

# THE DAVID HUME INSTITUTE



## Improving productivity in Scotland's public services

Policy Lessons

February 2008

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## **Foreword**

This paper is the second, and final, publication resulting from a major research programme carried out by Jo Armstrong for the David Hume Institute in 2007 and early 2008. As before, we are extremely grateful to a number of parties for their support. Financial backing for the research came from the Water Industry Commission for Scotland, Audit Scotland and the Office of Fair Trading. Shepherd and Wedderburn kindly sponsored our seminar in late 2007 and also hosted meetings of the steering group. Indeed I owe a personal debt of thanks to Gordon Downie of S&W for re-kindling my enthusiasm for setting out on this project, after the original concept had emerged at a seminar by Sir Ian Byatt of WICS for the Institute in 2006. I have no doubt that the outcome of the research fully supports the enthusiasm shown by Ian Byatt, Gordon Downie and so many others.

One further vote of thanks goes to Professor David Simpson. David has recently stepped down from being a Trustee of the David Hume Institute, but willingly agreed to take on the role of chair of our steering group. He was ideally suited for this role, as not only does he know the Institute so well, but also as Deputy Chairman of WICS he has an understanding of what has been achieved in recent years by way of enhancing productivity and efficiency in the water sector in Scotland; and the prime basis for this research is to see what lessons can be learned across the public sector from this success.

In her earlier report Jo Armstrong spelled out in some detail the lessons learned from three case studies – social housing, waste management and social care. This paper focuses on the general lessons learned, in what I believe is a remarkably accessible manner.

We hope that, given its relative brevity coupled with its accessibility, this paper will be widely read throughout the public sector; and that its key conclusions will be given thoughtful consideration by MSPs, those operating in local authorities and quangos, regulators, civil servants and many others.

I do not intend to summarise the findings set out below, but do believe that the four key lessons learned merit regular repetition – almost a mantra for the Scottish public sector. These are: - clarity about objectives; introduce competition where feasible, with effective economic regulation as a second best alternative; acquire reliable benchmarking data to assist the setting of meaningful output targets; and suitable incentivisation linked to such targets.

Jo has produced an excellent report, based upon first rate research. We are in her debt. Nevertheless I must end by noting that, as a charity and wholly funded by voluntary contributions, the David Hume Institute has no collective view on the research's findings or policy implications.

Jeremy A Peat  
Director  
The David Hume Institute  
February 2008.

## INTRODUCTION

1. Over the next three years some key parts of Scotland's public services will face substantial real terms cuts<sup>1</sup>, in their funding, making the delivery of efficiency savings critical to the continuation of current service levels. Though, overall, the Scottish Government's spending between 2007-08 and 2010-11 is forecast to reach record levels<sup>2</sup>, there exists a further significant challenge. Scotland's current budget has been bolstered by the inclusion of the £1.5 billion reserve at Whitehall which has allowed annual spending commitments between 2008-09 and 2010-11 to be increased. This is a one-off boost and consequently, by 2011-12, Scotland's baseline spending will be lower by around £200 million<sup>3</sup>.
2. With funding tightening, there is now an even greater need to generate productivity improvements to ensure the growing needs of public service users are adequately met. The question addressed here is how productivity improvements might be possible through the adoption of the kind of policy lessons drawn from recent Scottish Water experiences. This report summarises these lessons which are outlined in greater detail in the analysis undertaken earlier for the David Hume Institute (DHI)<sup>4</sup>.

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<sup>1</sup> For example, spending on Scotland's public transport is forecast to rise by minus 2% per annum in real terms between 2007-08 and 2010-11.

<sup>2</sup> By 2010-11, the Departmental Expenditure Limit (DEL) value (over which the Scottish Government's Cabinet Secretaries have discretion) will be £28 billion in 2007-08 prices.

<sup>3</sup> See CPPR budget briefing No 3 for a more detailed analysis of the Scottish budget arrangements, in [http://www.cppr.ac.uk/media/media\\_54616\\_en.pdf](http://www.cppr.ac.uk/media/media_54616_en.pdf)

<sup>4</sup> See Armstrong Jo, (2007), Improving productivity in Scotland's public services, DHI Occasional Paper,

<http://www.davidhumeinstitute.com/DHI%20Website/publications/Improving%20Productivity%20in%20Scotland's%20public%20services.pdf>

## CONTEXT

3. The delivery of productivity improvements or efficiency savings has been a key component of the last two Scottish budgets. The challenge in the 2004 settlement was to maintain or grow services whilst delivering 1.5% annual savings. The target is now 2% per annum. The delivery of this level of savings will challenge providers to examine their current modes of operation, building on best practice wherever it exists. The DHI analysis highlights the potential benefits available from introducing or extending the competitive framework within which many public services are delivered. Such an approach will help to ensure scarce resources are used efficiently and effectively whilst also encouraging innovation in service development and delivery. This is not to suggest that such a competitive framework requires all public services to be provided within the private sector. Suitable competitive environments can be created within the public sector. Where competition is not possible or desirable, effective economic regulation can act as a second best alternative, aiming to replicate the best of what competition can deliver, albeit requiring greater levels of bureaucracy to work effectively.
4. To deliver productivity improvements it is not sufficient to assume that all that is required is simply a cut in the cash cost of a service. Productivity improvements are delivered when the same or greater levels of service are achieved with the same or less funding whilst, at all times, maintaining service quality. Otherwise, services are simply put at risk.
5. A key aim of the DHI analysis was to highlight the possibility of such productivity being encouraged by adopting and adapting the lessons from Scottish Water's recent experiences.

Since its establishment as the monopoly provider of Scotland's water and sewerage services in 2002, Scottish Water has reduced its operating costs by 8% per annum in real terms whilst simultaneously improving the quality of its services. When creating a new form for Scottish Water, the Scottish Government also established an economic regulator - the Water Commission for Scotland (WICS) - to minimise the potential for Scottish Water to abuse its monopoly position. Scottish Water's management is incentivised to deliver challenging but achievable output targets and this arrangement has allowed it to pass on lower price increases than historically its customers might have anticipated.

6. It was this significant productivity improvement delivered by an organisation still within the public sector that was of interest to the DHI. The analysis concluded that there are 4 key lessons which could have wider relevance for other public service providers:
  - First, for effective delivery, those operating within the public sector need clarity about their objectives, i.e., what is to be delivered, by when and at what cost.
  - Secondly, the more open a sector is to competitive pressures the greater the chance for the efficient allocation of scarce resources. Failing the introduction or extension of competition, effective economic regulation acts as a second best option.
  - Thirdly, for an economic regulator to be effective they need to be able set and monitor the delivery of meaningful output targets which are based on suitable benchmarking data.

- Finally, productivity improvements are more likely to occur if those operating within a sector are suitably incentivised; rewarded for exceeding targets and penalised when delivering inappropriate or inadequate performance.
7. Although all 4 lessons have wider applicability as a means of driving productivity improvements, the degree to which each applies differs across the sectors, negating any belief that “one-size fits all”. Notwithstanding this caveat, if Scotland’s public service were to deliver Scottish Water-equivalent productivity improvements, this would release savings amounting to £2.25 billion<sup>5</sup> by 2010-11. Perhaps just as important a benefit from the appropriate application of these lessons is their potential to deliver a framework that encourages and rewards continuous quality improvement within service delivery.
  8. In addition to demonstrating the significant gains that are possible by adopting the Scottish Water lessons, the DHI analysis discovered a real lack of awareness amongst public service users and providers alike about its success. It is also clear that many are wary about adopting models of outright competition within public service delivery. However, with the need for increased efficiency savings it is now even more important than ever that service providers are encouraged to assess all possible models of delivery to capture much needed improvements in productivity.
  9. There are a number of current opportunities to develop such awareness, one such catalyst being the Crerar<sup>6</sup> review on regulation in Scotland. The Scottish Government’s response to this review accepts that it was not possible for Crerar to be comprehensive in his analysis of regulation.

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<sup>5</sup>Based on 8% of the total DEL in 2010-11.

<sup>6</sup> The Scottish Government (2007), The Crerar Review: The Report of the Independent Review of Regulation, Audit, Inspection and Complaints Handling of Public Services in Scotland, [www.scottishexecutive.gov.uk/Publications/2007/09/25120506/19](http://www.scottishexecutive.gov.uk/Publications/2007/09/25120506/19)

In particular, the review did not assess “...the use of scrutiny to regulate markets and market-entry...”<sup>7</sup>. As it seeks to implement many of the review’s recommendations, however, the Scottish Government might also seek to assess where introducing greater levels of competition or extending the regulatory framework to include economic regulation would be of additional benefit. After all, Scotland’s water authorities did historically operate with significant levels of regulation in both quality and safety, but it was only following the introduction of a suitably qualified and empowered economic regulator that substantial improvements in productivity were delivered.

## **POLICY LESSONS**

10. The relevance of these 4 lessons to generating productivity improvements was assessed across three sectors; social housing, care service and waste management (see text box). The remainder of this paper outlines the policy lessons for each, although reference to the earlier DHI paper is advised for a more detailed critique.

### **Clarity of objectives**

11. Critical to Scottish Water’s success has been the explicit statement of organisational objectives set by its shareholder, Scottish Ministers. The Regulator translates these objectives into measurable outputs, leaving Scottish Water’s management free to deliver these outputs as best they see fit, free from inappropriate political interference.

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<sup>7</sup> See the Scottish Government’s response to the Crerar Review, [www.scotland.gov.uk/Topics/Government/PublicServiceReform/IndependentReviewofReg/latest-news/Response-to-Crerar](http://www.scotland.gov.uk/Topics/Government/PublicServiceReform/IndependentReviewofReg/latest-news/Response-to-Crerar)

**Social Housing** accounts for around 30% of the total stock of housing in Scotland. Since 2002-03 more than £2 billion (2007-08 prices) has been spent on this sector to alleviate the serious shortage of affordable sustainable housing but a serious lack of suitable supply remains. Management costs are on an upward trend and rents are slowly becoming unaffordable. Due to a lack of suitable supply, tenants have no effective means of signalling their dissatisfaction by moving.

**Waste Management** is concerned with the collection of waste and the treatment of residual waste. The majority of waste is from the commercial sector but Local Authorities face EU penalties for non-compliance with landfill directives for the household waste they collect. The cost of recycling is rising as the easier, non-biological waste is recycled. The new waste treatment infrastructure is estimated to cost c£2-3 billion between now and 2019-20.

**Care Services** covers the provision of care for older people and for adults with learning disabilities in their own home, in residential care or in day care services as well as for adults with mental health problems or with drug and alcohol dependencies. Total social work spending by local authorities amounted to just over £2 billion in real terms in 2005-06 of which over 85% was used for the provision of adult care services. Indeed, Scotland's local authorities have received substantial increases in funding since devolution for the delivery of services such as a free personal care for older people. Not surprisingly, demand continues to rise as Scotland's population ages.

12. In social housing, housing associations offer a wide array of services ranging from managing their housing and building new housing to offering care support for vulnerable tenants. In many cases it also extends to ensuring the wider community is free from anti-social behaviour or indeed that tenants benefit from wider regeneration and employment activities. Whilst all are laudable and probably necessary activities, it is not clear the tenants want their management to undertake all such activities if this means they ultimately pay for them via increased rents. It is also not necessarily the case that the skills needed to manage houses are suitable to deliver all or any of the other wider activities. Management may wish to be involved in all activities but they need to affirm that this is what tenants want and that they are competent to do so cost-effectively.

13. The objective for Scotland's social care providers is to deliver more personalised and bespoke care packages as defined by its care users. Whilst this objective may be clear to all stakeholders, (i.e., the Scottish Government, Scotland's local authorities' and service users), what is actually being delivered is neither consistent across the country nor necessarily actually what users want. The Scottish Water lesson was that the regulator must translate what the objectives mean into outputs. This is also essential for Scotland's care service provision. Without clarity on how high level objectives translate into actual services for individual users, it is not possible to be certain that the sector is efficiently and effectively allocating its increasingly scarce funding.
  
14. Finally, the development of Scotland's new waste treatment infrastructure (i.e., combined heat and power or waste-to-heat plants) requires greater clarity on what quantity and type of waste needs to be accommodated as well as where local authority cooperation may be needed to ensure scale economies are possible. Without it, local authorities face the potential of having to fund penalty payments arising from breaches of EU waste directives as excess waste continues to go to landfill. It is widely accepted that building this new waste treatment infrastructure will require private capital and know-how. To reduce the associated risks to manageable levels and so to secure the necessary private finance will require local authorities to be clearer about exactly how much waste they wish to have treated in which locations, and how they envisage creating appropriate levels of transparency and certainty to deal with any related planning issues.

15. Being clear about what any policy aims to deliver is essential. Being sure what this actually means for users is just as important, even more so where such a service is perceived as being more complex than, say, the delivery of clean and affordable water and sewerage services. Without such clarity it is hard to show that the resources allocated for effective delivery are or will be adequate.

### **Effective competition and regulatory framework**

16. Scottish Water does not face direct competition in serving its household customers. Instead, it operates within a regulatory framework where performance is assessed against similar providers in England and Wales, who also operate within a regulated environment. Effective regulation aims to create the benefits of competition by setting challenging but deliverable targets, based on extensive knowledge of the relevant operating environment, reinforced by detailed monitoring of performance.

17. Currently there are over 200 providers of social housing in Scotland but there is little effective competition for the delivery of management services. Such limited competitive pressure could be compensated for by the intervention of an effective economic regulator challenging managers to operate efficiently and effectively for the benefit of tenants. In Scotland there are several regulators operating within the sector, all with different powers of intervention, and none with the rigorous economic regulatory role that the WICS has in Scotland's water sector. Such a structure allows poor performers to survive and does not ensure that tenants, both existing and prospective, receive value for money.

The Scottish Government has recently signalled<sup>8</sup> that it wishes to introduce a number of key changes in the sector, as it seeks to secure more, much needed, affordable housing. Increasing competitive pressures alongside rationalisation of the number of regulators operating with a wider range of powers would secure better value for money as well as better outcomes for tenants.

18. It could be argued that the provision of care services in Scotland is already highly competitive. Nonetheless, the roles that are expected of local authorities are arguably contributing to limiting productivity improvements. As both purchaser and provider, local authorities have a conflict of interest. Standardisation in services may deliver economies of scale in procurement, but this also carries the real risk of stifling innovation in service delivery, essential when personalisation is what users want. Quality in this sector is critical and the existing regulators play an important role ensuring only competent and trustworthy service providers operate. If, however, bespoke rather than institutional care packages are to be ubiquitous, then the current regulatory arrangements are unlikely to offer a cost-effective solution to the assessment of service quality.

19. The development of Scotland's new waste infrastructure could also benefit from assessing what market structure might be most appropriate. Rather than attempting to develop a number of complex PPP arrangements to secure the necessary private sector input, the same infrastructure could be provided using a more conventional competitive market option. The financial viability of the required waste treatment plants is likely to limit the total number of waste-to-heat plants built in Scotland, making those that are installed regional monopoly suppliers.

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<sup>8</sup> See the Scottish Government's current consultation document "Firm Foundations: The Future of Housing in Scotland: A discussion document".  
<http://www.scotland.gov.uk/Publications/2007/10/30153156/2>

To minimise the likelihood of any abuse of such monopoly power, price-capping arrangements may be needed to ensure that the financial return investors generate is adequate but not excessive<sup>9</sup>.

A combination of encouragement of the development of independently owned<sup>10</sup> infrastructure operating alongside a suitably empowered regulator will not only safeguard users but provide certainty for those who build and own the infrastructure.

20. Increasing the competitive structure of much of Scotland's public services - either in full or in part - offers greater opportunities for delivering productivity improvements. This is essential where demand for such services grows but where funding becomes harder to secure.

### **Effective benchmarking**

21. Setting meaningful output and outcome targets requires recourse to suitable benchmarking data. In Scottish Water's case the WICS benefits from access to extensive cost and performance data compiled over a number of years by OFWAT, the Regulator for England and Wales. A large array of data is currently being collected right across Scotland's public sector, utilising scarce resources that could otherwise be available to fund front-end services. It is essential that the data that are being collected are of practical value and assist users and/or regulators to measure the efficiency and effectiveness of the services on offer.

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<sup>9</sup> There are numerous of examples in the UK utility sector of how such an arrangement might be developed. For example, the UK off-shore gas pipeline infrastructure was developed by the market. Those wishing to use the pipelines to shore had recourse to the DTI in the event the price charged was not thought to be cost reflective (including a return to equity). Alternatively, the licence arrangement used in Scotland's water sector is another approach to the management of prices in such a monopoly arrangement.

<sup>10</sup> The ownership structure could be private or a combination of public and private and could involve dividend and non-dividend distributing models.

22. New competitive or economic regulatory structures should not be introduced across a wider section of Scotland's public services without careful planning. This need not impede those who hold budgets to make greater efforts to be fully accountable for the funds they command. Developing better benchmarking data, and using these to monitor performance, needs immediate attention. Poor data are costly in both time and money and leave users with little information to make effective choices.

This allows poor management to survive and diminishes the potential for excellence to thrive. Knowing what is good performance is a necessary but not sufficient aspect of effective benchmarking. To be truly effective requires the development of meaningful targets that are effectively monitored and suitably rewarded.

23. Finally, Scottish Water's achievements are not widely known amongst those active across Scotland's public services, leading to the conclusion perhaps that cross-discipline benchmarking is not widely applied. For example, how easy would it be to encourage managers in the NHS to look and learn from what has been achieved in Scottish Water? Could public service providers be encouraged to adapt current modes of operation to improve productivity by developing structures and approaches that involve greater levels of competition? Where best practice and exceptional performance exists, be that in the public, private or voluntary sectors, recognition of this is essential to ensure that all opportunities to capture efficiency savings are taken.

## **Incentives driving performance**

24. Scottish Water's stakeholders have developed an incentive structure that aims to deliver the objectives of an affordable and sustainable water and sewerage service. Setting suitable incentives for management has encouraged the necessary changes to working practices and so has delivered significant savings in a timely manner. For those operating in the public sector, taking on new activities or operating in a more competitive environment is likely to be more risky than maintaining the status quo. Unless reward structures are suitably flexible, the necessary behavioural changes are unlikely to be secured.
25. Rewards can be pay-related but they could also be linked to other factors. For example, in the social housing sector grant funding to support the construction of new affordable housing could be restricted to the more efficient housing associations. Alternatively, housing associations could be incentivised to make use of the spare capacity on their balance sheet to secure much needed private finance by, for example, giving them pre-emption rights to secure the management of existing housing currently under the management of under-performing housing associations. Just as important, poor performers would face the loss of their housing stock to more efficient managers.
26. In the delivery of care services the main concern facing local authorities is how to make personalisation work for the benefit of the user without putting unacceptable pressure on council finances. Users (and carers) are currently incentivised to secure the maximum level of service rather than simply the service they need.

The sector needs to develop a more flexible approach whereby users are incentivised to seek the care package that best meets their needs and local authorities provide or procure more bespoke services for service users whilst leaving the local authorities financially neutral<sup>11</sup>.

27. Incentives to improve productivity in waste collection are diminishing, since Scotland's local authorities have already received additional financial support to develop their various collection and recycling services. Introducing household charges may be a means of incentivising households to reduce the amount of domestic waste to be collected, but is unlikely to influence how local authorities collect and dispose of household waste.

To justify additional user charges, local authorities need to show that their current service is efficient and that they are undertaking suitable investment not only in collection but also in recycling and residual waste management. Subjecting their collection services to a best value review is an essential first step to convincing council tax payers that additional charges are essential.

28. The development of Scotland's waste infrastructure (e.g. waste-to-heat plants or incinerators), is costly, risky and will inevitably be limited in the number of units finally constructed given the accompanying economies of scale. Appropriate incentives to help develop efficient delivery could be financial (i.e. grants or equity subject to meeting state aids requirements), the development of a suitable franchise model or simply involve the local authority making unambiguous statements on how associated planning approvals will be managed to make the process more transparent and certain for suppliers.

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<sup>11</sup> How to determine the funding arrangements that secure financial neutrality will require careful analysis. It may also involve additional funding being made available from the Scottish Government to provide suitable incentives for local authorities to implement a managed reduction of their in-house services thus reducing the local authority conflict of interest as both procurer and supplier of care services.

29. Incentives that work in one sector may not be appropriate in another. The development of suitable incentives also needs careful planning to ensure the law of unintended consequences does not apply. Moreover, what incentives work at the start of any new arrangement may become inappropriate over time. Whatever incentive structure is to be applied, it needs to be carefully planned but also to be subject to on-going review.

## CONCLUSIONS

30. The demand for public services in Scotland continues to grow whilst the funds required for their effective delivery now seem unlikely to rise commensurately. Delivering 2% per annum efficiency savings, as signalled by the Scottish Finance Secretary in his 2007 budget, becomes all the more essential.

However, this 2% per annum target is in addition to the 1.5% per annum savings that Scotland's public service providers were required to deliver in the last 3 years<sup>12</sup>. To achieve year-on-year savings without putting services or service quality at risk would be challenging for any provider, be they in the public or private sector. That is why looking at all possible delivery modes and applying best practice wherever it resides is now even more important. Otherwise, the likelihood of a diminution of services seems ever likely.

31. The lessons from Scottish Water offer real opportunities to make the difference. Whilst their application may lead to radical change for some, they could unlock significant savings as service providers take the opportunity to do things differently for the benefit of their users.

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<sup>12</sup> The Scottish Government is unable to confirm the Efficient Government Initiative has not harmed service levels through the delivery of substantial as cash savings.

Reducing operating costs by 8% per annum - as Scottish Water has delivered - would release around £2.25 billion of increasingly scarce public spending by 2010-11. If this increase in operating efficiency also means an improvement in the quality of services, then many more Scots who are currently unable to receive essential services or receive inadequate services would be the real beneficiaries.

32. The Scottish Water lessons are not complex or indeed difficult to implement. Now may well be the time to test their applicability more widely. For example, the Scottish Government's response to its current consultation on how it might solve the serious social housing problem could start with a clear statement of objectives, supported by clarity on how many houses this means they wish to deliver, at what cost to the public sector and in what timescale, (assuming a minimum quality threshold). This will ensure that all operating in this sector fully understand what the Government is aiming to achieve with its scarce resources and so minimise the potential for wasted effort.
33. Whilst clarity of objectives is an essential element, on its own it is unlikely to deliver the level of savings that are possible. The Scottish Water experience suggests effective economic regulation was also essential to drive the necessary behavioural changes within a monopoly organisation. The current reappraisal of Scotland's regulatory landscape offers an ideal opportunity for the Scottish Government to substitute, where appropriate, more competitive arrangements, creating direct links between users and providers. Where regulation must continue, the inclusion of an economic regulatory element would offer the potential for more effective resource allocation.

34. Unfortunately, effective economic regulation is costly. It requires the development and monitoring of detailed operating data, to be used by suitably experienced regulators with adequate powers of intervention and sanction. Such costs are a powerful disincentive to a wider use of economic regulation. However, adaptation of the myriad of data sources currently gathered by Scotland's public sector could actually generate savings; inappropriate data collection could cease and efficiencies could be generated by the suitable application of relevant benchmarking data.
35. The introduction of new modes of delivery also requires the implementation of suitable incentive structures. In order to flourish under new governance arrangements service providers need to be adequately rewarded for embracing and managing the associated risks and uncertainties. They also need to be aware that inappropriate or poor performance brings with it penalties. In Scottish Water's case, management receive bonuses where they exceed their regulatory targets but they have also suffered when they have been unable to deliver the Ministerial objectives.
36. The Scottish Water lessons are an important pointer to the efficient allocation of scarce public funds. What has been achieved in only 4 years suggests these lessons deserve to be debated and, where appropriate, to be more widely applied to the considerable benefit of Scotland's tax payers and service users alike.

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