
Briefing Paper

THE NEW REGIONAL POLICY AND THE SCOTTISH ECONOMY

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The Government's new regional policy was finally announced on 28 November last year. The announcement constituted the culmination of a review of regional policy which began under Sir Keith Joseph in 1979. The 1983 White Paper, **Regional Industrial Development** Cmnd 9111, December (reviewed in the **Commentary**, February 1984), made clear the direction in which the Government was moving. The stated aim was to concentrate resources more closely on areas and communities in need and to make the policy more cost effective. This was to be achieved by a move to a more discretionary and less automatic incentive structure; greater emphasis on job creation and less on capital investment **per se**; less discrimination against service industries and emphasis on local job creation rather than job diversion.

The recent announcement adds the flesh to the White Paper's bones. In outline the main changes are as follows:

- two tiers of areas eligible for assistance instead of three. Development Areas (DAs) and Intermediate Areas (IAs) replace Special Development Areas (SDAs), DAs and IAs; Regional Development Grant (RDG) and Regional Selective Assistance (RSA) available in DAs and IAs, RSA available only in IAs.

- changes in particular areas eligible for assistance due to re-definition (based on new Travel to Work Areas (TTWAs) from 27 September 1984) and contraction of coverage.

- changes in RDG. Rate of award: now maximum 15% of investment outlays subject to a limit of £10,000 per job created, compared with 22% and no cost-per-job limit; alternative job grant of £3,000 per job created will

now be available. Eligibility criteria: now project- rather than item-related with exclusion of non job-creating replacement or modernisation projects; extension to some service activities; exemption from grant-per-job limit and partial exemption from modernisation exclusion for small firms with up to 200 employees undertaking projects up to £0.5m.

- Industry Department for Scotland (IDS) now responsible for administration of RDG as well as RSA.

The Government estimates that these changes will by fiscal year 1987/88 reduce expenditure on regional policy in Scotland from an outlay of £194m under the old system to £104m under the new: a saving or cut of £90m. The corresponding figures for Great Britain are £679m and £390m: a reduction of £289m. Scotland's share of these expenditures is therefore expected to fall from 28.5% to 26.6%.

The remainder of this article will try to assess the implications of these changes for the Scottish economy. We consider first the estimates of the scale of the cuts, then secondly, the likely short-term job-creation effects. Finally, the implications for development over the longer term are considered.

1. Regional Policy Expenditures

The Government estimates that by 1987/88 expenditure on regional policy in Scotland will be reduced by £90m (a cut of 46%) compared with the outlays that would have been incurred under the old policy. The

assumptions underlying these calculations do not appear to have been spelled out. It is evident that this estimate must be subject to a considerable degree of uncertainty because it requires forecasts of industrialists' future demands for investment in terms of scale, type and location. Specifically, the estimate of the size of the expenditure cut depends on the forecast level of eligible investments in: the service sector; the downgraded and derated areas; replacement and modernisation projects, particularly in small firms; and very high (£65,000) and very low (£13,500) investment-per-job projects.

One way of avoiding some of these problems is to ask what the expenditure would have been in Scotland if the new policies had been in force during the last financial year, 1983/84. On this basis, we estimate a cut in regional aid expenditures to manufacturing of £111m or 68%. We have obtained this figure by adjusting the actual payments made to investments undertaken during 1983/84 for, the revised areas, the new rates of RDG and the likely effect of the inclusion of some service activities and the exclusion of replacement and modernisation expenditures in medium to large firms. However, this estimate should not be viewed uncritically.

First, the favourable effect on expenditures of the inclusion of some service sector investment activities and the unfavourable effect of the removal of replacement and modernisation expenditures, is very difficult to estimate even for a previous year. We estimate that the inclusion of the former would have raised expenditures by about £5m. This is because the extension to services only appears to cover about 4% of the workforce in that sector. The removal of replacement and modernisation projects contributes £14m to the cut. We believe this to be a conservative estimate because we have no basis for calculating the effect of the restriction on payments to modernisation projects; accordingly, the cut could be higher. The cut could also be higher than we estimate because we have not been able to quantify the effect of the change from an item-related to a project-related RDG scheme. It seems likely that the need to define the desired expenditures in project terms may limit applications to some degree, particularly amongst the smaller firms. Finally, it should be noted that 1983/84 might be

considered to have been an atypical year since there were several oil-related expenditures which attracted high grant (eg. BP received RDGs of £8.5m for developments in the Shetlands and Britoil received £8.25m at Invergordon and Dingwall). Such investments are unlikely to occur in the future irrespective of the policy regime.

2. Job-creation Effects

The key question here is whether the changes in the assisted areas, the restructuring of the RDG, its extension to services, the small firm exemptions and the increased importance of RSA, will lead, other things remaining equal, to more or less job creation than under the old policy.

Our judgement is that given similar national economic conditions, the changes will result in less job creation in the near future than under the previous package. Specifically, we would argue that the effective contraction of the assisted areas, the reduction in the RDG rate and the removal of the replacement and modernisation project eligibility from the RDG, will have a greater effect in diminishing job creation than the positive effects of the cost-per-job constraint/job grant, the small firm exemptions, the extension to some services and the increased importance of RSA. Each of these will be considered in turn.

The Assisted Areas

The Government states that Scotland will in the future still have a higher share of assisted areas than GB as a whole. Given that Scotland was, is and will continue to be relatively disadvantaged compared with the rest of the country, then the higher share of assisted areas is hardly surprising or worth shouting about. Indeed, it is the logical outcome of having any sort of regional policy at all.

What does appear to be significant, however, is that while RDG continues to be the main instrument of policy, the areas within which RDG is payable have been reduced from just under 70% to 50% of the Scottish working population. The RDG derated areas are shown in Table 1 ranked by their relative RDG receipts in 1983/84.

Table 1 RDG derated areas ranked by relative importance of RDG receipts (>£25,000), 1983/84

TTWA	% of all RDG awarded in Scotland
1. Dunfermline	18.8
2. Falkirk	14.3
3. Invergordon	14.3
4. Kirkcaldy	3.9
5. Ayr	2.7
6. Orkney	2.2
7. Lochaber	0.3
8. Western Isles	0.3
9. Wick	0.2
9. Inverness	0.2
9. Girvan	0.2
12. Blairgowrie	0.1
12. Campbeltown	0
14. Bladenoch	0
14. Islay	0
14. Newton Stewart	0
14. Oban	0
14. Skye	0
14. Stranraer	0
14. Sutherland	0
14. Dunoon	0

The data in Table 1 show that while the areas in receipt of RDG have been cut by 29% of the working population, the cut in terms of RDG expenditures would have been 57% in 1983/4.

We noted above that the level and pattern of expenditures were to some extent influenced by oil-related outlays which were associated with very little job creation and probably would have occurred anyway. However, these outlays were not great and do not distort the pattern of expenditures overmuch. It follows that Government is expecting a great deal from the new policy if more jobs are to be created in the remaining areas under the new scheme than in the areas eligible under the old policy regime.

On our estimates the particular areas most likely to suffer following the changes are those newly-designated IAs that previously attracted high non-oil-related expenditures. We would single out here the Kirkcaldy (including Glenrothes New Town) and Ayr TTWAs. The effect on Dunfermline and Falkirk should equally not be ignored, although the proportion of locationally specific, low job-creating oil-related outlays has been much higher in these two areas.

The RSA will of course still continue to be paid in IAs, but it is not clear how readily such discretionary assistance will be granted in some of these areas. It has been suggested that the boundaries of the IAs have been drawn fairly widely in order to maximise the receipt of aid from the EEC and, in particular, the European Regional Development Fund. If correct, this could indicate that Government will not pursue its own policy so vigorously in these areas.

The value of the RDG

If other things remain equal, we would expect the cut in the rate of award in the DAs (with the exceptions of Bathgate and the old SDAs) and the cost-per-job constraint, to reduce RDG expenditures and job creation. The cut in job creation should, however, be proportionally less than the cut in expenditures.

First, let us consider the cut in the rate of award from 22% to 15% which affects all the proposed DAs with the exception of Bathgate. If, as the evidence suggests, the average capital investment per worker is about £30,000, then the cut in subsidy amounts to £2,100 per job. This will affect job creation if the RDG is important to investment decisions at the margin. Here the attraction of foreign firms would appear to be put at some risk because of the competition provided by regional and industrial policy subsidies in other countries. The RSA might, however, be used by the Government to 'top-up' the RDG payment so that the size of the available subsidy to foreign firms locating in Scotland is no less than before.

Nevertheless, given that the Government is seeking to reduce expenditures on the policy, if foreign firms are exempt then indigenous Scottish and mobile English firms are, on average, likely to experience a cut in subsidy compared with the previous policy regime. Job creation will be lower if firms incorporate regional policy subsidies into their investment appraisal, and the cut in subsidy is found to be important at the margin.

Recent survey evidence suggests that a large majority of firms (68%) in receipt

of RDG did undertake a quantitative appraisal which included provision for the RDG. In contrast, this research also indicates that RSA has less chance of being included in the investment appraisal. Indeed, companies were found to be less likely to apply for RSA because of uncertainty about the eligibility criteria. This problem might be mitigated somewhat by the decision to let the Scottish Office administer the RDG as well as RSA.

The imposition of a subsidy cost-per-job constraint of £10,000 appears to be well-judged. This restriction will prevent capital-intensive projects with investment outlays greater than £66,000 per job from receiving large amounts of subsidy, which was the case under the old regime. The rate of award paid on investment will fall correspondingly as outlays rise above that figure. With an average investment outlay of £30,000 per job, the RDG subsidy paid will be £4,500, so the cost-per-job limit should not reduce the RDG rate of award below 15% for the majority of projects. However, it should be noted that the cost-per-job limit will not of itself create any more jobs.

Other things equal, the changes in the value of RDG will only create more jobs if the loss of new jobs from the reduction in the RDG rate and the small loss from the imposition of the cost-per-job constraint are more than offset by job gains resulting from the RDG job grant.

Applicant companies will receive the job grant (£3,000) automatically when their investment outlay is £20,500 per job or less (ie. when the subsidy from the grant would be greater than 15% of outlays). Moreover, a company's investment outlay would have to be as low as £13,500 before the job grant provides a subsidy to the firm greater than the 22% of expenditures payable on the RDG under the old policy. Given the capital-intensity of modern production processes and the probable absence of substitution in favour of labour, it is unlikely that the take-up rate of grant by firms with investment outlays less than £13,500 would be sufficient to prevent the expenditures on regional policy from falling. Furthermore, it is unlikely for the same reason that the increased take-up by firms with

outlays per job lying between £13,500 and £20,500 would provide sufficient jobs to offset the job losses due to the changes noted above. Job creation must be reduced following the changes in the value of the RDG but by proportionally less than the reduction in policy expenditures.

The coverage of the RDG

Within the designated assisted areas the coverage of RDG has now altered with certain service activities becoming eligible, replacement and modernisation projects ceasing to be eligible and small firms exempt from the latter provision and the cost-per-job limit.

The extension to services would appear to be timely given that manufacturing now accounts for less than 25% of employment in Scotland. However, our estimates suggest that only 4% of the service sector in Scotland (by employment) will be eligible. The short-term effects on job creation of this provision are not, therefore, likely to be great. While the focus on 'high-tech' business services such as data processing and software development is to be welcomed, it is clear that many additional activities could have been included which would not displace other service expenditures, jobs and income in Scotland. One example is tourism even though there are problems in precisely defining which particular activities should be eligible.

The exemptions for small firms are unlikely to increase job creation in the short term compared with the old policy, although given that firms employing less than 200 employees account for one quarter of manufacturing employment, this provision should reduce the size of the cut.

Finally, the exclusion of replacement and modernisation projects bringing Britain into line with EEC requirements, could have damaging effects on Scotland. First, many of the projects aided by regional policy in the late 1960s and early 1970s are now coming to the end of their economic life. Without the subsidy to unit costs provided by RDGs for replacement investment, these companies might choose to relocate all or part of

their investment back to the parent establishment abroad or in the South of England. The narrowing of the differential between unit costs in Scotland and elsewhere might result in the attractions of the metropolitan areas being more difficult to resist. This could be important, given the high proportion of Scottish employment controlled from outwith the Scottish economy. Secondly, the exclusion of modernisation projects could, in comparison with the old policy, damage competitiveness and so threaten the existing employment base as well as future development. It is to this last issue, the implications for development in Scotland, that we now turn.

3. Scotland's economic development

It is very difficult to predict the likely long-run effects of Government industrial policies, or to be certain that they have any effect at all. However, in comparison with the unfavourable effects for job creation resulting from the new policy discussed above, the longer-term implications are a little less damaging and certain features of the policy may enhance economic development.

The hope for the future lies in the extension of the eligibility for the RDG to activities in the service sector. Much future growth will come from developments in this sector. Scotland is currently under-represented in those parts of the service sector that are showing the fastest growth in the United States and other developed economies: business services, wholesaling and banking and finance. Regional policy has a role to play here and the current policy changes have made a step, albeit small, in this direction.

One bright spot from the current changes is the inclusion of RDG support for companies' centralised administrative services and R&D and marketing functions. Over time this provision might start to reduce the degree of external control of the Scottish economy and the perceived limiting effects on the process of growth. Inward investors might in the future be more likely to site their HQs in Scotland along with the key operational functions of R&D and marketing. External acquirers

of Scottish companies might also be deterred from removing key managerial and administrative functions away from Scotland following acquisition. The change is small so one should not hope for too much but it does appear to be a step in the right direction.

4. Conclusions

The results of the Government's review of regional policy have several important implications for the Scottish economy. The assisted areas are to be cut back and the value and coverage of the main instrument of policy, the RDG, is to be changed. Expenditures on the policy will fall markedly and job creation will be less, although not in the same proportion as the cut in expenditures.

The changes in policy are not completely bad for Scotland. The transfer of the administration of the RDG to the Scottish Office is to be welcomed. Moreover, the long-term implications of the policy change are somewhat less discouraging because of the move towards the service sector. This should not, however, be taken as indicating agreement with the Government's stance towards the regions of Britain and Scotland in particular.

It is evident that the Government sees the case for regional policy primarily in social terms. The relative improvement in Scotland's economic fortunes is seen as good reason for cutting regional policy expenditures so reducing the 'drain' on the Exchequer. We do not accept that the case for regional policy rests solely on social grounds. There are strong economic reasons for continuing to foster the success that regional policy has previously had in Scotland. Entrepreneurs and companies do not always take decisions with an awareness of all the opportunities open to them, nor need they take into account the wider, but still economic, implications of their actions. Productivity in foreign, non-Scottish-owned plants is found to be at least as high, if not higher, than in similar plants elsewhere. Yet, many firms are reluctant to come to Scotland because they misperceive the advantages to their companies of location here. Regional policy can and does work to overcome these barriers, so improving the performance of the companies, the Scottish economy and the allocation of resources in the UK as a whole.