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BREXIT: WHAT NEXT FOR SCOTLAND'S ECONOMIC STRATEGY?

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Brexit: What next for Scotland's Economic Strategy?

Summary

The priorities within the Government's Economic Strategy - internationalisation, innovation, investment and inclusive growth - have been turned on their head by the decision to leave the EU.

An urgent review of how the strategy is to be delivered is needed. Initiatives to be reviewed should include:

- The strategic direction and level of investment in Scottish Development International and the export markets to be targeted;
- The nature and intensity of the support provided to exporters in a climate of political and constitutional uncertainty;
- The speed at which connectivity improvements – such as cutting air passenger duty – are delivered;
- The scale and scope of the newly planned international trade and investment hubs;
- The options to help Scotland continue to be an attractive destination for international students;

However, Brexit is of a scale so significant that policymakers need to consider the totality of their approach to supporting growth. In a world where the political and constitutional settlement is much more fluid, policy needs to be flexible, agile and responsive to change.

This year, the Scottish Government will spend over £1bn on the economy. *Are we getting value for money? Why – despite this investment– does Scotland still have a lower business start-up and R&D rate than the UK? What programmes might be more/less effective post-Brexit? What challenges are likely to be more/less significant as a result and need to be targeted?*

The focus of this paper is, naturally, the strategic thinking of the UK and primarily the Scottish Government. But it is imperative that everyone – from across the political spectrum – revisit their economic priorities in the light of the referendum.

The Scottish Government has so far shown strong political leadership since the referendum. But as the dust settles on the result, there is now a need for clarity and sharpness in the delivery of economic priorities.

Introduction

One of the fallouts from the EU Referendum has been the apparent lack of a structured economic plan within the UK Government – at least at a political level – for a leave outcome.

In the run-up to the vote, many leave campaigners were critical of the Governor of the Bank of England for outlining what he perceived to be the economic risks from Brexit. They have much to thank him for now. The Bank's contingency plans – including offering £250bn of emergency liquidity – helped dampen any immediate financial uncertainty. Last week's statement that the Bank is contemplating further interest rate cuts to support the wider real economy is also welcome.

But as the Governor rightly pointed out, there is only so much that a central bank can or should do in the face of a structural economic shock. Too much monetary easing will only build inflationary pressures that will ultimately undermine growth and stability in the longer-term.

So the onus turns to government.

The focus of this paper is, naturally, the strategic thinking of the UK and primarily the Scottish Government. But a critical conclusion is that it is imperative that everyone – from across the political spectrum – revisits their economic thinking and priorities in the light of the referendum. There is a cross-party obligation to understand the shortcomings of existing stances: all require to be re-focused for the massive challenges that have arrived.

The role of the UK Government

The key levers to manage the transition to life outside the EU will lie with the UK Government.

Even with a promise to consult the devolved administrations, the detail of the negotiations will be led by the Cabinet Office. Furthermore, it will be up to Westminster to set trade, migration and business regulation policy once powers are transferred from Brussels.

On domestic policy, George Osborne has indicated that he expects his successor to announce new fiscal plans in the autumn. The next Chancellor may avoid announcing immediate spending cuts or tax increases. But further austerity is likely in the years ahead, with the rate of adjustment and the phasing of measures crucial to avoid overwhelming any wider economic fragility.

The role of the Scottish Government

The Scottish Government and its agencies will be closely monitoring developments for signs of businesses under stress or for any indication international investors may be reconsidering their plans in Scotland. With this intelligence, how the Government responds will be critical.

The immediate positioning has been to try to ensure that Scotland remains inside the EU – or at least retains certain EU rights. However, to prepare for all contingencies, it will need to ready itself and the Scottish economy for the possibility of life outside the EU. This will include ensuring that Scotland's interests are fully represented in the forthcoming UK-EU negotiations and planning for any budget cuts that may follow. But crucially, the Government will also need to consider how to use its own powers in a post-Brexit world.

There is a consensus across much of Scotland that the theoretical underpinnings of the Government's Economic Strategy are sound. Indeed, it has been an evolution of a consistent approach first set out in the early 2000's.

The recent extension has been the increased emphasis on *inclusive growth* – and in particular, the commitment to fair work, workplace innovation and the importance of work-based learning. See David Wilson's article in the March Commentary.

The Government had been progressing with delivering its strategy with a degree of continuity. The key initiative since May has been the review into Scotland's enterprise and skills agencies.

But things have now changed with Brexit– and it's probably a massive step change, not a relatively marginal adjustment with a gentle transition. The First Minister has indicated that all options are now on the table.

The delivery of a strategy built on being part of the Single Market with access to European capital markets and the free movement of labour needs to be re-assessed. At the same time, in a world where the political and constitutional settlement is much more fluid, policy needs to be flexible, agile and responsive to change. A short review of enterprise and skills agencies won't be sufficient.

The impact of Brexit on the Economic Strategy

The current government Economic Strategy outlines four key drivers of growth – the "four I's". None will be immune to the consequences of Brexit:

- On *internationalisation* – the assumption of un-restricted access to the EU's 500 million consumers or that over £11bn of Scottish exports could pass freely across borders is gone. Export growth is vital to long-term prosperity, not just as a source of revenue but also because internationalisation opens up companies to new ideas, new techniques, competition and higher levels of productivity.

- On *innovation* – Scotland's universities have consistently punched above their weight in European research funding, the future of which is now highly uncertain. At the same time, many innovation focussed companies have been attracted to Scotland because of its skilled workforce and access to the Single Market - they may look again at their future plans both for their production operations and R&D centres.

- On *investment* – over time, investment is likely to be lower as a result of inevitably higher long-term interest rates, lower inward investment and slower economic growth and, of course, the substantive increase in political and economic uncertainty surrounding the UK. Access to the European Regional Development Fund, European Social Fund and European Investment Bank is threatened, with no plans as yet for what will take their place. If as predicted, there is a further round of austerity, infrastructure investment may fall.

- And the *inclusive growth* agenda will also face challenges - the business case put forward by the leave campaign centred upon reducing 'red-tape from Brussels'. One area of significant EU intervention has been in employment law with rules governing working time, health and safety and equal pay. These have helped reduce discrimination and protected workers' rights. Even within such a framework, the UK has retained one of the most lightly regulated labour markets in the world. A common mistake is to confuse a lightly regulated market with a flexible one. However if, as a result of Brexit, future UK governments seek to unwind certain EU labour market initiatives in an effort to further boost 'flexibility', then Scotland may find it much more difficult to implement a fair work and inclusive growth agenda given the current allocation of powers.

The Scottish Government's response

So what should the Scottish Government do?

The Economic Strategy's priorities have been turned on their head by Brexit. It is simply not possible for policy to continue as normal: it is absolutely ***not*** "business as usual". Therefore, an urgent re-assessment is required.

Let's be clear, we are not arguing for a wholesale re-write of the Economic Strategy. We *are* looking though for a practical look at **'how'** the Economic Strategy can best be delivered outside the EU.

It should extend beyond the current review of Enterprise and Skills bodies and involve business, trade unions and other key stakeholders.

It should consider specific policy responses – *for example*, the strategic direction and level of investment in SDI; the export markets to be targeted; the nature and intensity of the support provided to exporters in a climate of political/constitutional uncertainty; the speed at which connectivity improvements – such as cutting APD – could be delivered; the scale of the planned international trade and investment hubs; and the options to make Scotland continue to be attractive to international students.

But it should also ask bigger questions about the overall prioritisation of policy on the economy.

Official figures estimate that Scotland spends over £100 per head more each year on 'Enterprise and Economic Development' than in the UK as a whole.

In 2016-17, the Scottish Government will spend over £1bn on activities that could be broadly defined as 'economic support or development' – see the footnote below. And that's before considering the £1bn of infrastructure spending on transport connectivity, the £600m boost to the construction sector via house building, the £30m spent on social and economic regeneration or the multi-billion school, further and higher education budgets. It doesn't even include £100m of European Structural Funds or the various Tax Incremental Finance, Growth Accelerator models and Business Rates incentive schemes.

Are we getting value for money? Why – despite this investment– does Scotland have a lower business start-up or R&D rate than the UK? To what extent is there duplication in provision of business support? What programmes are more efficient than others? What programmes might be more/less effective post-Brexit? What challenges are likely to be more/less significant and need to be targeted?

Such analysis should run in parallel, and help inform the government's strategy in the upcoming exit negotiations. Whilst the starting point will be to protect all of Scotland's interests, the harsh reality will mean that priorities will have to be identified.

Access to the Single Market is likely to be number 1, but what's next – *a Scottish points-based migration system; continuation of employment rights; equivalent protection of EU CAP funding? What terms of exit might the government be able to use its own powers to respond to and what outcomes may it be powerless to react to? With 'nothing off the table', what further devolution of fiscal/economic powers might the First Minister seek to leverage from the UK?*

This won't be easy. But recognising that the economic landscape has fundamentally changed is vital. Failure to do so poses a significant risk to Scotland. But recognition of change also presents an opportunity. The Scottish Government has so far shown strong leadership since the referendum: but as the dust settles, there is now a need to demonstrate clarity and sharpness in economic strategic thinking. If Scotland's political leaders can be quick-footed, there is an opportunity to take advantage of the current uncertainty, move ahead of other parts of the UK and signal that the country is open to business, trade and investment. Putting in place a clear economic plan for a post-Brexit world will be vital to ensuring that the ambitions set out in the Economic Strategy are not lost.

Note:

In 2016-17, the Scottish Government Budget includes £250m on Scottish Enterprise; £70m on Highlands and Islands Enterprise; £50m via Visit Scotland; £70m on energy programmes; £9m on SG supported innovation and industry initiatives; £10m on Prestwick Airport; £10m on Social Enterprise; £30m on Cities Strategy; £12m on Enterprise Areas; £175m on the Small Business Bonus; £115m on Digital Infrastructure; £170m via Skills Development Scotland; £64m on Employability initiatives. http://www.gov.scot/Resource/0049/00491140.pdf

Furthermore, £200m - £250m will be spent on local economic development programmes via local authorities. http://www.slaed.org.uk/documents/slaed-indicators-framework-report-2014-15.pdf

Alongside this, the Scottish Funding Council will spend on approximately £280m in support of research and innovation. The government itself will spend £30m on health research and £50m on climate and environment research. Other budgets which have important links to the economy include the £150m spent on culture, £20m on climate change, £40m on the Scottish Environmental Protection Agency, £20m on Zero Waste and £500m on Scottish Water's capital investment.