Minute of the Second Meeting of the Council of Economic Advisers

8 October 2015 (Bute House)

The following Council Members were present:

First Minister Nicola Sturgeon MSP (8th only)
Crawford Beveridge (Chair)
Sir Harry Burns
Professor Sara Carter
Jim McColl
Professor Mariana Mazzucato
Amanda McMillan
Professor Sir James Mirrlees
Professor Anton Muscatelli
Professor Frances Ruane

Also present:
Deputy First Minister and Cabinet Secretary for Finance, Constitution and Economy
Graeme Dickson, Director General Enterprise, Environment and Innovation, Scottish Government
Dr Gary Gillespie, Chief Economist, Scottish Government
David Patel, Deputy Director, Office of the Chief Economic Adviser, Scottish Government (8th Only)
Uzma Khan, Senior Economist, Office of the Chief Economic Adviser, Scottish Government
Kevin Brady, Economic Adviser, Office of the Chief Economic Adviser, Scottish Government
Malcolm Fleming, Special Adviser, Scottish Government
Mia Ayres, Deputy Private Secretary to the First Minister, Scottish Government (8th Only)

Purpose

This note provides an overview of the key points arising during the second meeting of the refreshed Council of Economic Advisers. The meeting took place over the afternoon of 8th and the morning of 9th October, and focused on inclusive growth, inequality, innovation, and the measurement framework for Scotland's Economic Strategy.

Welcome

The First Minister and the Chair of the Council of Economic Advisers welcomed attendees and outlined the programme for the meeting.

Apologies had been received from Professor Joseph Stiglitz, who was unable to attend the meeting due to another commitment.

Update on Developments

The Chair gave an update on developments since the last Council meeting in March.

Council Members had held two conference calls with officials in May and August. The call in May had considered remits for the Council's workstreams on inclusive growth, innovation and measurement, and early priorities for analysis in each of these areas. The call in August had focused on inclusive growth in greater depth, including initial considerations for the development of a Scottish policy framework for inclusive growth and key inter-linkages.

On the morning of 8th October, the Chair, Professor Carter, Mr McColl and Professor Muscatelli gave evidence to the Scottish Parliament's Economy, Energy and Tourism Committee on the work of the Council.

In his capacity as Chair of the Council, Mr Beverage attended the meeting of the Innovation Forum on 7th October as an observer. The Chair also highlighted his recently announced role leading a review of Scotland's planning system. (This position was unconnected to his role as Chair of the Council.)

The Chief Economist gave an overview of wider developments since the March meeting that touched on the Council's areas of work:

- In June, the First Minister led a discussion on inclusive growth at the World Bank, involving officials from the World Bank and IMF;
- The Deputy First Minister led a discussion on inclusive growth with European and international policymakers at Bruegel – a Brussels-based think tank – in September, with an OECD official responding to the Deputy First Minister;
- There is continuing dialogue between the Chief Economist and OECD officials relating to inclusive growth and measurement of wellbeing. The Chief Economist has agreed to present the emerging framework at the OECD.

Priorities of Government, State of the Economy, Public Finances

The First Minister gave Council members an overview of the Scottish Government's policy priorities, as set out in the Programme for Government.

The Chief Economist gave an update on recent economic developments in the global, UK and Scottish economies. Points discussed during this update included:

- The evolving economic context for policymakers in Scotland: GDP and employment levels had risen above pre-crisis levels and in many areas the economy was returning to pre-recession norms. However real wages, though now growing, were still below pre-crisis levels in real terms with recent rises being attributable in part to near zero inflation. Low commodity prices were having varying impacts on the economy in Scotland (particularly oil prices) and the weaker external environment (particularly China) was maintaining wider deflationary pressures;

- Significant external headwinds remained for the Scottish economy, including continued uncertainty and divergence in economic performance within the Eurozone, and the slowdown in China's economy;
- The Scottish economy had grown for 12 consecutive quarters, but the latest data (for Q2 2015) were the weakest for several quarters. This reflected the negative impact of the contraction in onshore activities associated with oil and gas, including supply chain impacts. GDP growth in Scotland had been supported by the performance of the construction sector, where public sector investment in new infrastructure had driven output growth.
- Business expectations in Scotland remain broadly positive, although there are variations across business sectors. There are positive expectations around future growth for 2015.

The Deputy First Minister provided a brief update on developments around the UK Government's Comprehensive Spending Review, the outcome of which would not be known until 25th November.

Inclusive Growth

The Chief Economist gave an overview of emerging thinking in SG around inclusive growth, which had built on the discussions during the Council's conference calls. Inclusive growth has important interdependencies for the other key elements of Scotland's Economic Strategy (Investment, Innovation and Internationalisation), and has policy implications beyond traditional labour market policies.

Following the Council's conference call discussions, recent work had focused on development of a policy framework for inclusive growth, which is intended to help identify contributions, synergies and trade-offs between individual policies and objectives. This framework was being piloted with the Scottish Government's Directorate for Housing, Regeneration and Welfare, and was also the subject of on-going engagement with the OECD.

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

- The framework recognised the inter-linkage of inclusive growth with the Investment, Innovation and Internationalisation, the potential importance of the labour market and the need to recognise the impact of policy across the different spheres of the framework and over different time periods.
- There was discussion around how the framework could be developed into a practical model to support policy delivery, and to test assumptions underpinning policies. The importance of those involved in delivery understanding the impacts of policy was highlighted. There was also discussion about the use of improvement science, with a method and data to drive change in these key policy areas.
- The importance of corporate governance and behavioural change was noted as something that was potentially missing from the framework. The need to encourage business to look beyond the short term, and to have innovation and investment activity based on a longer term horizon, was emphasised. There was discussion of the Business Pledge in this context and the extent to which this policy, although voluntary, could be developed further to capture

the importance of corporate responsibility. Early indications around the Business Pledge policy suggested there were examples of culture and behavioural change, which the Scottish Government will continue to monitor.

It was recognised that inclusive growth was an emerging area of interest internationally and the work being developed in Scotland was potentially more applied given the range of new policy initiatives. There was an opportunity for Scotland to be a ‘brand leader’ in this area and lead the international agenda. It was recognised that continued engagement with organisations like the OECD and World Bank was beneficial.

The Council were encouraged by the work on inclusive growth that had been undertaken to date. It was agreed that further work would be taken forward to identify drivers around uptake of the Business Pledge, and analysis of the priority policy areas, including childcare and procurement, using the inclusive growth framework.

Innovation

The Deputy First Minister and Chair updated Council members on the previous day’s meeting of the Scotland CAN DO Innovation Forum.

The Innovation Forum includes members from several notable innovative companies in Scotland, along with representatives of Scotland’s universities and funding bodies. Its work is focused around the themes of Ambition, Connections and Culture, with the previous day’s meeting’s conversations revolving around how to motivate a wider group of individuals and companies to participate in innovation, how to make it easier to access new ideas, and how to improve connections through modern technology. The overarching aim was of making involvement in innovation a more mainstream, rather than niche, activity in Scotland.

The Deputy First Minister highlighted that a key priority for innovation policy in Scotland related to focusing the diffuse range of current innovation activities in Scotland. In order to ensure that its work dovetailed with that of the Innovation Forum, the Council was asked to focus its advice on the activities that could make a difference to Scotland’s innovation performance, and on how Scotland was performing.

9 October 2015 (St Andrews House)

The meeting resumed on Friday 9th October. The Chief Economist recapped on the previous day’s discussions, while members offered their reflections, particularly around inclusive growth. It was agreed that the important issue in this area lay around embedding ‘inclusiveness’ in policies aimed at supporting growth, and in the overall economic agenda.

Inequalities

Professor Sir James Mirrlees gave a presentation on some emerging research on income and wealth inequalities. Key points included:

- Gini coefficients for income are lower than those for wealth in the US and UK. although income Gini coefficients in both countries are relatively high. Income inequality is arguably of greater concern than wealth inequality, from a life cycle perspective.
- Income inequalities stem from inequalities in earnings, capital, and investment returns. Wealth inequalities arise from unequal incomes in the past, variations in savings (partly from differences in profits, losses, and random windfalls), and variations in giving and receiving.
- Randomness of returns to capital may be a major cause of inequalities. Investment is inherently risky, and it is empirically difficult to distinguish success and returns due to effort from those due to chance. Wealth exhibits 'random walk' characteristics – these might explain a considerable part of observed inequality.
- These insights can also apply to labour income, as well as capital income. Education, career and job-search decisions are similar to investment decisions, subject to risk, and with uncertain outcomes.
- The cause of inequality matters for policy decisions. Redistribution should apply to the source of inequality – earnings, and excess income from capital.

Professor Anton Muscatelli offered the initial response to the presentation, which was followed by a wider discussion among Council members. The following points were noted:

- Understanding the drivers of inequality (such as the role of technology, education and bargaining power) is essential to developing an inclusive growth agenda.
- Important to recognise the dynamics of wealth in UK – housing and property, rising value of inheritance. Gains from these are often not the result of productive investments by the beneficiaries themselves.
- Redistribution through the tax and benefit system is important for reducing inequalities, but there needs to be greater focus on drivers that affect inequalities in market incomes. Priorities would include early years.
- Change in corporate environment in 1980s onwards: perception of shareholders being only risk-takers leading to shareholders having main claim on 'residual'.
- Changes in corporate governance and culture to promote 'long termism' are needed, as is a recognition that 'risk takers' are a wider category than private shareholders. The importance of greater corporate responsibility (e.g. through the Business Pledge) was emphasised.
- The need for improvements in employability initiatives such as the Work Programme were noted, given their importance in addressing economic inactivity and improving resilience.

There was also a wider area discussion of the drivers of inequality, growth in financial services activity, focus on short term returns and the ability of certain sectors of the economy to extract economic rents above market norms. The marked reduction in the top rate income tax threshold in the US and elsewhere.

Innovation

Professor Mariana Mazzucato gave a presentation on Innovation Policy, concentrating on government's role in innovation. Key points included:

- The public sector's role in the innovation economy is about more than creating 'level playing fields' or addressing market failures: it sets and supports 'missions' that guide innovation activity, and help development and use of general purpose technologies.
- US experience shows that Government plays an important role each stage of the 'innovation chain', not just at the basic research stage.
- The public sector's role as an investor raises issues around sharing risks and rewards associated with innovation. Ensuring taxpayers receive clear benefits from innovation investments help offset costs of 'failed innovation'. Approaches to this include providing income-contingent loans, retaining equity, allocating shares of 'payback' from successful innovation into innovation funds, and state investment banks.
- Challenges for economic policy include: learning how to actively set directions for change (missions); evaluating public sector investments; building explorative public sector organisations – ones that welcome trial and error; and, how to socialise risks and rewards from innovation.

Professor Frances Ruane offered the initial response to the presentation, before a wider discussion took place. The following points were noted:

- Government has an important role as a long run investor, with different investment timescales to private actors. Important to understand how government interacts with each part of the innovation ecosystem.
- How far is the US innovation 'narrative' replicated in Europe, and what actors play the equivalent roles of US institutions.
- Need to explore what drives differences in R&D behaviour between Scotland and other countries: industrial structure; policy landscape. Need to avoid establishing a system that tries to incentivise R&D in sectors with low innovation potential and capacity.
- Question of what Scottish 'failure' in business R&D activity is: are companies focusing on research, development, doing both or neither. Does Scotland's higher education sector substitute for companies' basic research.
- The importance of a country's vision for innovation was emphasised: this helps attract talent and investment (e.g. Denmark and wind technology).
- Contracts matter for how innovation takes place, as they determine relationships, and distributions of risks and rewards.
- Scottish examples of approaches to sharing risk and reward include initiatives like Scottish Enterprise's Co-Investment Fund.

The Council requested that further analysis be undertaken around the factors underlying differences in R&D and innovation performance between Scotland and other small countries, and that analysis be undertaken to identify the Scottish

Government and its partners' innovation activities and spend against the stages of the innovation value chain.

Measurement

The Chief Economist gave a brief update on developments since the last Council meeting regarding measurement of the priorities in the SES and economic progress, along with wider developments around performance measurement in the Scottish Government. These included the Scottish Government signing up to the United Nations Sustainable Development Goals, progress with the refresh of the National Performance Framework, and OCEA's on-going engagement with the OECD on measurement of wellbeing.

The Chief Economist undertook that OCEA would continue to take forward work around measurement of Scotland's Economic Strategy and its ambitions, and provide options to the Council for consideration and approval before the New Year.