Introduction

The recently published Scotland's Economic Strategy set out an over-arching framework for how the Scottish Government aims to achieve a more productive, cohesive and fairer Scotland.

This paper provides illustrative estimates of the potential impact that improving Scotland's levels of productivity, investment and export performance could have on employment, GDP and tax revenue. The analysis demonstrates that relatively small changes in these areas can have a potentially significant impact.

The ability of the Scottish Government to grow Scotland's economy depends in part on having the opportunity to retain and reinvest the additional tax revenues generated from increased economic activity. This creates a virtuous circle where improved economic performance can enhance public services which in turn can improve the economy's productivity.

To demonstrate the importance of this point, the analysis below is undertaken under two scenarios.

The first scenario reflects the situation under the Smith Commission powers where the majority of additional tax revenue generated by increased economic activity are retained by the UK Government and cannot be directly reinvested back into the Scottish economy.

Under the second scenario, all additional tax revenue generated by the expansion in the economy are assumed to be retained in Scotland and reinvested back into Scotland's public finances and public services. This scenario is referred to in the paper as 'Full Revenue Retention'.

The analysis demonstrates that when Scotland is able to retain and reinvest the proceeds of faster economic growth, the overall positive impact on Scotland's economic performance is greater. The impacts after 10 years under this scenario are summarised below.

- Increasing Scotland's total factor productivity by 0.1% a year over a 10 year period could boost GDP by 1.8%, employment by 29,000 and tax revenue by £700 million

- Narrowing the gap in investment between Scotland and its international peers could increase GDP by 2.0%, employment by 51,000 and tax revenue by £1 billion

- Achieving the Scottish Government's target to boost exports by 50% could boost GDP by 3.0%, employment by 81,000 and tax revenue by £1.8 billion

Impact of an increase in Total Factor Productivity

Total Factor Productivity (TFP) is determined by how efficiently and intensely production inputs are utilised. It is often seen as a measure of technological progress and is a key driver of economic growth.

Improving Scotland's TFP could have a significant impact on the country's economic performance, employment and the tax revenue generated.

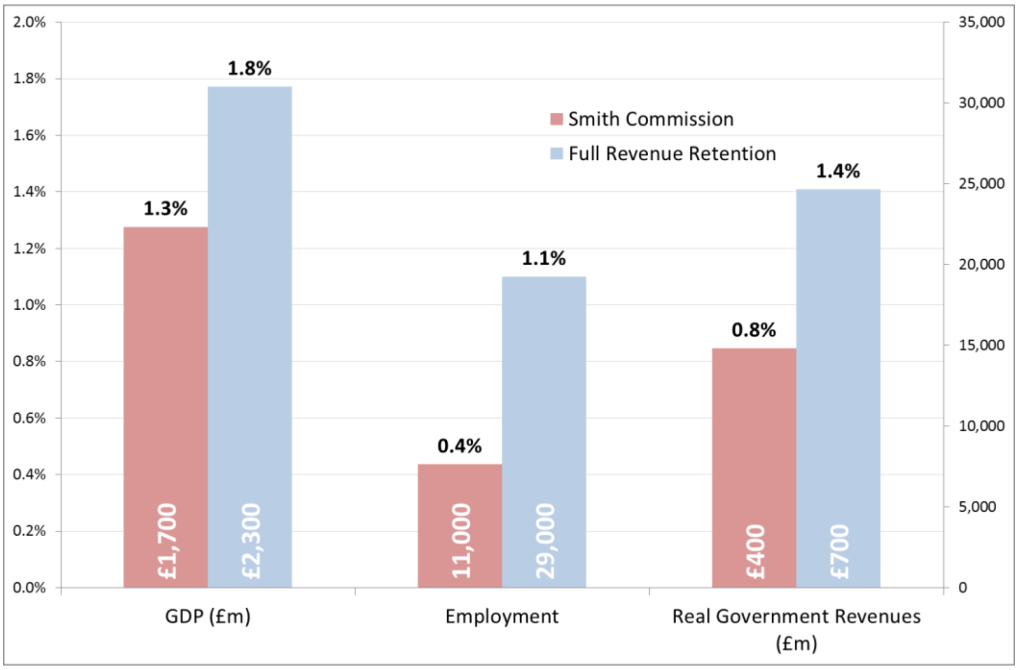
Over the decade prior to the recession, 1997-2007, the ONS estimate that TFP growth in the UK averaged 1.0% a year.[1] The analysis below therefore models the impact of a small additional increase in Scotland's TFP amounting to 0.1% a year over a 10 year period on Scotland's economic performance.

The results demonstrate that such a change in the level of TFP could lead to significant increases in Scotland's economic performance.

Under the Smith Commission scenario, additional increases in TFP of 0.1%, per year are estimated to add 1.3% to the level of GDP by year 10. Employment could rise by 11,000 and tax revenues could increase by £400 million as a result of the expansion in the economy.

With the opportunity to reinvest the additional tax revenue generated by such an improvement in performance, the potential effects could be even greater. Under this scenario, by year 10 GDP could expand by 1.8%, employment could rise by 29,000 and tax revenue by £700 million.

Impact of a 0.1% increase in TFP per annum over 10 years



[1] Multi-factor Productivity, Indicative Estimates to 2012, http://www.ons.gov.uk/ons/dcp171766_349616.pdf

Impact of a rise in business investment

Business investment and innovation is also a key driver of economic performance. As firms invest in new technology, the improvement in productivity increases their competitiveness and supports increased output and employment.

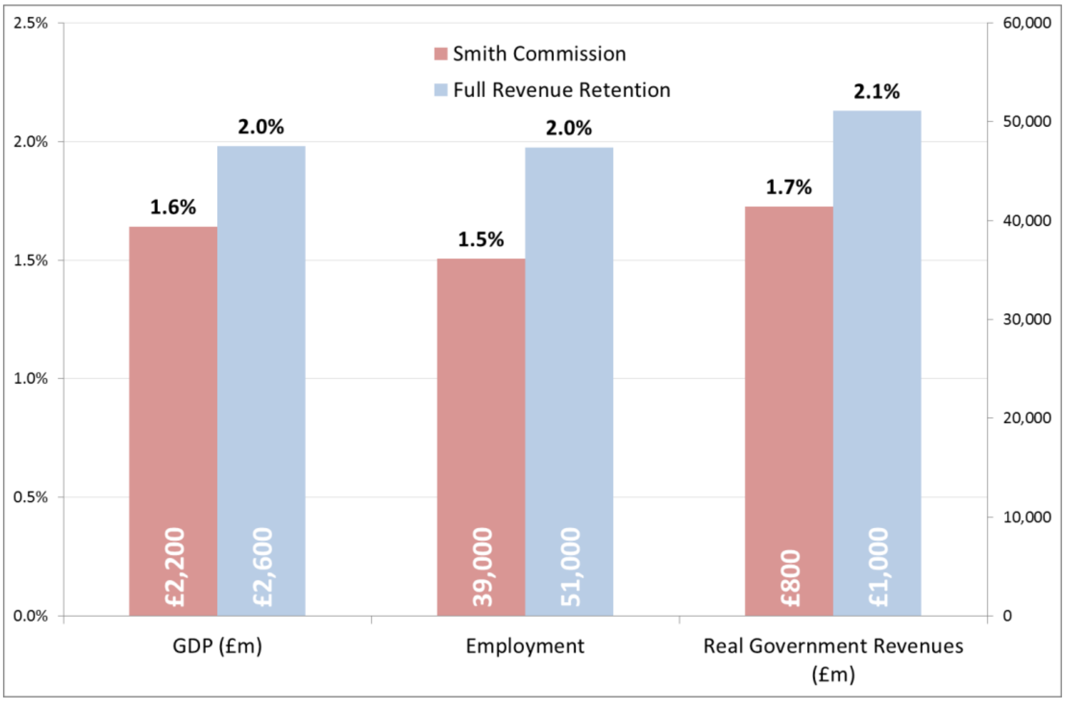
International comparisons show that investment in the UK remains at a low level as a percentage of GDP. In 2013, Gross Fixed Capital Formation (GFCF), a measure of investment, was 16% of GDP in the UK compared to an average G7 of over 20%.[2] A similar trend is evident in Scotland.

Increasing the level of GFCF by an additional 0.5% a year would bring the investment spending in the UK closer to that observed in other G7 economies such as France and the US in the decade prior to 2007.

The results show that under the Smith Commission scenario, such an improvement could drive a 1.6% increase in GDP at the end of a 10 year period. This could potentially boost employment by 39,000 and increase tax revenues by £800 million.

If all of the increase in tax revenue generated by such an increase in economic performance could be reinvested in Scotland, it is estimated that GDP could increase by 2% after ten years, 51,000 jobs could be supported and tax revenue could increase by £1 billion.

Impact of a 0.5% increase in business investment per annum over 10 years



[2] World Bank World Development Indicators

Impact of boosting exports

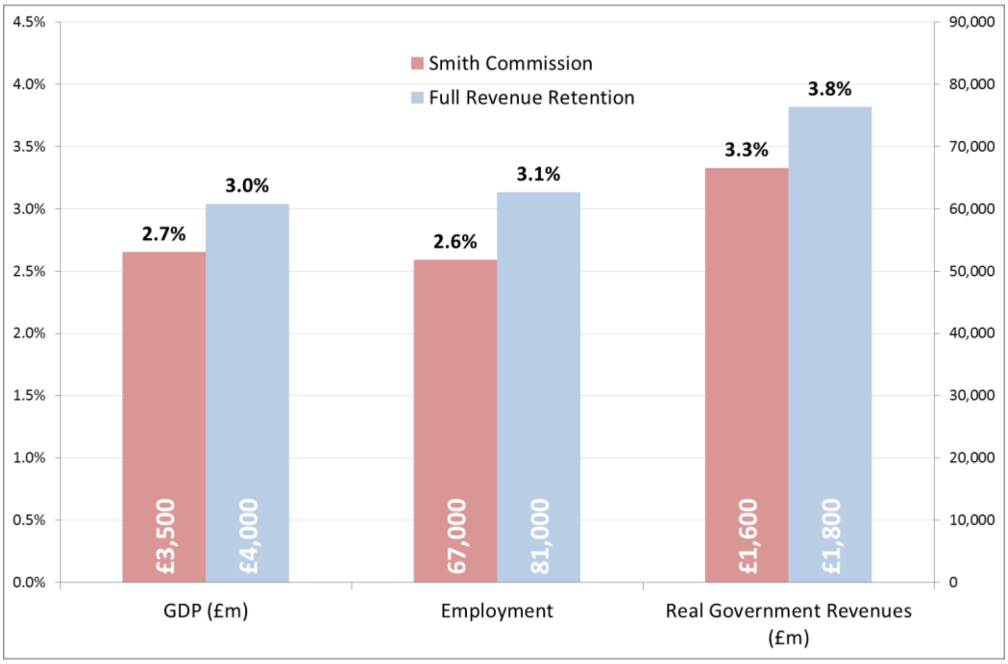
With increasing globalisation, exports will make an increasingly vital contribution to Scotland's future economic performance. The Scottish Government has a target of boosting exports by 50% in cash terms over the period 2010 to 2017. Over the first three years of this period, exports have increased by 20%.

Achieving this target could have a potentially significant impact on the wider economy.

As an illustration over a ten year period, achieving this target is estimated to increase GDP by 2.7%, increase employment by 67,000 and boost tax revenue by £1.6 billion under the Smith Commission scenario.

With the opportunity to retain and reinvest all the proceeds of the additional tax revenue generated by increasing exports however, GDP could be an additional 0.3% higher, there could a further 14,000 increase in employment and a further 0.5% increase in tax revenues accruing to the Scottish Government.

Impact of a 50% increase in the value of exports



Conclusion

This paper has shown how three drivers of economic growth – productivity, business investment and exports – can act to increase economic growth, employment and tax revenues.

The analysis demonstrates that by being able to retain and reinvest the proceeds from successful economic policies in Scotland the overall impact on Scotland's economy can be increased.