Quarterly Economic Commentary

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Notes to contributors

The editors welcome contributions to the Briefing Paper, Feature Article and Economic Perspective sections. Material submitted should be of interest to a predominantly Scottish readership and written in a style intelligible to a non-specialist audience. Footnotes and references should conform to recent issues of the Commentary. Contributions should be typed and two copies submitted to the Editor.

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QUARTERLY ECONOMIC COMMENTARY

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Outlook and Appraisal

Both the short-term and medium-term prospects for the Scottish economy are favourable. To date there is little evidence that the upheavals in the equity and currency markets during the final quarter of last year have had a harmful effect on Scottish firms.

The **Scottish Chambers' Business Survey (SCBS)**, provides one of the best guides to the short-term prospects of the Scottish economy. The most recent SCBS, which was conducted between 7 December 1987 and 6 January 1988, suggests that prospects are continuing to improve (see **Business Surveys** section). A balance of firms in all sectors reported an increase in optimism about the general business situation. In manufacturing, a net 7% of companies were more optimistic than they were three months ago, although it is perhaps worth noting that this positive balance had fallen somewhat from the previous survey. In construction, the balance of firms expressing increased confidence was, at 33%, the highest ever recorded by the survey. This was the fifth successive quarter in which the industry had recorded a growth in confidence following falls in nine previous quarters (see **Construction** section). In wholesaling, the number of firms reporting increased optimism was the highest since July 1987, while the continuing boom in retail sales led to a net 36% of respondents being more optimistic about the business climate (see **Distributive Trades** section). The heightened optimism reflects the sustained growth of new orders and sales in all sectors. Of particular interest here, is the evidence of a substantial increase in the balance of manufacturing firms experiencing growth in Scottish orders and sales. Moreover, expectations of further growth during the first quarter of 1988 were at a high level.

These particular findings represent a significant departure from previous quarters and are encouraging on two counts. First, they suggest that growth in the Scottish economy is becoming more broadly based reflecting the pattern of growth in the rest of the UK. Secondly, the revival in the domestic component of final demand is timely in view of the concern, shared by many commentators, that export orders are vulnerable to the continuing uncertainties in the world, and particularly American economies. However, with a substantial balance of manufacturing firms reporting increased growth of export orders and sales, there is no indication at present of a deterioration in export performance.

Employment prospects also appear to be encouraging. During the final quarter of 1987 a positive balance of respondents in manufacturing, retailing and construction witnessed an increase in total employment, with the upward trend expected to continue in the three months to March. Wholesaling is, however, something of an exception, with a large balance experiencing a decline in employment during the final quarter of 1987 and a small balance anticipating a further decrease during the first quarter of 1988. In manufacturing, in line with anticipated increases in employment, firms are also revising their investment intentions upward for plant and machinery although not for investment in buildings. The upward revision in investment intentions reinforces the generally optimistic outlook revealed elsewhere in the survey. It suggests that many firms view the recent upturn as something more than a temporary phenomenon. For these firms, confidence is sufficiently strong to allow an increased commitment of resources for investment to meet expected future growth. Indeed, increased domestic investment may be necessary to sustain the current rate of growth. The main cause for concern in the recent SCBS was the emergence of evidence that the output of the construction and retail sectors may be becoming constrained by supply-side factors. While shortages of skilled labour are important in construction, insufficient floor space is the key factor in retailing, a constraint that can only be relieved by further investment.

What of the medium term? The Institute's **Medium-Term Forecasting Model** predicts that Scottish GDP growth will achieve an annual average rate of 2.7% in the period to 1992. This is slightly lower than our previous forecasts and reflects the depressing effects of the expected downturn in world economic activity. Nevertheless, our forecast for Scottish GDP growth during 1988 of 2.9% is greater than the forecasts for UK GDP growth of 2.8% and 2.2% prepared, respectively, by the National Institute and the London Business School. The forecast must be seen against a background of Scotland's lagging economic performance in recent years and in part reflects the significant boost to tourist expenditure in Scotland provided by the Glasgow Garden Festival; buoyant personal income growth; and a continuation of recovery in the oil industry. The Institute's forecasts are revised in the Spring so with later information we shall know by then how well founded the current forecasts are.

At the sectoral level, the computer and electronics industry is forecast to display the highest rate of growth, with an expected average increase in output of 8.76% per annum over the five-year period 1987 to 1992. The forecast growth of oil and gas exploration is almost as impressive. This sector is forecast to grow by an average 8.17% per annum over the same period, although to some extent this represents a process of recovery from the effects of the oil price collapse in 1986. At the other extreme, the forecasts for the traditional heavy manufacturing sectors of shipbuilding, mechanical engineering and vehicles, suggest that these industries will continue to exhibit slow growth. The same also applies to public administration and defence.

Employment growth is also expected to be fairly buoyant over the forecast period, rising on average by 3.9% between 1987 and 1992. Both manufacturing and construction are expected to display above average rates of employment growth, indeed higher than that for the service sector. However, this in part reflects the low levels reached by employment in the two sectors during recent years.

In considering the future prospects of the Scottish economy it would be foolish to ignore the longer-run consequences of the changes to regional policy which were introduced by the government in January. It is beyond question that these changes represent a radical shift away from a consensus that has existed for forty years and more on the nature and causes of Britain's regional problems and the role of regional policy. This goes far beyond the questions that have been subsequently raised about whether expenditure in Scotland will be more or less under the new regime or whether the proposals promise better or worse value for money.

Traditionally Britain's regional problems have been viewed as the outcome of an imbalance between supply and demand in regional labour markets. A deficiency in the demand for labour in the peripheral regions was matched by excess demand and congestion elsewhere, and especialy in the prosperous South East. One could argue about the causes of the problem: regional myopia and metropolitan bias by firms in the 'south' on the one hand, or a failure of workers to accept lower wages or migrate from the 'north' on the other, but the key point was that the fortunes of the north and south were inextricably linked. The south might prosper at the expense of the north but that prosperity would be limited by shortages of skilled labour and space, leading to higher prices and a lower level of competitiveness than in the absence of regional imbalance.

Regional policy sought to tackle this problem either by assisting workers to move south to find work, or more usually by encouraging firms to locate their new and existing operations in assisted areas in the north. The objective of promoting a "balanced distribution of industry and population", which could be found in the preamble to almost all the regional policy legislation since the war, was justified on national economic efficiency grounds as well as regional considerations. The new measures implicitly reject the view that the regional problems of the prosperous and depressed areas are interdependent. Certain areas in Scotland and the north are to remain assisted but in focusing the policy on indigenous development and enterprise the government is signalling that the assisted areas must look primarily to their own devices to improve their relative position. Meanwhile, Greater London and the South East are currently experiencing a significant boom in land and property prices, while shortages of skilled labour are increasingly reported. There is thus mounting evidence of a high and possibly increasing imbalance in regional labour and property markets. In these circumstances, the implementation of the new policy could result in damage to both national economic efficiency and regional equity.

The government have argued that they intend to channel more funds to both local and mobile industry through discretionary regional selective assistance (RSA). In addition, by introducing two new aids for small firms, a regional investment grant and a regional innovation grant, coupled wth a major expansion of business advisory services for small and medium size firms at preferential rates in the assisted areas, the government claim that regional policy in the future will be more relevant, better resourced and more able to assist the growth of enterprise. None of these claims is easy to accept.

The shift from the Regional Development Grant (RDG) to the RSA reflects the government's belief that under the automatic RDG much assistance was given to projects that would have gone ahead anyway. This is despite the fact that after the November 1984 changes the RDG was more precisely targetted to minimise this problem. Nevertheless, redirecting assistance through the discretionary RSA appears to offer the prospect of resources only being provided for viable projects that would not otherwise occur. But the change effectively amounts to the adoption of a policy of "picking winners", contrary to so much government rhetoric about businessmen and the market place knowing best. Moreover, even assuming that civil servants can successfully identify the viable projects that would not otherwise occur, there is no guarantee that applications will be received on a sufficient scale to make the adoption of a discretionary approach worthwhile. Empirical evidence suggests that firms often discount discretionary aid in their investment appraisals because of the uncertainty attached to the receipt of assistance. Many mobile firms in the South of England previously applied for an RDG because the grant made a material difference in their appraisal of alternative locations; and academic evidence suggests that the RDG contributed to the successful attraction of large numbers of mobile jobs from the congested and overheated south. If in the future such firms simply view the RSA as a possible "windfall gain" then either they may not apply for the grant preferring another location instead, or an application and hence a decision to locate in assisted areas will be made on other grounds. Even if civil servants can weed out the majority of this latter group, the volume of regional aid applications from mobile investments from the south that *would not otherwise have occurred* is likely to be lower than under the RDG.

The government's desire to promote enterprise and raise management skills is laudable. There is considerable evidence to support the view that many Scottish companies have exhibited a lack of entrepreneurial flair and other management skills. However, while the provision of subsidised advice and the incentives for innovation in small firms would have provided a valuable supplement to the existing policy regime, it is questionable whether they can be viewed as an effective replacement. The encouragement and stimulation of small firms is important but even in ostensibly more entrepreneurial economies they contribute only marginally to the overall performance of the economy. Indeed, while the rate of new firm formation has tended historically to be fairly low in Scotland, it has been the managerial performance of some of the larger Scottish firms which has left much to be desired. Yet, there is little if anything in the new proposals to help improve the performance of the larger Scottish firm. The government's continuing permissive approach to takeovers and the acquisition of key regional companies in particular suggests that, in this area at least, it is prepared to leave management improvement to the disciplines of the market.

Yet, to the extent that Scotland does have a "dependency culture" it is to some degree due to the indirect effects of the high level and continued growth of external ownership and control rather than any latent deficiencies in the national character. External takeovers, for example, often do improve the managerial performance of the acquired companies but as local linkages are severed and key functions switched to headquarters in the south there is a drain of managerial and other operational skills from the Scottish economy. This reduction in the managerial talent available to Scotland inevitably results in less spin-offs from the larger companies and hence a lower rate of new firm formation.

It is true that the RDG may have in part contributed to a reduced demand for high level managerial skills by encouraging English and foreign firms to locate branch plants in Scotland. But to abolish the key instrument which attracts mobile firms and therefore substantial jobs to the Scottish economy without doing anything to mitigate the effects of external takeovers suggests a blinkered approach to the UK regional problem.

7 March 1988