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Notes to contributors

The editors welcome contributions to the Economic Perspectives section. Material submitted should be of interest to a predominately Scottish readership and written in a style intelligible to a non-specialist audience. Contributions should be submitted to Cliff Lockyer c.j.lockyer@strath.ac.uk

Articles accepted for publication should be supplied electronically and conform to the guidelines available from Isobel Sheppard at: fraser@strath.ac.uk

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Outlook and appraisal

Overview

Since we last reported in October there has been a considerable deterioration in the actual and forecast performance of all the major economies. In October we considered there was a ‘high probability’ that Scotland would go into recession in 2009. Now, we are certain that not only is Scotland currently in recession but that the recession looks likely to be as severe as that in the 1980s and could even be worse. The tentacles of recession are spreading throughout the economy with construction and financial service activity subject to sustained contraction, hotels & catering turning down from the first quarter of last year and real estate & business services contracting appreciably after March. Economy-wide GVA contracted by -0.8% in the third quarter and seems likely to have fallen markedly in the fourth quarter if the UK’s performance is any guide. Third-quarter manufactured exports decreased by 1% in real terms and by 0.4% over the year. Business surveys covering the fourth quarter period reinforce the expectation that the slowdown will be severe. In the labour market employment is falling and unemployment is rising.

We are in the midst of a deepening world recession driven by significant falls in aggregate demand, as the effect of bursting asset prices bubbles in property and shares leads households to scale back demand. High levels of household and corporate debt are also influencing the scale of the cut back in aggregate demand. With world demand generally contracting the principal exporting countries are likely to be disproportionately hit, other things equal. Conversely, those countries with a productive structure where exports count for disproportionately less e.g. the US, and where the public sector is disproportionately bigger, might be expected, other things equal, to do less badly in the recession. France offers a

possible example on both criteria. In these circumstances the impact of the recession on the UK and Scotland will not be the worst in the world as some have predicted.

The banking crisis and the apparent freezing of the credit supply function are secondary to the fall in aggregate demand. However, one should not minimise their importance. Lending has clearly dropped considerably, in part because individual countries have lost the lending previously provided by foreign banks. In the UK this amounted to about 30 percent of overall lending. Lending by UK banks has also declined as they seek to rebuild their balance sheets. The drop in the supply of credit has clearly accelerated the downturn in GDP as any monetary buffer that might have been available to provide working capital to help companies adjust more slowly to the downturn in demand has been removed. It remains to be seen how quickly the UK government's injection of capital into many of the key British banks, the introduction of its loan guarantee or insurance scheme, and the lower interest rates and quantitative easing effected by the Bank of England's Monetary Policy Committee, mitigate the scale and duration of the recession. It is clearly the case that in the face of severe restrictions on the supply of credit any recovery in demand and GDP growth will be more difficult to engineer.

The developing scale of the global downturn suggests that the US fiscal package is unlikely to compensate for the depressing effect on world trade of the US recession, although it may mitigate it, and will not be sufficient to substitute for inadequate demand stimulus policies in the surplus countries. As world demand contracts there are rising protectionist fears and a clear need to develop a better global governance of the financial system. The UK fiscal injection appears to be too little too late, and relatively small compared to the US stimulus package. A case can be made for a further fiscal stimulus, although rising public sector debt and foreign exchange market pressure on sterling may limit the government's options. The significant loosening of monetary policy in the UK, which is continuing, appears to be thwarted by a 'liquidity trap' as asset prices fall and economic agents seek to hold cash rather than invest or spend. The case for temporary bank nationalisation in the UK and the creation of a 'bad bank' for toxic assets appears to grow stronger as the only effective means of unfreezing lending.

With macroeconomic policy powers reserved to Westminster the Scottish economy will benefit from the UK fiscal injection. Yet, while the Scottish government action will contribute little to aggregate demand it can play a constructive role in helping the economy adjust to the consequences of the recession and mitigating the effects on long-term growth.

Against this background we have prepared new forecasts that significantly revise downwards our expectation for Scottish growth over the next three years. Again because of the heightened levels of uncertainty we present a range of forecasts. On this occasion, a central forecast, which is bracketed by 'optimistic' and 'worst' projections.

On our central case we predict that GVA will fall by around -2.6% this year and by -1.2% next year. Recovery does not begin to get underway until 2011 and remains below trend in 2012. Employment is forecast to decline by 14,200 in 2008, by 94,200 in 2009 and by 51,400 in 2010, a total net job loss of nearly 160,000 over the three years. Unemployment rises from 137,000 in 2008 to a peak of around 210,000 in 2010.

GDP performance in third quarter 2008

The latest official government outturn data for the Scottish economy refer to the third quarter 2008. Total Scottish gross value added at real basic prices fell by -0.8% in the quarter but rose by 1.4% over the year. The deterioration was worse in Scotland than in the UK – see Figure 1 - with UK GVA contracting by -0.6% in the quarter, while output over the year rose by 1.9%.

Service sector growth was appreciably weaker in Scotland during the quarter with an outturn of -1.1% here compared to -0.5% in the UK – see Figure 2. Over the year, Scottish services grew by 2%, while UK services expanded by 2.4%.

Within Scottish *services* the sector contributing most to the weak performance of Scottish services during the quarter was *real estate and business services* (REBS), which accounts for 18% of overall Scottish GVA compared to 23% in the UK. REBS contracted by -3.7% in the quarter compared to a much smaller fall of -1.2% in the UK. GVA in Scottish REBS has been declining from the first quarter of last year – see Figure 6 – while UK REBS began to contract only in the third quarter. It is difficult to understand precisely why the downturn is more severe in the Scottish part of the sector. *Real estate and property related services* account for a 45% share of Scottish REBS, so there may be a property market link to the weaker performance of REBS. But the difficulty with this view is that the scale of the downturn in the housing market is greater in the UK overall, although that may not be the case in commercial property. Pure *professional & business services* make up a 13% share of REBS and they may be contracting more rapidly in Scotland because of banking and financial service linkages and the weaker performance of that sector in Scotland – see Figure 5.

Elsewhere in services, the *retail & wholesale sector* contracted in both Scotland and the UK during the quarter, by -1.5% and -2.7% respectively. But the additional data produced by the Scottish government indicating that it was wholesaling and not retailing that weakened in Scotland. Scottish Retail GVA rose by 1.9% in the quarter and by 3.1% over the year. *Financial services* while weaker in Scotland grew by 0.5% in the quarter compared to growth of 1.1% in the UK. Figure 5 suggests that Scottish financial services has consistently underperformed UK financial services since the second quarter of 2006, with the exception of the fourth quarter 2006 and fourth quarter 2007. We only have Scottish data for GVA growth in *banking* and this series indicates a fall of -1.9% in the third quarter of 2008. Other weaker Scottish service sectors in the third quarter included the *public sector*, which grew by 0.1% here compared to an increase of 0.5% in the UK. Other services contracted by -1% compared to growth of 0.8% in the UK, while *hotels & catering* cut back GVA slightly by -0.1% compared to growth of 0.3% in the UK. The only service sector, apart from retail and wholesaling, which out performed its UK counterpart was *transport & communication* which grew slightly by 0.1% compared to a small fall of -0.1% in the UK.

Manufacturing in Scotland contracted by -0.6% in the third quarter, a smaller contraction than in UK *manufacturing*, which cut back output by -1.6% - see Figure 3. Over the year, GVA in Scottish *manufacturing* rose by 1.9% whereas UK manufacturing output fell by -0.5%.

Within manufacturing, the relatively stronger Scottish performance in the third quarter was essentially driven by *chemicals*, - accounting for 10% of manufacturing GVA - which grew by a staggering 9.5% in the quarter, while UK chemicals expanded by only 0.5%. Such a large change suggests a one-off adjustment of some description and is, therefore, unlikely to be sustained. *Refined petroleum products* also turned in a very strong growth performance in Scotland compared to the UK, expanding by 6.8% while its UK counterpart contracted by -2.9%; however, the sector accounts for only 1.4% of Scottish manufacturing GVA. Most other principal manufacturing sectors displayed weak or negative growth in Scotland during the third quarter. The *food industry* grew by 0.3% here compared to 0.1% in the UK. The *drinks sector* experienced a fall in GVA of -0.7% in Scotland but registered a fall of -1.5% in the UK. *Engineering* overall contracted markedly both in Scotland and the UK by -2.3% and -2.5% respectively. Within engineering, the *electronics* sector cut back considerably in Scotland with GVA falling by -4.6%, while its UK counterpart registered a lesser but still marked fall of -2.9%. In contrast, both *mechanical engineering* and *transport equipment* grew by 0.1% and 0.4% in Scotland while contracting by -1.3% and -3.1%, respectively, in the UK. Finally, *paper, printing & publishing* and *other manufacturing* cut back production appreciably with the former contracting by -2.1% and the latter by -4.9%. The comparable UK figures were -2.1% and -2.8%.

Despite the relative buoyancy of the housing market in Scotland, the construction sector in Scotland has effectively been in recession for some time – see Figure 4. This clearly reflects a drop-off in demand for major project activity from both the public and commercial property sectors. GVA fell by -1% in Scottish construction inn the quarter, while UK construction activity dropped by -0.2%. GVA in Scottish construction has now dropped by more than 6% since its peak in the forth quarter of 2006.

Figure 6 brings together the GVA indexes for 10 key sectors that are, or have been, significant for the growth of the Scottish economy. The figure reveals the continuing strength in *chemicals* and *transport & communication services*, the weakness in *financial services*, *electronics*, and deterioration in *REBS* and *hotels & catering*.

Figure 7 provides a clearer picture of how the downturn is affecting the Scottish economy. It does so by charting the scale of the decline in sectoral GVA from the last peak in GVA in the sector. Clearly, we can't be certain whether the peaks identified actually do represent a cyclical peak and so the analysis could change once later data become available. It is appears to be the case that the downturn started in construction from 2006q3, which by 2008q3 had lost -6.3% of GVA in the sector. *Financial services* began to turn down two quarters later in 2007q1 and then contracted more sharply, with GVA falling by -8.5% by 2008q3. In the next quarter 2007q2 *mining & quarrying* started to turn down and by 2008q3 it had lost -2.5% of its

GVA. Of course, whether the downturn in mining & quarrying is related to wider forces promoting the recession in Scotland is a moot point and could well be unrelated. From the fourth quarter of 2007 *electronics* started to turn down suggesting perhaps that export demand for manufactures was starting to be affected by falling demand conditions across the globe. Then from the first quarter of last year *hotels & catering* and *REBS* registered falling output. The former will clearly have been affected by both slowing domestic demand and the effect on tourism of falling foreign as well as domestic demand. We discussed above some of the likely drivers of the downturn in REBS.

Recession issues and policy responses

What is driving the recession?

There is now much agreement that the ultimate cause of the global slowdown lies in the large financial imbalances in the world economy that built up over the past decade. Burgeoning current account surpluses from mid to late 1990s in China, other emerging market economies, oil exporting economies, Germany and Japan, led to significant flows of surplus savings mainly to the United States (70%), a little to the UK and an array of smaller economies such as Spain, Ireland and Iceland. These surplus savings served to lower long-term real and nominal interest rates across the world economy and fostered a boom in credit aided by the financial de-regulation that occurred in the US, UK and elsewhere in the early 1980s.

The boom in credit growth facilitated higher personal consumption and spending on a range of perceived high yielding assets, with associated growth in investment banking activities, hedge funds and private equity funds across the globe. Asset price bubbles began to emerge especially in housing and property markets in US, UK and some other European countries. The bubbles burst in 2007, as the US fed funds rate rose some 4 percentage points to 5.25% between 2004 and 2006, and the extent of credit excess began to be evident, e.g. failed repayments and foreclosures in US sub-prime mortgage market. Banking losses were initially triggered by the defaults on sub-prime-mortgages. But such losses were then magnified dramatically throughout the banking and financial system on a global scale due to the creation and rapid growth of complex financial instruments that were perceived to diversify risk and returns. Examples of such instruments include mortgage backed securities such as collateralized mortgage obligations (CMOs), collateralized debt obligations (CDOs) based on all types of assets including mortgages, and credit derivatives, especially the credit default swap (CDS), a way of insuring against losses on a loan portfolio, CDOs of CDOs and synthetic CDOs.

The complexity of these instruments meant that the losses generated by the deflation of house prices, commercial property prices, other asset prices, and associated loan re-payment defaults, could not easily be gauged or located. Banks began to lose trust in one another and inter-bank lending rates rose. Then, to dramatise the narrative, the major US and world investment bank Lehman Brother was allowed to go into administration by the US government on 15th September 2008. This sent a signal round the financial world that insolvent banks would not necessarily be bailed-out by governments, so inter-bank lending largely ceased and the wholesale money markets effectively froze. The consequent loss of confidence and trust in the banking and other parts of financial system led to a breakdown in the credit supply mechanism within and outside the system - the so-called “credit crunch”. The scale of the losses also meant that banks had to restructure their balance sheets resulting in loans being called in, overdrafts reduced, reduced possibilities for re-financing of corporate loans, and a general cut back in lending, further exacerbating the credit crunch.

There would appear to be some uncertainty about the specific drivers of the current downturn and hence the predicted consequences for national economies. There is a body of opinion that sees the bursting of the housing market bubble in the US, the extensive defaults on ‘sub-prime’ mortgages, the subsequent banking losses and insolvencies as locating the main incidence of the global downturn in those countries, such as the US and the UK, with previously highly buoyant housing markets, significant household borrowings and large banking and financial sectors. Hence, the OECD and the IMF and others have forecast that the UK will be one of the countries most affected by the downturn.

We take a somewhat different view and do not necessarily accept that the UK and Scotland will be the worst affected in terms of the size of the GDP contraction, although the downturn will be sizable here and perhaps unprecedented.

The first point to note, perhaps obviously, is that it is falling aggregate demand that is driving the contraction of GDP. Secondly, the banking crisis and the apparent freezing of the credit supply function are secondary to the fall in aggregate demand. However, one should not minimise their importance. Lending has clearly dropped considerably, in part because individual countries have lost the lending previously provided by foreign banks. In the UK this amounted to about 30 percent of overall lending. Lending by UK banks has also declined as they seek to rebuild their balance sheets. The drop in the supply of credit has clearly accelerated the downturn in GDP as any monetary buffer that might have been available to provide working capital to help companies adjust more slowly to the downturn in demand has been removed. It remains to be seen how quickly the UK government’s injection of capital into many of the key British banks, the introduction of its loan guarantee or insurance scheme, and the lower interest rates and quantitative easing effected by the Bank of England’s Monetary Policy Committee, mitigate the scale and duration of the recession. It is clearly the case that in the face of severe restrictions on the supply of credit

any recovery in demand and GDP growth will be more difficult to engineer.

Thirdly, as Martin Wolf notes[1] drawing on work by Richard Koo[2] on the Japanese deflation in the 1990s, falling asset prices will have a greater impact on demand the more assets have been funded by debt. This is because the evidence from Japan suggests that as asset prices fall borrowers will seek to pay down their debts so increasing saving and reducing consumption by more than would be the case from a simple wealth effect of the falling asset price. If this analysis is correct then significant falls in asset prices after a major credit boom and debt inflation are likely to precipitate large falls in aggregate demand. Moreover, the UK and the US where levels of household borrowing are high should, other things equal, experience a disproportionate drop in demand compared to those countries where household borrowing is lower even if asset prices have fallen similarly. And some asset prices such as those for houses and commercial property are likely to fall further in the US and UK. Added to this, the relatively greater size of the banking and financial sectors in the UK and US and the scale of the insolvency present in such banks offers a further reason, both in terms of direct demand reduction and restricted credit supply, why the UK and the US might suffer a more severe downturn.

So, the analysis so far might appear to suggest that the US and the UK are likely to experience a more deep and prolonged recession than other principal economies. But there is another issue that needs to be considered.

Fourthly, the downturn in aggregate demand is clearly worldwide, even though the incidence might vary *inter alia* according to the extent that asset price falls and household and corporate debt vary across countries. The worldwide contraction in demand is not of course confined to demand for domestic goods and services. Demand for imports is much affected and growing protectionist tendencies, including attempts to encourage domestic banks to lend locally rather than abroad, may serve to worsen the deterioration in import demand. However, import demand is not met evenly from the world economy. Countries such as Germany, Japan, China, and export 'platforms' such as Taiwan, Ireland and Singapore that serve world trade disproportionately through their export activity are likely to experience a sizable contraction in the demand for their goods and services. A simple numerical example should make the point. Suppose there are ten, equal-sized countries and each experience an initial drop in domestic demand of 5 percent. Now assume that in nine of those countries the drop in import demand amounts to a fifth or 1 percent point of the drop in domestic demand and they all import from the tenth country, which imports nothing. GDP falls by 4 percent in the nine but by 14 percent in the tenth country.

The conclusion is that with world demand generally contracting the principal exporting countries are likely to be disproportionately hit, other things equal. Conversely, those countries with a productive structure where exports count for disproportionately less e.g. the US, and where the public sector is disproportionately bigger, might be expected, other things equal, to do less badly in the recession. France offers a possible example on both criteria.

The latest GDP growth figures for the fourth quarter of 2008 appear both to offer some support for this contention and to underline the seriousness of the crisis. In Japan GDP fell by -3.3% in the quarter, in Germany GDP contracted by -2.1% in the quarter, in Italy the decline was -1.8%, while in the UK the fall was -1.5% the same rate of contraction as euro area (EA15) and the EU27. At the same time the US economy contracted by 1%, and French GDP fell by -1.2%. Even the Chinese economy, for so many years a key engine of global growth, slowed to 6.8%, at an annualised rate, in the fourth quarter, from an annualised rate of 9% in the third quarter and growth of 13% in 2007 as a whole. Chinese GDP growth over the year to the fourth quarter was 9%, the lowest rate since 2001, when an annual rate of 8.3 percent was registered, and it was the first time China's growth fell into the single figures since 2003.

Policy responses

We consider successively issues for global, UK and Scottish policy responses to the recession.

Global

It might appear to be a truism to suggest that the global nature of the downturn requires a global solution. However, there is a danger that some countries while acknowledging the global nature of the recession may seek to pass responsibility for dealing with it to other countries and/or international bodies such as the IMF. Countries such as China, Germany, Japan that have tended to produce much more than their domestic demand, so running significant savings surpluses and current account surpluses, will find it easy to blame countries such as the US, UK and Spain where domestic demand has far outrun supply. If such feelings translate into a policy stance in Germany, China and Japan that refuses to recognise their own obligation to take responsibility for maintaining global aggregate demand by expanding their own domestic demand, then the world economy will in all likelihood experience a depression. It is, in any event, in the direct interest of these countries to avoid a significant contraction in world supply because they will bear the brunt of it as the drop in world trade disproportionately reduces demand for their exports[3]

The $800 billion fiscal stimulation package that is being introduced by the new Obama administration in the US is a welcome development notwithstanding the flaws in the package. While this package – equivalent to about 5% of US GDP - may help to promote confidence in the world economy generally its effect on world trade flows will be limited. A rough calculation suggests that if the stimulus

package raises US aggregate demand by an equal amount – unlikely given that there will be some flow into savings and taxes - US imports will expand by around 14% of the GDP expansion and given the level of world exports - $16.34 trillion according to the CIA World Factbook - the stimulus to world exports will be less than one percent. However, before the stimulus package was enacted the US Congressional Budget Office was forecasting that US GDP would fall by 7% over the next two years. So, the package is unlikely to compensate for the depressing effect on world trade of the US recession, although it may mitigate it, and will not be sufficient to substitute for inadequate demand stimulus policies in the surplus countries. Moreover, in the medium to longer-term the post-recessionary equilibrium in the US will require reduced fiscal and current account deficits, which implies that the US demand for world exports must fall.

There is of course also the fear that surplus countries may be tempted to protect their market share by adopting increasingly protectionist measures such as subsidising domestic industry. This is already beginning to happen in deficit countries such as the US and UK e.g. the auto industry, in response to the initial drop in domestic demand due to the asset price deflation that accompanied the credit crunch. Financial protectionism is also on the increase as governments seek to encourage domestic banks to focus their lending on the domestic economy. Retaliation by both surplus and deficit countries will eventually serve to destroy world supply capacity in the medium to long-term even if there are short-term domestic supply benefits. A more prolonged recession and slower long-term growth is the likely result.

Finally, looking to the longer term, the governance of the global financial system must change. Specifically, the system must be able to facilitate the channelling of surplus savings into investment opportunities in emerging countries rather than fund debt expansion in the advanced countries such as the US and UK. The IMF needs to become more responsive to the needs of emerging country borrowers and help provide more effective insurance against systemic risks than at present.[4]

The United Kingdom

In the November 2008 Pre-Budget Report (PBR) the government introduced a fiscal stimulus in an attempt to counter the recession, which amounts to a £25 billion injection of demand over the two fiscal years 2009 -10 and 2010 –11. A £12.5 billion temporary – for one year – VAT cut and proposals to bring forward capital spending mean, according to the IFS Green Budget, that government borrowing will rise by £9.3 billion this year and £16.3 billion next year. This therefore amounts to an injection of additional demand equivalent to roughly 0.6% of GDP this year and 1.1% of GDP next year. The fiscal injection should be viewed in the context of a developing consensus that GDP may contract by -3% or more this year – in February a consensus of new forecasts averaging -2.8% for 2009 - and by low or zero growth in 2010 – new forecast consensus in February of 0.5%.[5] Against this background the fiscal injection looks like too little too late, and relatively small compared to the US stimulus package. It is also assumed that the injection will actually raise aggregate demand as hoped for by the government. It may not do so, of course, if households fully anticipate that they will have to pay higher taxes and experience lower public spending in order to fund the current stimulus.[6]

We contend that there is a case for the government to go further and introduce a new fiscal stimulus, front ended as far as is feasible on the 2009-10 fiscal year. The orders of magnitude required are for about a further £20 billion for the two fiscal years 2009-10 and 2010-11, with reversal of the overall £45 billion injection progressively after that to restore the public finances. This would amount to an approx stimulus to aggregate demand of 3%, which would, therefore, be closer to the anticipated decline in GDP over the two years and a little closer to the relative scale of the US fiscal stimulus package.

The deteriorating state of the UK's public finances and the rising yield on 10-year government bonds – now at 3.41%, 40 basis points above 10-year German government bonds – suggests that a further fiscal stimulus could be destabilising. Moreover, the greater the delay the greater the risk that the stimulus will become irrelevant while the risk of a loss of confidence in sterling in the foreign exchange markets and the threat of future inflation will weigh more heavily. All of these factors need to be weighed carefully but in our view the most pressing need is for further injections of aggregate demand from the public sector to offset the apparent continuing and perhaps worsening downward spiral in private sector demand across the global economy.

Since we last reported in October 2008 the Monetary Policy Committee (MPC) of the Bank of England (BOE) has cut bank rate from 5% to 1%. There is an expectation that interest rates will fall further to zero. With interest rates close to zero and prices rises turning negative, real interest rates will effectively be increasing and expectations will generally be for nominal interest rates to rise[7]. The expectation will also be for bond prices to fall. There will be no incentive to hold monetary assets that are falling in value for speculative/investment purposes and so economic agents will seek to hold cash – a 'liquidity trap'. In such circumstances a policy of boosting liquidity and interest rate cuts will fail to influence the real economy. There is evidence that this is happening in the UK with narrow measures of the money supply showing some growth following the efforts of the BOE to raise liquidity. But this does not appear to be passing through into lending and growth in the broader money supply. For example, non-seasonally adjusted M4 lending – which includes private sector bank and building society deposits – fell by -0.1% and -0.3% in November and December respectively. It is in

this context that the BOE is expected to seek to expand the money supply by directly buying up public and private assets – so-called 'quantitative easing – and so bypass the banking system.

It is also in this context that calls for the government to temporarily nationalise the main UK banks should be viewed with increasing sympathy. There may also be a further case for the removal of the toxic assets currently residing in these banks and their placement in a 'bad bank', where they can be priced and subsequently sold off when market conditions allow. The UK government has already done much. New capital has been brought into the main banks – with the exception of Barclays and HSBC – in two successive tranches of £37 billion and £20 billion. Loan guarantees representing contingent liabilities of up to £600 billion have also been given. But there is a view increasingly gaining acceptance that the government should go further and nationalise the key banks, all be it temporarily.

The *case for* temporary nationalisation rests on four propositions:

- There is a positive externality to the wider economy from increased bank lending. The profit maximising objectives of shareholders require balance street restructuring and reduced lending risk. Banks are withdrawing loans and are applying tighter lending conditions to new lending. The existence of a non-priced externality offers a classic example of market failure and prima facie justification for government intervention. The government's majority shareholding does not appear to be changing current bank behaviour in the interests of the minority private shareholders and so temporary nationalisation may be justified.

- Despite falls in the inter-bank lending rates, there is still uncertainty about whether British banks are insolvent. This uncertainty and lack of trust will continue until toxic assets are taken out of the banks.

- Relatedly, issues of capital adequacy of the banks seem likely to continue as long as they remain outside complete government ownership.

- The need to focus on more traditional forms of lower return/less risk banking may be opposed by existing private shareholders.

The *case against* nationalisation appears to offer the following key points:

- There would be a significant further rise in public debt, which might encourage a loss of confidence in the UK's credit rating, damage sterling and even the City of London's reputation.

- Private sector banks not taken into public ownership may be 'crowded out' by what is in effect a government subsidy.

- A so-called 'temporary' nationalisation may be difficult to unravel.

- Non-market considerations may begin to dominate the behaviour of the banks as politicians interfere to put social objectives, even short-term political objectives, above corporate efficiency and private shareholder returns.

We recognise the case against but, on balance, believe that current circumstances give greater weight to the case for a temporary nationalisation of the main British banks.

Scotland

In considering policy issues for the Scottish government it is useful to distinguish between:

- policies to counteract the recession, and
- policies to deal with the consequences of recession

Counteracting the recession

While the Scottish government has little power to influence aggregate demand in the short-term in the Scottish economy, it should be remembered that the current constitutional settlement reserves macro-economic stabilisation to Westminster. The Scottish economy should benefit from the £25 billion UK fiscal injection introduced in November's PBR by a direct boost to demand of up to 2% of GDP. A significant injection. But leakages from a small open economy are greater than from a larger economy and so both the direct and indirect stimulus to demand will be less.

The Scottish Government has introduced a six-point stimulus plan: bringing forward some capital expenditure e.g. investment in affordable housing; enhanced support for tourism promotion; speeding up the planning process; increased support for energy efficiency; increased advice to businesses and individuals; and improved financial advice to vulnerable individuals. The package will bring a very small stimulus to aggregate demand in 2009 and 2010 as some expenditures are brought forward but the overall macro effect will negligible. Nevertheless, taken together with the UK government fiscal stimulus and the significant monetary easing introduced by the MPC the package is valuable. The information and advice elements of the package may offer some market adjustment assistance and some mitigation of recession effects.

There are other possibilities and imperatives for the Scottish government in seeking to counteract the recession. The Scottish construction industry was first into recession and as noted above has been languishing for

some time. The government needs to consider not just how much public investment can be brought forward within the budget. The government has been criticised by opposition parties for the delays to public investment allegedly caused by the development and introduction of the Scottish Futures Trust to replace Public Private Partnerships (PPPs). But in current recessionary circumstances PPPs will find it difficult to proceed given the difficulties of raising private finance. In such conditions there may be a case for bringing forward conventional procurement projects and temporarily delaying any planned PPPs, although conventional procurement raises its own financing issues.

Further support for the construction industry might be possible if the government was willing to consider making advance payments to contracted companies that may be experiencing financial constraints, such as those undertaking government construction work.

Other actions to ease credit difficulties that the Scottish government could consider include, directly encouraging banks in Scotland to lend. The Scottish government will be a very large customer of the banks. It could seek to make its banking contracts conditional on a more pro-active stance on lending by the banks in Scotland. It could further ensure that the rule of ten-day payments of invoices to suppliers was adhered to in order to assist small firms.

Finally, perhaps more could be done to assist the labour market to more flexibly adjust to the recession by: encouraging the further and higher education sector to provide short-term but intense training courses for those coming on to unemployment register; and assisting redundant workers in starting their own firms (see below).

Dealing with the consequences of recession

The policy objective here should be to try and ensure that the recession does not damage the long-term trend of Scottish growth. Further, there is the question whether the recession might provide an opportunity to raise the trend in Scottish GDP growth? We plan to deal with the question what post-recession Scottish economy might look like and related policy issues in a later edition of the Commentary. We confine ourselves to a few observations here.

The government should through Scottish Enterprise and related agencies seek to minimise the impact of the recession on the Scottish growth trend. Existing investment funds such as the *Seed Fund, Co-investment Fund and Venture Fund* should be examined to see if they can play a role in overcoming key firms' cash flow and liquidity problems due to credit constraints associated with the current recession. A debate should be encouraged on how Scottish Development International might deal with the expected decline in inward investment through the recession e.g. Increased marketing? Increased corporate targeting? Greater flexibility in provision of Regional Selective Assistance?

It might seem fanciful but the recession could offer possibilities for raising the trend rate of growth of the Scottish economy. We know R&D and innovation are critical to growth but there is also evidence that companies that raised their R&D spend during a recession improved their subsequent competitive position. A US study of a large sample of firms over 20 years, which included the 1990-91 recession, found that many industry leaders at end of period were those increasing their R&D during recession.[8]There is clear need for the government and its agencies to publicise this message and examine what public policy in Scotland can do encourage R&D at a time when many firms will be under pressure to cut back on R&D outlays.

Research also suggests that in a recession many unemployed workers will wish to start their own firms. The Enterprise Allowance scheme in the 1980s was introduced to help workers made redundant in the early 1980s recession start their own firms. This was superseded by a shift away from start-up support as an unemployment measure. But there may now be a case for policymakers in Scotland to examine the possibility of using existing business birth rate support policies to target the newly redundant who may be encouraged to start their own firm.

Forecasts

Since we last reported in October there has been a considerable deterioration in the actual and forecast performance of all the major economies. In October we considered there was a 'high probability' that Scotland would go into recession in 2009. Now, we are certain that not only is Scotland currently in recession but that the recession looks likely to be as severe as that in the 1980s and could even be worse. The tentacles of recession are spreading throughout the economy with construction and financial service activity subject to sustained contraction, hotels & catering turning down from the first quarter of last year and real estate & business services contracting appreciably after March. Economy-wide GVA contracted by -0.8% in the third quarter and seems likely to have fallen markedly in the fourth quarter if the UK's performance is any guide. Third-quarter manufactured exports decreased by 1% in real terms and by 0.4% over the year. Business surveys covering the fourth quarter period reinforce the expectation that the slowdown will be severe.

In the Scottish labour market net job creation is falling and unemployment is rising – see *Labour Market Issues* section of this Commentary. In the final three months of 2008, employment fell by 0.2% to 2.53 million, while unemployment, on the preferred ILO measure rose by 9.2% to 137,000. The rate of increase in unemployment was faster than in the UK but at 5.1% of the labour force the level of unemployment remains below the UK rate of 6.3%.

Table 1: Forecast Scottish GVA growth in three scenarios, 2008-2012

GVA Growth (% per annum)	2008	2009	2010	2011	2012
Optimistic	0.65	-1.90	-0.43	1.08	1.73
Central	0.59	-2.57	-1.21	0.52	1.14
Worse	0.51	-3.07	-1.65	-0.13	0.55

Table 2: Forecast Scottish net jobs growth in three scenarios, 2008-2012

Net job no's	2008	2009	2010	2011	2012
Optimistic	-14,200	-73,007	-42,400	7,923	25,089
Central	-14,200	-94,179	-51,440	3,037	14,476
Worse	-14,200	-108,984	-63,064	-6,639	10,734

Table 3: Forecast Scottish ILO unemployment in three scenarios, 2008-2

ILO 16+ no's and rate%	2008	2009	2010	2011	2012
Optimistic	137.2	173.3	194.5	191.0	176.3
	5.1	6.5	7.3	7.2	6.6
Central	137.2	184.4	209.9	207.4	199.9
	5.1	6.9	7.9	7.8	7.5
Worse	137.2	191.6	223.1	226.1	220.4
	5.1	7.2	8.4	8.5	8.3

Against this background we have prepared new forecasts that significantly revise downwards our expectation for Scottish growth over the next three years. Again because of the heightened levels of uncertainty we present a range of forecasts. On this occasion, a central forecast, which is bracketed by 'optimistic' and 'worst' projections. These forecasts and the underlying scenarios are discussed in detail in the Commentary section: *Forecasts of the Scottish Economy.*

GVA

On our central case we predict that GVA will fall by around -2.6% this year and by -1.2% next year – see Table 1. Recovery does not begin to get underway until 2011 and remains below trend in 2012. On the worst case the global recession and financial sclerosis continues well in to 2011 and while there may be some recovery in the latter part of 2011 growth remains weak and significantly below trend in 2012. Only in the optimistic case does recession effectively end next year but with a weak then strengthening recovery in 2011 and 2012.

In our central case projection, we now take the position that Scottish economy will perform a little stronger than expected UK growth. We take this view because the impacts of the systemic drop in global aggregate demand resulting from falling asset prices and financial sclerosis will be sufficient to outweigh specific sectoral outcomes such as the contraction of financial service and banking activities. Experience shows that the Scottish economy is

more robust than the UK to a sharp contraction in aggregate demand as we noted in the previous Commentary. In the circumstance of the causes of the present recession the factors of relevance include: the somewhat bigger public sector and higher degree of social security payments in Scotland, while lower asset ownership e.g. houses and shares, means less exposure to asset price bubbles and bursts. On the other hand, Scotland's relatively higher export propensity may make Scotland a little more vulnerable to a drop in global demand. But overall, we now consider that the circumstances of the recession make it more likely than we previously thought that the Scottish economy will hold up relatively better than the UK. On our worst-case scenario this may not be the case.

Employment

Table 2 outlines our net job change projections on the three cases. In the *central forecast* employment is forecast to decline by 14,200 in 2008, by 94,200 in 2009 and by 51,400 in 2010, a total net job loss of nearly 160,000 over the three years. This is bracketed by an anticipated net job loss of nearly 130,000 in the *optimistic case* and by 186,000 in the worst case. To the *worst case* must be added a further 6,600 net job loss as the contraction in the labour market runs into 2011.

It is worth pointing out, as the *Labour Market Issues* section of this Commentary indicates, that it remains unclear how the more flexible and deregulated labour market that has emerged over the past 25 years will impact on the level of jobs and the level of unemployment during the current recession. We note that there are strong signs that the downturn may affect more adversely those employed on more flexible employment terms, with companies and co-operating unions making much effort to retain key skills and expertise.

Unemployment

Table 3 presents a summary of our ILO unemployment forecasts under the three scenarios. With such significant job losses forecast then it is inevitable that forecast unemployment will rise appreciably. But the effect of job losses will not wholly be registered by a growth in measured unemployment. Some unemployed workers will leave the labour market either by ceasing to offer themselves for work, a drop in the activity rate, or by leaving the economy all together, migration. Our forecasts of unemployment reflect an average pass through from job loss to the measured increase in unemployment of around fifty per cent on average in any one year. On this basis unemployment in the *central case* rises from 137,000 in 2008 to a peak of around 210,000 in 2010. On the *worst case,* unemployment peaks at 226,000 in 2011 and 195,000 in 2010 in the *optimistic case*. When expressed in rate terms these forecasts suggest that unemployment will rise to a 7.3% average in 2010 on the *optimistic case*, 7.9% in 2010 on the central case and 8.4% in 2010 and 8.5% in 2011 on the *worst-case* scenario. It is worth stressing that unemployment is a lagging indicator of economic performance and continues to rise for some months, even quarters, after output has begun to recover.

Brian Ashcroft
23 February 2009

Endnotes

[1] Martin Wolf, Japanese lessons for a world of balance-sheet deflation, Financial Times, 18 February 2009.

[2]Richard Koo, The Holy Grail of Macroeconomics, John Wiley, 2008.

[3]Such points have been consistently stressed by Martin Wolf in several of his FT articles and reflect the excellent analysis of global financial imbalance in his recent book Fixing Global Finance.

[4]M Wolf (2008) Fixing Global Finance

[5]HM Treasury (2009) Forecasts for the UK economy: A comparison of independent forecasts February

[6]The so-called 'Ricardian equivalence' argument.

[7] Zero will be regarded as the interest rate floor, although it need not be so if the authorities are prepared to effect negative interest rates by offering subsidies to borrowers and taxing lenders. This would of course be completely uncharted waters for the monetary authorities and the money supply implications would be unclear.

[11] Richard N. Foster (2003) "Corporate Performance and Technological Change Through Investors' Eyes", Research-Technology Management, Volume 46, Number 6, 1 November pp. 36-43(8)

Figure 1: Scottish and UK Quarterly GDP Growth, 1998q2 to 2008q3

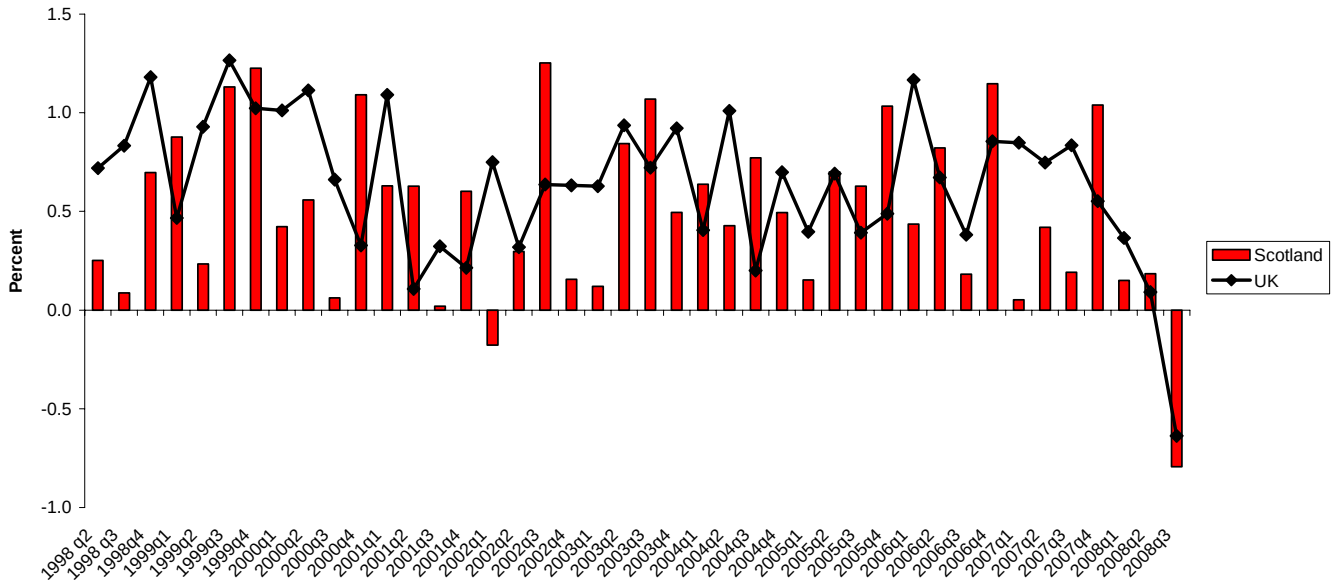


Figure 2: Scottish and UK Services GVA Growth at constant basic prices 1998q2 to 2008q3

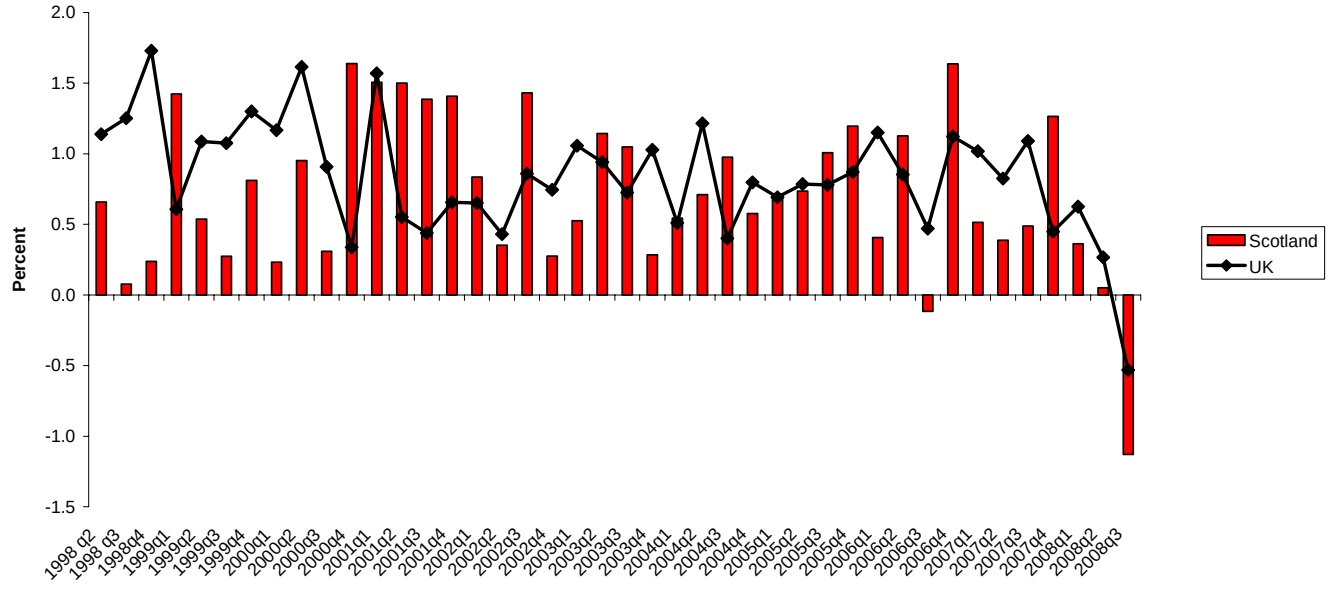


Figure 3: Scottish and UK Manufacturing GVA Growth at constant basic prices 1998q2 to 2008q3

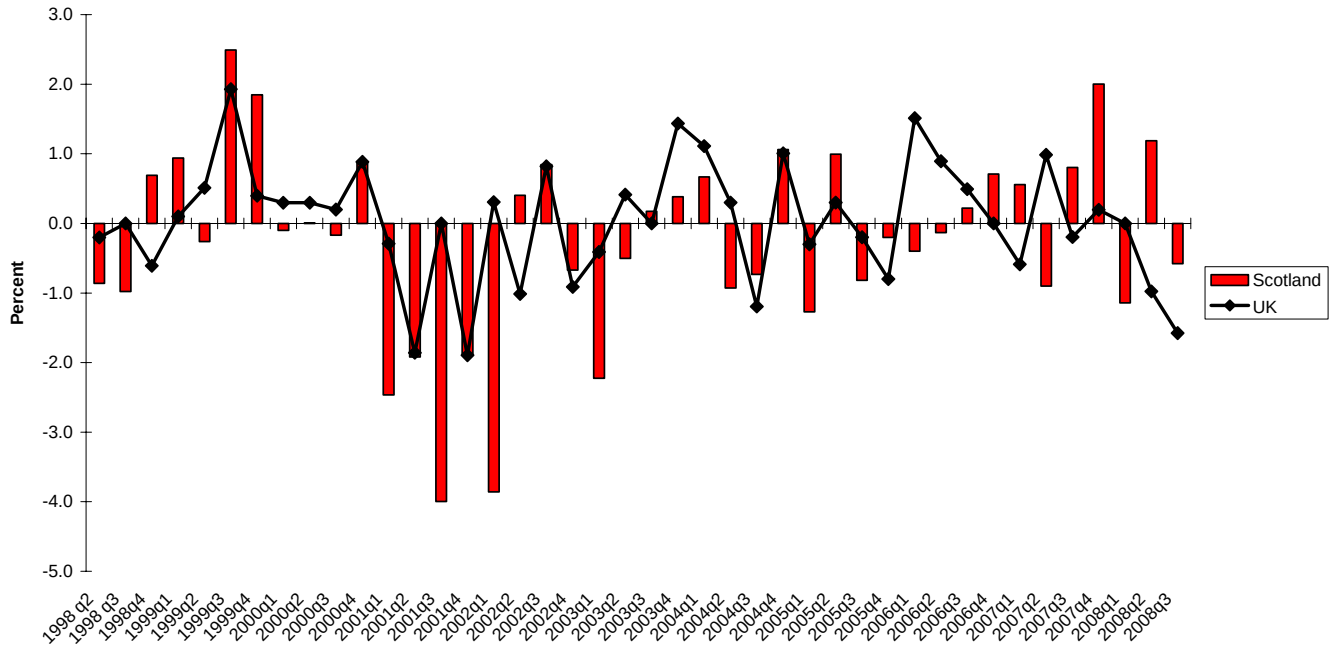


Figure 4: Scottish and UK Construction GVA Volume Growth 1998q2 - 2008q3

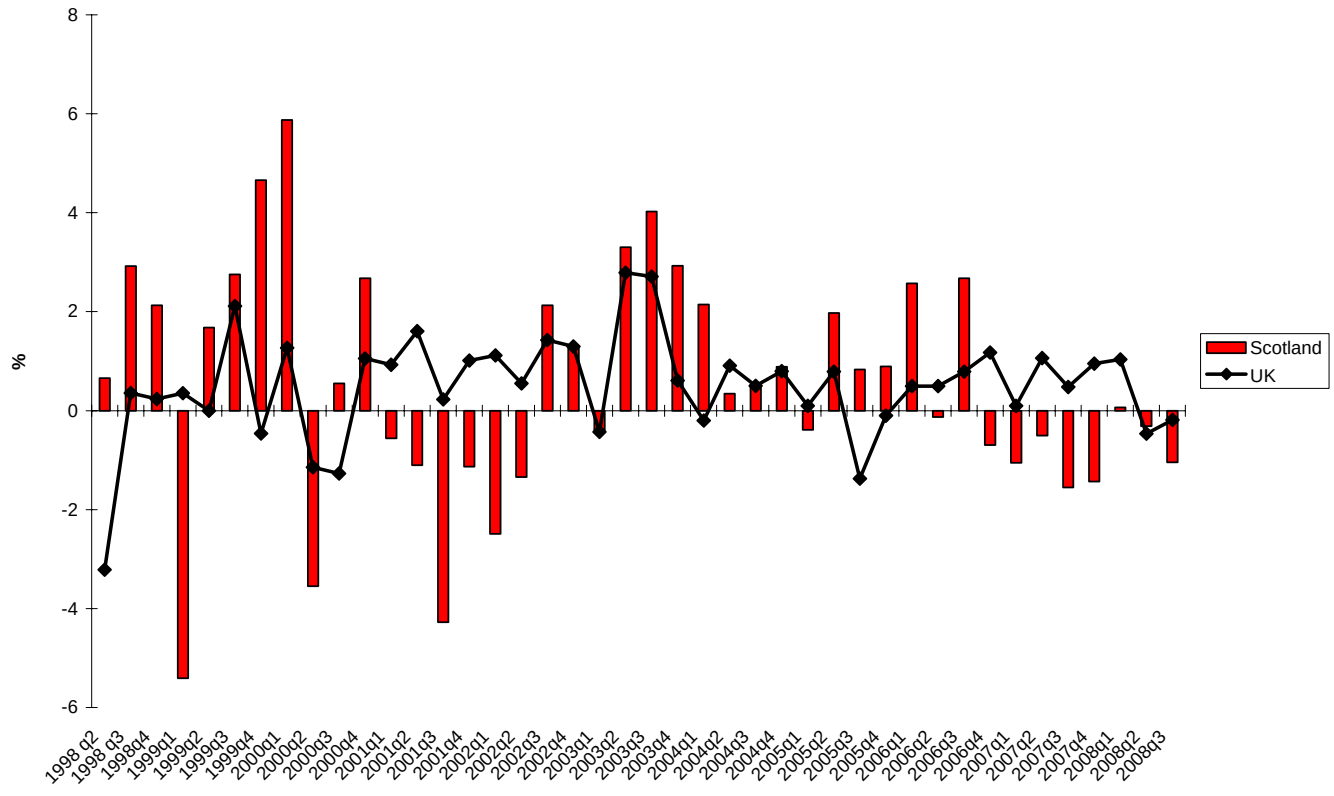


Figure 5: Scottish and UK Financial Services GVA Growth at constant basic prices 1998q2 to 2008q3

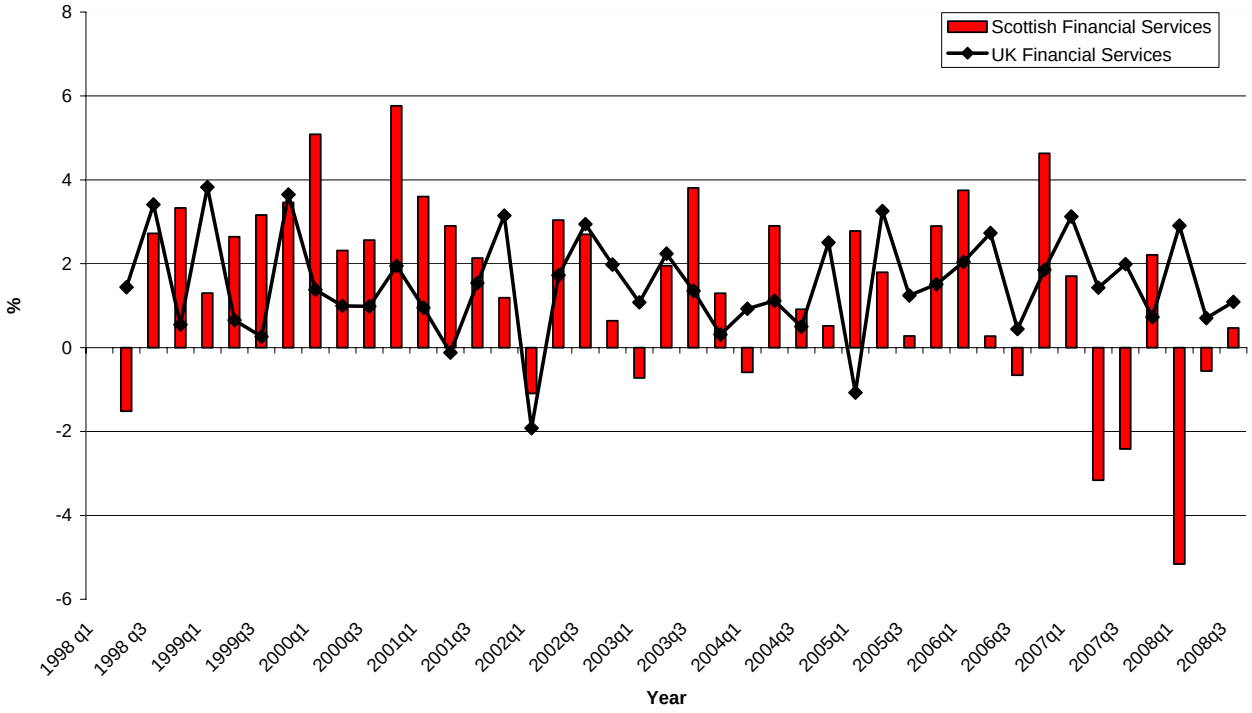


Figure 6: Growth of key sectors in Scotland 1998q2 to 2008q3

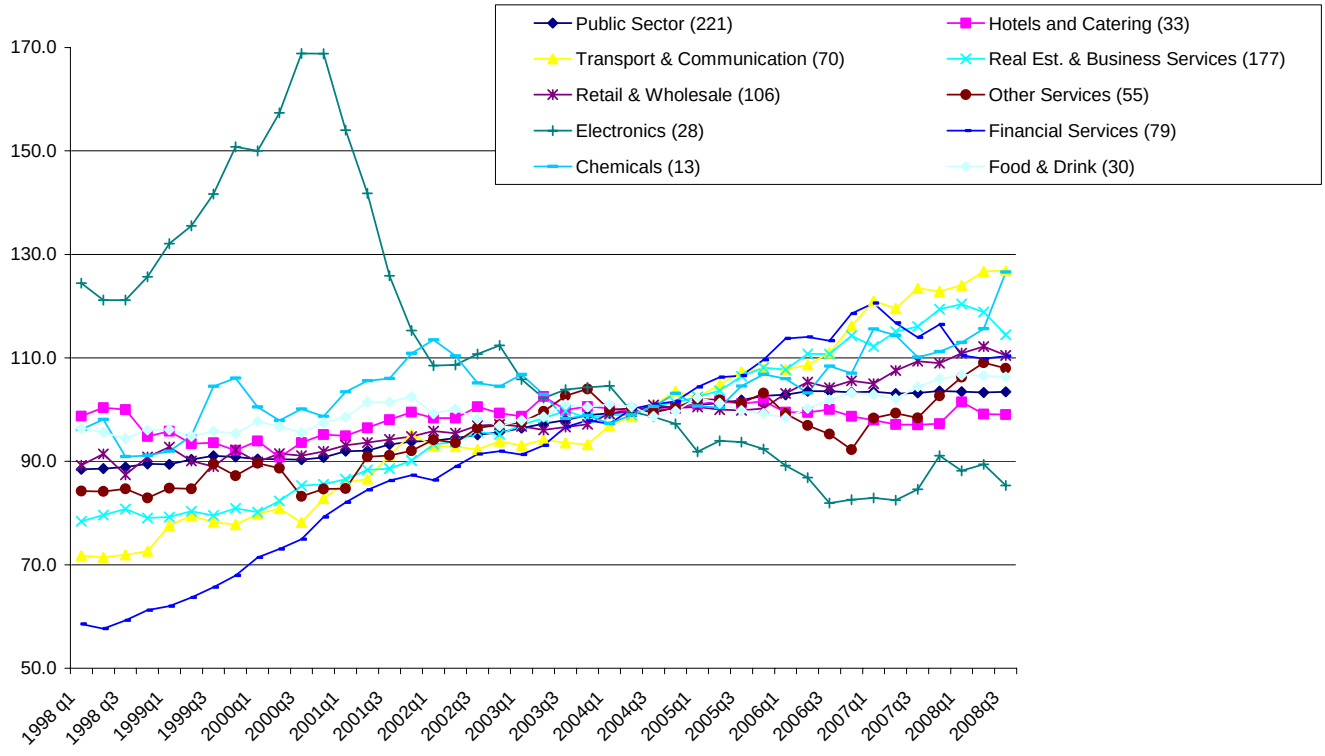
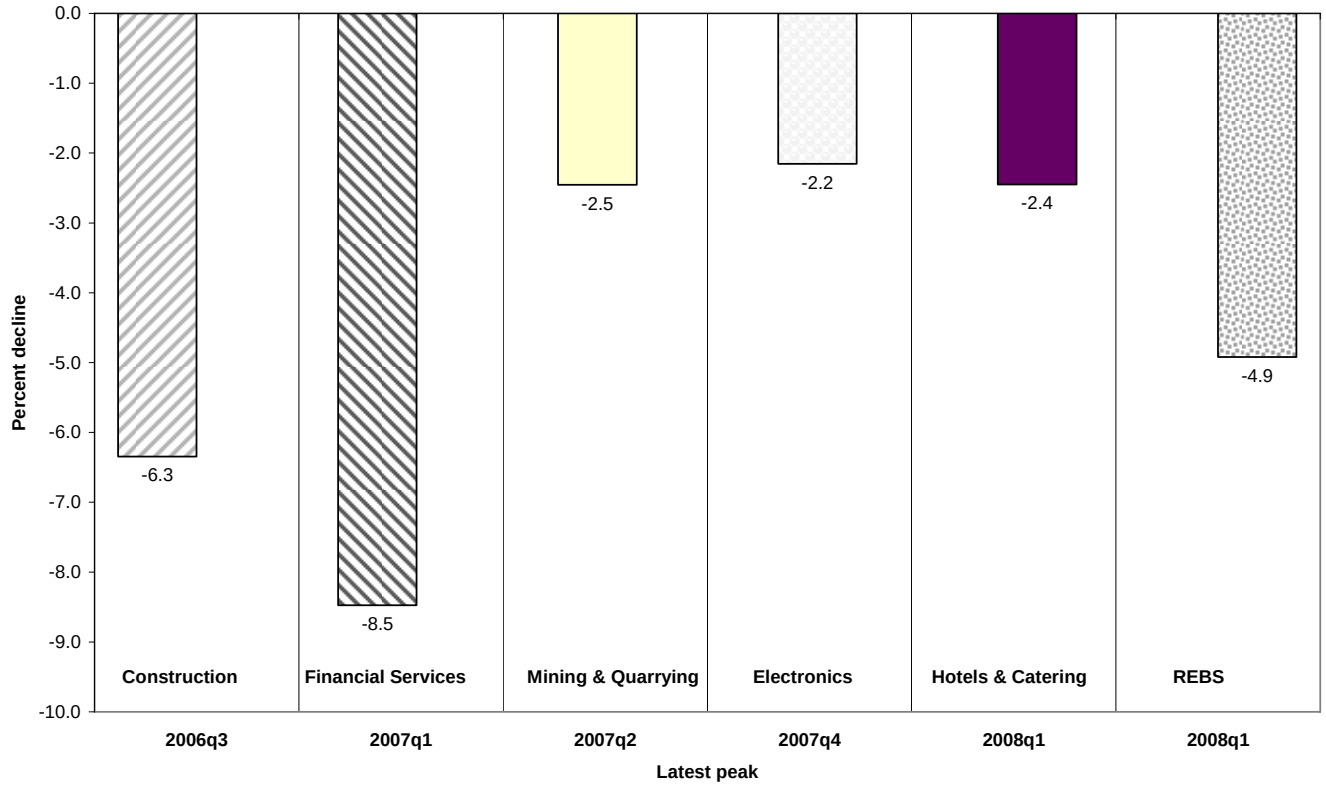


Figure 7: GVA percentage contraction to 2008q3 from latest peak by sector



The Scottish economy

Forecasts of the Scottish economy

Economic background

The global economy is experiencing a significant contraction due to the spreading effects of the sub-prime and financial crisis. This has greater effects in the main developed economies (US, UK, France, Germany and Japan) but the repercussions affect countries such as Russia, China and India, where a sharp downturn in global growth adversely impacts on their growth. Trade is down and both the IMF and the OECD have recently revised down their expectations for growth and trade. With global growth predicted to be only 0.5 per cent this year, the world is facing perhaps its deepest recession yet, although it is too early to call it a depression. Indeed the early co-ordinated response of the main economies to deal effectively with the situation will probably avoid a 1930s style depression. This does not mean however that there will be a quick recovery – it is more likely that the recession will be deeper and longer than any previous recession, certainly since the end of World War II.

The UK economy is not immune from this, and contracted by 1.5 per cent in the fourth quarter of 2008. The common expectation is that the first quarter of 2009 will also produce very weak data and that the economy will continue to shrink through 2009. Many forecasters expect the UK economy to contract by about 2.7 to 3.1 per cent this year. The UK recession is broad based affecting: banking, services manufacturing and construction. The Bank of England has lowered interest rates to 1 per cent – its lowest level ever since 1694 (the year of its founding) and is offering a number of other measures to support the economy: the Special Liquidity Scheme and it intends to operate 'Quantitative Easing' – a method of extending the money supply without printing extra money. This will involve swapping government gilts for corporate bonds – a key objective of this is to reduce the interbank lending rate (Libor) so that lending between banks becomes easier. In the UK CPI inflation is expected to be close to 1 per cent although in the second half of 2009 deflation cannot be discounted. Public sector borrowing was set to be £78 billion but this may grow to £87.5 billion by the end of the year as the government continues to support the economy. This weakens sterling considerably particularly against the Euro. In Oct-Dec 2008 UK unemployment hit an 11-year high at 1.97 million. It is unlikely that the UK will experience a V-shaped recovery and that 2010 will also be a very tough year. It is more probable that the UK will experience a longer recession with a slower recovery from the end of 2010 onwards.

The Scottish economy

Scottish GVA growth in 2008Q3 was -0.8 per cent leaving growth for the last four quarters on the preceding four quarters at 1.4 per cent. These data however are likely to be supplemented by very weak growth in 2008Q4 leaving growth for 2008 in the 0.5 to 0.7 per cent range. Exports are also likely to be poor. Manufacturing and services growth for 2008 are likely to be close to 1 per cent for the year based on the 2008Q3 data and assuming weaker data for 2008Q4 they may perform more poorly. Construction will probably contract by approximately 2.7 to 3 per cent in 2008. Most service sectors had negative growth in 2008Q3 and the expectation is for more of the same in 2008Q4.

The employment rate in Scotland fell by 1.1 per cent on a year ago to 75.4 per cent for the three months to December 2008. Unemployment rose to 137,000 (5.1 per cent), up 0.3 per cent on the year. The claimant count measure of unemployment was 101,100 (3.7 per cent) in January 2009, up by 1.2 per cent annually. So as there is weakening growth in the economy, falling exports and a deteriorating labour market: it is clear that Scotland is in recession. The forecasts for the Scottish economy are made in the context of this worsening economic situation.

Final demand

The drivers of the economy are consumption; government spending; investment; tourism and exports (to the rest of the UK and to the rest of the world). For all three scenarios the main effects from the current economic climate are:

- Investment declines sharply in 2009 and recovers slowly thereafter – in the central scenario this decline is slightly steeper and longer whereas in the last case the contraction is severe and growth is not seen until 2012;

- Traditionally Scottish consumption holds up relatively well in a UK downturn – in this recession Scottish consumption indicators point to a significant fall in 2009 with mild recovery following. In the worse case scenario the decline is slightly sharper but more importantly it lasts considerably longer and it is 2012 before consumption returns to about 1 per cent growth;

- Government consumption is held to be constant with a fixed budget to the Scottish Parliament. The UK government spending in Scotland will be substantial with increased benefit flows; a share of the fiscal stimulus (perhaps adding between 0.25 to 0.3 per cent to GVA in 2009 and 2010) and rescue packages for RBS and Lloyds Banking Group (for HBOS);

- Tourism is expected to perform poorly in terms of increased GVA – volumes might rise slightly but the assessment is that revenues from tourist expenditure will fall. Across the three scenarios this is reflected as a small negative effect except the last one where it is a large negative impact over two years and

- Exports fall considerably, particularly to the UK as its economy shrinks. The expectation is that in the optimistic scenario recovery of all exports will take place in 2011; in the central scenario exports to the rest of the world are better than that to the rest of the UK and in the last case that recovery is weak in 2011 and does not really impact until 2012.

Background to the forecast

The previous forecast was scenario based with a number of factors that potentially impact on economic performance. It was clear that if the banks returned to the government for more money for re-capitalisation then the worst case situation from the previous forecast would apply. That occurred in February and it also fits with poor bank lending conditions. On the up-side monetary policy has been quick to respond and is supportive as is fiscal policy. The Scottish labour market remains more buoyant than its UK counterpart but the rate of job shedding is accelerating. This may indicate that Scotland is simply catching up with the rest of the UK. Traditionally however, the Scottish economy does relatively better than the rest of the UK in a downturn but this particular recession appears to be much tougher and deeper than expected. It is the speed and the depth of the contraction that has taken most people by surprise. This is why most forecasters have shifted their expectations down considerably. The outcome of this may be that Scotland does not outperform the UK economy but different paths are possible thus a scenario forecast is the best tool to use in the current economic situation. The forecast is presented in three scenarios to reflect the very different paths that the economy could take, given particular events occurring. These scenarios are:

- Optimistic;
- Central and
- Worst.

The factors that support these scenarios are described briefly in each section. The scenarios are determined by the same variables used in the last forecast. As they were discussed in significant depth in the last FEC the factors are more succinctly presented here.

The forecast

The optimistic scenario

This is the most probable result if the following outcomes actually prevail. The main influences under this scenario are:

- The labour market in Scotland remains relatively buoyant and outperforms that of the UK with the

employment rate being higher and the unemployment rate being lower than their UK counterparts;

- Businesses can secure funding from banks and other financial institutions relatively more easily as bank lending improves significantly resulting in a smooth flow of funds in the Scottish economy;

- Confidence holds up more in Scotland as spending in retail; investment and exports hold up. Manufacturing makes a significant contribution to the economy;

- External demand is a key factor here and supports export growth while tourism is not severely affected and

- House prices are not depressed for too long and the expectation is for recovery to start by mid-2010 but definitely by 2011.

Critically appraising the above, it is clear that at the beginning of 2009, there are not many signs of lending becoming more efficient and similarly confidence is very weak at the moment. There are few indications of a quick recovery although in places the rate of decline in house prices has slowed significantly, and some companies are announcing jobs growth. The upside includes the labour market is in a relatively good state (compared to the UK) while monetary and fiscal policy remain supportive of economic recovery. These initial observations perhaps make it less likely that this outcome will prevail compared to the central forecast.

The central forecast

In this scenario the main drivers are:

- A further tranche of money has gone to re-capitalise the banks but lending behaviour remains sticky;

- Confidence is very low and firms face considerable constraints while trying to continue trading;

- External demand is also weak thus exports perform weakly and tourism revenues fall. The weakness of sterling cannot offset the poorer external demand;

- The labour market is hit by a series of job losses but a significant number of workers remain in employment and this supports basic consumption;

- The impact on the financial sector is quite sharp in 2009 and 2010 and is felt across the rest of the economy and

- House prices in Scotland are not as weak as that elsewhere in the UK and there are some early signs of some housing market segments showing growth as interest rates fall – this is the discerning and opportunistic buyer effects.

This scenario is perhaps closest to what is happening at the moment but of course there are many other variables that could change the course of the economy. This is why the worst case scenario is considered below.

The worst case scenario

This scenario is presented because the impact of the financial crisis, and a sharp drop in the labour market, are important drivers. This early and sharp collapse of activity has repercussions for the path of recovery, as it tends to have a deeper recession with a slower recovery. The main factors here include:

- The impact of the finance sector across the whole economy is severe and job losses in the economy come earlier in 2009 thus the support from the labour market weakens significantly;

- Confidence collapses early in 2009 and it is very difficult to stimulate the economy;

- External demand is very weak up to the end of 2010 and perhaps into 2011;

- Investment contracts substantially and there is little expectation of growth here until 2012 and

- House prices in Scotland remain depressed for a longer period of time and as a result private housing investment continues to shrink until 2012.

The outcome here is very disappointing and if this scenario were to come about there would be little growth in the economy until 2012 – a much longer and deeper recession than previously expected would take place.

GVA

The forecast for Scottish GVA is negative for 2009 and 2010 in all the scenarios. Table 1 presents the forecasts for each of the scenarios for the years 2008 to 2010. Data for growth per annum is also given for the period 2005-07 and for 2009-12, which demonstrates the marked difference between the two periods as the economy experiences a recession. Figure 1 plots the probable paths of GVA over the period 2008 to 2012 for the three scenarios. Figure 1 demonstrates that in the worst case that the recession could last until 2011 with only weak growth thereafter. In the best possible outcome the recession lasts until 2010 and growth of 1 per cent is achieved in 2011 and by 2012 growth is approaching 2 per cent.

Table 1: Forecast GVA Growth in the three scenarios, 2008-2012

GVA Growth (%)	2008	2009	2010	2005-07[1]	2009-12[1]
Optimistic	0.65	-1.90	-0.43	2.32	0.79
Central	0.59	-2.57	-1.21	2.32	0.15
Worse	0.51	-3.07	-1.65	2.32	-0.45

Source: Fraser of Allander Institute, February 2009
Note: [1]This is per cent per annum

Table 2: Main forecasts of the Scottish economy (central scenario), 2008-2012

	2008	**2009**	**2010**	**2010-12**
GVA	0.59	-2.57	-1.21	0.15
Agriculture	0.60	-2.85	-1.10	-0.14
Manufacturing	0.60	-2.28	-1.34	-0.11
Construction	-2.73	-3.01	-1.21	0.14
Services	0.98	-2.31	-1.30	0.17

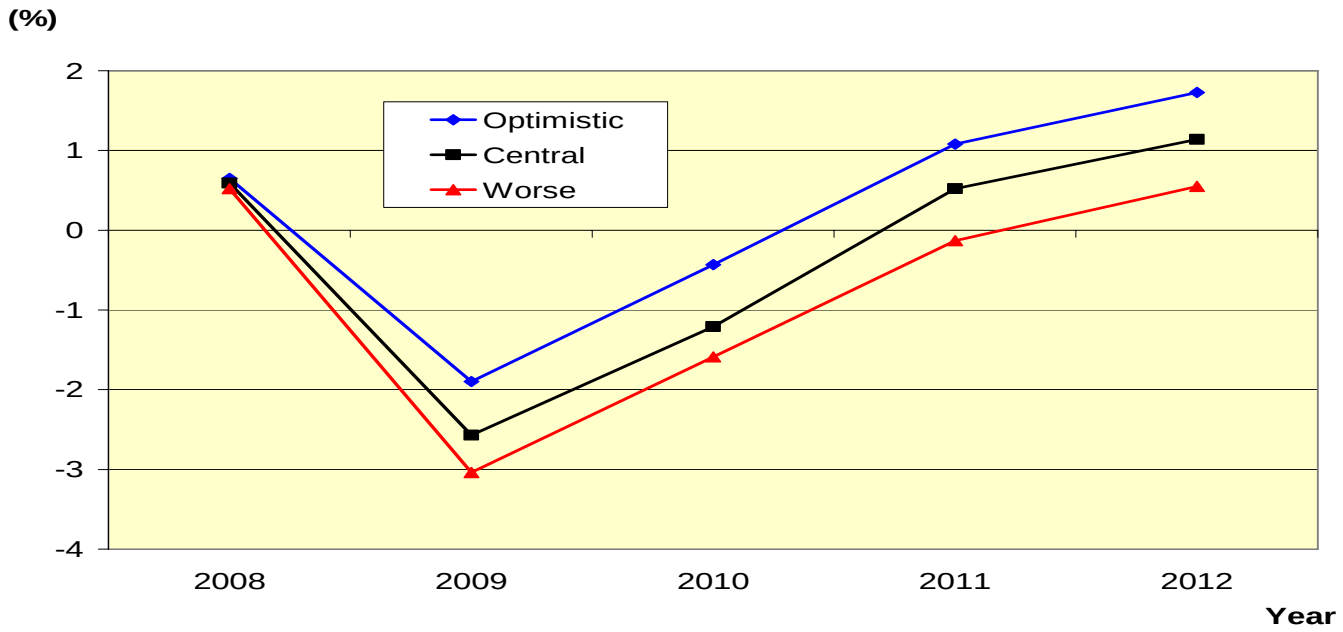
Source: Fraser of Allander Institute, February 2009
Note: [1]This is per cent per annum.

In the central forecast the recession lasts until 2010 and Table 2 presents forecasts for the sectors under this scenario. All sectors are forecast to have negative growth in 2009 and 2010 and to return to positive growth in 2011. In 2009 the forecast is for all sectors to contract by more than 2 per cent with construction declining by just over 3 per cent. In 2010 the picture is similar – most sectors shrink by just over 1 per cent. This reflects the broad base of the current recession. Previous recessions have left the service sector relatively unscathed, not so this time as the downturn affects the whole economy. Within services the expectations are for financial services, retail, tourism, business services and other private services to do worse while the public sector and transport, communication services do relatively better. The crucial importance of a strong public sector is clearly seen at this time when it will support employment and provide spending in areas where private consumption and investment are severely curtailed.

Figures 2a to 2c demonstrate the impacts on the construction, manufacturing and service sectors for each of the scenarios. For each broad sector the pattern of the scenarios is the same, all show longer recovery as the scenarios worsen. Previously in the Scottish economy key sectors including manufacturing, electronics, financial services or REBS have driven growth in the economy. It is likely in the near to medium future that this will not be the case. Growth will be more broadly balanced and the influence that 'key' sectors may have, will not be as strong as in previous years. Manufacturing is hit by both the severe slowing in domestic demand and the deterioration in external demand. Key exports like food, whisky, paper, electronics etc. have all seen activity and orders drop sharply. The construction sector has suffered and continues to experience a considerable downturn due to the lack of private residential demand as house prices have collapsed and the bulk of that market remains stagnant. Public sector investment continues to provide some stimulus to the economy but the current tranche of PPP schools, hospitals etc. are coming to an end. The new funding arrangements for major public works are not in place yet and projects of this nature take a long time in the planning stage.

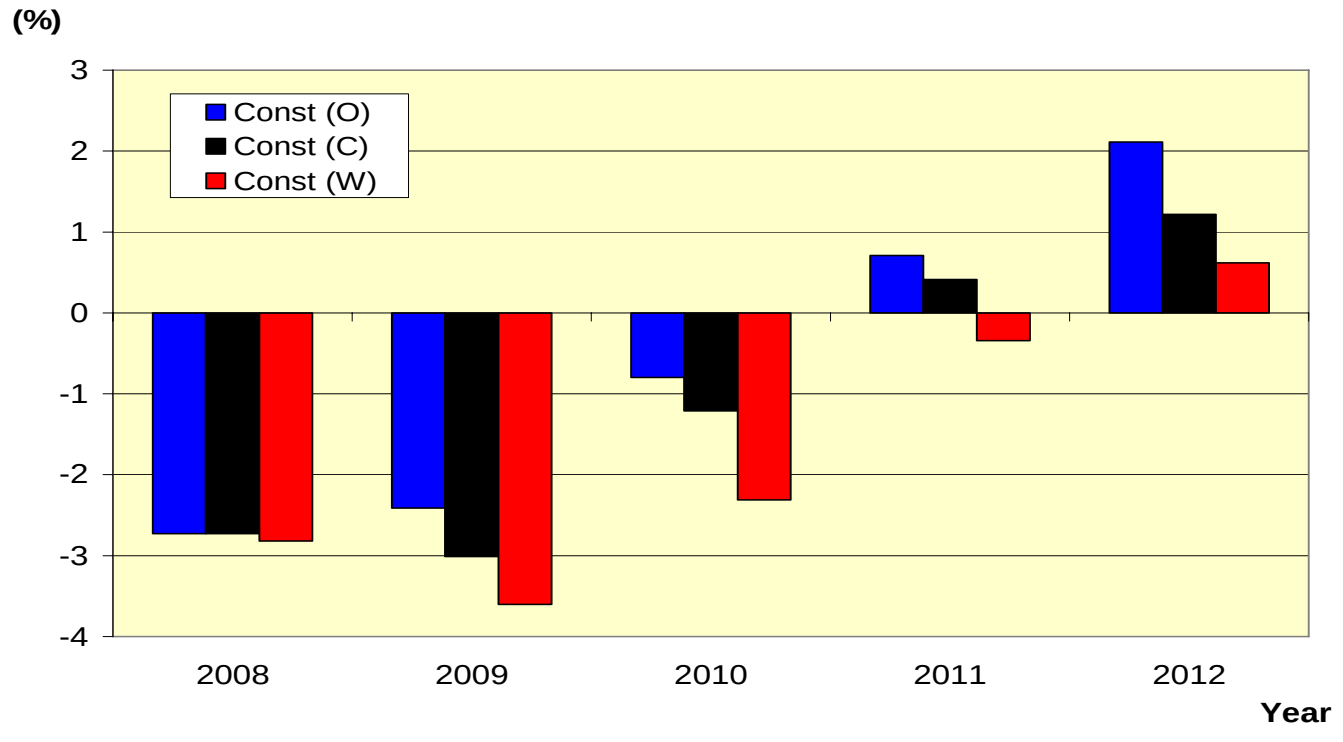
Services are badly hit because of the sharp downturn in economic activity in the economy. Retail sales data is confounding as it shows the sector holding up to a degree but in truth is due to heavy discounting. Large expenditures are not being made as people see the drop in interest rates as a continued run so in part it is having the opposite effect. People believe rates will fall further thus hold off spending. Similarly companies postpone investment. These actions simply exacerbate the situation where minimal spending takes place. Tourism is weak as incomes and demand in foreign countries decline. Visitor spend is down as is business conferencing. Other private services, services related to housing are all down. Business services are likewise adversely affected. Without doubt however the most significant impact is on the financial sector in Scotland. The losses posted by RBS and HBOS are massive and it is difficult to see these banks returning to the large profits and aggressive acquisitions strategy that previously existed. This does not mean that these two major banks will revert to simply retail banking. They will maintain a large degree of specialist services and where

Figure 1 Forecast GVA growth for all three scenarios, 2008-2012



Source: Fraser of Allander Institute, February 2009

Figure 2a: Forecast construction GVA growth, three scenarios, 2008-2012



Source: Fraser of Allander Institute, February 2009

profitable, retain some of their overseas operations. Investment banking and dealing in derivatives and securities may continue but there will be more stringent limits and supervision put in place both nationally and hopefully internationally, to ensure the risks of such a catastrophe taking place again are minimised. A mark of the international banking crisis is the extent to which most governments have taken substantial ownership of banks and nationalisation is widely accepted as necessary. As it is, this is what has happened and the interesting question is 'how does the economy move forward so that this is not repeated and a situation of sustainable growth is achieved?'

In going forward there are two key factors to consider:

- The strength of external demand – if this picks up then it will feed into exports and help manufacturing significantly. Tourism would also benefit if as predicted sterling remains weak. This would help stimulate retail and hotels & catering as well as other private services and

- The speed and number of jobs lost in the beginning of 2009 is absolutely crucial. As time goes on the more people who remain in employment means that incomes are supported, as is consumption. Large numbers of people being ejected from the labour market will lead to a double whammy of a bigger strain on public finances (less taxes and more benefit spending) as well as the reduction on income thus weakening consumption and investment. On a large scale these have significant impacts on the economy going forward and have potentially very serious effects on the economy.

Overall, the forecast for the Scottish economy is cautious but realistic. There is no clear way forward that indicates that the economy will go in a particular direction or grow at a particular rate. Each of the scenarios indicates a probable path that the economy could take. The central forecast is the most likely of them all. The downside risks would lead to the worse case scenario while it is unlikely that the Scottish economy can achieve the most optimistic case. If external demand remains very weak for a prolonged period and labour shedding is quick and jobs growth is sluggish for a couple of years then the worst case scenario could become reality.

Employment

Our forecasts of employment (for the central scenario) are presented in Table 3 with the net employment change figure in brackets. The employment figures are calibrated on the latest Employers' Quarterly Survey Series as given in Table 6.06 in Economic and Labour Market Review, National Statistics.

In the central forecast employment is forecast to decline by 14,200 in 2008; by 94,200 in 2009 and by 51,400 in 2010. If this were to happen the economy would be facing one of the most serious job loss periods it has experienced. The forecast job loss for the period 2009-12 in this scenario is 128,100 compared to 82,400 in the optimistic scenario. If the economy has a deep and prolonged recession (the worst case) then job loss over 2009-12 is forecast to be 168,000. It appears that it will be impractical for the economy to shed this quantity of jobs without impacting adversely on unemployment (the forecasts of unemployment are presented in Table 4).

In all the scenarios the service sector sheds a significant amount of jobs. The forecast is for services to lose 74,400 in 2009 and a further 39,600 in 2010. This represents 78.9 per cent of all job losses in 2009 and the comparative figure for 2010 is 77 per cent. The most significant jobs loss comes in services comes from the financial services sector. The assumption of the central forecast is that there is a significant jobs loss in both 2009 and 2010 from financial services. This could total 24,700 in 2009 and 18,900 in 2010. This is because the sector will have some immediate costs to cut and these come mostly in 2009. As banks consolidate and review their activities then efficiency savings will bite in 2010 as cost-cutting continues. REBS also faces a major shakeout in 2009 with the forecast loss of 28,700 jobs. In the worst case scenario the jobs loss is considerable in both years, with a shedding of 25,200 and 22,400 in 2010 for financial services. Elsewhere in this service sector the jobs loss is weighted towards 2009 and REBS is forecast to lose 33,000 jobs but only 11,200 in the year 2010. Similarly, retail is forecast to lose 16,300 jobs in 2009 but less in 2010; 10,900.

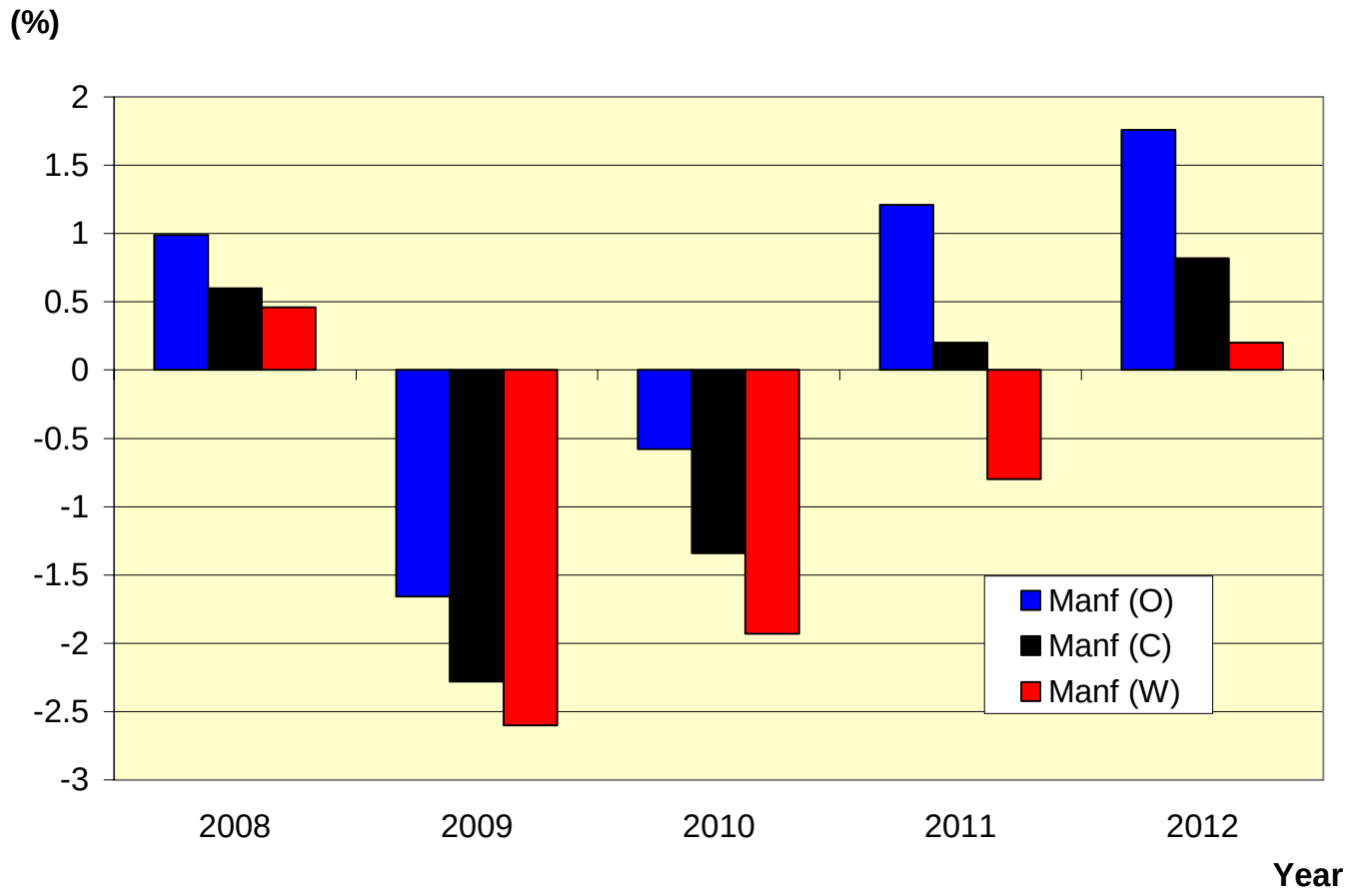
The construction sector is forecast to lose 8,000 jobs in 2009 under the central forecast but this could be as high as 8,800 in the worst case scenario. Under this scenario it loses 4,300 jobs in 2010 compared to 2,900 in the central case.

Manufacturing job losses are spread across the sector relatively evenly. The exceptions to this are: ORNF, chemicals and transport equipment. The former two shed only a small number of jobs while transport equipment is buoyed by positive job growth of 1,600 in 2009 due to shipbuilding orders for naval vessels on the Clyde and at Rosyth. Over the forecast period manufacturing is forecast to shed 14,400 jobs in the central scenario but this could be as high as 20,100 if the worst case prevails. The other sectors, especially those with export markets, tend to have much higher job losses forecast as activity reduces sharply. It is unlikely that firms will hoard labour for a longer time and this is a key danger as skills will be lost as jobs are shed swelling the ranks of the unemployed.

Unemployment

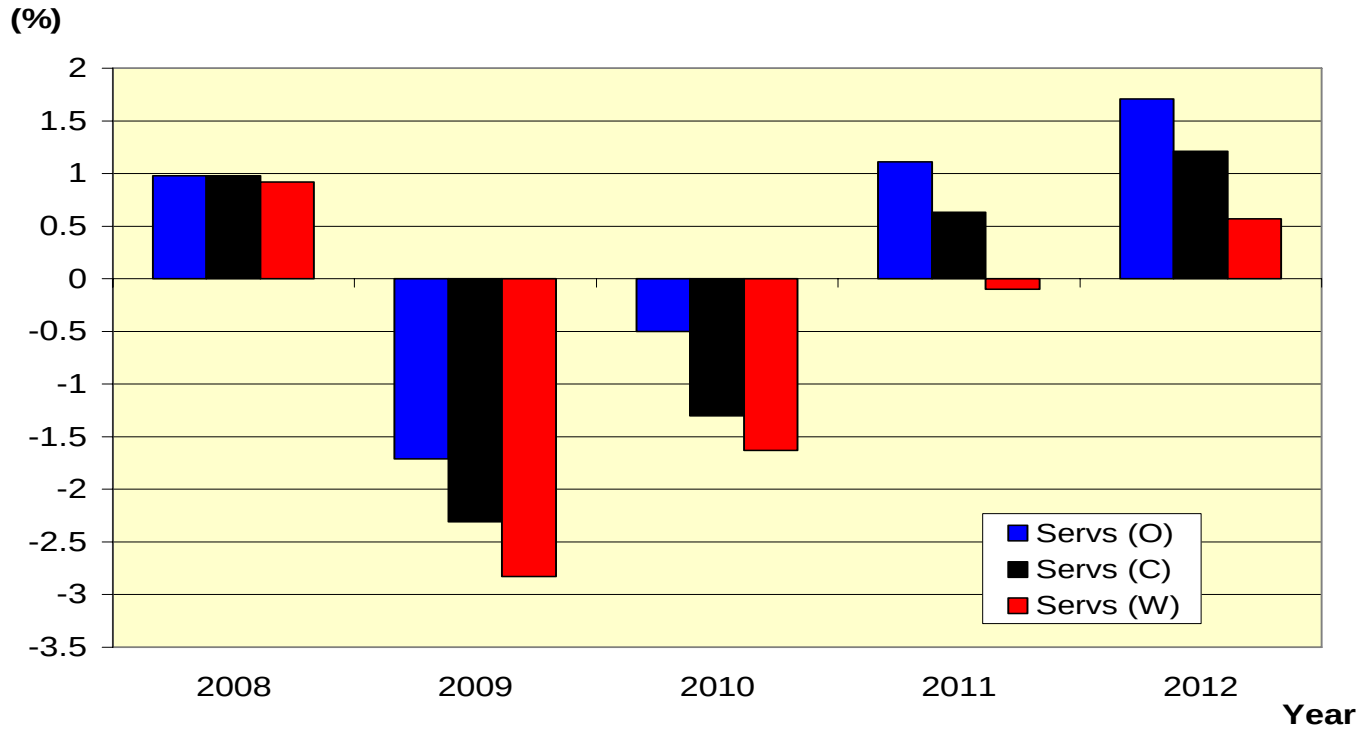
We present our forecasts of unemployment in Table 4. Both the ILO measure and claimant count measure are

Figure 2b: Forecast manufacturing GVA growth, three scenarios, 2008-2012



Source: Fraser of Allander Institute, February 2009

Figure 2c: Forecast services GVA growth, three scenarios, 2008-2012



Source: Fraser of Allander Institute, February 2009

Table 3: Forecasts of Scottish employment (000s) and net employment change, (central scenario) 2008-2012

	2008	2009	2010	2009-12
Total Employment	2,384.6	2,290.4	2,239.0	
	(-14,200)	(-94,200)	(-51,400)	(-128,100)
Agriculture	33.3	31.1	29.0	
	(4,000)	(-2,200)	(-2,100)	(-2,400)
Manufacturing	216.3	207.4	201.4	
	(-4,700)	(-8,900)	(-6,100)	(-14,400)
Construction	137.2	129.3	126.3	
	(-2,000)	(-8,000)	(-3,000)	(1,500)
Services	1,955.8	1,881.4	1,841.8	
	(-10,800)	(-83,500)	(-48,500)	(-100,900)

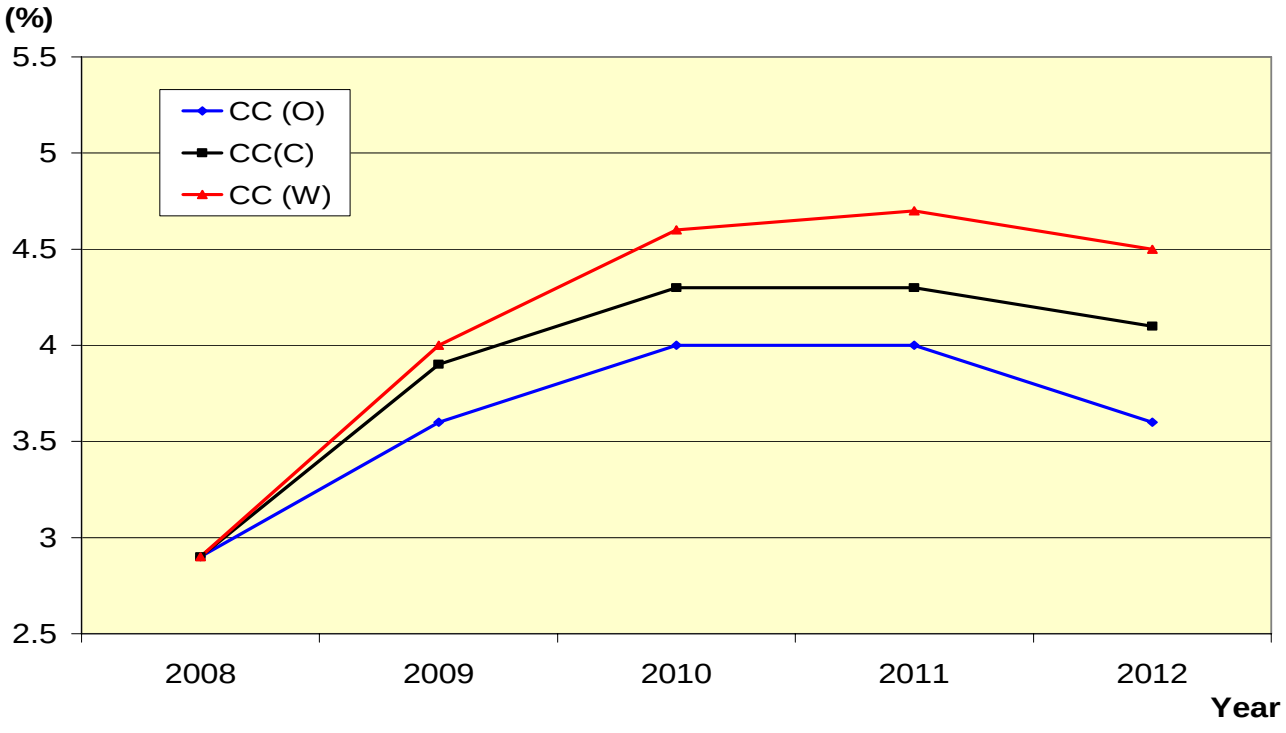
Source: Fraser of Allander Institute, February 2009

Table 4: Forecasts of Scottish Unemployment (Central Scenario), 2008-2010

	2008	2009	2010
ILO Unemployment	137,200	184,400	209,900
Rate	5.1%	6.9%	7.9%
Claimant Count	77,800	110,600	125,900
Rate	2.9%	3.9%	4.3%

Source: Fraser of Allander Institute, February 2009

Figure 3: Forecast claimant count unemployment, three scenarios, 2008-2012



Source: Fraser of Allander Institute, February 2009

given. The preferred measure of unemployment however is ILO unemployment as given by the LFS. Figure 3 illustrates the different outcomes for claimant count unemployment in the three scenarios.

The forecast for unemployment has changed somewhat over the most recent period. It had been the case that the Scottish labour market had been outperforming the UK labour market and still does in relative terms. This had led to an employment rate that was higher than that of the UK and unemployment that was at historically low levels. The forecast for the central scenario is that unemployment will rise from 5.1 per cent in 2008 to 7.9 per cent in 2010 before falling at a much slower rate to 7.5 in 2012. In the worst case scenario unemployment is forecast to peak at 8.5 per cent in 2011 indicating the different profile of unemployment in this situation. The claimant count forecast is for unemployment to peak at 125,900 (4.3 per cent) in 2009 whereas the forecast for the worst case scenario is that it is at its highest in 2011 at 135,700 (4.7 per cent).

Claimant count unemployment currently stands at 77,800 (2.9 per cent) for 2008.

Figure 3 show the likely paths unemployment could take, where the first two scenarios plateau over 2010 to 2011. The change in the worst case scenario is that it continues to rise but does not have a flat portion. Using the claimant count measure more people will fall into inactivity and stop claiming benefits over protracted periods of time. Data from previous recessions indicate that in a severe recession (say that of the 1980s in Scotland) unemployment continues to rise after such a deep and long recession. So in the case of the worst scenario unemployment may continue to climb even after growth and jobs creation takes place. Deskilling, jobs mismatch and discouraged workers all add to this.

Kenneth Low
20th February 2009

Review of Scottish Business Surveys

Overall

All of the major Scottish Business Surveys showed a further sharp deterioration in the private sector economy during the latter part of 2008 and into 2009. The latest Lloyds TSB Scotland Business Monitor (Issue 44 September – November 2008) reported the downturn in the Scottish economy intensified in late summer and winter 2008. "The implication is that growth in the private sector of the Scottish economy has not only slowed dramatically but has reversed into a contraction. This is the most negative result in eleven years of the Business Monitor." The PMI Scotland Report (Royal Bank of Scotland (January 2009) found that "Output and new business both contracted at near –record rates and, despite backlogs of work being reduced at the fastest pace in the eleven-year history, staff were shed at the strongest rate on record." The Scottish Chambers' Business Survey noted "The results for the fourth quarter 2008 are the most depressed results recorded since the survey commenced in 1984. This is the first time that negative trends have been recorded for the key indicators in all sectors." According to the fourth quarter 2008 Quarterly Review of the engineering industry in Scotland; "The global financial crisis has finally caught up with the Scottish manufacturing engineering sector. For the first time in five years output volume and recruitment figures are negative" The latest Scottish Industrial Trends Survey published by CBI Scotland (Quarter 4 2008 date) pointed to "sharp deterioration in the trends of new orders and output among Scottish manufacturers, bringing the picture here back in line with the UK average. "

Oil and Gas Sector

Activity in the UK oil and gas sector slowed in slightly in 2008 after a period of increased investment, activity and employment. Underpinning these trends has been the relentless increase in oil prices, which had risen from an average of $54 per barrel in January 2007 to an average of over $90 per barrel by January 2008 peaking at $147 in July 2008. In early 2008 a number of institutions were confidently predicting that prices would reach over $200 per barrel by the end of 2008. In reality average oil prices tumbled to $34 per barrel in December 2008 and current central predictions are for oil prices to be in the region of $30 – 45 per barrel in 2009. The Oil and Gas UK Activity Survey (published February 2009) noted a slight reduction (6%) in investment levels in 2008 compared to 2007, and expects reduced investment and a reduction in the number and scope of sanctioned investment in 2009, reflecting the declining price of oil and the availability of credit, and called for measures to prevent the effects of the global recession combined with the banking crisis from dampening new investment in the recovery of the UK's oil and gas reserves.

Upstream and downstream capital costs have risen substantially in the global oil industry. The IHS Cambridge Energy Research Associates (IHS CERA) Upstream Capital Costs Index (UCCI) reported new record highs, with the index at 210 (base 100 in 2000). However, IHS CERA noted some moderation in September and October which 'points to a precursor to a downward turn in the direction of the UCCI' (CERA press release Dec 2008).

Evidence from the 10th Oil and Gas Survey (Aberdeen & Grampian Chamber of Commerce, February 2009) noted that the majority of contractors engaged in UKCS activity continued to report working at or above optimum levels, but there are expectations that these trends will weaken in 2009 and that the majority of operators expect to reduce total employment levels in 2009, with some reduction in the use of contract and temporary staffs. A net balance of contractors expect to increase total and permanent employment in 2009, but likewise expect to make less use of temporary and contract staffs.

The 10th Oil and Gas Survey also noted that the business strategy for some smaller exploration and production companies that relied on raising capital to finance exploration spending is likely to be less sustainable in the current climate of substantially reduced oil prices and a reduction in capital availability, or increased costs of capital. This problem is likely to be more acute in those areas where costs and lift costs are high. Additionally the survey concluded that the resulting decline in share prices has increased the probability of a wave of consolidation in the sector and of new overseas companies purchasing North Sea assets and contractors. All operators and 87% of contractors shared the view that the current credit issues would lead to more mergers and consolidation in the UKCS and all believe it will have an adverse effect on working capital and activity. In addition whilst the economic downturn will lead to spare capacity in the short term; the combination of financial constraints, sector consolidation and low prices will hinder new investment and oil markets will tighten in the medium term and a new upward price cycle is likely to emerge in a context of reduced investment levels in the UKCS.

Production

The Lloyds TSB Scotland Business Monitor - Issue 44 to November 2008, showed that production businesses showed a marked decline, displaying a worsening performance. In the latest quarter, 20% of firms experienced an increase in turnover, 37% a static position and 43% a decline giving a net balance of -23%. This compared unfavourably to the +6% of the previous quarter

and was significantly down on the +14% of the same quarter one year ago.

Manufacturing

The surveys differed in terms of when in 2008 orders turned down and the rate of decline accelerated. The Scottish Chambers' Business Survey noted a sharp drop in the level of total orders in q2 2008 and a further sharp drop in quarter 4 2008. The PMI data (not seasonally adjusted) likewise indicated a drop in orders in q2, a sharper drop in q3 and then a similar drop in q4 2008. In contrast Scottish Engineering recorded rising trends in new orders in q1 and q2 (although the rate of increase eased in q2), followed by a decline in q3 and a sharper decline in q4 2008.

Confidence and Orders

The Scottish Chambers' Business Survey reported that during the fourth quarter business confidence continued to deteriorate for a net of firms in all size bands. The proportion of firms reporting declining levels of business confidence in the fourth quarter is the highest reported in the history of the survey. The actual and expected trends in total orders in the second half of 2008 are the weakest ever recorded. Weakening trends in orders were again reported by a net of firms in all size bands and these trends are expected to continue through the next year.

Scottish Chambers reported that declining trends in the level of work in progress continued and are expected to deepen further in the first quarter of 2009. Average capacity remained at 73.6%, some 5 percentage points lower than a year ago, and once again 65% reported capacity used was below preferred levels. In both the 3rd and 4th quarters of 2008 the expectations as to the trends in orders and turnover for the next twelve months are the weakest reported in the history of the survey. However, pressures to raise prices eased significantly.

The latest Scottish Industrial Trends Survey by CBI Scotland (Quarter 4 2008) pointed to sharp deterioration in the trends of new orders and output among Scottish manufacturers. Output continued to fall and the contraction intensified. The proportion of respondents reporting sales/orders as a constraint on output almost doubled during the past two surveys. Total new order volumes fell at their sharpest rate since October 2001 – a notable deterioration from the comparatively modest decline seen in the previous survey. A slightly weaker fall is anticipated next quarter, with expectations for domestic orders appearing to have stabilised somewhat. It was in export markets that the trend in orders deteriorated most noticeably, and this is expected to continue as the global recession deepens. The CBI reported that export prospects for Scottish firms appear to be deteriorating faster than across the UK as a whole.

The Royal Bank of Scotland PMI Scotland (January 2009) report noted the sharpest fall in manufacturing production in eleven years of data collection. The main reason given for the decline was a fall in new business with the report highlighting the steepest decline in new order books in the history of the survey. The survey also showed a continued downturn in export orders albeit at a slower rate of decline than in the previous survey.

Costs/Prices

For Scottish Chambers' respondents pressure to raise prices eased significantly from more than 80% anticipating price increases in quarter 3 2008 to 29% in quarter 4. PMI Scotland report indicated that prices had broadly remained unchanged with firms claiming that rising costs had left them unable to lower charges due to rising competition.

Scottish Engineering Quarterly review noted that prices were holding up well in UK markets but export prices were slightly down although margins remained negative in both UK and export markets. Prices are expected to fall for a net of firms in the latest Scottish Industrial Trends Survey by CBI Scotland. Firms reported that costs had continued to rise albeit at a slower rate than in previous surveys.

Employment

Amongst Scottish Chambers' manufacturing respondents changes to employment levels were reported by 33% of which 23% reported declining employment; 23.3% reported reductions in total hours worked. Scottish Engineering reported that staffing levels in general, but notably in small companies, were negative. PMI Scotland noted that 27% of manufacturing firms recorded a fall in employment. CBI Industrial Trends Survey on the other hand reported that employment had remained broadly unchanged for almost a year despite expectations in the past two surveys that marked reductions would be seen.

Construction

Confidence and Orders

The Scottish Chambers' Business Survey noted that for a further quarter 80% of construction firms reported being less confident than a year ago, and the net trend in business confidence was the lowest recorded in the history of the survey. The declining trend in new contracts accelerated further in the fourth quarter, with a sharp downturn in the trends in public sector, in private commercial and domestic/house build contracts. Now only 28% (41%, 52%, 69%, and 71% in the previous four quarters) expect level or rising trends in the level of work through the next six months. Average capacity declined to 72%, the lowest figure recorded, a decline of 18 percentage points over the year. 43% reported and 59% expect a declining trend in the level of work in progress, again the weakest trends in the history of the survey. The UK PMI Construction index (January 2009) likewise noted continued contraction in the sector, but suggested the rate of slowdown was easing and that confidence, although falling, was easing at a more modest rate than in preceding

months, although it would be premature to interpret these signs as heralding a recovery of the sector.

Costs/Prices

For respondents to the Scottish Chambers Business Survey, expectations as to turnover trends over the next year have weakened significantly over the past three quarters. In the fourth quarter a net of 65% (37% and 25% in the previous two quarters two) anticipate declining turnover trends over the next year (in contrast rising net trends of 3%, 10% and 29% in the preceding three quarters). A net of -78% (-54%, -49% and -3% in the previous three quarters) anticipate declining profitability over the next twelve months. 83% of construction firms anticipate declining tender margins over the next twelve months.

Employment

Almost two thirds of Scottish Chambers' construction firms reported reducing employment and 73% reducing overtime in the fourth quarter. Recruitment was at the lowest level since the start of the survey.

The Service Sector

The PMI Scotland Report indicated that service sector activity declined for the tenth consecutive month although the rate of decline eased in January. The Lloyds TSB Scotland Business Monitor to November 2008 noted that Service businesses were more severely affected by the downturn than production businesses. For the last three months, the net balance on turnover of service businesses was -35%. This is significantly down on the -20% of the previous quarter and the +18% of the same quarter one year ago. The net balance on turnover for service businesses has now fallen for six consecutive quarters to the lowest level ever recorded in the 11 years of the Business Monitor. Compared to production firms service businesses were again more pessimistic with the overall net balance for increasing turnover in the next six months at -50% compared to the -34% of the previous quarter and the +13% of the same quarter one year ago. Only 10% of service business expect turnover to increase in the next six months compared to 60% who expect a decline.

Retail Distribution

Optimism and Sales

Business confidence among Scottish Chambers respondents fell to unprecedented levels in the fourth quarter. The proportion reporting and expecting declining sales was the highest ever reported in the history of the survey. Over two thirds of respondents reported declining sales trends and over 80% expect sales to ease in the first quarter of 2009.

The SRC Scottish Retail Sales Monitor (December 2008) reported that like-for-like sales in December were 0.8% higher than in December 2007, when they had risen 0.4%. Total sales in December were 3.4% up on a year ago. The small like-for-like increase was the best since June, but was largely driven by food sales, discounts and clearance sales. Food sales showed stronger growth but non-food sales recorded their largest decline since 1999, despite increased discounting.

Costs/Prices

Scottish Chamber of Commerce retail respondents reported that cost pressures were less evident in the fourth quarter. A net of -69% of retailers anticipate declining turnover, and a net of -72% (-49% in the previous quarter) anticipate declining profitability over the next year, suggesting rising pressures on margins in 2009. This was echoed in the Scottish Retail sales Monitor (December 2008) which noted "Widespread promotions and discounts for all goods put immense pressure on margins. With mounting fears about jobs and plummeting consumer confidence these figures provide little reassurance about Scottish retail's prospects for 2009".

Employment

Changes in employment levels were reported by 44% of Scottish Chamber respondents (13% in the previous quarter) and the proportion reducing employment was the highest recorded. The trends in employment indicated continuing declining trends in full time, temporary and permanent employment, overtime working was sharply down.

Tourism

Optimism and Demand

For a further quarter concerns as to the business situation were widely reported by respondents in the Scottish Chambers' Business Survey. Over 70% reported lower levels of business confidence, the most widely reported figure since 2001. The current declining trend in business confidence emerged in 2007 q4, and the proportions reporting declining trends more than doubled in the fourth quarter. The net trends in demand were weaker than in the previous fourth quarters of 1997 - 2007. Only 12.5% reported increased demand for accommodation, 7% increased numbers in restaurants and 9% increased demand for function/conference facilities. Average occupancy at 58% was lower than in the fourth quarters of 2006 - 2007, but broadly similar to that of q4 2005 and above that for q4 2001. Overall tourist demand accounted for 38.5% of total demand with business trade generating 27.3% and the balance was local demand.

A net of -37% Scottish Chamber of Commerce firms reported declining turnover trends (compared to a decline of -33%, -8% and increases of 10% and 38% in the previous quarters) and a net of -48% (-43.5%, -22.4%, -34% and -5% in the previous four quarters) reported falling trends in margins. Discounting of room rates was more

widespread than expected and 47% expect to discount room rates in the first quarter.

Employment

Changes in employment levels were reported by 52% of Scottish Chamber respondents. Net declining trends in full time, part time, seasonal and overtime working were reported, and the proportions recruiting staff was lower than for the past ten years.

Outlook

All surveys continue to note the slowing down in the Scottish economy becoming more evident over the fourth quarter, with the services sector continuing to be more affected than manufacturing.

Eleanor Malloy/Cliff Lockyer
February 2009

Current trends in Scottish Business are regularly reported by a number of business surveys. This report draws on:

1. The Confederation of British Industries Scottish Industrial Trends Survey for the quarter to December 2008;
2. Lloyds TSB Business Monitor for the quarter to November 2008 and expectations to May 2009;
3. Scottish Engineering's Quarterly Review for the fourth quarter 2008;
4. The Royal Bank of Scotland's Monthly Purchasing Managers' Index to end January 2009;
5. The Scottish Retail Consortium's Monthly Scottish Retail Sales Monitor for December 2008;
6. The Scottish Chambers of Commerce Quarterly Business Survey, reports for the fourth quarter of 2008;
7. Oil & Gas UK 2008 Activity Survey;
8. 10th Oil and Gas Survey (Aberdeen & Grampian Chamber of Commerce, February 2009).

Overview of the labour market

Current interest in the Scottish labour market inevitably focuses on the unemployment figures, and in this issue, in addition to noting recent changes in Scottish labour market trends, we take a wider view of Scottish labour market issues.

The Scottish labour market enters the recession following a prolonged period of rising numbers in employment and declining levels of unemployment, the latter down from 157,000 in 2001 to 113,000 in 2008 (Scottish Economic Statistics, 2008), falling from 6.2% in 2001 to 4.2% in 2008 (Scottish Economic Statistics, 2008). Over the same period activity rates have consistently risen.

Trends in the Scottish claimant count (1977-2008)

Inevitably the current climate invites comparisons with the patterns and unemployment levels in previous recessions. A consistent trend of the claimant count can be used to give some indications, although differences between the claimant count and the higher numbers generated using the ILO definition of unemployment, together with changing levels in activity rates and the impact of job creation measures need to be borne in mind (see figure 1).

In the recession of 1974 – 1975 the claimant count fluctuated through 1974, rose consistently through 1975, 1976 and 1977 and only began to decline in January 1978. In April 1974 Scottish it stood at 69,500, rising to 73,000 in September, but falling back to 69,000 in December 1974. The claimant count rose consistently through 1975 reaching 104,500 in December 1975, and 131,200 by December 1976 and peaked at 147,300 in December 1977, easing by some 11,800 through 1978 to 135,500 by December 1978.

In the recession of 1980 – 1981 the claimant count had already began to increase from September 1979 (137,800), and rose consistently through 1981 (reaching 262,200 by December 1981), 1982 (297,900 December 1982) and 1983 (298,200 December 1983), and a general upward trend continued through to January 1987 when unemployment peaked at 334,700.

The rise in the claimant count in the 1991 recession was much more modest, although the difference between the claimant count and ILO based measure of unemployment was increasing. The claimant count eased through 1987 to October 1990 (197,300) but rose month on month to December 1992 peaking at 248,100 before beginning to decline. By May 1995 it had fallen to under 200,000 and from December 2002 – July 2003 fluctuating around 100,000, falling to under 90,000 by October 2004, to under 80,000 by April 2007 and bottomed at 68,500 by January 2008.

A flexible labour market

Patterns of work have changed significantly over the past thirty years as a more flexible labour market and flexible working arrangements have emerged. Within the EU the UK is recognised as having one of the most flexible and lightly regulated labour markets in the EU and this has been regarded as contributing to increasing numbers in employment.

The deregulation of the labour market coupled with the rise in non standard hours, part time employment, shift work, annualised hours, flexible hours, temporary, sub contracting and self employment have arguably changed the employment landscape and are likely to impact on both the trends and patterns of unemployment. Annualised hours offer companies the ability to vary hours worked over the year to meet short term fluctuations in demand, and for the major retailers, with large numbers of part time staffs working a variety of shift patterns, automated labour scheduling programmes afford the ability to significantly vary the total numbers of hours worked without changing the numbers employed. Scottish data for 2008 indicates that there were 628,000 part time workers, 284,000 self employed and some 10,000 unpaid family workers. Detailed Scottish data on shift patterns, temporary, agency and sub contract is less readily available. Nevertheless, the Review of Scottish Business Surveys indicates the use of temporary and sub contracting employment terms have enabled companies in a number of sectors to re-adjust total employment, to meet declining demand, and at the same time to endeavour to retain core skills.

The promotion of flexible working arrangements and the general deregulation of the labour market has prompted considerable debate as to their desirability and usage in practice. As unemployment increases concern has re-emerged as to the extent to which flexibility is equated with insecure employment. Flexible labour and non standard employment have been variously termed ‘precarious employment’, ‘contingent work’, as forming part of the ‘peripheral’ or ‘insecure’ workforce, and as such are amongst the first groups to experience unemployment in a recession. Within the EU there is the concern with ‘flexicurity’ the balance of flexibility and security in the labour market, of meeting the employers’ need for flexibility and employees’ need for security in employment (Flexicurity and Industrial Relations, European Foundation for the Improvement of Living and Working Conditions, 2008).

Before the onset of the current recession Futureskills Scotland noted (The Scottish Labour Market 2006) that whilst employment growth is expected to be modest over

Table 1: Headline indicators of Scottish and UK labour market, Q4 2008

October to December 2008		Scotland	Change on quarter (%)	Change on year (%)	United Kingdom	Change on quarter (%)	Change on year (%)
Employment*	Level (000s)	2,532	-0.8	-0.2	29.361	-0.2	-0.1
	Rate (%)	75.4	-0.9	-1.1	74.1	-0.3	-0.7
Unemployment**	Level (000s)	137	9.2	5.9	1971	8.0	23
	Rate (%)	5.1	0.4	0.3	6.3	0.4	1.1
Activity*	Level (000s)	2,669	-0.3	0.1	31,333	0.4	1.2
	Rate (%)	79.7	-0.5	-0.9	79.2	0.1	0.2
Inactivity***	Level (000s)	653	2.6	4.8	7,858	-0.4	-0.6
	Rate (%)	20.3	0.5	0.9	20.8	0.5	-0.2

Source: Labour Market Statistics (First Release), Scotland and UK, Feb 2009

* Levels are for those aged 16+, while rates are for those of working age (16-59/64)

** Levels and rates are for those aged 16+, rates are proportion of economically active.

*** Levels and rates for those of working age (16-59/64)

Table 2: Employee jobs by industry, Scotland, June 2008

	All jobs (not seasonally adjusted)	All jobs	Agriculture, Forestry and Fishing	Mining Energy and Water Supplies Industries	Manufacturing Industries	Construction	Distribution etc, transport etc, finance and business services	Education, health, public admin and other services
SIC 2003 Section		A-O	A,B	C,E	D	F	H-K	L-O
Sep 05	2,373	2,373	32	37	232	129	1,102	842
Sep 06	2,361	2,360	33	38	224	138	1,085	841
Sep 07	2,389	2,389	33	43	222	139	1,108	844
Dec 07	2,391	2,400	25	42	220	139	1,127	847
Mar 08	2,392	2,382	28	42	218	137	1,109	849
Jun 08	2,396	2,396	35	42	216	136	1,114	853
Sep 08	2,387	2,388	35	41	216	138	1,105	852

Source: Labour Market Statistics (First Release), Scotland, February 2009

The next ten years 'this moderate growth masks significant opportunities (demand), as existing workers leave the Scottish labour market through migration, ill health and early retirement'. There will be a need to replace these workers and to meet the 'middle ranking challenge' of attracting the necessary numbers of skilled staff. Retaining the skills base, the balance of skills and experience necessary to grow after the recession, will be a significant issue for some sectors, especially those with shortages in key skills and with an aging workforce.

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The move towards more flexible labour markets has also reflected a move towards financial flexibility, or variable payment systems, with pay less linked to collective bargaining and national rates, as in the 1970s, and increasingly linked to combinations of individual and company performance. The Workplace Employment Relations Survey (2004) found performance related payment arrangements in 40% of UK workplaces, '37% of private sector workplaces gave profit related payments or bonuses, whilst 21% operated employee share schemes' (Inside the Workplace: First Findings from the 2004 Workplace Employment Relations Survey). More recent data suggests that bonus schemes are more widespread. The CIPD Annual Reward Survey (2009), a more limited survey, reported that 70% of respondents used a cash based bonus or incentive plan to reward employees, this ranged from 33% in the Public services to 89% in the private services sector, where over 80% of executive board members and over 70% of senior managers, middle management and clerical/technical were covered by bonus scheme, where over 80% of executive board members and over 70% of senior managers, middle management and clerical/technical were covered by bonus schemes. The survey data suggests not only a wide range in the potential and maximum possible bonuses as a percentage of base salary. The CIPD survey found that 43% of private sector respondents offered some form of employee share ownership scheme.

Recent trends and statistics

Comparable figures on the labour market[1] between Scotland and the United Kingdom in the fourth quarter of 2008 are summarised in Table 1. Labour Force Survey (LFS) data show that in the final three months of 2008 the level of employment in Scotland fell by 0.8 per cent, to 2,532 thousand. Over the year to December 2008, employment in Scotland fell by 6 thousand, approximately 0.2 per cent. For the same period, UK employment fell by 0.3%. The Scottish employment rate – those in employment as a percentage of the working age population – was 75.4 per cent, down 1.1 per cent compared to one year earlier.

Figure 2 provides an account of Scottish quarterly LFS employment over a sixteen-year period to the most recent quarter. Employment levels remain close to historical highs, reached in Q2 2007.

Table 1 shows that for Scotland the preferred International Labour Organisation (ILO) measure of unemployment rose by 9.2 per cent to 137 thousand, between the third and fourth quarters of 2008. This equates to a 5.9 per cent annual increase in the number unemployed under this measure[2]. The ILO unemployment rate rose in the three months to December 2008 and now stands at 5.1 per cent. This represents a rise of 0.4 percentage points over the last quarter and a rise of 0.3 percentage points relative to the same period a year earlier. The comparable ILO unemployment rate for the UK stands at 6.3 per cent, and is up 0.4 per cent over the most recent quarter, and up 1.1 per cent over the year.

The economically active workforce includes those individuals actively seeking employment and those currently in employment (i.e. self-employed, government employed, unpaid family workers and those on training programmes). Table 1 shows that the level of the economically active fell by 0.3 per cent between Q3 2008 and Q4 2008. There were 2,669 thousand economically active people in Scotland during Q4 2008. This comprised 2,532 thousand in employment and 137 thousand ILO unemployed. The level for those of working age economically inactive rose in the last quarter, up 2.6 per cent on the previous quarter to 653 thousand people. This indicates an increase of 4.8 per cent in the number of people of working age economically inactive over the last year.

The most recent (seasonally adjusted) figure for Jobseekers allowance claimants in Scotland stood at 101.1 thousand in January 2009, up 3.4 thousand from the previous month. The claimant count rate in January 2009 stood at 3.7 per cent. This is up 0.1 percentage point from the previous month, but up 1.2 percentage points over the year. In April 2008, the Scottish claimant count rate was identical to the UK claimant count rate at 2.5 per cent, but both have risen in the last five months. The UK claimant count rate in January 2009 was 3.8 per cent. Figure 5 shows the claimant count rates for Scotland and the UK since comparable records began in April 1974.

Figure 3 shows net flows to Jobseekers Allowance in Scotland between November 1988 and the most recent data (January 2009). The reduction in the claimant count unemployment over recent years can be seen by the greater outflows than inflows over much of this time period. The recent sharp increase in claimant count levels can be seen by the increase in the scale of inflows to Jobseekers allowance since March 2008.

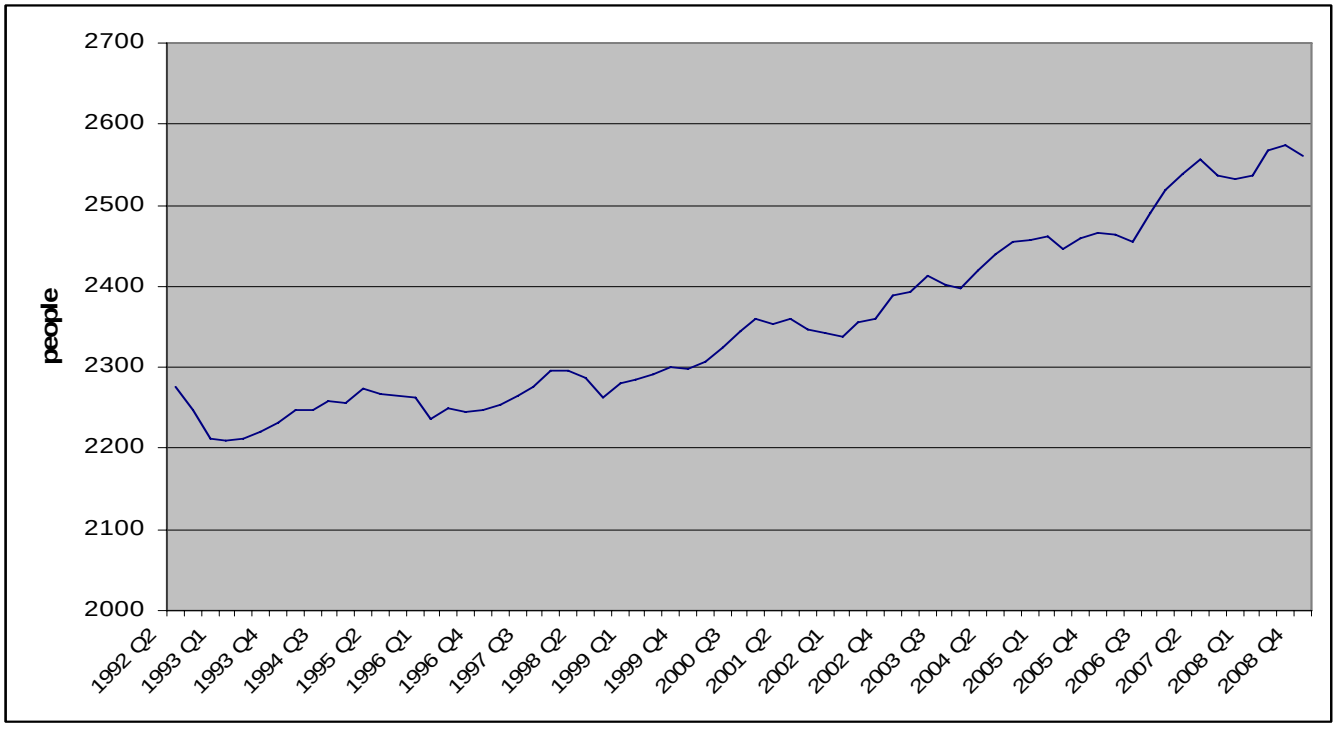
The most recent figures for the number of employee jobs by industrial activity are detailed in Table 2. Employee job figures are a measure of jobs rather than people. Total seasonally adjusted employee jobs for the quarter ending September 2008 stood at 2,387 thousand. The number of jobs in the manufacturing industry continues to fall, and

now stands at 216 thousand, the same as the previous quarter, and down 6 thousand against the same quarter

Figure1: Claimant count 1974 – 2009, Unemployment 1992 – 2009

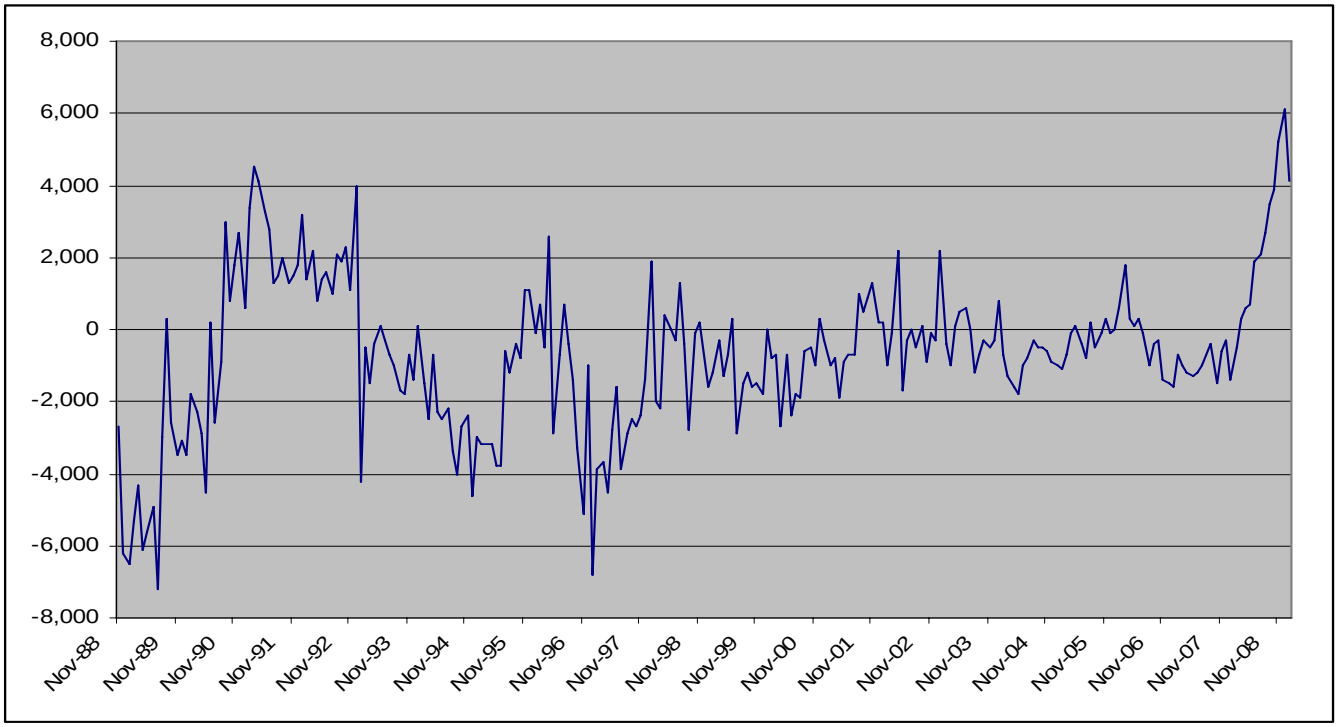
Source: Nomisweb

Figure 2: Total (16+) employment in Scotland, Q2 1992 to Q2 2008, seasonally adjusted



Source: Labour Force Survey, National Statistics

Figure 3: Net flows of claimants to Jobseekers allowance, November 1988 to January 2009



Source: National Statistics (accessed through Nomisweb)

one year earlier. The number of jobs in the service industry fell by 9 thousand over the last quarter to 1,105 thousand, and there are now 2 thousand fewer jobs in the service industry than the same period ending a year earlier.

Outlook

Scotland's labour market continues to perform reasonably well; the trend in unemployment is increasing, but as yet not at much higher rates. However there are signs that the unemployment rate will increase more strongly through 2009. As yet it is unclear as to how the more flexible and deregulated labour market that has emerged over the past 25 years will impact on the pattern and level of unemployment; there are stronger signs that it may affect more adversely those employed on more flexible employment terms. At the company level policies to ensure the retention of key skills and expertise will be a challenge, especially where these are distributed towards the older age groups.

Endnotes:

[1]The Census 2001-consistent population figures at local authority level were released in February 2003. This has allowed the production of interim regional LFS estimates. The population data only cover the periods up to mid-2001. The data presented here are taken mainly from Labour Market Statistics, May 2008 and are consistent with the updated LFS data available on NOMIS from Summer 2004. Labour Market Statistics continue to report data for Scotland at the quarterly level, so this will continue to form the basis of our analysis of movements in the labour market between quarters.

[2]The Labour Force Survey definition of ILO unemployment takes precedence over the claimant count measure. ILO unemployment is much less sensitive to changes in the regulations governing unemployment benefit, and conforms to a widely accepted standard to allow for more meaningful cross-country comparisons.

Cliff Lockyer
16 February 2009

Economic perspectives

Opinions expressed in economic perspectives are those of the authors and not necessarily those of the Fraser of Allander Institute

A recommendation on how the method of setting water prices in Scotland should be changed: customer financed capital as a notional loan to the utility

Jim Cuthbert
Margaret Cuthbert

Introduction

It is difficult to over-estimate the importance of setting prices appropriately for a major utility like water, given that inappropriate pricing can cause unnecessary damage to the comparative competitiveness of a country's economy. In an earlier article in the Commentary, (Cuthbert and Cuthbert, 2007), we gave a critique of the current cost regulatory capital value (CCRCV) method of utility pricing: a method used, for example, in setting revenue limits, and so prices, in the water industry in Scotland and in England. While that article identified significant problems with the CCRCV approach, we did not make detailed recommendations about how these problems might be rectified. This paper makes a specific proposal about how CCRCV should be modified: our proposal is particularly well suited to the circumstances where, as in the case of Scottish Water, CCRCV pricing is being applied in a publicly owned utility. We argue that implementation of the proposed approach would have a number of advantages: in particular, it would lead to significantly lower water charges, while being fully sustainable well within current levels of public expenditure provision; it would reduce the likelihood of eventual privatisation of the water industry in Scotland; and there is the technical advantage of greatly reducing the cost to the Scottish Budget of the capital charge levied by the Treasury on the assets of the water industry in Scotland.

1. Background

1.1 Full details on the history and background of the CCRCV approach to utility pricing can be found in Cuthbert and Cuthbert, 2007. But to recapitulate briefly, the Regulatory Capital Value of a utility is an estimate of the total value of the capital value of the assets employed by

the utility in performing its functions. We draw a basic distinction between applications which value the assets of the utility at historic prices, and those which value the assets in some form of current prices. We denote the latter approach as an application of current cost regulatory capital value, (CCRCV).

1.2 In a typical application of the CCRCV approach to utility price setting by a regulator, the CCRCV is rolled on from year to year by:

a. uprating for inflation
b. adding in the value of gross investment
c. deducting depreciation, as assessed in current cost terms.

The regulator then sets revenue caps for the industry, (that is, maximum allowable revenues, which therefore determine maximum allowable prices), as the sum of:

i. the level of current operating expenses the regulator is prepared to allow, (after adjusting, for example, for whatever level of efficiency savings the regulator judges is achievable);

ii. current cost depreciation;

iii. a capital charge, calculated as the product of an assumed rate of return times the estimated CCRCV.

1.3 A version of CCRCV utility pricing was initiated in the mid 1990s in England and Wales by the water regulator OFWAT, (see OFWAT 2004), to set the revenue caps for the water and sewerage companies, which had been privatised in 1989. The approach has subsequently been extended in the UK to the regulation of, for example, the electricity distribution network, airports, and the publicly owned water industry in Scotland, and is also proposed for the water industry in Northern Ireland.

1.4 There is, however, a major problem with the CCRCV approach. This can be seen by considering the simplest possible case, where the provision of capital assets is funded by borrowing. What the utility operator actually has to pay out to the market, to fully fund the provision of capital, is equal to depreciation and interest calculated at historic cost. But current cost depreciation and interest are normally greater than historic cost depreciation and interest, particularly where, as in the water industry, average asset lives are long: the CCRCV method thus leaves the operator with a financial surplus.

The implications of this were examined in detail in Cuthbert and Cuthbert, (2007). That paper set out the underlying algebra, and showed that, under CCRCV pricing, the utility operator will typically benefit from a windfall profit on any capital invested: this profit is a function of the rate of interest, the rate of inflation, and the length of asset life. The profit will commonly be very significant. For example, for an interest rate of 5%, with inflation running at 2.5%, and an asset with a thirty-year life, the operator will receive a windfall profit of over 40% of the value of the capital asset.

The probable consequences include:

- overcharging, and excess profits
- for a privatised utility, excess dividend payments;
- for a non-privatised utility, funding an undue proportion of capital from revenue;
- likely distortion of the capital investment programme, as capital investment itself becomes a profitable activity for the utility;
- unnecessary uncompetitiveness of water's business customers as they are over-charged for an important input.

For a public sector utility, the likelihood is that substantial cash surpluses would build up in due course: this is likely to make the utility a tempting target for eventual privatisation.

2. The proposed approach: treating capital financed from revenue as a notional loan

2.1 Is it possible to retain the key features of the CCRCV approach, (for example, the way that it smoothes the impact on present day charges of the accident of the timing of past investment decisions), while at the same time correcting the above problems? We argue that the modification proposed in this section achieves precisely this. The proposal put forward here is particularly relevant to the CCRCV method as applied in a publicly owned utility, where the financial surplus arising from the application of unmodified CCRCV pricing is likely to be used, in the first instance, to fund net new capital formation out of revenue.

2.2 In Cuthbert and Cuthbert 2007, we suggested that one route towards a more acceptable form of CCRCV would involve working out a proper decomposition of the current cost value of the capital assets of the utility into the components arising from different funding sources, that is, from borrowing, equity where appropriate, revenue raised from customers, inflation, etc. Once this was done, we argued that it should then be possible to find a more rational basis for determining how these different funding sources should be appropriately rewarded. What we are going to propose in this paper is in line with the spirit of this suggestion.

2.3 What is proposed is that the basis of CCRCV should be retained: but that where the CCRCV surplus, (the difference between what is charged to customers under CCRCV pricing and what is needed to cover historic cost depreciation and interest), is used to fund the creation of net new capital assets, then this should be regarded as customer-provided capital. More specifically, it is proposed

that this customer-provided capital should be regarded as a notional loan from the consumer base to the company: a rebate would then be paid to the customer base, equal in amount to the value of historic cost depreciation and interest charges on the customers' loan.

(For the avoidance of doubt, we should make it clear that we do not propose that the calculation of notional debt would be carried out at the level of the individual customer. There would be an overall notional debt, owed to the customer base as a whole, on which an aggregate rebate would be calculated. This aggregate rebate would then need to be allocated to individual customers. This could be done in a variety of ways: e.g., as a flat percentage reduction in charges. This paper is not concerned with the precise detail of this last stage.)

2.4 The following quotation, taken from a reference book on utility regulation issued under the auspices of the World Bank, is relevant to this proposal:

> "The regulator may consider customer-provided capital to be an interest free loan to the operator, in which case the operator receives no return on that portion of its regulated assets, or the regulator may impute to the operator an interest payment on the customer provided capital, the effect of which is to lower the operator's regulated prices." (M.A. Jamison et al., 2004)

The underline in the above quotation is ours. It is clear that our proposed approach is entirely consistent with the principle embodied in this quotation.

3. Limiting behaviour in the steady state

3.1 We illustrate the implications of our proposal by considering what happens in a steady state model, where real investment is running at a constant amount each year. This is a not unreasonable description of, for example, a utility like Scottish Water: witness the following quotation from the then Water Industry Commissioner, giving evidence to the Scottish Parliament Finance Committee in December 2003:

> "… Scottish Water needs to make on-going investment in the industry at the present levels for the foreseeable future. There is no prospect of a diminishment in the investment spend of £400 million to £500 million a year. Every year for as long as I will be on the planet, Scottish Water will have to spend a similar sum of money…"

3.2 Specifically, we assume that gross investment is running at a constant real amount of 1 unit per annum. It is assumed that inflation is constant at r% per annum. The nominal interest rate is assumed to be i%, (which we assume is both the rate at which the utility can borrow from the National Loan Fund, and the rate used to assess the cost of capital in current cost pricing.) Each year, customers are charged an amount to cover the cost of the capital goods employed in the industry, where this amount is assessed using CCRCV charging. We assume that any surplus of customer charges over what is required to pay historic cost interest and depreciation is used to fund net new investment, and is regarded as a notional loan from the customer base. The customer base will in due course get a rebate, equal to historic cost interest and depreciation on this notional loan. Investment not funded from revenue is funded by borrowing from the NLF.

3.3 In the long run, the real, (as opposed to nominal), unrebated current cost charge to customers implied by the CCRCV approach will settle down to a limiting value, which we denote by cc: and the real historic cost interest and depreciation on the total annual investment of 1 will settle down to a constant amount, denoted by hc. (Note that hc is the historic cost interest and depreciation on the gross investment of 1: it is not affected by whether gross investment is funded in whole or part by borrowing from the NLF or the customer).

The limiting behaviour of the rebated payment system is entirely determined by cc and hc, as the following argument shows:

> Each year, the utility has to fund gross real investment of 1. The amount of free customer revenue which is available to fund this investment is what is left out of cc after paying hc historic cost interest and depreciation, (either to the NLF, or as a customer rebate): so the amount of gross investment funded from customer charges would be
>
> (cc – hc), if cc – hc $\leq$ 1:
> and 1, if cc – hc > 1.
>
> Hence, if φ is defined as min(cc – hc, 1), then the limiting proportion of gross investment funded out of customer charges will be φ.
>
> Clearly, φ is therefore also the limiting proportion of outstanding debt, (actual and notional), funded from customer charges: so φ also represents the limiting proportion of historic cost charges which will go back to the customer as a rebate.
>
> Therefore, in the limit, the real amount which customers pay after rebate is (cc - φ hc).

3.4 This expression, (cc - φ hc), in fact tells us a great deal about the limiting behaviour of the rebated system. As we will see, the way the system behaves depends critically on whether real interest rates are positive or negative, (which corresponds to whether hc > 1 or hc < 1): and on whether or not all capital expenditure is eventually funded direct from revenue, (which corresponds to whether φ < 1 or φ =1).

The following table shows how the amount customers pay after rebate, (denoted PAYS), depends on the different possible combinations of real interest rate and φ. The derivation of the relationships in the table is given in Annex 1.

Table 1: The rebated charge: PAYS

	$0 < \varphi < 1$	$\varphi = 1$
Real interest rate positive	1 < PAYS < hc	PAYS $\geq$ 1
Real interest rate zero	PAYS = 1	PAYS $\geq$ 1
Real interest rate negative	hc < PAYS < 1	PAYS $\geq$ 1

3.5 This table is interesting because it gives a fairly complete account of the possible relationships under the rebate model: but of course, not all the possibilities considered in the table are equally likely. If we regard as normality a situation where real interest rates are positive, (which is equivalent to the situation hc > 1), and if at the same time inflation is relatively low, then we would expect to be in the top left hand corner of the table. In this case, the rebated charge which customers will pay will actually be less than what customers would have paid if the utility had been operating historic cost pricing. If inflation rises, however, (with interest rates increasing so that real interest rates still remain positive), then we would find ourselves in the top right hand cell, with all of capital being funded from customer charges. In these circumstances, we could find ourselves back in the situation where a financial surplus is building up in the utility: however, the rate at which this surplus would accumulate would be much slower than under unmodified CCRCV pricing.

3.6 But how does this model translate into some potential real-life scenarios? First, we need to bring in one further parameter, which is the length of life of the capital assets. We assume that capital assets have a fixed life of n years. So, to summarise, we assume that we are operating a rebated model where we have fixed gross investment of 1 unit in real terms per annum: that inflation is r %: the nominal interest rate is i %: and that capital assets last for n years. The following tables show the limiting real values which will result for a number of different combinations of n, i, and r. In each case, we show:

- the CCRCV charge: that is, what customers would have been charged if full CCRCV pricing were in operation;
- the Historic Cost charge: that is, what customers would have been charged if historic cost pricing were in operation;
- the Rebated Charge: that is, the net amount customers would have been charged, after rebate, if the rebate system were in operation;
- the percentage of capital financed from customer revenues, if the rebate system were in operation;
- annual borrowing from the National Loan Fund.

The specific formulae used in deriving these figures are given in Annex 2.

3.7 The first point to note about Table 2 is that in all the cases considered, the rebated charge is a good deal less than the unrebated CCRCV charge: for example, in the case where asset life is 30 years, nominal interest rate 5%, and inflation 3%, the rebated charge is 62% of what the CCRCV charge would have been. Note too that the extent of the saving increases with asset life.

In most of the cases considered, the rebated charge is also less than the historic cost charge. The exceptions occur when there is a conjunction of long asset life with relatively high inflation: (for example, asset life 50 years, interest rate 8%, and inflation 5%, 6% or 7%). Under these, possibly relatively unlikely, scenarios, the rebate model would imply that substantial financial surpluses would still accrue within the utility, (though the extent of these surpluses would be much less than implied by unrebated CCRCV charging.)

In most of the cases considered, the rebated charge is in fact not much higher than 1, (which is what would be implied by funding all capital expenditure direct from revenue): typically, the rebated charge lies in the range 1.02 to 1.23. The exceptions occur with the conjunction of long asset life with high inflation, in which case the rebated charge is a good deal higher.

In most of the cases considered, the percentage of capital financed from revenue is substantial: (for example, for asset life 30 years, interest rate 5%, and inflation 3%, 54% of gross capital expenditure is financed from revenue). This percentage increases with asset life, and the rate of inflation.

The bottom row in each table gives the net amount of borrowing which would be required from the NLF. For example, for asset life 30 years, interest rate 5%, and inflation 3%, borrowing from the NLF each year would be 0.158, (as compared to a gross annual investment programme of 1.) To put this in context: if Scottish Water's investment programme is assumed to be around £600 million per annum in real terms, then this would imply an annual borrowing requirement of less than £100 million: this compares with a current public expenditure provision of around £180 million per annum for Scottish Water. (In most of the other cases illustrated in the above table, the borrowing requirement would be significantly less than for this particular example.)

3.8 As noted in the previous paragraph, the rebated charge in the steady state will very often be close to 1: that is, it will be close to what consumers would have paid if all capital investment had been funded direct from revenue

Table 2: Limiting values for customer rebate model (gross investment = 1 unit per annum

			Asset life in years	*30*
			Interest rate	*5%*
	Inflation rate	2%	3%	4%
CCRCV charge		1.78	1.78	1.78
Historic cost charge		1.38	1.23	1.11
Rebated charge		1.23	1.11	1.04
% of capital financed from rev		39.5%	54.4%	66.9%
Borrowing from NLF		0.153	0.158	0.14

			Asset life in years	*30*
			Interest rate	*8%*
	Inflation rate	5%	6%	7%
CCRCV charge		2.24	2.24	2.24
Historic cost charge		1.29	1.18	1.08
Rebated charge		1.02	1.06	1.16
% of capital financed from rev		94.7%	100%	100%
Borrowing from NLF		0.026	0	0

			Asset life in years	*10*
			Interest rate	*5%*
	Inflation rate	2%	3%	4%
CCRCV charge		1.28	1.28	1.28
Historic cost charge		1.15	1.1	1.05
Rebated charge		1.13	1.08	1.04
% of capital financed from rev		12.2%	17.7%	22.8%
Borrowing from NLF		0.089	0.121	0.146

			Asset life in years	*10*
			Interest rate	*8%*
	Inflation rate	5%	6%	7%
CCRCV charge		1.44	1.44	1.44
Historic cost charge		1.14	1.09	1.04
Rebated charge		1.1	1.06	1.03
% of capital financed from rev		30.3%	35.2%	39.7%
Borrowing from NLF		0.159	0.171	0.179

			Asset life in years	*50*
			Interest rate	*5%*
	Inflation rate	2%	3%	5%
CCRCV charge		2.28	2.28	2.28
Historic cost charge		1.56	1.32	1.14
Rebated charge		1.16	1.02	1.13
% of capital financed from rev		71.8%	95.1%	100.0%
Borrowing from NLF		0.105	0.024	0

			Asset life in years	*50*
			Interest rate	*8%*
	Inflation rate	5%	6%	7%
CCRCV charge		3.04	3.04	3.04
Historic cost charge		1.38	1.23	1.1
Rebated charge		1.66	1.81	1.194
% of capital financed from rev		100%	100%	100%
Borrowing from NLF		0	0	0

each year. This raises the question: why not move to the even simpler, and ultimately cheaper, system, where all capital expenditure is funded direct from revenue. In real life, however, while our assumption of constant real investment is likely to be reasonable as an average, the actual path of investment is likely to wobble around this average from year to year. The advantage of the rebated CCRCV approach is that it will smooth the impact of such wobbles on customer charges.

4. Dynamics of system in transitional phase

4.1 The preceding section looked at the limiting behaviour of the rebated system, under the assumption of steady state real investment. It would, however, take n years after the introduction of the rebate to reach this steady state, where n is the asset life. It is a question of great practical importance, therefore, to consider how charges would move in the early years following the introduction of the rebate system.

4.2 In this section we look at the dynamics of the transition from unmodified CCRCV pricing to rebated charging. It is assumed that, initially, traditional CCRCV charging is being operated: we assume that the system is operating in the limiting steady state, with unit real investment per annum: we assume that, initially, all gross investment is funded by borrowing from the NLF, with the CCRCV surplus over historic cost loan charges being removed from the system. Suppose that, at a given point in time, the rebated charging system is introduced. As before, we consider the three parameter model specified by asset life, interest rate, and inflation rate.

4.3 Chart 1 illustrates the resulting path of rebated charges, in the specific case of asset life 30 years, interest rate 5%, and inflation 3%.The following table shows the rebated charge as a percentage of the CCRCV charge, for each of the first 15 years after the introduction of the rebate system, for a number of different combinations of asset life, interest rate and inflation:-

What the Chart and Table 3 demonstrate is a pattern of a fairly rapid initial decline in the rebated charge, which then tapers off as the limiting value is approached after n years. Of the cases considered in the above table, the slowest rate of decline occurs in the left hand column, corresponding to asset life of 10 years, interest rate 5%, and inflation rate 3%. Even in this case, however, the rebated charges initially decline at a rate of 2% relative to CCRCV charges. In the other cases considered, (with longer asset lives which would be more typical of the water industry), the initial rate of decline lies between 2.5% and almost 5%. The implication is that substantial customer benefits are likely to accrue from a rebated charging system immediately from its date of introduction.

4.4 Finally, a note of caution is appropriate. If a rebated charging system were being introduced in real life, then the starting point would not be CCRCV charging operating in a steady state. For example, in the water industry in Scotland, while future real investment appears likely to be fairly steady on average, (witness the quotation in paragraph 3.1 above), past investment experienced a significant real uplift to around its present level, round about year 2000. This implies that the starting point, if rebated CCRCV charging were introduced now, would be different from the steady state CCRCV taken as the starting point in the above illustrations. To understand the actual dynamics of rebated CCRCV charging, introduced from the current starting point, would therefore require further modelling, which lies beyond our present scope. It is clear, however, even without detailed modelling, that a rebate system would produce rapid reductions in customer charges, relative to the profile of unrebated CCRCV charges.

5. Implications for the Treasury's capital charge

5.1 In a 1995 White Paper, the then government at Westminster set out proposals for a new system of government accounting, called Resource Accounting and Budgeting, (RAB). RAB is a method of taking into account the full cost of assets consumed in the delivery of a government service. Essentially, in preparing their budgets, government departments count against their Departmental Expenditure Limit the cash costs of providing services, together with what are known as "non-cash" costs. These non-cash costs include an annual capital charge, related to the value of the capital assets controlled by the department. The capital charge is calculated as a rate of interest times the residual value, (having taken off depreciation), of the capital stock measured at today's prices. Between 1997 and 2003 the rate of interest used by the government for the capital charge was 6% in real terms: this became 3.5% in real terms in 2003.

Since Scottish Water is a public corporation, the Scottish government has to account each year for a capital charge based on the value of Scottish Water's capital assets.

5.2 The following quotation, from a Treasury document, describes the exact basis on which the capital charge is calculated:

> "The cost of capital charge is 3.5 per cent of the net assets (fixed capital and financial assets, net of financial liabilities and provisions) employed by each department." (Treasury, 2007)

This quotation clearly states that the capital charge should be calculated on the basis of the current cost value of the capital assets employed, net of any financial liabilities. The introduction of a rebate scheme, as proposed here, would mean that Scottish Water, in addition to conventional NLF debt, would have a notional financial liability, equivalent to the notional historic cost debt on which the customer base earns its rebate. In the spirit of the above quotation, therefore, the capital charge on the Scottish Government

Chart 1: Real CCRCV charges historic cost charges and rebated charges: asset life 30 years

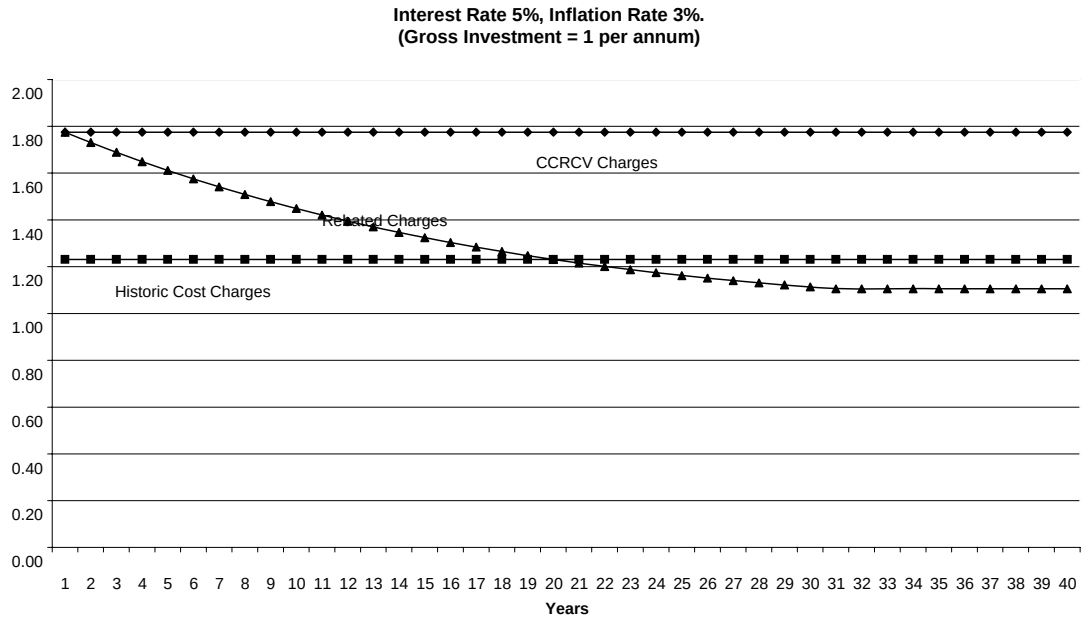


Table 3: Rebated charge as % CCRCV charge, by years since introduction of rebate

Asset Life		**10**		**30**		**50**	
Nominal Interest rate		**5%**	**8%**	**5%**	**8%**	**5%**	**8%**
Inflation rate		**3%**	**5%**	**3%**	**5%**	**3%**	**5%**
Year	1	100.0	100.0	100.0	100.0	100.0	100.0
	2	98.0	96.4	97.5	95.4	97.2	96.9
	3	96.1	93.1	95.2	91.2	94.4	93.9
	4	94.3	90.1	92.9	87.2	91.8	91.2
	5	92.6	87.4	90.8	83.6	89.3	88.6
	6	91.1	85.0	88.8	80.2	87.0	86.2
	7	89.6	82.8	86.8	77.0	84.7	83.9
	8	88.3	80.8	85.0	74.1	82.5	81.8
	9	87.0	79.0	83.3	71.4	80.4	79.8
	10	85.8	77.5	81.6	68.9	78.4	78.0
	11	84.8	76.1	80.1	66.6	76.5	76.3
	12	84.8	76.1	78.6	64.4	74.7	74.6
	13	84.8	76.1	77.2	62.4	73.0	73.1
	14	84.8	76.1	75.9	60.6	71.4	71.7
	15	84.8	76.1	74.6	58.9	69.8	70.4
	Limit	84.8	76.1	62.3	45.3	44.6	54.6

for the assets of Scottish Water should be calculated on the basis of net assets reduced by this liability: so the rebated system should result in a significant reduction in the capital charge on the Scottish Government.

5.3 In fact, we would go further than this: a strong case could be made that that portion of the capital stock which has been funded from customer charges had never represented a burden on public expenditure resources, and should therefore be exempt from the capital charge: that is, the entire portion of CCRCV which was financed from revenue should be exempt from the capital charge. As the relevant figures in Table 2 above indicate, the percentages of capital financed from revenue are typically high: so the savings to the Scottish Government from this would be very significant.

6. Conclusion

6.1 To recapitulate, the modification to CCRCV pricing proposed in this paper has the following advantages:

It would lead to a rapid decrease in water charges, relative to charges under unmodified CCRCV pricing: this would be of direct benefit to consumers, and bestow a significant comparative advantage on industry in Scotland, relative to, for example, England, (where unmodified CCRCV remains in operation.)

The proposed approach is fully sustainable, both in the sense that all sources of finance are appropriately rewarded, and also in the sense that the residual public expenditure requirement is well within the level of real borrowing provision for water currently in the Scottish budget.

It should significantly reduce the burden on the Scottish Budget of the Treasury's capital charge for water.
It prevents the build-up of a financial surplus within Scottish Water. In addition, it will be very clear to consumers in general exactly what proportion of the capital stock has been funded directly by consumers, so increasing the feeling that consumers own, and benefit from, a stake in the industry. Both of these factors should reduce the likelihood of eventual privatisation.

The proposal is entirely consistent with the World Bank principles of how customer funded capital might be rewarded: and it retains the smoothing benefits of the CCRCV approach.

6.2 In the light of the above, we suggest that the proposal should be given active consideration by the Scottish Government.

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Annex 1: Derivation of relationships in Table 1

Recall that PAYS = (cc - φ hc).

First of all, suppose φ < 1:

If hc > 1, then (cc - φ hc) = (cc – hc) + (1 - φ)hc > (cc – hc) + (1 - φ) = 1.

If hc = 1, then (cc - φ hc) = (cc – φ) = hc = 1.

If hc < 1, then (cc - φ hc) = (cc – hc) + (1 - φ)hc < (cc – hc) + (1 - φ) = 1.

Moreover, (cc - φ hc) > hc

if and only if (cc – hc) > (cc – hc)hc

if and only if 1 > hc, (since (cc – hc) > 0).

Secondly, if φ = 1, then

(cc - φ hc) = cc – hc $\geq$ 1.

Annex 2: Formulae used

The specific values quoted in the paper were calculated using the following formulae. The model assumes that there is a steady state real level of gross investment of 1 unit per annum. There are three input parameters: interest rate, i, inflation rate, r, and length of asset life. The model assumes that, up to year n, pure CCRCV pricing has been in operation, with the CCRCV surplus, (that is, the excess of CCRCV charges over historic cost interest and depreciation), removed from the system. From year (n+1), the surplus is used to fund investment, and regarded as a notional loan from customers, on which they will then get a rebate, equal to the historic cost depreciation and interest charges on this loan. The model then models the transition to the new steady state. The formulae used are as follows: (note that in these formulae, r and i are expressed as fractions). Note that the values calculated are in nominal terms, whereas those given in the text have been deflated to be in real terms:-

Gross investment in year t = $(1+r)^t$

Current cost depreciation in year t = $CCD_t = (1+r)^t$

Current cost asset value in year t = $CCRCV_t = 0.5(n+1)(1+r)^t$

Current cost interest in year t = $CCI_t = 0.5i(n+1)(1+r)^t$

Historic cost depreciation in year t $= HCD_t = \frac{1}{n}\sum_{k=1}^{n}(1+r)^{t-k}$

Historic cost interest in year t = $HCI_t = \sum_{k=1}^{n} i(1+r)^{t-k}\frac{(n+1-k)}{n}$

Self financed investment in year t = SFI_t

= 0, for $t \leq n$,

= min(($CCD_t + CCI_t - HCD_t - HCI_t$), $(1+r)^t$),

for $t \geq (n+1)$.

Depreciation element of rebate in year t = $RD_t = \frac{1}{n}\sum_{k=1}^{n} SFI_{t-k}$

Interest element of rebate in year t = $RI_t = \sum_{k=1}^{n} iSFI_{t-k}\frac{(n+1-k)}{n}$

Net borrowing from NLF in year t = $(1+r)^t - SFI_t - HCD_t + RD_t$

Scottish Ferry Policy

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1. Introduction

The purpose of this paper is to review the evolution of Scottish policy for the provision of ferry services 1999-2009, a period broadly coinciding with the life of the re-established Scottish parliament. We shall argue that, despite clear and consistent warnings by this author and others, the government failed to put in place measures and safeguards that were regarded as standard practice for such an industry providing essential services. These failures in economic regulation in the first Session of Parliament (1999-2003) in turn had knock-on implications for potential breaches of EC State aid and competition law. The second (2003-2007 and third (2007-continuing) Sessions added further new problems in terms of potential compliance with EC State aid and competition law. We suggest reasons for the emergence and persistence of these problems and also identify possible solutions.

Most ferry operations in Scotland are provided by two State-owned companies, CalMac Ferries and NorthLink. CalMac Ferries recently won a six year contract to provide Clyde and Hebrides ferry services. The contract to provide the Northern Isles (Orkney and Shetland to Mainland services) was the subject of re-tendering in 2006. In 2008, the Scottish Government initiated a pilot study to test a Road Equivalent Tariff (RET) fares system for Scotland's ferry services. Then in May 2008, the European Commission announced[1] it was to investigate payments of subsidies to CalMac and Northlink

As far as the current policy is concerned, the Scottish Parliament Information Centre (SPICe) recently produced a briefing paper on ferry services in Scotland and noted;

The Scottish Government has never produced a separate ferry strategy document. However, the National Transport Strategy (Scottish Executive 2006) does briefly mention lifeline ferry services, stating: *"Once the tendering of the Clyde and Hebrides ferry service has been completed in 2007 we will undertake a comprehensive review of lifeline ferry services to develop a long-term strategy for lifeline services to 2025. The review will include a detailed appraisal of routes to determine whether a better configuration could be developed in response to calls for new and faster connections serving these isolated communities and a review of fares structures as part of a broader review of the affordability of public transport"*[2].

That Terms of Reference of that Review have recently been announced and we deal with it later in this paper.

We shall use the term "Executive Branch" to refer to those Scottish Office / Scottish Executive / Scottish Government officials and ministers who have held responsibilities individually and collectively for formulating and implementing ferry policy here down the years. Similarly, we shall use the generic term "Transport Committee" to refer to the Scottish Parliament's committee with responsibility for ferry services, the name and remit of the relevant transport committee has changed over all three sessions of the new parliament.

2. Scottish Parliament Session 1: May 1999 - May 2003

Before the new (or reconstituted) Scottish Parliament was a year old, the Executive Branch published *"Delivering Lifeline Ferry Services, Meeting European Union Requirements: a Consultation Paper"*[3] in April 2000. Reading it now in the light of subsequent developments in terms of EC policy and law here (and the Executive Branch's interpretation of that policy and law), it actually provides a clear and succinct view of the economic and legal issues facing policy makers in the context of what they could reasonably be expected to know and advise at the time in terms of policy options. The consultation paper announced with respect to a possible legislative agenda;

> *The existing legislation under which subsidies are provided to Caledonian MacBrayne … predates the UK's accession to the European Union and may require some amendment. Ministers take the view that any new legislation can be prepared to a longer timescale as domestic legislation does not preclude the Executive complying with the State aids rules. Nevertheless, Ministers believe there could be advantage in reviewing the legislation in the longer term. Whilst it would not, in any case, be possible to have new provisions in place for the first tender exercise, for subsequent exercises new legislation might be introduced to set the framework for:*
>
> - *the requirement to tender services in respect of PSOs;*
> - *powers to grant exclusive rights to routes in certain circumstances (to rule out "cherry-picking" in the peak tourist season in a way which might undermine the overall viability of a route); and*
> - *setting out appropriate roles in respect of a possible Highlands and Islands authority, local authorities and others.*[4]

Before considering the fuller implications of this agenda, it is important to clarify the respective roles and potential contribution of PSOs (public service obligations) and PSCs

(public service contracts) under EC law in this process especially since contingent issues assume even greater significance in later years. The relevant EC laws and guidelines here are contained in a variety of forms; regulations, cases and communications of various kinds, and I have collected extracts from some seminal or indicative documents in a single collation[5], each of whose extracts deals with some or other aspect of PSOs in this context. Three points merit emphasis.

First, the respective roles of PSOs and PSCs in this context were set out in the EC's 1992 Maritime Cabotage Regulation[5] which made clear that a PSC could be concluded *"in order to provide the public with adequate transport services" specifying such issues as "continuity, regularity, capacity and quality". On the other hand, a PSO was defined as "obligations which the Community shipowner in question, if he were considering his own commercial interest, would not assume or would not assume to the same extent or under the same conditions". PSOs were "limited to requirements concerning ports to be served, regularity, continuity, frequency, capacity to provide the service, rates to be charged and manning of the vessel".* The Commission recognised that it would not constitute State aid if the shipowner was awarded appropriate compensation (subsidy) for carrying out such PSOs, providing any compensation for PSOs "must be available to all Community shipowners".

In short, much like a knife and fork, both PSCs and PSOs are alternative tools or instruments designed for different economic and legal purposes. If you want to maintain an adequate and reliable service, you use a PSC. If you want to compensate (subsidise) an operator or operators for carrying out socially desirable (though commercially unprofitable) services, you use a PSO.

Second, there may be cases (in some circumstances, the norm) where a government would wish to ensure that services were both reliably provided and compensated appropriately with subsidy. This was acknowledged by the European Court in 2001 in the Analir case which recognised that that: *"even after public service obligations have been imposed on the shipowners … complementary services could be provided by concluding a public service contract.*[7] In short, you could use these two tools separately and for different purposes, or you could use them together in complementary fashion to pursue a particular task – again, much as a knife and fork can be used independently of each other, or in complementary fashion to eat a meal.

Third, are defined public service obligations required in order to subsidise EC ferry services and ensure compliance with the Martime Cabotage Regulation and EC state aid law? This was the question asked by an MEP of the Commission in 2006 and the answer was unequivocal: *"These obligations may be imposed by regulation or, if this does not suffice to meet essential transport needs in an adequate manner, laid down by way of public service contracts. If necessary, financial compensation may be granted to operators to cover the costs involved in meeting public service obligations. The imposition of public service obligations is therefore a precondition for any compensation being given".*[8]

In short, while there are various methods by which PSOs can be imposed (including concurrently and in complementary fashion with PSCs as the Analir case above implied), the imposition of clearly defined PSOs is a precondition for any compensation if such subsidy is not to run the danger of being treated as illegal State aid.

That PSOs are diferent instruments for PSCs; that you can use PSCs and PSOs separately or together; and that you must have a clearly defined PSO if you wish to subsidise ferry operations under Maritime Cabotage and State aid law; all these were (and are) well-established and accepted principles following from EC law. Not only are they law, from an economics perspective, they are also common sense; a PSC can be a complex and detailed instrument and if you do not clearly and separately define what is the PSO (even if it is being delivered with the help of a PSC) then it can be difficult to isolate and disentangle the part of the contract that is being (legitimately) subsidised from that part which could be a purely commerial activity. None of this would have been regarded as a matter of controversy in the first Session of the Scottish Parliament, but as we shall see it has become very much a major issue in recent years.

Returning to the legislative agenda sketched out above in *"Delivering Lifeline Ferry Services"*, it could be said to have been both appropriate and proportionate. It included provision for PSOs embodied in legislation; measures to deal with cherry picking and the issue of exclusivity; and consideration of the possible roles that an "authority" could take here, this opening up the possibility of provision for oversight by an independent Regulator as was common practice in other industries providing essential services and subject to competitive tendering.[9]

The problem was that none of this ever happened. The Consultation Paper said that all this should be deferred until after the first tender exercise, which was very much a matter of putting the cart before the horse. If the rules of the game are not drawn up until after the game is played, then it is not surprising if players and referees are confused about what does and does not constitute a legitimate strategy. The reason given for the deferment in the first place was timing. The Executive stated they were "aiming to have the first tender in place by Spring 2001 with implementation to follow"[10], in short, in about a year from the public announcement of the intention to consult the public on the matter. However, as I argued in 2001 in two submissions to the first Parliamentary Inquiry[11], even then such timing was hopelessly optimistic. But this deferment did have the effect of helping pre-empt serious debate on

what the statutory and policy frameworks could and should look like here.

It must be noted that the Executive Branch could reasonably claim genuine achievements in this context over this period. First, it argued and sustained the case for maintenance of the bundling of routes as represented by the CalMac network through to the first tendering of these routes (though it should be noted that the Commission has raised questions in its current investigation as to whether the Executive Branch's actual bundling of routes here has led to potential State aid issues[12]). Second, the original 1992 Maritime Cabotage Regulation[13] made no provision for estuary or peninsular services to be compensated for (subsidised) under EC law; pressure from the Executive Branch and Professor Neil McCormick MEP led to the Commission recognising in new guidelines[14] in 2003 that estuary/peninsular services that fulfilled certain geographical criteria could be treated as islands for such purposes. Third, it arranged for CalMac's vessel and shore-based infrastructure to be allocated to a VesCo or an asset owning company, later to be named Caledonian Maritime Assets Ltd (CMAL), with actual ferry operations to be carried out through competitive tendering of routes under 5-year (later 6-year) contracts. Since the relevant legislation made provision for possible subsidy of route operations through PSOs but not subsidy of investment in vessel construction, such separation made it easier to ring fence subsidy to operations only, and, as importantly, made it easier in principle to demonstrate to the European Commission that such ring fencing had taken place.

However, a consequence of the absence of a clear statutory framework for the new regime which was to be put in place was that the problem was not properly defined and structured. It was seen narrowly as one of contract writing and adaptation of an existing transport service to comply with (what were to the Executive Branch) new EC rules. The problem should have been clearly defined in the first instance as one of the introduction of competitive tendering for a de-nationalised industry providing essential services. Had the problem been properly defined, then policymakers could have drawn on the considerable body of knowledge and experience of how to deal with such problems in other formerly nationalised UK industries that also provided essential services. If that had been done then, as I strongly argued in evidence[15] in 2001 to the first Parliamentary Inquiry into the tendering of CalMac, policy makers would see from previous cases that what was needed was: (a) an independent regulator (b) a clearly defined Operator of Last Resort (OLR) and (c) a well developed supporting statutory framework.

Had the problem been properly defined, policy makers would have been more likely to have anticipated and dealt with issues contingent on what would have to be radically transformed roles and functions of economic actors and policy makers in such circumstances. For example, when the need for this process became public in 2000, the "CalMac" Clyde and Hebridean ferry services were run by a nationalised industry which could buy and sell its own vessels and had a planning horizon that in principle could encompass the life of these vessels, 20 years or more. Today, the "CalMac" Clyde and Hebridean ferry services are run by an operating company that owns none of the vessels or linkspans it uses and whose planning horizon (and existence) is limited by a public sector contract which is constrained to 6 years under EC law. One side effect of the ad hoc manner in which the subsequent process was been handled was confusion over who is and who should be responsible for the long term strategy formulating role and functions that were previously the responsibility of CalMac in its capacity as a nationalised industry.

But perhaps the most serious set of errors to flow from the misspecification of the problem was that it gave a false impression of what competences and capabilities were necessary to deal with it. As long as this was regarded as just another transport problem, the Executive Branch could be regarded as having an abundance of inhouse resources that could be allocated to deal with it. But specifying the problem properly makes it clear that, in the UK, the competences and capabilities to deal with the introduction of competitive tendering for a de-nationalised industry providing essential services (such as gas, electricity, telecommunications, rail), lay not in Scotland but in the UK regulatory agencies and Whitehall. The Executive Branch, certainly those responsible for transport, could not in all fairness be regarded, then or now, as having significant direct experience of these matters.

Part of the reasons for the misspecification of the problem may well have been political. There had been attempts to privatise CalMac during the term of the Thatcher government which had encountered fierce public opposition. Even though the Minister responsible told the Scottish Parliament in November 2000 that "*I am happy to assure members that we have no plans to privatise CalMac*"[16] the introduction of the EC competitive tendering dimension was seen by some as an attempt to *"privatise CalMac by the back door"*[17] and led to considerable debate inside and outside of Parliament.

It was true that CalMac was not to be privatised, though its status as nationalised company was to be revoked and it was eventually broken up into constituent State-owned parts. In October 2006, ownership of the CalMac's vessel and harbour assets was separated out from the associated ferry operations and the operations were transferred to a new operating company within the David MacBrayne Group, CalMac Ferries Ltd. A separate State-owned company, Cowal Ferries Ltd, took over responsibility for CalMac's Gourock-Dunoon operations. Caledonian MacBrayne Ltd. retained ownership of these vessel and harbour assets and was renamed Caledonian Maritime Assets Ltd. (CMAL). In July 2006, operation of the Northern Isles ferry services had been transferred to NorthLink Ferries Ltd. from the predecessor operator. The David

MacBrayne Group became the State-owned holding company for the operators CalMac Ferries Ltd, Cowal Ferries Ltd, Northlink Ferries Ltd, and Rathlin Ferries Ld (the latter in Northern Ireland).[18]

Given that the introduction of competitive tendering and de-nationalisation for industries providing essential services in the UK had typically been through outright privatisation, any attempts to apply direct comparisons, capabilities and experience from these previous exercises to the CalMac case could have run the danger of providing ammunition to those who suspected and claimed that the exercise had a hidden agenda, irrespective of whether or not that was the case.

Whether or not ultra-sensitivity on the part of the Executive Branch to charges of "back-doors privatization" contributed to the failure of the Executive Branch to properly specify the problem, the reality was that officials in the Executive Branch handled a major policy problem area with which there was no reason to believe they could have direct experience and familiarity, and with little evidence of learning lessons that could have been drawn from obvious and available comparators from UK regulated sectors.

One area where this self-imposed myopia had an almost immediate effect was with respect to the apparently arcane (but absolutely crucial) issue of Operator of Last Resort (OLR). Essential services subject to competitive tendering in regulated sectors such as in the UK generally stipulate there should be a *pre-designated and qualified operator* ready to take over a tender immediately in the event of an incumbent's failure (whether for technical, financial or any other reasons). This is not something that is really needed in the case of nationalised industries (as CalMac was at the start of this exercise). Nor is it a matter which tends to greatly exercise the European Commission. This is a provision where principles of subsidiarity tend to come into play with it generally left as a matter for national governments or their devolved authorities to deal with.

Nor is the question of OLR something that tends to be raised on a day to day basis for anyone looking at current issues affecting regulated sectors. It is rarely called on, which to a large extent is part of the intention behind it. An analogy can be drawn with the rule in tennis that a fault is called if a player *"deliberately touches (the ball) with the racket more than once".*[19] Once you have the rule, there is little chance of it being called on. But if you do not have the rule then you would have a very different game indeed. OLR is a safety net for the case of unexpected technical or financial failure which may befall even a well-intentioned operator. However, it is also a guard against moral hazard and the dangers of a tenderer using a weak or loose contract to misrepresent their true intentions or situation, and renegotiate in the course of the contract in the knowledge that the contract awarding authorities have little alternative but to accept their new terms for continued provision of an essential service.

Ironically, the issue of OLR need not have become a major issue had the Executive Branch adopted a proposal they set out in their original Consultation Paper in 2000 to split CalMac into a small number of route bundles and tender the bundles separately from each other.[20] Had this been done, the Executive Branch could have considered the option of inserting a clause into each tender that required winning tenders to act as OLR for another tender, if called upon to do so, with provision made for appropriate compensation to be made in such circumstances. There was no reason in principle why OLR responsibilities could not encompass both CalMac and Northern Isles operations. Solutions of this nature had been well tried and tested for competitive tendering regimes in other industries providing essential services. But once it was decided to tender CalMac operations as a single bundle, this option was effectively precluded. With the self-imposed myopia that arose from failing to clearly define the problem as discussed above, not only was there failure to appreciate the opportunity for OLR solutions when they arose, it led to unintended consequences being overlooked when the parameters of the problem was changed.

We emphasise that does not mean that CalMac operations should have been broken up (indeed as we were to argue later in 2005, the Altmark case suggested that there was perhaps no need to tender its operations in the first place). As was argued at the time, there are network benefits from maintaining its route operations in a concentrated bundle. But what was a serious issue then and now was how failure to recognize such issues and bring them directly and openly on to the policy agenda created potentially adverse consequences.

The potential significance of the OLR issue is illustrated with the case of the Commission announcement[21] in May 2008 of their intention to investigate CalMac and Northlink subsidies. The announcement notes that in the summer of 2003, a few months after starting operations, NorthLink informed the Scottish Executive that it could no longer realistically deliver its contractual obligations over the four years remaining of the contract period[22]. The Scottish Executive concluded Northlink was heading for insolvency and unless additional subsidy was paid, lifeline services could have been interrupted[23] Significant additional subsidy of about £43mill was duly paid[24] and retendering eventually took place. The Commission Announcement[25] here notes that *"According to the UK authorities, in preparing its bids, NorthLink assumed that it would also enjoy a monopoly on the ro-ro traffic … This assumption proved however incorrect".* It could be added that the UK authorities also assumed at the initial tender award stage that Northlink would not threaten to withdraw from the route unless they were provided with more subsidy. That assumption also proved incorrect. The Commission's provisional conclusion which the current Inquiry is investigating is that as far as the emergency additional subsidies paid to Northlink are concerned, *"the payments in question likely constitute State aid"*[26]

Some points are worth emphasising regarding this series of events.

First, despite the fact that there had been many tenders and franchises in the UK transport sector over many years, what happened in the Northlink case was remarkable and unusual and indeed forced retendering of transport operations[27] has been a relatively rare event.

Second, there should have been no basis for excusing Northlink's "incorrect" assumption that it "would…enjoy a monopoly". As noted above, the *Delivering Lifeline Ferry Services* consultation paper in 2000 noted that one of the areas that should be looked at in future was *"powers to grant exclusive rights to routes in certain circumstances".* Had that been done, and the conclusions spelled out (whether to award, or not award, exclusive rights), then it would have removed any confusion or ambiguity regarding monopoly rights. If exclusivity *was not* to be granted, then the tenderer would bear the commercial risks that might accrue from any market entry in the course of the tender. On the other hand, if exclusivity *was* to be granted, then it would be the responsibility of the Executive Branch to ensure that the legitimate interests of the tenderer did not suffer from illegitimate market entry. It was failure to properly specify property rights over market operation that helped contribute to the subsequent problems in contract execution.

Third, having properly established rights, risks and responsibilities in this case, if the operator could be seen as being unable or unwilling to deliver on promised performance for reasons which were seen as its responsibility, then in the final reckoning the Executive Branch should have been in a position to trigger the OLR option and replace the tenderer (as happened in the case in the Connex rail franchise in the South of England in the same year, 2003).[28]

Fourth, we see no reason why similar circumstances could not re-occur with the resulting collapse of all or part of a tender since there has been no meaningful substantive changes in these respects to the regulatory framework that still underlies such tenders in the Scottish context.

Fifth, and crucially, even though (as we have noted) the question of whether or not to have a clearly defined OLR was not something that tended to automatically raise issues of EC law and attract the interest of the European Commission, failure to deal adequately with the OLR issue directly limited the options available to the Executive Branch when the first Northlink tender threatened default. In turn, regulatory failure here (and the Hobson's Choice of a subsidy-fuelled bail-out by the Executive Branch) led to possible State aid failures under EC law. In other words, it was not sufficient for the Executive Branch to make every effort to be complying with the letter and spirit of EC law in this context, its failure from the beginning to deal adequately with the routine administrative nuts and bolts contingent on the introduction of competitive tendering into a denationalized industry providing essential services had knock-on implications for its potential ability to comply with EC law.

Along with Professor Tony Prosser and Captain Sandy Ferguson, I had warned in evidence[29] to the Scottish Parliament's first Inquiry into ferries in 2001 about the potential regulatory failings and omissions in the context of the proposed tenders, particularly with respect to the absence of an independent Regulator and clearly defined OLR. In their Report[30] to the Committee, the committee's reporters noted my specific warning that *"the (Northern Isles) contract is not yet operational, so the regime has yet to be proven effective in practice".*[31] In the second Inquiry into Scottish ferry services in 2005, an MSP asked the Minister who was giving evidence to the committee: *"Do you accept that the evidence that Neil Kay gave to the Transport and the Environment Committee back in 2001 about the tendering exercise for the northern isles (Northlink) contract has—unfortunately—proved relevant, given the disastrous collapse of that tender?"* The Minister replied that there were *"lessons to learn"* from that exercise, but did not expand on what he thought they were.[32]

All this is without prejudice to the question of whether or not the additional payments to Northlink constituted illegal State aid, which is a separate matter for the Commission and possibly the courts to decide. Our concern here is not with these subsequent payments as such, but solely with the events which led up to them, and the point is that had the Executive Branch followed proper and well-established regulatory systems and procedures, there should have been no significant risk here of being hostage to the misfortunes that subsequently befell them (and the public interest) in the Northlink case. Nor is there to the best of our knowledge any suggestion or evidence that Northlink was indulging in moral hazard here, and we are not suggesting that was a factor. The point is that vulnerability to such behaviour remains a structural flaw which can infect all such contracts given the weakness of the current regulatory regime.

I had noted in evidence to the Scottish Parliament in 2001, *"If the public interest is subsequently damaged because issues such as regulatory control and SOLR (Operator of Last Resort) have been neglected, this will be the Executive's responsibility, not the EU's".*[33] The Northlink case may be taken as an early example of the consequences of such neglect. The Commission investigation may consider here from a legal perspective what the Executive Branch actually did (in terms of additional unplanned subsidy payments), whereas from a regulatory economics perspective the source of these problems is actually to be found earlier in what the Executive Branch did not do.

I provided a fuller analysis[34] of the OLR issue as an appendix to my submission to the second Transport Committee Inquiry into ferry services in 2005 with an update[35] in 2006. Despite the lessons that should have been learned from the Northlink fiasco, the Executive Branch has not acknowledged, at least in public, that this continues to be an unresolved issue with serious public interest concerns

As for the question of an independent Regulator, in 2003, the Commission advised that for ferry tenders; *"In principle, an independent authority should be responsible for the whole procedure. However, the Commission recognises that, in some cases, it might be sufficient for only the final part of the procedure (evaluation of the bids and adoption of the final decision) to be entrusted to an independent body."*[36]

Whether we describe the agency responsible as an independent Regulator, an independent authority, or an independent body, the Commission's view on how this process should be governed is consistent with the arguments put forward by Professor Prosser and me to Transport Committee[37] and the Executive Branch in 2001. In ignoring or rejecting these arguments, the Executive not only rejected what was recognised good practice for essential services subject to competitive tendering, it should have been clear to the Executive Branch (by 2003 at the latest) that they were also rejecting what the European Commission regarded as an important minimal requirement for compliance with EC law here. I once again made the arguments for an Independent Regulator in 2005 to the second Transport Committee Inquiry into ferries, the Executive Branch once again noted my arguments, and once again they failed to act on them.[38] In July 2006, I wrote[39] to the Minister drawing attention *inter alia* to the Commission instructions that an "independent authority/body" should be appointed to deal with the ferry tendering process but did not receive a satisfactory reply.

3. Scottish Parliament Sessions 2 and 3: May 2003 – Present Day

The second Session of the Scottish Parliament May 2003 to May 2007 was characterized by the re-formation of an Executive Branch coalition of Labour and Liberal Democrats. The most visible sign of change in terms of governance was that responsibility for ferry services had been in the hands of Labour ministers during the first session, and this now switched to Liberal Democratic responsibility for the whole of the second session. It is not known whether this had any direct or indirect impact on government policy. The election of an SNP government in May 2007 created an even more visible change in governance, though as we shall see its approach to EC law largely reflected changes that had taken place in the second Session; however, there were some substantive policy changes such as the introduction of a pilot Road Equivalent Tariff (RET) Scheme which we discuss briefly below.

However, soon after the start of the second Session, there was a major development in the interpretation of EC law as it pertained to such services. On 24 July 2003, the European Court of Justice in the Altmark case[40] ruled that providing compensation is no more than is necessary to carry out clearly defined, transparently and objectively established public service obligations to enterprises entrusted with these obligations, such compensation did not constitute State aid.[41]

Some of this built on established EU case law, but one aspect which did add new elements to the public debate was that the European Court now appeared to make provision for choice of operator of a PSO service not necessarily having to be chosen by open tender. The European Court had noted that where the undertaking was not chosen in a public procurement procedure, the level of compensation should be determined by a comparison with an analysis of the costs that a typical transport undertaking would incur (taking into account the receipts and a reasonable profit from discharging the obligations).

There has been considerable debate over the meaning, relevance and significance of the Altmark judgment, much of which goes beyond the scope of this paper. For the purposes of the live debate over policy that existed at the time, what Altmark appeared to offer was the possibility of alternatives to competitive tendering, a process which had been criticised from a variety of perspectives ranging from the potential expense of such an exercise to alleged backdoors privatization.

It was in this context that the Scottish Parliament's Transport Committee set up a second inquiry into the proposed tendering of CalMac and invited two other academics (Jeannette Findlay of Glasgow University and Paul Bennett of Edinburgh University) and me to give written and oral evidence on the issues. The then Minister gave assurances in evidence to Transport Committee that we would be consulted on these issues;

> *If they are willing, we will make contact with (Findlay, Bennett and Kay) who obviously have worked so hard on these complicated issues over the past weeks and months. We will try to get clarification from them where that is important.*[42]

That never happened. Instead, on 12th September 2005, just two days before the scheduled debate in the Scottish Parliament on the proposed tendering of CalMac, the Executive Branch published a series of documents on the issues, including what could only be described as, in part, systematic attempts to discredit the evidence by Bennett, Findlay and me.[43] There was no warning that this was to be done, no opportunity to discuss or rebut what were in many cases misleading or incomplete statements and criticism of these works. The debate in Parliament[44] took place on the 14th September 2005 and the point was made strongly in the debate that our evidence had not been

treated fairly and we had not been given the (promised) opportunity to speak for ourselves and refute misunderstandings or misrepresentations. To make matters worse, the debate added further serious misrepresentation with arguments that my proposal would lead to route-by-route tendering, a totally spurious allegation without foundation which I had refuted in direct evidence to the Scottish Executive own Consultation on the issue some months earlier.[45]

I have no hesitation is stating that Parliament was misled in that debate (which decided to agree to the Executive Branch's proposal to tender CalMac). Why that should have taken place, and who was responsible, is best left for others to judge. One of the most seriously misleading issues was when the Executive Branch started its analysis of *"Professor Kay's 5 part proposal which he suggests would meet the 4 Altmark criteria"* with the bald statement that *"the Altmark criteria are not applicable to ferry services which fall within the scope of the Maritime Cabotage Regulation"*.[46]

That was what Parliament was told in September 2005. Since then the European Commission has made it abundantly clear that not only were the Altmark criteria "applicable" to such ferry services, adherence to the Altmark criteria is essential if such services are not to run the danger of being vulnerable to charges of illegal State aid.[47] But of all the statements by the Commission the most serious is the announcement[48] in 2008 of the intention to investigate the possibility of illegal subsidies to CalMac and Northlink by the Executive Branch. Indeed, much of the announcement is largely reducible to two inter-related issues; the apparent failure of the Executive Branch to apply the Altmark criteria to these ferry services, and the linked issue of their apparent failure to apply clearly defined public service obligations to ferry services which were to be compensated with public subsidy. As the Commission had clearly warned in 2006;

> *The imposition of public service obligations is therefore a precondition for any compensation (for EC ferry services) being given …Such compensation does not constitute State aid if it complies with the criteria laid down by the Court of Justice in its judgment in Altmark.*[49]

In short, in rejecting the relevance of Altmark and attempting to discredit the academic proposals based around Altmark, not only was the Executive Branch case against alternatives to tendering CalMac based on totally false premises, even worse any proposals they actually implemented ran the danger of falling foul of EC State aid law. If you do not understand what the rules are, then it obviously increases the chances of breaching them, even if inadvertently and in good faith. Ignorance is no excuse under the law, especially when the law has been set out clearly and consistently, and you still choose to ignore it.

These points hold forcibly in the case of the issue of the role of public service obligations (PSOs) in EC ferry services. The new Session May 2003 – May 2007 had coincided with a significant switch in policy with respect to PSOs, though one which was not to become publicly apparent for several months. Right up until the dissolution of the Scottish Parliament at the end of the first Session in May 2003, the Executive Branch had made consistently clear the need for clearly defined and justified PSOs for subsidized ferry services under their jurisdiction. The last reference I can trace to any stated intention by the Executive Branch to award PSOs for any ferry service was a News Release[50], 20th March 2003. The following week, Parliament was dissolved.

Such references by the Executive Branch ceased once the new Session of the parliament was underway, but much as in the Sherlock Holmes case[51] of the dog that did not bark, the lack of references to PSOs only became apparent when sometime later attention was drawn to them. Following questions in the Scottish Parliament, the Executive Branch stated in 13th June 2006:

> *The Executive is tendering on the basis of Public Services Contracts (PSCs). The Executive considers that a single PSC for the Gourock-Dunoon ferry service and another single PSC for the rest of the network offer the certainty and security of a set service specification that will be welcomed by Cowal residents, residents served by the rest of the network and all other users of the ferry services. Public Service Obligations (PSOs) would not provide that certainty and security of service nor deliver on the Executive's key policy objectives. Consequently there is no need to consider, nor do we intend to consider, issues arising in relation to PSOs.*[50]

Two years later (June 2008) during the third Session of the Scottish Parliament), the Executive Branch stated in evidence to the Transport Committee of the Scottish Parliament[53];

> *"Creating a formal public service obligation in relation to ferries can be done by Westminster but not by us. Of course, a PSO merely protects the route's infrastructure; it in no way provides for there actually being a ferry service, because of the different definition of PSO in the maritime world compared with the aviation world …a PSC enables us to specify all the things that we could do with a PSO"*

It has to be said that the position of the Executive Branch in repudiating the use of PSOs in this context is bizarre, and from the point of view of what is publicly known at this stage, inexplicable.

First, the statement that the Executive Branch cannot award PSOs contradicts what the Executive Branch had stated in 2006; *"The Scottish Executive also has powers to designate particular routes as Public Service Obligations (PSO)" and "the Scottish Executive retains control of the planning system and PSO designation which both affect ports, harbours and ferry routes"*[54].

Second, on the question of a PSO supposedly protecting the route's infrastructure and not services, Olivier Chassagne, an official with EC's Transport Direcorate noted (consistent with the 1992 Martime Cabotage Regulation) that; *"for maritime transport, PSOs can contain requirements only in relation to the 'ports to be served, regularity, continuity, frequency, capacity to provide the service, rates to be charged and manning of the vessel' (p. 410).*[55] Clearly, PSOs here are about operational matters and services, not infrastructure. When the Executive Branch stated later in the same evidence, *"in the maritime context, PSOs are about infrastructure; unlike in aviation, they are not about the provision of services"*[56], they were plainly wrong.

Third, as for the supposed different definitions of PSO in maritime and aviation worlds cited by the Executive Branch, Chassagne notes; *"In all transport modes, the concept of PSOs is quasi-identical"(p.408).*[57]

Fourth, on the question of a PSC supposedly enabling the Executive Branch to specify all the things that they could do with a PSO, Chassagne notes that the 2004 Combus judgement of the European Court of First Instance clearly states; *"contractual obligations under a public service contract do not constitute PSOs"(414)*[58]

But that is just the beginning of the problems. As we noted earlier, extant EC law both in principle and in actual case law makes it absolutely clear that if you do not have clearly defined and justified PSOs, then any compensation (subsidy) for ferry services may be judged illegal State aid. This is not an abstruse point, this is what concerned the Executive Branch in the first Session of Parliament 1999-2003. But, most bizarrely of all, if the Executive Branch was in now in any doubt about the need to apply clearly defined and justified PSOs if you want to subsidise ferry services, all they had to do was to consult the Commission announcement[59] of the decision to investigate the possibility of illegal State aid by the Executive Branch to CalMac and Northlink ferry services which had been made public some months ago and to which the Executive Branch had been invited to respond. Right at the beginning of this document, the fourth paragraph of the Summary reads:

> *With respect to the grants awarded to CalMac, NorthLink 1 and NorthLink 2 the Commission questions whether these grants correspond to properly defined public service obligations within the meaning of EC law, and has doubts as to whether the related compensation is compatible with the common market.*[60]

The rest of the document is largely concerned with noting cases where the Executive Branch may have failed to properly define public service obligations (and adherence to the Altmark criteria) and possible implications under State aid law.

How the Executive Branch could still now deny that properly defined public service obligations (and the Altmark criteria) were not only relevant but essential for ensuring that subsidised ferry services do not run the danger of falling foul of EC law here, is simply difficult to comprehend. Even if, despite the Executive Branch's statements in this matter, the Commission subsequently takes a view (contrary to that of the Executive Branch) that clearly defined PSOs can indeed be somehow identified within the PSCs in question, why take the unnecessary risk that the Commission will not take such a view? I made these points consistently and forcibly since I first became aware of the problem, including in a letter to the Minister[31] in July 2006, but none of this appears to have had any discernable effect.

In short, it appears that the Executive Branch's evidence on what they understood by EC law in this context was not only wrong on a number of counts, it was so badly wrong as to represent a complete misunderstanding and misrepresentation of what had been known for a number of years to be accepted EC law here, posing real problems and dangers for the public interest.

It should be emphasised that this is without prejudice to whatever the Commission might decide in their current investigation into alleged illegal subsidies to Scottish ferry services. The Commission may indeed take a sympathetic line to the Executive Branch's interpretation of EC law here, the point is the Executive Branch's approach to these problems has exposed the public interest here to completely unnecessary risks on these grounds, as well as failing to provide a coherent foundation for the formulation of past, present, and future policy in this context.

Finally, we note in passing that in August 2007 the Executive Branch announced details[62] of a Road Equivalent Tariff (RET) pilot scheme for setting ferry fares in Scotland. RET involves setting ferry fares on one measure of the comparative cost of travelling an equivalent distance by road. The pilot scheme started on 19 October 2008 with RET applied to several routes in the Western Isles. The pilot was scheduled to run for 2½ years from October 19 2008 to Spring 2011.

The Executive Branch argued that the high cost of ferry fares have been seen by many as a barrier to economic growth on the islands and on this point there is widespread agreement. I had previously conducted a review[63] in 2001 of CalMac fares policy and concluded there was an

economic case for a significant fares decrease across the board. That still leaves the question of whether the RET approach can be justified on economic and social grounds, whether in principle and/or in practice.

Reviewing RET goes beyond the scope of the present analysis, from the point of view of its place here it is sufficient to note that when the European Commission was asked by an MEP regarding its attitude to RET, the Commissioner replied that even if RET was used as a basis for pricing and subsidising ferry services, EU law on maritime cabotage and State aid would still apply.[64]

Beyond RET, the fundamental problem here is to fathom a coherent way forward when the Executive Branch appears to know less now about the proper regulatory and legal basis for the formulation and implementation of ferry policy than was expressed in *"Delivering Lifeline Ferry Services"* in 2000.

4. Conclusions

It is difficult to overstate both the scale of the failures in policy making with respect to Scottish ferries post-devolution, nor how unnecessary such failures have been. The context was set in 2000 with what can be seen as little more than a hasty response by the newly-formed Scottish Executive to comply with EC law here in a matter of months. In principle, the old Scottish Office pre-devolution could be criticised for apparently having been slow to respond to the policy needs here, since the Maritime Cabotage Regulation had been put in place in 1992, while relevant EC State aid legislation here dated from even earlier periods. The time horizon set out by the Executive Branch for compliance (which I pointed out at the time was never realistic) was used as a justification for shelving any proposals for the kind of statutory framework and regulatory oversight that was by now regarded as normal practice for protecting the public interest in the provision of essential services which were to be subject to competitive tendering and EC law. Had the proper steps been taken, there would have been no need to start with a blank page. Lessons could have been drawn from precedents associated with other such industries providing essential services, and a coherent statutory framework and derivative rules and guidelines would have set out the roles and functions of the basic building blocks for such an exercise, such as an independent Regulator, Operator of Last Resort (OLR), and public service obligations (PSOs). It would also have constrained the policy making *ad hocery* which has characterised this area in subsequent years

The most obvious and direct failures in the first Session of the Scottish Parliament 1999-2003 were in the context of domestic and administrative failures to provide adequate regulatory oversight and safeguards. However, as we have seen, the regulatory issues of independent Regulator and OLR had spillover implications for the Executive Branch in terms of potential issues relating to compliance with EC law. The dangers here were exacerbated in the periods of the second and third Sessions of the Scottish Parliament by the Executive Branch's rejection of PSOs and the Altmark criteria in this context – despite the clear and consistent messages from the European Commission and the European Court that if you want to subsidise Scottish ferry services you have to have both clearly defined PSOs, and adhere to the Altmark criteria.

We now stand at a position for which I can find no precedent, indeed it is difficult to discern logic behind it. We have a situation in which commentators (author included) have been interpreting and advising what has been accepted good practice in terms of regulatory standards, and essential practice in terms of EC law, yet on major issues that advice has tended to be consistently rejected by the Executive Branch. Even when it has become absolutely clear that the European Commission supports these positions on issues such as an independent Regulator, PSOs and Altmark, the Executive Branch either explicitly rejects or continues to ignore such arguments. This is a situation where even when a position can be shown to be demonstrably false there appears to be no effective way to alter it. It is with that mindset that the Executive Branch's ferry policy has steamed full speed ahead into the current European Commission investigation into alleged illegal subsidies to Scottish ferry services.

The dangers are now both specific (contingent on the current Commission investigation) and general (with respect to the future of Scottish ferry policy, and the resulting economic and social implications).

On the specific dangers contingent on the current Commission investigation, by default the Executive Branch have effectively ceded much control and discretion over ferry policy to third parties in Brussels. The Commission has already made it clear in their announcement[65] that they see a *prima facie* case that there may have been illegal subsidies to CalMac and/or Northlink, for reasons we have discussed above. One issue which the Commission has signalled they will be looking at is the bundling of CalMac routes[66] raising once again the possibility that the Executive Branch may be forced to break up the network into separate smaller tenders – not for economic or social reasons but because the Commission wish to force through one version of increased transparency, an issue which the Executive Branch has demonstrably failed to deliver to date. Ironically, this tendency to break up of the network may be reinforced by the failure of the Executive Branch to put in place safeguards against cherry picking (cream skimming or market skimming), even though the Commission provided clear guidelines[67] in 2003 on how this could be done under EC law. These omissions had given the moral and legal high ground to potential cherry pickers who had been publicly pressing for the break up of the CalMac network to allow them to target high value / low cost market segments. Unconstrained market entry through cherry picking remains a potential threat to the

sustainability of ferry tenders in this context, whether or not routes are to be bundled.

Another issue which is likely to arise[68] in the current Commission investigation is the questions of subsidy to the Gourock-Dunoon CalMac public service when there is an unsubsidised private service close by. There are solutions to this situation consistent with EC law as I have argued[69] but since the Executive Branch has repudiated the use of PSOs, it is difficult to see how they can make any coherent representations on this matter to the Commission.

But more generally, the failures by the Executive Branch here are likely to prejudice and distort any attempts at developing workable policies in this context. In August 2008, the Executive Branch announced a Review of ferry policy;

> *The review will include how lifeline ferry services should be procured. It will consider among other things; appropriate legislation and regulations, the use of PSOs and PSCs, how the routes should be bundled together, the need for a tendering system in future and flexibility in contracts.*[70]

But how could such a Review set out to credibly discuss role of PSOs when, as we have seen, the Executive Branch in evidence to Transport Committee only two months earlier had once again completely dismissed any notion that they would use PSOs in this context – together with the totally misleading inference that anything a PSO could do, a public service contract (PSC) could do as well? As for discussion of *"how the routes should be bundled together, the need for a tendering system in future and flexibility in contracts"* there is absolutely no point in discussing strategies and tactics when, as we have noted, you clearly do not understand the rules of the game. The potential scale of public and private involvement in this Review is substantial, but given the premises on which it is built, it also promises to be a considerable waste of these resources and a focus for false expectations

One point that should be noted in passing is that it has been argued that a reason why the Executive Branch has resisted PSOs (in regional air services as well as ferry services) is possibly lack of co-operation and support (or even active resistance) from Whitehall. While the Executive Branch has devolved authority here, the UK is still the recognised national authority from the perspective of Brussels. If Whitehall was concerned that awarding PSOs for Scottish regional air and ferry services could trigger a wave of "me-too" lobbying for PSO-supported subsidies from other regional transport services south of the border, then they might be reluctant to support such mechanisms.

There is not enough information in the public domain at this point to judge and evaluate the role of UK authorities, if any, in this context. What can be said is that even if the attitude of the UK authorities could be construed as actively unhelpful, this does not explain the extent and persistence of the failures on the part of the Executive Branch that we have documented here.

If there is a common theme running through the problems we have discussed here, it is that we have seen that, if faced with a choice between recognising and accepting incontrovertible facts and evidence versus sticking to discredited past decisions and policies, the Executive Branch's default option is for the latter. If the responsible departments we were dealing with were private or commercial organisations, such failings would usually not be tolerated for long and would normally be fairly easily exposed and dealt with. However, government departments raise more complex issues of adaptability, responsibility and accountability.

Before any solutions can be developed here it must be clearly understood where the problems lie. It is ultimately a question of competences and capabilities, or, more precisely, the lack of them. The first step is to define the problem as not just another transport issue but as one of one of regulatory issues for an industry providing essential services under EC law. Once that is done, then it opens up real possibilities for drawing on lessons, precedents, guidelines and statutory frameworks developed for other essential services.

One part of a coherent path forward would be the appointment of a Task Force composed of qualified experts in the regulation of industries providing essential services, and in EC Competition and State aid law, to advise how policy options should be framed and pursued here. I argued for this in 2005 and it was supported in Parliament by the main opposition party the SNP[71], but it has not been pursued since it formed the new government in May 2007.

The second part of a coherent path forward would be, having now defined the problem properly, to appoint and give responsibility here to full time administrators and officials here with backgrounds, experience and qualifications in the administration and regulation of industries providing essential services under EC law. This is not to denigrate the competences and capabilities of the officials who have been responsible for developing and administrating Scottish ferry policy to date. However, the fact of the matter is that they could not be expected to possess the necessary experience and skills required here since virtually all previous work relevant to the introduction of competitive tendering and de-nationalisation for industries providing essential services had taken place at UK and not Scottish level. Unlike most of the other formerly nationalised UK industries, State owned ferry services were essentially a Scottish phenomenon; indeed their relative unimportance at UK level and political sensitivities at Scottish level were almost certainly contributory reasons as to why it had been left effectively untouched by the wave of de-nationalisations and privatisations of the Eighties and Nineties started by the Thatcher government.

But what it also meant was that the repositories of expertise that existed on how to deal with these problems were mostly to be found south of the border.

There should have been, and should be, no shame in looking beyond the Scottish border for the appropriate competences and capabilities; indeed anyone who recognises the merits of cross border trade knows it can take place in intellectual and administrative human capital as well as other goods and services. Historically, there have been many areas of Scottish competences and capabilities where the cross border trade in human capital has emphasised exporting, so importing necessary competence and capabilities here should not have been controversial or problematic. Had the problem been defined properly to begin with, this part of the solution would automatically have suggested itself. However, given the default tendency of the administrative apparatus for old solutions and procedures despite being discredited, even sensible and logical suggestions are inclined to look hopelessly unrealistic and unattainable in such contexts. While that might not seem an optimistic conclusion, it might be regarded as not unreasonable given that this unresolved and muddled policy debate has already run almost the full course of the reconstituted Scottish Parliament's first decade. The answers you get depend on how you frame the questions, and until the Executive Branch properly frames policy questions here along the lines advocated in this paper, there are major obstacles in the way of obtaining a coherent policy framework that pursues social and economic objectives while still being sustainable and defensible under EC law.

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[5]"Answers from the Commission and the European Court" http://www.brocher.com/Ferries/answers.doc

[6]Council Regulation (EEC) No 3577/92 of 7 December 1992, See Eztracts 1 and 6 in http://www.brocher.com/Ferries/answers.doc

[7] See Extract 5 in http://www.brocher.com/Ferries/answers.doc

[8]Reply from Commissioner Barrot on behalf of the Commission, 10:01:2007, see Extract 3 in http://www.brocher.com/Ferries/answers.doc

[9]A precise definition of "essential" or "public interest" services is not provided in EC law, the closest approach to it is recognition of public interest "services of general economic interest", potentially encompassing at least aspects of industries such as gas, electricity, telecommunications, post, and transportation services. See for example the discussion in: Services of General Economic Interest: the package of 20/11/2007 State aid aspects: EC DG Competition http://www.berliner-gespraechskreis.eu/SGEI_Berlin_290108.pdf

[10]Delivering Lifeline Ferry Servics, op cit, see page http://www.scotland.gov.uk/consultations/transport/fese-03.asp

[11] Transport and Environment Committee Papers, June 18, 2001, op cit see papers TE/01/18/03 and TE/01/18/04.

[12] European Commission, State aid C 16/08 op cit, see para 111

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[15]See Transport and Environment Committee Papers, June 18, 2001, Paper TE/01/18/03 http://www.scottish.parliament.uk/business/committees/historic/x-transport/papers-01/trp01-18.pdf Also, see papers by Professor Tony Prosser and Captain Sandy Ferguson for same meeting.

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[22] ibid para 70.

[23] Ibid, para 71.

[24]Provisionally estimated (with some uncertainty) for 2002-06 compared to original subsidy set out as per contract, ibid, paras 77-79.

[25]Ibid, paras 65-66.

[26]European Commission, State aid C 16/08, op cit, pPara 113.

[27]See, for example, the Connex rail franchise case in 2003. http://www.tssa.org.uk/article-72.php3?id_article=520

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[29]See especially the papers by Prosser, Ferguson and (two) by Kay in: Transport and the Environment Committee, 18th Meeting,

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[32]See Scottish Parliament Transport Committee Official Report for meeting 15th March 2005
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[33]Transport and the Environment Committee, 18th Meeting, 2001 (Session 1)
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http://www.brocher.com/Ferries/APPENDIX%203%20%20operator%20of%20last%20resort.doc
[35]See http://www.brocher.com/Ferries/olr.htm
[36]Communication from the Commission (2003) COM/2003/0595 final page 15 footnote 21
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2003:0595:FIN:EN:PDF
[37]Though it should be noted the EC tends to take an interest in the issue of an independent authority particularly from the point of view of the award stage of a public service contract. The role of the independent Regulator in regulatory economics tends to encompass that role but also tends to be wider and deeper in terms of helping to buffer the tenderers from political interference and the politicians from corporate lobbying.
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http://www.brocher.com/Ferries/Letter%20and%20Note%20Lifeline%20Ferry%20Services.doc
[40] Judgment of the Court of Justice of 24 July 2003 in Case C-280/00, Altmark Trans & Regierungspräsidium Magdeburg [2003] ECR I-7747.
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[58] Ibid p.414
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[60]Ibid.
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http://www.brocher.com/Ferries/Letter%20and%20Note%20Lifeline%20Ferry%20Services.doc
[62] Details are set out through a number of links on the Scottish government website at:
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[63] See
http://www.brocher.com/Ferries/CalMac%20fares%20review%20EKOS.pdf
[64]See Extract 4, http://www.brocher.com/Ferries/answers.doc
[65]European Commission, State aid C 16/08, op cit
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[67]See section 5.5 in Communication on the interpretation of Council Regulation (EEC) No 3577/92 applying the principle of freedom to provide services to maritime transport within Member States (maritime cabotage) (2003) op cit.
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About the author

Neil Kay is Professor Emeritus, Economics Department, University of Strathclyde, Special Professor, University of Nottingham, and Visiting Professor, University of Queensland 2005, 2006, 2007 and 2009. He is also Academic Associate Judge Business School University of Cambridge; has held two Visiting Associate Professorships in the University of California (Irvine 1980-82) and was Visiting Professor at the European University, Florence, 1987-88. He has been a member of ACOST (Cabinet Office) and DTI working parties and has advised private and governmental institutions, including the European Commission and United Nations Development Programme (UNDP). He has published five books and numerous articles of research on industrial economics and corporate strategies, particularly on topics of diversification, multinationalism, collaborative activity, internal organisation and innovation.

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