Reforming Scotland

Economic Growth in Scotland: From Ideas to Policies

Reforming Scotland

Economic Growth in Scotland: From Ideas to Policies

Professor David Simpson
Professor David Simpson founded the Fraser of Allander Institute in 1975, and was Professor of Economics at the University of Strathclyde from 1975 to 1988. From 1988 to 2001 he was Economic Adviser to Standard Life. From 2005 to 2012 he was Vice-Chairman of the Water Industry Commission for Scotland.

Reforming Scotland
This is the latest in a series of individual contributions to the publication, 'Reforming Scotland', which aims to set out a possible vision for Scotland's future which can inform and influence the policy debate in the coming years. The contributions are by people from a range of different backgrounds and political perspectives who have looked at how policy could be reformed across a range of different areas and they represent the views of the authors and not those of Reform Scotland. They are published under the banner of our blog, the Melting Pot, since they are in keeping with the shorter pieces done by various people for this which can be found on our website reformscotland.com

August 2016
Reform Scotland is a charity registered in Scotland (No SCO39624) and is also a company limited by guarantee (No SC336414) with its Registered Office at 7-9 North St David Street, Edinburgh, EH2 1AW

About Reform Scotland

Reform Scotland, a charity registered in Scotland, is a public policy institute which works to promote increased economic prosperity and more effective public services based on the principles of limited government, diversity and personal responsibility.

Reform Scotland is independent of political parties and any other organisations. It is funded by donations from private individuals, charitable trusts and corporate organisations. Its Director is Geoff Mawdsley and Alison Payne is the Research Director. Both work closely with the Advisory Board, chaired by Alan McFarlane, which meets regularly to review the research and policy programme.

About The Melting Pot

The Melting Pot is our guest blog page, where Scotland's thinkers, talkers and writers can indulge in some blue sky thinking. **The posts do not represent Reform Scotland's policies.**

Reform Scotland's Advisory Board

Economic Growth in Scotland: From Ideas to Policies

We can begin by reminding ourselves why economic growth matters so much. To Adam Smith and his contemporaries and successors whose ideas formed the Scottish tradition of Political Economy, economic growth was important because it offered the only route out of the poverty that the vast majority of human beings had endured from the earliest times. Now that we in the West have made that escape, economic growth is still vital to us because we need it to generate the increasing tax revenues to pay for the sophisticated health, education and other welfare services that today we have come to take for granted, services that continue to increase in cost.

This chapter is divided into three parts. The first part defines the Scottish tradition of Political Economy. As we shall see, this has some congruence with Craig Smith's Scottish Liberal Tradition.

The second part of the chapter discusses the principles that govern current global thinking about economic growth, most of which derive from the Scottish tradition.

In the third part of the chapter we discuss the application of these principles to the formation of economic policy. How do we improve the historic underperformance of the Scottish economy, and thus release it from its relationship of dependence on England?

1.The Scottish Tradition of Political Economy

The Scottish tradition can be defined by a set of Principles to which most of its members would, consciously or unconsciously, have subscribed. The tradition began in the eighteenth century with David Hume, Adam Smith and Adam Ferguson as the leading figures. There were of course many others. Thereafter the tradition was kept alive in the Scottish universities down to the middle of the twentieth century by a succession of distinguished scholars. Among the last of those were Cairncross and Macfie at Glasgow, Gray at Edinburgh and Nesbit at St Andrews. All of these men had retired by 1960, when the economics curricula in the universities of the Western world were overturned by the arrival of something called 'the neoclassical synthesis'. First year courses were re-built to follow Samuelson's textbook and its many imitators. The teaching of Economic History and the History of Economic Thought virtually disappeared. University departments changed their names from 'Political Economy' to the more trendy 'Economic Science'. In its native land the Scottish tradition was extinguished overnight. Like the Austrian school, however, it survived by emigrating to America, its most distinguished proponent there being Buchanan. For half a century political economy remained marginalised within the mainstream of economic theory, but the undermining of the neoclassical analysis by the events leading up to and following the financial crisis of 2008-9 offers scope for its return, not as a peculiarly Scottish approach but as a global one.

The characteristic features of the political economy tradition are principally three. The first is the belief that the growth of the economy rather than relative prices should be the principal object of study. Coupled with that belief is an understanding of the market economy as being a collection of processes of continuing change rather than a structure, and that the nature of this change is self-organising and evolutionary. Finally there is a conviction that economic activity is rooted in human nature and in the interaction of individual human beings within institutions, many of which have evolved without conscious design.

Political economy therefore sees economic activity as being inseparably linked to other areas of human activity, notably politics and the law, and should not be studied in isolation from them. Since its origins lay in discovering principles for wise policymaking, it does not, or did not, always clearly distinguish between what we should nowadays call positive and normative statements.

2. Principles of Economic Growth

(i) Perhaps the most basic principle is the Rule of Law: personal security, public order and protection of private property. In Smith's words "“Little else is required to carry a state to the highest degree of opulence from the lowest barbarism but Peace, Easy Taxes and a Tolerable Administration of Justice; all the rest being brought about by the natural course of things.” [1]

We can still observe in the world today that economic activity is impossible in regions where there is violent disorder. Smith made no bones about the fact that, after security, the protection of private property was the most important function of government. Without such protection there could be no incentive to accumulate capital.

(ii) The second most important principle is freedom of trade. Trade, pricing, investment and innovation should be the responsibility of

[1] A. Smith, *Essays on Philosophical Subjects*, Oxford: The Clarendon Press, 1980, p.322

markets. For markets to work properly, there should be strong incentives to work, save and invest. In modern parlance, there should be an environment in which it is easy to do business. The Scottish economists were keen to point out that free trade would have a number of beneficial effects on human behaviour, encouraging punctuality, integrity (business men who betrayed the trust of their colleagues or customers would not survive), and outward-lookingness (internationalism).

(iii) The implication of a primary reliance on markets to bring about growth is that governments should play only a limited part in economic activity. Where governments do intervene, their interventions should be predictable, not arbitrary.

(iv) One of the functions of government should be education. According to Smith, this was so important for society that it could not be left to the market, but had to be provided by government.

(v) But the really important aspect of free trade is that it permits specialisation, or the 'division of labour' as the Scots called it. As we shall see, this is the key driver of growth.

(vi) Personal characteristics, too, are important for growth. Chief among these, according to Smith, is ambition – or in modern parlance, aspiration. Not far behind are parsimony (frugality) and an ethic of hard work. These must be complemented by a sense of social responsibility – concern for the well-being of one's neighbour. Greed is *not* good.

(vii) Another important principle is self-reliance or self-help. This is the opposite of dependence, a factor that is as corrosive at the social level as it is at the individual level.

(viii) The Scottish economists took it for granted that sustained growth would require a stable monetary regime that was not subject to political manipulation.

It will be noticed that the foregoing list of influences on the rate of growth are all 'supply-side' factors. The Scottish economists would have been surprised to learn that economic growth could be promoted by artificially stimulating aggregate demand. Of course, from Hume onwards they realised that an expansion of the money supply could result in a temporary upturn in economic activity, but it did not occur to them to think that this could be effective in the long run. And the long run was what they were interested in.

Specialisation and Economic Growth

Adam Smith's greatest contribution to economic theory was his emphasis on the importance of specialisation as the source of increases in productivity and hence of economic growth. No other economist before or since put so much weight on this factor. His conclusion emerged from his own twelve year research using historical evidence to try to find out why the economies of some countries grew at certain periods and not at others, while other countries had remained trapped in backwardness. Taking Britain as a case study, he noted that over his lifetime more, although not all, people were slowly becoming better off. As a result of the growth of trade and the consequent increase in specialisation the living standards of the employed common labourers in Scotland had improved, although not by much. He wanted to know what inhibited the British economy from growing more rapidly. He concluded that faster material progress for the poorest majority was being held back by the political handicaps of protectionism, monopolies, internal restrictions on commerce and unwise external adventures such as colonial wars. Does this sound familiar?

The failure of most of the world's population to advance beyond the hunting stage by the eighteenth century suggested to him that economic progress was not inevitable. The right 'recipe' had to be found. Smith saw the problem as being how to overcome the political, institutional and psychological constraints embedded in society that were obstacles to economic growth. He saw his task as being to identify the practical policies that contemporary legislators could adopt to weaken those constraints.

Smith lived and died before industrialisation really got under way. Writing about specialisation in an economy dominated by agriculture and trade, it is understandable that he did not appreciate the full significance of the increasing returns to be obtained from specialisation. These productivity gains cannot be illustrated by the deliberate reorganisation of tasks within one workshop at a moment of time. Almost a hundred years later both Marx and Marshall observed the continuous growth in productivity that followed from the specialisation of industrial activities. But it was left to Allyn Young in 1928 to extend Smith's thinking, and to give a systematic exposition of the role of specialisation in economic growth. [2]

---

[2] Young described Smith's observation that the division of labour is limited by the size of the market as being " ...perhaps the most fruitful generalisation in all of economics.", A. Young, "Increasing Returns and Economic Progress", *Economic Journal* December 1928.

Young pointed out that the progressive division and specialisation of industries that takes place over historical time gives rise to increases in productivity at the level of the economy as a whole. The biggest gains come about from using labour in more and more indirect or roundabout ways, such adaptations producing new technologies, new forms of capital and new knowledge, and result in increasing returns. In other words, it is organisational specialisation, the progressive subdivision of productive processes resulting in increasingly indirect methods of production that is mainly responsible for the aggregate productivity gains that constitute economic growth in a market economy.

A virtuous spiral of increasing specialisation and productivity is continuously at work in every well-functioning industrialised market economy. As increasingly specialised equipment is used in any part of an economy the productivity of the process incorporating that equipment rises. Whether that productivity gain is reflected in increased wages or increased profits in the industry concerned, when these wages or profits are spent they will contribute to an expansion of purchasing power in the economy as a whole, i.e. to an increase in the size of the overall market. This will in turn result in an increase in the demand for some goods and services which will justify a further degree of specialisation in those industries, thus raising aggregate output still further, and so on in a cumulative spiral of growing output and incomes. This process of economic growth does not depend for its continuation on changes in any external factors such as increases in population, new scientific knowledge or access to new markets, although these factors may of course augment what is otherwise an entirely endogenous and self-organising process.

3. Principles and Policies to Encourage Growth in the Scottish Economy

The rate of growth of the Scottish economy has for long been below that of England, and even further below its counterparts among the smaller countries of North Western Europe. How can this situation be changed? Primarily by creating a business environment that's attractive to entrepreneurs, not just native ones but foreign ones as well. When the pool of native business talent is quite shallow, as it is in Scotland at the present time, then the need to attract incomers is more urgent. Experience suggests that if you create a sympathetic environment, entrepreneurs will come. One third of the successful business start-ups in California between 1980 and 2000 had Indian-born or Chinese-born founders.

The modern recipe for economic growth is well-known, even if it is frequently ignored for political reasons. It can be illustrated by the experience of Singapore. When that country gained its independence in 1965 by leaving its political union with Malaysia, it was so poor that anyone who suggested at the time that Scotland would have anything to learn from a backward Asian country would have been laughed at. Today those same people would no doubt argue that Singapore was too rich a country for us to compare ourselves with. Singapore became rich by following a fairly simple set of principles, most of them recognisable from the list in section two above.

The first principle is self-reliance. Right from the beginning, Singapore refused to accept foreign aid of any kind. By doing so it avoided a culture of dependence and established instead a culture of confidence. This is the exact opposite of the economic policies of the unionist parties in Scotland, (in so far as they can be said to have any). The Labour Party openly advocates dependence on continuing fiscal transfers from the south east of England. This is the philosophy of the begging-bowl, or perhaps the cargo cult. It is a policy that is tacitly shared by the other unionist parties.

The second policy principle for modern economic growth is freedom of trade, with low rates of business taxation and light, but smart, regulation. Singapore is at the top of the World Bank's annual *Doing Business* rankings, which measures the ease with which entrepreneurs can conduct business in a country. The metric uses 10 factors and covers 183 countries. Countries with better *Doing Business* rankings tend to have higher life expectancy rates.

A third principle is the rule of law. The Singapore strategy emphasises personal security, public order and the protection of private property.

Finally, there is stable money. A currency board provides stable prices and free convertibility at a fixed exchange rate which attracts foreign investment. It also delivers discipline to the spheres of money, banking and fiscal affairs.

What about Government? Singapore has a small, transparent system of governance that minimises red tape. It appoints only first class civil servants and pays them first class wages. In return for high salaries, the civil servants are expected to tolerate no waste (Edinburgh's trams) and no corruption. The Singaporean Government plays a central role in the country's healthcare market. Its health care system is characterised by innovation (e.g. personal health savings accounts), simplicity and transparency, resembling neither the public monopolies of Europe nor the complex regulatory nightmare of the US.
This is light years away from the public sector scene in Scotland today. How can that change? Change will not be brought about by argument but by the facts on the ground. Governments everywhere, not just in the UK but throughout most of the Western world, are heavily in debt and have great difficulty in meeting their current expenditure commitments, especially the

financial demands of their healthcare services and the needs for new infrastructure. Things cannot go on as they are. The alternatives are either ‘austerity’ (higher taxes and lower public expenditure) prolonged indefinitely or doing things differently. What we need is not just smaller government, but smarter government.

That this is possible in Scotland is demonstrated by the experience of Scottish Water, a public sector monopoly. When it was formed in 2002, the water industry in Scotland had operating costs and levels of service that were about thirteen years behind those of the same industry in England and Wales. Average household water bills in Scotland in 2002 were £19 higher than the average in England and Wales. Since then, operating costs have fallen by around 40%, so that household bills are now £50 lower than the average bill south of the border. This has been achieved by smart regulation providing strong incentives that reward both management and workers for meeting stiff targets.

Resources in the public sector in Scotland and elsewhere will be stretched for many years to come. A business-friendly environment, the only kind that will produce faster growth, means lower tax rates at both the corporate level and at the higher end of the income tax scale. Well judged reductions in tax *rates* should produce increases in tax *revenue*s in the medium term, but in the short term increased taxes on consumption may have to take some of the strain. Consequently a fiscal regime in which income taxes alone are devolved will never be able to deliver economic growth, which is perhaps why this has been offered.

A further important role for Government is in the provision of finance for infrastructure. Only government investment in the necessary infrastructure will make the exploitation of many of Scotland’s natural advantages, especially renewable sources of energy, commercially attractive.

The recipe for promoting economic growth that Scotland can learn from the success of other states is that sovereignty brings two essential ingredients: the ability to design policies to suit the country’s own circumstances and a culture of confidence. As Keynes pointed out, the principal determinant of the level of private investment in a market economy is not the rate of interest nor even the level of aggregate demand but the state of business confidence. The prosperity that many other small states enjoy today is an indication of what is possible for Scotland.

Reform Scotland is committed to informing and influencing the public policy debate in Scotland.

The Melting Pot is Reform Scotland's guest blog, where Scotland's thinkers, talkers and writers can indulge in some blue sky thinking. The views expressed do not necessarily represent those of Reform Scotland.

www.reformscotland.com/category/melting-pot