The Industrial Investment Policy of the SDA

1. Introduction

In its Annual Report for 1977-78 the SDA reveals that it had £17million invested in twenty-six companies. This modest level of investment represents its contribution over its first five years of activity towards attaining its rather ambitious goals: *"to help in uplifting and regenerating Scottish industry and the Scottish economy, and in improving the total stock and quality of Scotland's industry in terms of equipment, products and management"* (SDA 1978b). With only some £120million to invest over a five-year period, the contribution of the SDA to the achievement of these objectives can be little more than marginal. It has been suggested that to make any significant impact on the problems of Scottish industry the SDA needs to be given substantially more funds for investment. Does the Agency's performance suggest that a far larger investment budget could be justified?

Of course it is far too early to be able to provide any empirical assessment of the impact of the SDA's investments. However, it is now possible to form some idea of the role that the SDA sees itself playing and this poses certain questions. Considerable emphasis has been placed on the need to ensure the commercial viability and long-run profitability of the Agency's investments. This stress on market tests is somewhat paradoxical as the case for the SDA is based on the argument that private institutions and market forces have failed to solve the problems of the Scottish economy. The objectives of the Agency have still to be clearly defined and consequently its investment criteria lack clarity, and without more precisely stated objectives and criteria it is difficult to see how the Agency can be made accountable for its expenditure.

2. Statutory Obligations and the Guidelines

When the Agency was established in 1975 the objectives for its industrial investment function were defined very broadly:

" (a) furthering economic development,
(b) the provision, maintenance, or safeguarding of employment,
(c) the promotion of industrial efficiency and international competitiveness. " (SDA Act, 1975)

It was left to the Secretary of State for Scotland to attempt to give

operational content to these vague objectives. He was given the power to issue directions to the Agency and determine its financial duties. In 1976 the Scottish Economic Planning Department issued Draft Investment Guidelines which required the Agency to earn a minimum rate of return on its investments but otherwise left it considerable freedom to formulate an investment policy. The Guidelines recognised that the Agency's purposes "*are wider than those of commercial enterprises, and the return on capital in individual cases will reflect this*". Nevertheless, it was stressed "*in taking investment decisions it must, however, always have regard to their profitability*". (The target rate of return for the SDA was not announced until August 1978, the Agency is expected to earn 15-20% on its investment in 1981-82.) The Guidelines avoided the contentious issue of the potential conflict between the statutory objectives of efficiency and employment. It would appear that constrained by the need to meet the target rate of return the Agency is expected to cross-subsidise investments in the pursuit of non-profit objectives.

The Act also gives the Secretary of State the power to direct the Agency "*to assist companies in financial difficulties which need to be restored to a sound state for reasons of employment or industrial policy*" (Guidelines 1976). In these circumstances the Agency will be reimbursed specifically for its involvement and to ensure that the financial discipline is not undermined, these activities will be separately accounted for. It is recognised that in such rescue cases an explicit subsidy must be provided and accounted for. As yet the Secretary of State has not used this power, allowing the Agency to remain untainted by any explicit rescue operations.

To a large extent the Agency itself was left to decide upon its role and strategy and to assess the appropriate trade off between competing objectives. This is very similar to the experience of the Industrial Reorganisation Corporation on its establishment in 1966. Graham has contended that "*the IRC's vague terms of reference meant that the personnel who operated it were crucial in determining its shape*". (Graham 1972). The role of agencies, such as the IRC and the SDA, and the determination of their social priorities are issues far too important to leave to the professional staff of the agencies. While some degree of operative independence may be necessary for effective commercial decision taking, there is no justification for the delegation of broad issues of policy.

3. Criteria for Investment

The criteria adopted by the Agency have been described in the Annual Report and in the evidence to the Committee to Review the Functioning

of Financial Institutions (Wilson Committee). The primary criteria adopted by the Agency are (i) Profitability; (ii) Management; (iii) Employment; both direct and indirect through multiplier effects; and the technological impact.

(i) Profitability

Considerable emphasis is placed by the Agency in its public pronouncements on the profitability and commercial viability of the concerns in which it intends to invest. the Agency had interpreted its profitability goal as implying *"that there must be a commercially acceptable prospect of an appropriate level of profit, and thus of return on investment, within a reasonable period of time".* (SDA 1978 a) But this does not imply that the SDA is determined to compete on the same terms as other financial institutions. It is pointed out that *"the Agency is prepared to exercise patience and to refrain from requiring an immediate return on its money"* (ibid). Of course this could be interpreted as implying that the Agency is looking for the same discounted rate of return as the market, but is prepared to wait longer for the benefits of the investment to materialise. But the oral evidence to the Wilson Committee suggests that this is not the case, and it appears that little significance is attached to DCF evaluation. The SDA's Finance Director, Mr R P McEwan, explained why the DCF evaluation might be inappropriate *"in quite a number of instances we could invest equity in a company which in year 1 and year 2 could be showing absolutely negative return, but we would not do so unless by years 3,4, or 5 we saw something above average. In fact in terms of a DCF calculation we might get the wrong answer, and we would look to yields with some confidence because in year 1 and 2 we could see ourselves as assisting these companies to reach the targets".* (SDA 1978 a. But in such a case a DCF evaluation would establish whether or not the positive cash flows expected in later years provide adequate compensation for the negative cash flows of the earlier years.

If the profitability criterion implied nothing other than a commercially acceptable accounting rate of return in the long run, it suggests:

(a) that an inappropriate criterion is being employed for purposes of resource allocation,

(b) an element of subsidy is concealed in any short-run relaxation of the long-run target.

It is generally agreed that the rate of return on capital employed has no theoretical basis as a criterion for the appraisal of investments. More appropriate is the DCF rate of return which takes the time dimension of costs and benefits into account. Unfortunately, no statutory obligation is imposed on the Agency to evaluate investments on a discounted basis. This is in contrast to the requirement imposed on the National Enterprise Board to employ the public sector test rate of discount for appraising investments.

The DCF rate of return does appear in the SDA's checklist for the evaluation of investment proposals but appears to play a subordinate role to the profitability test in the Agency's decisions. If the Agency used the DCF rate of return to appraise investments a role would remain for the profitability test: carefully interpreted it is usefully employed as an ex post control mechanism to maintain financial discipline.

The SDA makes great efforts to stress that it is only interested in investing in commercially viable concerns: *"long run profitability is an essential of sound business and a necessary and salutory discipline on management ... the Agency will hold firm to a viability test, both because it is required to do so and because it sees this as essential to its purposes in fostering sound development"* (SDA 1977). But even if the Agency is not prepared to subsidise failing firms on a continuing basis, and few would disagree with this policy, this does not imply that it should not be prepared to supply finance on a subsidised basis to viable concerns as a means of achieving its objectives.

If the SDA is to provide some finance on softer terms than the market, and there are likely to be somewhat limited demands placed on it if it is content to try to fill gaps in the capital market and offer finance on strictly commercial terms, the subsidy should be made explicit and related to the non-financial objectives being pursued. The subsidy needs to be made explicit for effective decision-taking in the Agency, and so that an adequate basis for maintaining accountability can be developed. The subsidy implicitly offered by the Agency being *"prepared to exercise patience and refrain from requiring an immediate return on its money"* is quite possibly not the most effective way of buying the co-operation of private firms in pursuing employment and other non-profit objectives. In principle, the Agency seeking to allocate its limited resources to greatest effect, would be prepared to trade off the DCF rate of return against non-finacial objectives in a more flexible manner.

Commercial viability and profitability are understandably stressed by the SDA for political purposes. Financial discipline and the efficient use of resources are readily associated with profitability while subsidies are normally seen as evidence of inefficiency and failure. Moreover, the SDA purporting to seek a commercial rate of return on its investments defines an acceptable role for the Agency in relation to the private sector. If the SDA explicitly recognises it can offer finance on soft terms it implies it has an unfair advantage over other financial institutions, and it requires their co-operation for its effective functioning. Also if firms are financed by the SDA on a subsidised basis it provides them with a possible cost advantage over their competitors in the product markets, and the Guidelines quite explicitly state that *"companies controlled or financed by the Agency are not to be given an unfair competitive advantage whether through the availability of public funds or other means"* (Guidelines 1976).

(ii) Management Quality

Management quality is presented by the Agency as a separate and *"an entirely indispensable criterion"* (SDA 1977) for the evaluation of investment proposals. At the analytical level the quality of management, without at all denying its significance, can be readily subsumed into the profitability criterion. It appears the Agency is so intent upon stating its commitment to the well-managed and efficient firm rather than the lame ducks associated with the NEB and Government rescue operations, that it is prepared to sacrifice analytical clarity in the development of its criteria.

(iii) Employment

The most important non-financial criterion is the consequence of the investment proposals for long-run employment prospects. The Agency purports to take the secondary effects on employment into account in addition to the direct effects:

> *"The Agency will take into account in evaluating any proposition its potential for generating or enhancing activity and employment in other (normally supplier) companies in Scotland"* (SDA 1978a)

The Agency normally seeks to minimise the possible conflict between

the goals of profitability and employment contending that sound commercial investments are the best means of securing long-term employment prospects. When it does recognise the difficulties of always reconciling the efficiency and employment criteria the Agency comes firmly down on the side of efficiency:

> "*The Agency is clear that because of its proper concern with the longer term, it must stand on the side of efficiency and modernisation, and it is convinced that the pursuit of these and the enhanced level of economic activity to which they give rise, must be the proper path towards dependable and continuing job creating*" (SDA 1978b)

But (1) increasing employment opportunities is the key to greater prosperity in Scotland and the reduction of above average levels of unemployment and net migration; (2) there is an inevitable conflict between these objectives in the Agency's overall strategy if not in some individual investments, a conflict which will only disappear when the problems of the Scottish economy have been solved. To keep the Agency's role in proper perspective far more emphasis needs to be given to the employment objective. It might be more appropriate for the Agency's investment policy to be redefined as the maximisation of long-run employment opportunities subject to a budgetary constraint. There is some scope for dealing with the conflict between profitabilty and employment criteria through the use of cost benefit analysis which by recognising the relatively low real cost of employing labour would favour the expansion of employment opportunities.

(iv) Technological Impact

In addition to profitability and employment criteria the Agency also purports to take the technological nature of proposals into account Those proposals which lead to the "*enhancement of the general technical level of Scottish industry justify the Agency's attention and support*" (SDA 1978a). Such investments generate social benefits that will not be taken into account by firms, and there is consequently a tendency to under-investment in such projects in the private sector. Some element of subsidy may be justified to increase the level of such investments, and the SDA by providing finance on softer terms than the market can help achieve this goal. Some explicit relaxation of the tests of commercial acceptability would appear to be appropriate.

4. Investment Policies

The Agency has drawn a distinction between reactive investments, those

investments made in response to initiatives taken by others, and those investments undertaken as a result of its own initiatives. So far almost all of its investments are of a reactive character but the Agency anticipates that it will soon be in a position to start implementing its own investment policy. It is argued below that the scope for the Agency developing an effective investment policy while employing commercial criteria is quite limited.

In its evidence to the Wilson Committee (SDA 197) the Agency claims that it has identified a clear need for its services. It is argued that while the demands for short-term borrowing are well served by the clearing banks it has some role to play in the provision of longer term loans. But its primary role is seen to be in the provision of equity capital to small and medium-sized firms. Its analysis of the functioning of the capital market suggests:

(a) it is responding to national (British) problems at the regional (Scottish) level rather than dealing with the particular problems of the Scottish economy

(b) there is no evidence to indicate that the low level of growth and investment in Scotland can be traced to any weakness in the provision of finance

(c) it is doubtful whether the gaps in the capital market that it seeks to fill will provide many opportunities for investments expected to yield commercial rates of return.

The Agency's analysis of 'need' for equity concentrates on factors affecting the UK economy as a whole:

(a) high rates of inflation which have increased the working capital requirements of firms;

(b) high interest rates which make firms reluctant to borrow;

(c) high rates of gearing which have made it impossible for firms to borrow;

(d) high rates of personal taxation which have made it difficult for the proprietors of firms to retain enough capital for expansion;

(e) the non-allowability of personal overdraft interest as a tax-deductable expense which has pushed up the cost of capital for smaller firms;

(f) the impact of the capital transfer tax which has made the inheritance of business difficult. (SDA 1978a)

It is the alleged failure of the capital market to fill these needs that has allowed the SDA to develop its reactive investment role. The gaps in the capital market identified by the SDA tend to be of a national character but an attempt is made to argue that the effects of these gaps are particularly onerous in Scotland.

The SDA sees a major role for itself in filling the 'equity gap' for the smaller non-quoted company. The Scottish Clearing Banks in their evidence to the Wilson Committee point out that equity finance is already made available to such companies by bodies such as ICFC, FFI and Technical Development Capital Limited. But according to the SDA these bodies do not operate effectively in Scotland and there is a specifically Scottish need for the services it can provide. In its evidence to the Wilson Committee the Agency contended that as ICFC *"is based in London ..... this must limit the extent to which decision-making is devolved to the Scottish offices, and will at least interpose some delay in handling cases"* (SDA 1978a). In the oral evidence it was suggested that ICFC had not made much impact on Scotland. But this could be a reflection on the lack of suitable investment opportunities being generated in Scotland. The Bolton Committee while recognising the existence of a gap considered that the regional differences in the financial facilities available to small firms were marginal. Even the existence of a gap which is worth filling is open to question It might be argued that no institutions have developed to fill the gap as there is no scope for profitable investment in this area. Information and transactions costs are relatively high and this has tended to inhibit the development of a market. The absence of a market for the shares of non-quoted companies is going to pose problems for the SDA as it attempts to implement a disinvestment policy to allow it to recycle its funds.

The SDA contends that the private institutions leave another gap in the capital market as they are not prepared to take action to remove management deficiencies even when this constitutes the only barrier to profitable investment. It is suggested that *"lack of confidence in management is for most institutions a conclusive bar"* (SDA 1978a). When the Agency is presented with such proposals it will consider the possibility of resolving management weaknesses:

> *"The Agency can provide company management with some short-term assistance and support in particular or specialised spheres but it does not aim to have the capability of providing major operational management resources for long periods of time"* (SDA 1978a)

In the oral evidence to the Wilson Committee it was pointed out that the strengthening of management is a factor in more than half the SDA's investments.

If the management weaknesses can be eliminated by a limited short-term

input by the Agency, why have the private institutions not developed the necessary expertise to fulfil this function and increase the range of their business? It is quite possible that some institutions have felt inhibited in developing such an explicit proprietorial role, but this is hardly the case for all institutions. It is far more likely that the institutions appreciate the difficulties associated with programmes of management change or improvement. Difficulties to which the SDA may be more sensitive following its failure to get the management of Triadynamics to respond to its prodding. And there is considerable evidence to suggest that conglomerates have not found it easy to improve the efficiency of their constituent companies. If management weaknesses are a significant factor in accounting for the poor performance of Scottish industry, and this is a widely held view (see the West Central Scotland Plan 1975), it is difficult to see how the Agency can improve matters while seeking a commercial rate of return on its investments.

The Agency also believes that it has a role in the promotion of indigenous firms. This has been explained by the Agency's chief executive:

> *"There are strong arguments for encouraging the further development of indigenous industry and an increase in the proportion of Scottish-based companies. The arguments are not chauvinistic or political but rest in the fact that the existence of a greater number of decision-making centres in Scotland will encourage and hold men of talent, and strengthen the total Scottish management pool. The Agency will therefore do all it can to assist and support developments that will enhance the indigenous proportion of Scottish industry, recognising that this must be a process extending over many years"* (Robertson 1978)

There is some evidence to suggest that the birth rate of new enterprises in West Central Scotland has been relatively low (Firn 1973) Without discussing the factors responsible for these findings, or the desirability of this policy, it may be argued that the Agency will be unable to make any real contribution without subsidising the birth process of new enterprises and the relaxation of its commercial tests.

The Agency is likely to find that it tends to be approached by firms that have failed to obtain finance from private investors. Its analysis of the gaps in the capital market generating investment proposals promising commercial rates of return is not very convincing. If the equity investments and loans extended by the SDA could be expected to satisfy normal commercial criteria there would appear to be no real need to supplement existing market institutions. But this does not mean there is no role for the SDA to play. Many investments may not offer the prospect of commercial rates of return but nevertheless constitute worthwhile investments from a social standpoint.

The Agency is now considering a more positive investment role in which it will be taking the initiative and not merely responding to the requests of firms for finance. Firms will be encouraged to develop in ways that are beneficial to the Scottish economy. Without considering in detail the character or merits of such initiatives it quickly becomes clear that there is little prospect of the SDA obtaining a commercial rate of return on such investments. The company investments in the various growth sectors that the SDA might wish to develop in Scotland might well be profitable but the return on the SDA's investment is likely to be below that expected by the market. If the SDA is to induce firms to undertake their development in Scotland some inducement is necessary. The SDA finance may be made available on condition that firms are prepared to develop at certain locations and at a certain time and must consequently be offered at a lower cost than that of the market to be acceptable to firms. Other investments might be favoured by the SDA because of their high linkage or multiplier effects. These external benefits are not taken into account by individual firms and they will only be prepared to invest if the inducement is made sufficiently attractive.

One way in which the Agency's objectives and criteria could be clarified, while at the same time allowing its executives independence in the exercise of commercial judgement, would be to use cost benefit analysis as the basis of the investment policy. The case for the use of cost benefit analysis has been well argued by a member of the SDA board (Alexander 1975). He believes the theoretical limitations and data difficulties associated with cost benefit analysis have been exaggerated and that one of the major barriers to its more extensive use is the reluctance of decision-makers to see their decision-taking powers constrained. '*Managers and politicians now enjoying the freedom of decision-making in the absence of a calculus of costs and benefits can, within limits, indulge in their own preferences for regions, for votes, for prestige, and so on. The curtailment of such freedom will be resisted. It is not surprising that the most far-reaching applications of cost benefit analysis take place where there is an extraneous party who makes aid for a given purpose conditional upon its costs and benefits satisfying rigorous scrutiny.*' Cost benefit analysis would allow the identification of socially desirable investments and provide a systematic basis for resolving the conflict between the Agency's efficiency and employment objectives.

5. Accountabilty

In quasi non-governmental institutions such as the SDA there is inevitably conflict between the claims of independence and effective operation and accountability. While those para-governmental agencies in the UK associated with industrial development have to a large extent

been modelled on the Italian IRI it is essential we avoid the lack of accountability attained by that body:

> *"The IRI experience could be summarised as that of an industrial state within a state within a state, almost free of government interference, wholly unaccountable to any democratic body..."*

(Corti 1976)

In formal terms the Agency is accountable to Parliament through its sponsoring ministry, the Scottish Office. The accounts of the SDA are audited by the Comptroller and Auditor General and he reports to the Public Accounts Committee. A good working relationship between the C & AG and the SDA, while not enough to ensure an adequate degree of accountability, will be of considerable assistance in Parliament in its endeavours to make the SDA accountable. How this relationship is developing should become clearer with the publication of the proceedings of a recent session of the PAC concerned with the activities of the SDA.

The NEB, which is in a somewhat different position to the SDA as its accounts are not audited by the C & AG, has fiercely argued that detailed surveillance of its activities would impair its commercial effectiveness (Public Accounts Committee 1977-78) It would, it is suggested, injure relationships with client companies, as transactions would no longer be confidential, and lead to a loss of efficiency in the NEB as its executives became less prepared to take initiatives that would be open to scrutiny by a Parliamentary Committee The NEB contends that its performance should be assessed over a period of time against its statutory obligations.

The Report of the Expenditure Committee on "Public Money in the Private Sector" suggested that Parliament had two basic duties in relation to public expenditure:

(1) to insist that objectives were clearly stated

(2) expenditure be monitored to ensure that value for money was being obtained in pursuing these objectives

(Expenditure Committee 1971-72). The more precise the objectives the greater the degree of accountability that may be achieved. As the objectives of the SDA are ill-defined, and its criteria purport to be based on commercial standards that are not relevant for the role it is expected to play, it is going to be difficult to exercise effective control over its operations. Another factor that is going to make it difficult to evaluate the SDA's performance is the tendency for it to invest its capital alongside other government money provided under

the Industry Act:

> *"The great majority of the cases we handle involve also Industry Act money and selective financial assistance, and therefore will, to a greater or lesser extent, be discussed with the Scottish Economic Planning Department"* (SDA 1978a)

This inevitably leads to a diffusion of responsibility and a loss of accountability.

6. Conclusion

If the SDA has a role to play, and this question has not been explicitly considered here, it has been suggested that it should not be shaped primarily by commercial considerations. Social objectives, particularly the generation of employment opportunities, need to be stressed and it is unreasonable to expect the SDA to purse these objectives and earn a commercial rate of return on its investments. On the whole the SDA must work through the provision of finance on relatively soft terms to induce companies to undertake those investments and policies that it believes to be in the social interest. These companies, and even most of the capital expenditures that they are encouraged to undertake, may be commercially viable but the SDA cannot be expected to earn market rates of return on its outlays if it is to make a significant contribution to the solution of Scotland's industrial problems.

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