

The David Hume Institute

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Chair: Mr Jim Mather MSP

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“Does size matter? – An investigation of the link between post-devolution growth in public spending and Scottish economic performance”

Chairman Mr Jim Mather MSP introduced speakers Dr Fabian Zuleeg and Professor Brian Ashcroft to a packed audience which he took to be a sign of the importance of the topic. Dr Fabian Yulee noted the divergence of views on the effect of the size of the public sector on the wider economy. This size can be measured in up to fourteen ways but Zuleeg showed two, employment and share of GDP. On both measures Scotland was high, giving Scotland the second highest identifiable public spending per head in the UK.

Public spending can influence the private sector in a number of ways. Traditional “crowding out” is caused by increased government spending financed by a deficit creating increased government borrowing, higher interest rates, higher taxes and therefore less private sector investment. This does not apply since Scotland’s deficit is financed by the UK government. However, “resource crowding out” through competition, particularly for labour, was possible but difficult to prove. He noted a 2004 OECD study tentatively supported the hypothesis of the size of government lowering economic growth.

Without oil revenues, the Scottish fiscal deficit (spending exceeding tax revenue) amounted to 12.9% of Scottish GDP in 2002-03 and with oil revenues was 6.2% compared to the UK level of 3.7%.

Resource crowding out was occurring in the construction sector with direct evidence of a higher “public sector wage premium” or how much more can be earned in the public sector. Zuleeg then identified that almost half of Scottish graduates enter the public sector.

The impact of public spending depended on what the expenditure was on – in other words how productive the spending was and on the efficiency of that spending. Zuleeg speculated on the “safety” of the public sector dampening entrepreneurial spirit, but in answer to the question “should public spending be cut?” answered with “not necessarily”.

He argued for a bigger focus on what is productive public spending and on efficiency. Acknowledging that productivity is difficult to measure, Zuleeg recommended copying the Irish National Development Plan which would help to achieve consensus over several political cycles for longer term productive investment in Scotland.

Professor Brian Ashcroft noted the sharp rise in public spending as a share of GDP in Scotland from 45% in 1999-00 fiscal year to 51% in 2003-04. However, he noted that public sector job share in Scotland over the same period, has remained largely unchanged at 23%. Ashcroft identified similar crowding out effects to Zuleeg but introduced the concept of dynamic crowding out effects which

have a negative impact on the drivers of private sector growth such as entrepreneurship, innovation, investment, competition and skill formation.

Quoting work by Handler *et al*, Ashcroft noted that UK public spending as a percentage of GDP was close to the apparent European optimum of 40% but that Scotland was significantly higher. However, Ashcroft argued that crowding out effects can be reduced in a small, open economy like Scotland since resources of people and capital can be pulled in from outside.

Quoting a simulation using the University of Strathclyde general equilibrium model of the Scottish economy, Ashcroft demonstrated real crowding out effects from increased government spending over a number of years. However, the subsequent increase in wages and the lowering of the unemployment rate led to in-migration to Scotland. Crowding out effects increased if little migration took place. Under this scenario, according to Ashcroft, there were “large swathes of industry where output was lower”. Sectors losing most output were sea and air transport, machinery and vehicle manufacturing, agriculture and fishing, forestry and metals. Ashcroft speculated that a negative effect on entrepreneurship of a large and growing public sector appeared the most likely possibility.

In a comprehensive and lively discussion period, questioners queried whether the Strathclyde model takes enough account of the growth process particularly through innovation. Most questions centred on (a) how to ensure that public sector investment was as productive as possible and (b) the efficiency of public sector spend. The example of the Irish National Development Plan was again quoted as a possibility in helping to set priorities and achieve consensus over investment spending.

The inevitable connection to forthcoming pressure on the level of public spending was highlighted by several questioners, with Ashcroft maintaining that Scottish investment was no less than the UK and Zuleeg pointing to the need to have priorities for public spending taking account of productive investment.

The answer from both presenters to the question set for this David Hume Institute seminar was that the size of the public sector does matter but that the type and efficiency of spend matters more. Measuring more accurately the efficiency of public sector spending remains an elusive, but potentially richly rewarding goal.

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