-off is needed in an optimal financing system for subnational governments.

Part 2: Opportunity

Higher economic growth is the priority for many European regions, especially in the context of demographic change and the pressure that is likely to place on pension provision and government expenditures. At the same time, most also value social cohesion extremely highly, and the political centre of gravity in Scotland is certainly squarely in this tradition. This part of the book looks at the ambition for greater opportunities for all citizens in the context of a dynamic economy. Both chapters conclude that investing in the young is where growth and opportunity meet.

James Heckman and Dimitriy Masterov assess the evidence on the formation of human capital. Their central insight is that families, not schools, are the key sites of skill formation. Hence, any commitment to equity of opportunity for all children must involve ensuring the acquisition of skills through support for appropriate parenting. Both cognitive and non-cognitive skills are formed in the early years of life. Cognitive skills are largely determined by the age of eight while non-cognitive skills remain more malleable into the teenage years. Remedial interventions thereafter are both costly and less effective. The policy implications of this analysis are significant, notably that where there are scarce funds, returns to society are maximized by focusing expenditures on the early years rather than universal university tuition fee support, since only a small proportion of the tertiary student population is truly income constrained. Investments in schooling should be subject to rigorous cost–benefit analysis and the focus should shift to improving teacher quality.

Chapter 7, by Heather Joshi and Robert Wright, sets the demographic scene in Scotland. The main factor contributing to its ageing population, as in the rest of Europe, is a low fertility rate. Broadly speaking, this is lower the further south and east one travels in Europe but Scotland stands out from the rest of the UK, and from near neighbours such as Ireland and Denmark, in having a low fertility rate, typical of the Mediterranean. The chapter introduces the first results from the Millennium Cohort Study, a new dataset tracking a large sample of children born mainly in 2001 in Scotland and the rest of the UK. The striking result is evidence of a social and economic polarization between women who start childbearing early, often having relatively few labour market prospects, and those with better educational attainments and earning power, who start their families when they are near or into their 30s. There appears to be a hollowing-out of the birth rate among women in their 20s. The results make the case, the authors argue, for public policies to offer more support to families with working parents. Whether or not this would succeed in stabilizing or raising the fertility rate, as evidence from Scandinavia and France hints, better support for all children is a necessary response to the social polarization apparent in the data. Nurturing the nurturers is vital because of the impact they have in shaping the skills, well-being and productivity of the next generation.

Part 3: Governance

Both Chapters 6 and 7 in Part 2 imply the need for a substantial reconfiguration of existing public policies, especially government spending priorities. The final part turns to what is arguably the most important question of all for anybody interested in policy, namely *how* to implement the recommendations that follow from the first two parts of the book. This in turn can be divided into two issues. How can we ensure that the delivery of public policies is as effective as possible and offers value for money, given both the growth and opportunity objectives? And how can we improve, within a particular institutional and political framework, the set of policies chosen to improve growth and enhance opportunities, given the need to develop a consensus among many participants and stakeholders whose interests may conflict?

Nicholas Crafts sets out the evidence that public services, especially health and education, are valued extremely highly and can also make a greater contribution to economic growth than is widely appreciated. In Scotland, as elsewhere in Europe, the public sector accounts for a large share of GDP, making value for money paramount. However, the evidence is that the efficiency and effectiveness of health and education services are often disappointing. One reason is the providers of services often have little incentive to deliver the outcomes users want, in the absence of the profit motive and competition which align managers' and owners' incentives more closely in the private sector. In the UK, including Scotland, the government has placed much emphasis on setting targets to monitor and improve the productivity and quality of public services. Crafts argues for two alternative approaches: better measurement of the value of services, to allow greater use of social cost–benefit analysis and to emphasize how much is at stake for citizens; and greater competition or contestability in the provision of public services in order to improve incentives in the public sector and stimulate innovation. Both approaches can assist in overcoming institutional hurdles to reform within the organization of the public sector.

John Bradley draws on the experience of Ireland, often eyed enviously in Scotland as a model for Celtic growth, but in fact facing from the 1950s onwards the simpler task of economic convergence from a low level of GDP per capita rather than renewal. However, the lesson of the Irish experience in its transition from a protectionist, agricultural economy to a highly open, hi-tech economy is that the conceptual framework for policy is decisive. Ireland and Scotland are archetypes of two types of European economic unit—the region of a large nation and the small nation state—and now face similar economic policy challenges. Bradley argues that while the politics of institutional design and implementation are different in the case of regions and nations, both need to combine economic analysis with insights from business research to get the right conceptual framework for a renewal of growth, a second or third wind. The task of policy makers is to create a favourable economic environment, and this involves close alignment between government and business.

Finally, we highlight the principal conclusions and challenges emerging on policies to grow small economies in general and the Scottish economy in particular. The conclusion emphasizes the role of greater openness, incentives and capabilities in stimulating future growth. But it also stresses the importance of winning the battle for people's hearts and minds in support of good policy, because if the politics do not make sense, the policy will rarely change.

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