CITY & WORLD

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Content summary

City & World looks at economic and public policy issues from Edinburgh's perspective. As a capital city trading in a global economy, this means adopting an outlook that moves outwards from local infrastructure, to national policy, to global trends in urban economics.

This bulletin focuses on the impact of public finances on the local economy. It begins with a **general outlook for the Edinburgh economy in a Scottish context (page 2).** Recent surveys paint a picture of a tentative recovery lead by manufacturing and investment, but with rising cost pressures and weak consumer activity.

The strength of the recovery will depend to a large extent on the impact of the government's budgetary squeeze ahead.

Public spending in Scotland (page 3) explains that, while we do not yet know fully how Scotland's finances will be affected by UK spending reductions, the Scottish Government has considerable fiscal leeway to mould spending to local circumstances.

How public spending affects the economy is therefore dependant on decisions made locally. **The opportunity – public sector productivity (page 4)** points out that, with public pending in Scotland 12% higher than the UK average, but with little evidence of better outcomes, a great opportunity exists. If the Scottish Government and local authorities can undertake meaningful reform of public services, the budget cuts could be accommodated, leaving more efficient public services and greater scope for private sector growth in the future.

By way of example, the bulletin looks at **School education in Edinburgh and Scotland (page 5),** where despite big increases in funding in recent years, performance has remained inadequate, with less than half of school pupils getting a decent minimum of good grades at the end of compulsory education. **Routes to reform (page 6)** looks at the kind of direction policy makers should consider to achieve performance improvement.

Next, the bulletin looks at **Non Domestic (business) Rates and the Edinburgh economy (page 6).** One of the Scottish Government's main economic tools, this tax accounts for 5.2% of devolved expenditure. Yet Edinburgh Chamber of Commerce believes the levy is badly mishandled and is damaging our prospects for recovery.

The five year cycle of assessment leads to massive fluctuations in the levy which are very damaging to cash-flow sensitive businesses. The Scottish Government was wrong to scrap Transitional Relief, the mechanism designed to spread increases over time.

The way in which NDR revenue is recycled to local authorities penalises successful economies and prevents them investing in the necessary infrastructure to accommodate growth.

The bulletin concludes with comment on two recent development – an update on the latest from the **Edinburgh tram project (page 8)** and information about the new **Planning Concordat (page 8).**

General outlook for the Edinburgh economy in a Scottish context

The Scottish economy as a whole did not grow at all in the 1st quarter of 2010, after weak expansion of 0.2% in the 4th quarter of 2009 (compared to the 0.4% UK figure). There can be little doubt that Scotland's experience of the downturn has been more severe than the UK as a whole, in contrast to the recession of the early 1990's.

The indications are that, after stalling in the first part of 2010, the economy has picked up somewhat in the spring and summer, though it is unlikely that Q2 growth matched the UK figure of 1.3% (Scottish GDP data comes out four months after the period end). The Scottish Chambers of Commerce businesses survey reported a rebound in business confidence in Q2 after a weak Q1. The Lloyds TSB business monitor reported that a net -7% of business experienced increased turnover in the three months to May 2010, but this is up from -22% in the previous quarter, and overall the monitor saw the best figures for two years. The Bank of Scotland Purchasing Mangers' Index also shows increased private sector activity in the spring, lead by strong manufacturing growth

The Scottish picture seems to be of a recovery badly affected by the poor weather at the beginning of this year, but with improvement in recent months. Manufacturing appears to be doing particularly well (a picture confirmed by the CBI and Scottish Engineering surveys), with exports boosted by a weak Sterling. Services and consumer spending lag somewhat, a picture confirmed by July's retail sales figures.

On the downside, there is evidence of inflationary pressures which may counter the impact of lower government borrowing on base rates. Lloyds TSB predicts overall growth for the Scottish economy of between 0.5% and 1% this year. The Fraser of Allander Institute has a mid-range forecast of 0.7% this year and 1.1% in 2011.

The City of Edinburgh Council collects monthly data on a range of local economic indicators. These show a broadly similar picture of recovery from a difficult winter.

Investment seems to be particularly healthy. New business incorporations grew to 1,012 in July, up 33% since a year ago. Over the same period, planning applications have shown a strong upward trend since a slump in January and February. Both of these point to encouraging increases in business activity.

The Labour market has also performed relatively strongly. While the claimant count is up over the year to 3.1%, it fell last month and is now following a modest downward trend. The level of claimants per job vacancy is also relatively healthy at 4.2. These figures compare favourably both with the Scottish picture (5.8 claimants per vacancy), and with the performance of similar mid-to-large UK cities (5.2).

The data on consumer activity is more tentative, with indices on hotel occupancy, airport usage, retail footfall and housing market activity all showing a slow recovery.

How the UK Budget will impact on the local economy is the crucial question for the next year. In practice, many of its measures do not take effect immediately. The VAT increase takes place in January 2011, allowing time for consumer patterns to recover vitality, and even offering the prospect of a pre Christmas boost as shoppers aim to beat the hike. Retailers may plan to beat the January blues by lifting prices before the year end and then holding them come the VAT increase. Meanwhile we can hope that the staggered reductions in corporation tax, combined with measures such as the added NICs break for employers in Scotland and Northern England will further encourage investment. In the round, given the circumstances, the Budget fits quite neatly with a tentative, investment led recovery, and this reflects the government's stated aim of rebalancing the economy away from debt-fuelled consumption.

However, the main impact of the budget will be in its implications for public spending. With a low growth Scotland especially dependant on the public sector, there has to be a greater risk locally that the budgetary squeeze will damage recovery prospects. Indeed, the Fraser of Allander forecasts had the Budget reducing growth prospects in Scotland by 0.1% this year and 0.2% next compared to the scenario under the previous government's fiscal plans. The institute is also predicting a net loss of 64,000 jobs, with the boost to the private sector from less 'crowding out' by the public sector outweighed by redundancies in the latter.

It is therefore essential that the Scottish Government and local authorities adjust to the new circumstances in a way that aids long term recovery and does not damage growth in the short term. Edinburgh Chamber of Commerce has been campaigning for public sector reform throughout the downturn as the key to finding a successful balance between spending reduction, economic growth, and public service improvement.

The next section of this bulletin therefore looks in more detail at the impact of the UK budget on Scotland's public finances and how these might be accommodated in a way that enhances Scotland and Edinburgh's prospects.

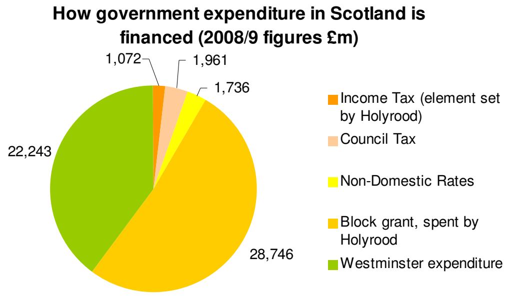
Public spending in Scotland

The full impact of the Emergency Budget on Scotland's public finances will not be known until the details of the Comprehensive Spending Review are announced in October. The amount made available to Holyrood is mainly a function of spending decisions made at the UK level.

However, this year's Government Expenditure and Revenue Scotland (GERS) figures, released in June, show that the Scottish Government still has considerable room for manoeuvre.

Estimates of the impact of the budgetary squeeze on Scottish Government finances vary. In June the Centre for Public Policy for Regions (CPPR) suggested that next year the Scottish Government would need to find savings of between £1.1bn and £1.5bn extra - or 5.2% to 6.2% of its budget. The Fraser of Allander estimate is that the Scottish Government's budget will be reduced by 14% overall.

It is wrong to suggest that this must all come from budget cuts, however. In his statement to the House of Commons, George Osborne said that the UK government's deficit reduction measures were 77% cuts and 23% tax rises. The Scottish Government possesses more than enough fiscal powers to adjust this ratio to fit local circumstances. The GERS figures show that in 2008/9 nearly £4.8 bn or 14% of the Scottish Government's spending was financed by taxes that were set locally - income tax, council tax and non-domestic rates (see page 6 for more on the latter):



Source: Government Expenditure and Revenue Scotland

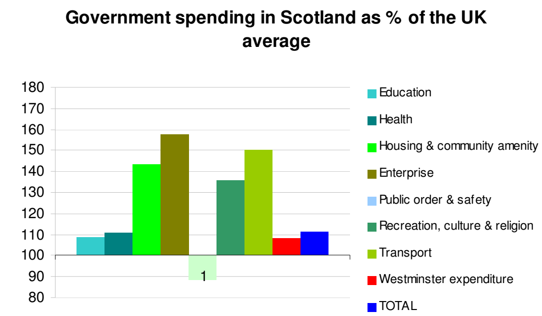
In addition, there is considerable scope for raising revenue through charges of one kind or another – for infrastructure use, licence sales, parking or local service fees, for example. Fixing Council Taxes has foregone nearly £1billion of potential income in this Scottish Parliament. For Scottish politicians to assert that cuts are 'imposed' from Westminster is misleading, therefore. An alternative strategy involving either higher or lower taxation is clearly possible.

The Scottish Government could also increase borrowing by using public private partnership arrangements to finance capital projects, thus releasing more funds for current spending. But this would simply postpone the need for higher taxes or spending cuts. John Swinney himself has suggested that further borrowing of this kind would be unsustainable – payments under current PPP contracts already account for £794m in 2010/11.

So in practice Scottish Ministers would be ill advised to fill the budget gap with increased taxes or borrowing. Spending reductions in line with the UK would be preferable. How easily could these be achieved, and at what costs to local public services and the economy?

The opportunity - public sector productivity

Again, the GERS figures provide some revealing insights. Public spending in Scotland is 12% higher than the UK average on a per capita basis. Of all the major government programmes controlled by the devolved administration, only Public Order & Safety enjoys less lavish funding than the average across the UK:



Source: Government Expenditure and Revenue Scotland

The two biggest budgets, health and education, which account for £10.1bn and £7.5bn respectively, are 11% and 9% higher than the UK average per capita.

And yet the available evidence does not show commensurate advantages in the performance of these key public services in Scotland.

For example, healthcare accounts for 30% of the Scottish Government spending. Two recent reports into the NHS in the different countries of the UK suggest that outcomes are no better here than south of the Border. A study by the CPPR found little evidence that poorer health or geographic factors in Scotland justify higher spending here. And a January report by the Nuffield Trust said that productivity in Scotland was much lower than in English regions such as the North East.

A similar story is apparent in education (see following section). There can be little doubt that the additional government spending in Scotland does not deliver value for money. ECC's view is that this presents a major opportunity for the devolved Government and local authorities in Scotland. There is clear scope for productivity improvements that have the potential to deliver major public finance savings.

The GERS figures show that, for 2008/9, if spending on health and education fell to UK average levels that would deliver a saving of £1.6bn while leaving spending still higher than that in England. Reducing spending across the portfolio of devolved responsibilities to UK average levels would imply savings of up to £3.5bn. Combined with other measures such as reform of public sector pensions to bring them into line with private sector norms, this would allow a medium term goal of reduced taxes as well as lower spending.

This is not to say that UK levels of productivity in public services should be the ultimate goal of Scottish policy makers. We should be more ambitious still, for it is not as if the public sector in England leads performance tables internationally.

But it would seem to be a reasonable first step to match English levels of productivity just as the First Minister's economic target is to match UK GDP growth rates.

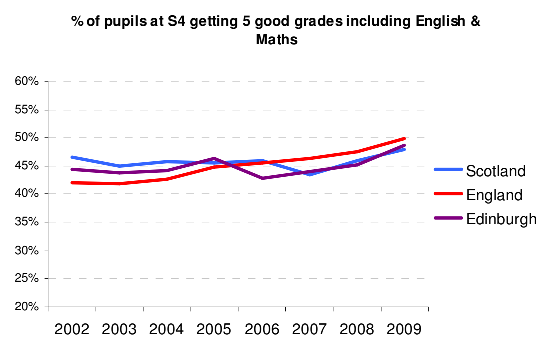
In fact the two go hand in hand. For public sector reform is not just a necessity triggered by difficult financial circumstances. It is a golden opportunity to reduce the size of the state in Scotland, thus expanding opportunities for economic growth. A more efficient public sector will also be able to deliver improved public services as the economy recovers and government revenues begin to rise once again.

School education in Edinburgh and Scotland

For a global city such as Edinburgh, excellence in education is an important driver of economic success. Good schooling not only helps to generate human capital and a skilled workforce locally, but is crucial in attracting talented workers from elsewhere.

But exam results suggest that Edinburgh schools, like those in Scotland more generally, have now fallen behind their English equivalents, despite higher levels of funding.

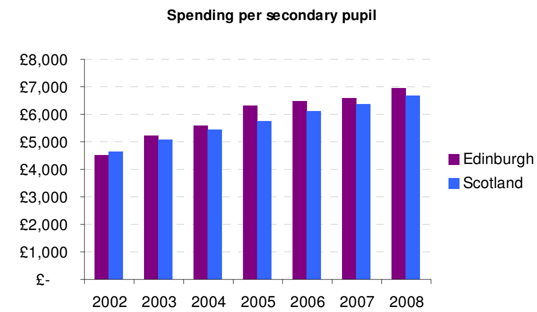
The gold standard statistic in school performance measures the proportion of all pupils at the end of compulsory education who achieve five of more good grades[1], including the essential subjects of English and Maths.



Source: Scottish Government Statistics

Performance has been broadly flat in Scotland, though Edinburgh has now seen three years of modest improvement from a low base. This is against a backdrop of major increases in funding per pupil in recent years:

[1] Standard Grade at 1-3; Intermediate 2 at A-C; Intermediate 1. The English equivalent is GCSE A*-C.



Source: Scottish Government Statistics

Education is, of course, more than exam results, and this data gives an incomplete picture of performance. However it is the best currently available because it uses real figures from thousands of cases in a way that is comparable across jurisdictions.

Scotland also takes part in a number of international studies that compare student performance. The OECD's PISA study rates Scottish pupils highly (along with those from other English speaking countries), but performance has been in relative decline over the last decade. Two further studies by Boston College show Scotland near the bottom of the educational league table.

As with healthcare, we need to make much more effort to understand Scotland's relative performance compared to other jurisdictions. But there can be little doubt that Scotland suffers from a productivity problem in its public sector. In Edinburgh school spending has doubled in the last decade with little to show for it in terms of actual outputs.

We need to be far more ambitious. It is unacceptable that less than half of school pupils in our city are capable of achieving five decent grades at the end of compulsory schooling.

Routes to reform

This bulletin will not set out in detail proposals for public sector reform. However, clear trends are emerging in domestic and international research to indicate the direction that reform should take. Scotland's post war model for the public sector, most notably in health and education, has been for centralised, monopoly provision, with a uniform approach to standards and regulation.

By contrast, the norm in continental Europe is for a diversity of competing service providers, backed by state finance to ensure universal access. The problem with a centralised approach is that is allows no inherent incentives towards improved performance from competitive pressures. As long ago as 2004, this issue was highlighted by the leading economic historian Nicholas Crafts, who warned that Scotland would be unable to deliver effective public services by persisting with its centralised approach[2].

Since then, numerous academics and think tanks have pointed to the relative failure of public services in Scotland, and how these might be addressed by encouraging diversity and competition. So far, however, the policy response has been muted.

By contrast, policy makers from all the main parties at Westminster have taken this message on board, and have started to reform public services in England along European lines. There is a danger that in reacting negatively to events south of the Border, Scotland's public services will be left behind.

Fortunately, there are good local precedents which may help us to address reform in the Scottish context. For example, East Lothian Council is conducting a project examining ways of

[2] *High Quality Public Services for Scotland*, Allander Series 2004

awarding schools greater autonomy in an effort to encourage better cost control and a more flexible approach to teaching.

And in Edinburgh there is a strong tradition of educational excellence. Fully 19.6% of pupils in the city attend independent schools. The City of Edinburgh Council and the Scottish Government would do well to learn from the experience of policy innovation both locally and aboard, and to use local expertise to explore different models of running public service providers such as schools.

Non Domestic (business) Rates and the Edinburgh economy

One of the most important fiscal and economic tools at the disposal of the Scottish Government is Non Domestic Rates (often called business rates, and abbreviated here to NDR).

ECC believes that this tool is being badly mishandled by the Scottish Government.

NDR generated £1.74 bn for the Scottish Government in 2008/9, 5.2% of devolved expenditure. Although in theory NDR is a local tax, the Scottish Government sets the poundage at which the levy is raised, and the revenues are pooled before being redistributed to local authorities. In practice therefore, NDR is a national levy over which local authorities have no control save in an administrative sense.

There are two main problems with NDR that cause serious economic damage to business in Edinburgh and elsewhere. The first relates to the way the tax is levied.

The amount paid by any business is a factor of its Rateable Value (RV), reassessed every five years, based in theory on potential rental value. The long time gap between assessments inevitably leads to big fluctuations in the RV. With the latest values coming into force this April, 40% of businesses are now being faced with sudden, steep variations (up or down) in one of their major cost items.

Previously in Scotland 'Transitional Relief' was available to smooth these fluctuations over the five year cycle, but this scheme has been scrapped by the Scottish Government (it continues to be applied in England). This move presents some serious problems for many Scottish businesses, particularly as we struggle to escape recession:

- A big increase in a cost item can threaten the viability of a business. An ECC member survey[3] found that 41% said it would affect their viability
- It is no consolation that other businesses benefit from a reduction in costs. They are unlikely to take up the slack left by those negatively affected. 33% said they would consider moving to smaller premises, while none said they would upgrade.
- The revaluation process introduces unwelcome uncertainty and variability to business. The survey by ECC found that 82% found their new RV higher than expected.
- The situation is particularly grave for hotels and other leisure venues, whose assessment is based on turnover. The assessment took place as at 1st April 2008, in a peak year before the recession took hold.

ECC, is campaigning strongly for Transitional Relief to be reinstated. The Chamber's position was endorsed by Labour leader Iain Gray at the ECC

[3] ECC e-survey March 2010

annual general meeting on 1st September.

A second problem with NDR is the way in which the revenue is distributed. It is not returned to Local Authorities, but pooled by the Scottish Government. This means that an economically successful city such as Edinburgh is a net loser from NDR. Last year the city paid £100m from its NDR income. In essence this is a redistributive tax that penalises businesses that chooses to locate in successful areas such as Edinburgh.

ECC believes that the NDR poundage ought to be set at the national level, but revenues retained where the business is located. That would encourage local authorities to pursue policies that attract businesses s to their areas and promote economic growth.

It would also allow high growth areas to reinvest revenues to upgrade the infrastructure that a growing economy relies on.

Difficulties with the Edinburgh tram project

An essential element of economic success in modern cities is the development of effective transport infrastructure. Above all this must recognize the flexibility of the car and the importance of efficient road access to the city centre, residential areas and the workplace.

On top of this, efficient public transport helps to relieve congestion and is an important tool for commuters and shoppers alike. ECC supports the Edinburgh Tram project, and has also worked to minimize any harm done to city centre businesses by the construction process.

There continue to be contractual difficulties between Transport Initiatives Edinburgh (Tie, the council-owned company managing the project) and the Billfinger Siemens CAF Consortium (BSC) over the construction of the Tram. It now seems that the full network initially envisaged will not be possible within the set £545m budget. Construction of a more limited route should be possible by the end of 2012, depending on the outcome of the contract negotiations. This will be between the airport and either Haymarket or Picardy Place.

ECC continues to meet with Tie, HMRC and Lothian Rates Assessor to advance the business case. Princes Street businesses have won against an appeal by the Lothian Rates Assessor against a 20% devaluation of Rateable Value during construction.

Meanwhile The 'Open for Business' campaign continues to support City Centre retailers. Measurements of pedestrian footfall in the City Centre show stable growth in the early part of this year in line with comparator cities elsewhere in the UK, indicating modest recovery in retail and consumer activity from the recession despite the tram works.

Planning Concordat

Edinburgh has major competitive advantages in terms of the quality of life it can offer residents and those seeking to invest and build their careers in the city.

The challenge for somewhere with Edinburgh's architectural heritage is to preserve and enhance what is best about the urban landscape while allowing maximum flexibility in the development of new commercial premises and attractive, affordable homes for the full range of households

With this in mind a major advance has been achieved in the field of development planning in Edinburgh. The ECC Property Development Group has agreed a Planning Concordat with the Council to establish a much clearer and more structured process for guiding development through the planning process. At all stages developer and planning authority (represented by a dedicated case officer) will work together to exchange information and ensure that developer requirements are fulfilled according to a clear timetable. The concordat has been hailed by the Scottish Government as an example of best practice in the planning system.

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