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FABIAN PAMPHLET 551

Reviving the Regions

by Jim Taylor

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Introduction

Regional disparities in economic performance are a fact of life. In a world of rapidly-changing market conditions, it is inevitable that some regions will fare better than others as some markets disappear and new ones emerge.

This would be of no concern to policymakers if there were forces in the economic system which automatically improved the performance of depressed regions relative to prosperous regions. But this does not happen. Regional economic disparities persist for generations. The southern regions of Britain have consistently performed better than the northern regions on all the major economic indicators since the 1920s. The south has had the lowest unemployment rates, the fastest employment growth, the highest investment in new processes and new products, the highest home ownership rates, the best qualified workforce, the best jobs and so on. Of course, the simplistic notion of a north-south divide hides many success stories in the north as well as ignoring the existence of depressed localities in the south. It does, nevertheless, help us to focus on the main issue: that people in the southern regions of Britain are generally more prosperous and have better economic prospects than those in the northern regions. Successive governments have recognised the existence of regional problems, and many different policies have been tried since 1934, when several Special Areas were designated as being in need of financial assistance. But in spite of nearly 60 years of regional policy, the spatial pattern of regional economic imbalance in the UK is very similar to what it was in the 1930s.

What has gone wrong? Is there any prospect that regional policy will ever succeed in achieving its objective of reducing regional economic disparities to socially-acceptable levels? This pamphlet argues that there is no chance that regional policy will achieve any lasting success unless central government is willing to commit substantially more resources to the problem. However, increasing public expenditure on regional policy is not in itself a sufficient condition for reducing regional economic inequalities. The entire structure of regional policy needs to be overhauled. Existing policy instruments need to be revamped and some new policy instruments need to be added to the armoury. It is the purpose of this pamphlet to suggest what changes need to be made to regional policy to make it more effective.

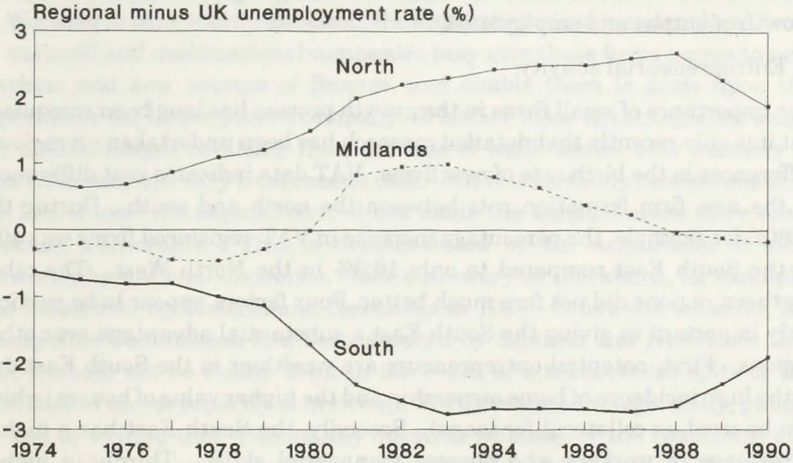
1 Regional disparities

Persistent disparities in the economic health and performance of a nation's regions are widely regarded as being socially and politically unacceptable.

But what exactly do we mean by regional economic disparities and how might the economic health and performance of individual regions be measured? The most obvious indicator of regional economic disparities is the unemployment rate. Disparities in unemployment were the reason why regional policy came into existence during the 1930s and this has been the major factor influencing the continuous use of some form of regional policy since the end of the Second World War. For the first 25 years of the post-war era, however, regional disparities in the unemployment rate were very small compared to the inter-war years. The regional unemployment gap began to widen ominously in the late 1970s as the national unemployment rate increased (see figure 1) but it was the slump induced by Sir Geoffrey Howe's monetarist policies in the early 1980s which caused the north-south unemployment gap to reach levels not seen since the 1930s. Although all regions suffered from the depression of the early 1980s, the consequences for the North turned out to be far more severe than for the south. Not until the last two years of the 1980s did regional unemployment disparities begin to fall - and the current recession is likely to stop this trend in its tracks, in spite of the fact that on this occasion the decline in demand hit the south before the north. There seems little prospect of regional unemployment disparities falling back to their 1970s levels in the foreseeable future. As the recession drags on, the longer-term consequences will be more severe for the northern regions.

The starkly different economic prospects of the north and the south are also indicated by disparities in employment growth. After achieving quite reasonable levels of employment growth in the 1970s, the northern regions suddenly found the gains of the 1970s wiped out in the early 1980s. After Nigel Lawson became Chancellor, household spending was bolstered by several consecutive cuts in the standard rate of income tax and the economy began to experience a typically Keynesian demand-induced boom through successive tax cuts. National employment expanded rapidly - but with a very strong bias in favour of the southern regions.

Figure 1: Regional disparities in UK unemployment 1974-90



The vivid picture of regional economic disparities painted by employment and unemployment statistics is reinforced by other economic variables - such as household income and expenditure. As might be expected, household income in the South East is way above the levels in all other regions. The higher income and expenditure levels in the South East is to some extent illusory, however, since they fail to take into account the substantially higher living costs in the south due to the higher cost of accommodation.

Finally, north-south disparities in economic performance are reflected by inter-regional migration patterns. As expected, people of working age tend on balance to leave areas where jobs are scarce and move to areas where jobs are plentiful. Net migration flows during the 1980s showed a southward drift of the population, as those of working age have moved south and those of retirement age moved into the South West and Wales.

Why have the southern regions of the UK continued to outperform the northern regions over many decades? Several factors can be identified which have contributed to the persistence of regional economic disparities.

- Industry mix

One of the most commonly-cited explanations of the better economic performance of the south is that it possesses a more favourable mix of industries than the north. The northern and midland regions have suffered from being over-dependent on slower growing manufacturing industries whereas the south has benefited from the faster growing service sector. It is also the case, however, that industries in the north have in general grown at a slower rate than the same industries in the south. This indicates that factors other than industry mix have been instrumental in causing regional disparities in the growth of output and employment.

- Entrepreneurial activity

The importance of small firms in the growth process has long been recognised but it is only recently that detailed research has been undertaken on regional differences in the birth rate of new firms. VAT data indicates vast differences in the new firm formation rate between the north and south. During the 1980s, for example, the percentage increase in VAT-registered firms was 40% in the South East compared to only 16.3% in the North West. The other northern regions did not fare much better. Four factors appear to be particularly important in giving the South East a substantial advantage over other regions. First, potential entrepreneurs are wealthier in the South East due to the high incidence of home ownership and the higher value of houses (which can be used as collateral for loans). Secondly, the South East has a higher percentage of workers who possess managerial skills. Thirdly, a higher proportion of workers have jobs in small firms and this can be expected to provide valuable experience for those who decide to go it alone. Fourthly, the South East has an industry mix which is more favourable to new firm formation than other regions.

The south's inherent advantages over the north as a generator of new firms are enhanced by the present Government's small firms policy. The take-up rate of government grants to new and small firms is higher in the south than in the north for the simple reason that the demand for financial assistance is greater. Low unemployment areas create more new start-ups than high unemployment areas and this has meant that the south has acquired the lion's share of financial assistance to small firms.

- Loss of local decision-making

Much concern has been expressed about the loss of managerial control in firms located in the assisted areas to national and multinational firms which have their headquarters in other regions, often in the South East. This loss of managerial control occurs if independent firms are acquired by 'outsiders' or if large numbers of branch plants are established in the assisted areas, perhaps as a direct result of regional policy.

The consequences of this loss of managerial control in the assisted areas are not easy to predict. On the down side, a locality becomes more vulnerable to decisions over which it may have little influence. Plant closures often occur as a result of company reorganisations which are unrelated to the operating efficiency of individual plants. Takeovers often result in a loss of business for local suppliers as the acquired firm switches to the suppliers used by the parent company. In addition, higher level functions such as financial control, marketing and R & D are switched to the parent plant, thus resulting in a loss of high-skill jobs.

Working in the opposite direction, the acquisition of independent local firms by national and multinational companies may give these firms access to new markets and new sources of finance, and enable them to draw upon the expertise of the larger parent company. Whether these advantages outweigh the disadvantages resulting from the loss of local control over industry is uncertain and will vary from case to case. But it is certainly conceivable that the loss of local managerial control has made the assisted areas more economically vulnerable. This is demonstrated by the acquisition of local breweries by national breweries. Lion's Brewery in Blackburn, for example, was taken over by Scottish and Newcastle in 1987. Before the takeover, the Monopolies Commission had been assured by Scottish and Newcastle that Lion's would not be closed down in the event of a takeover (in spite of the existence of excess capacity in brewing): 'We have stated categorically, publicly, and in writing that without any question whatsoever the Blackburn and Masham breweries are sacrosanct for continued brewing purposes.' (Scottish and Newcastle's statement to the Monopolies Commission, 1985. See *The Guardian*, 10 November 1990.) The Blackburn brewery was closed down just three years after the takeover.

European economic integration

Regional inequalities, particularly for the peripheral regions of the European Community, will intensify after 1992. The intention to eliminate all barriers to trade, labour mobility and capital mobility within the EC by the end of 1992 (as a result of the Single European Act 1986) is likely to have a substantial impact on the geographical allocation of resources throughout the Community during the 1990s. The purpose of eliminating all restrictions on the free movement of goods, labour and capital is to induce a more efficient allocation of resources in order to increase productivity, thereby making European industry more competitive. Firms will be faced with an internal market of nearly 350 million people and there will be a reorganisation of production in order to exploit economies of scale. This is likely to result in a spate of mergers and acquisitions within the EC. Indeed, there is evidence that this has already been happening in anticipation of 1992. Mergers and acquisitions are also a useful method of gaining access to new markets very quickly, particularly when markets have been traditionally served by domestic firms, as in the case of banking and financial services. The removal of trade restrictions will also result in intensified competition for local and national firms. Inefficient firms will be driven to the wall while efficient firms take advantage of more open markets.

The actual impact of the removal of internal barriers in the EC on regional economic disparities will depend upon several factors. First, regions on the geographical periphery of the EC are likely to be at a locational disadvantage compared to regions nearer the Bonn-Paris-London triangle. The heavy concentration of purchasing power in the core regions of the EC will act as a magnet for mobile capital, especially labour-intensive service sector activities. Secondly, the industry mix is more favourable to economic restructuring in some regions than in others. The South East, for example, has an industry mix which is better able than other UK regions to respond to the sectoral restructuring that will occur as a consequence of the '1992 process'. Thirdly, the higher quality of the economic infrastructure in the core regions of the EC makes these regions more attractive to mobile capital than the peripheral areas. This applies not only to fixed capital assets, such as transport networks, but also to human capital. The educational qualifications and skills of the workforce tend to be of higher quality in the core regions, partly because of higher living standards in these areas and partly because of the inflow of more highly-educated and highly-skilled workers from the peripheral regions. Although these advantages of the core EC regions will be partly offset by lower labour costs and lower land costs in the peripheral areas, there is nevertheless a strong presumption that it is the core regions which will benefit the most from further economic integration. This expectation is clearly reflected by the decision of the European Council of Ministers to double the funds available (between 1989 and 1993) for assisting those regions likely to be adversely affected by the single market.

Regional economic disparities in the EC will be further aggravated by the steady progression towards full economic and monetary union (EMU). The adoption of a single currency throughout the EC, for example, will mean that individual nations will no longer be able to use currency devaluation to offset any inflationary tendencies which originate within their own borders. It will no longer be possible to devalue the pound in response to higher inflation rates in Britain compared to our major competitors. Wage bargaining will *have* to become more responsive to market circumstances if high levels of unemployment are to be avoided. Full economic and monetary union will impose severe penalties on any country (and hence regions within countries) which refuse to take into account the effects of wage increases on the competitiveness of the products they produce. Moreover, the adoption of a single currency will impose severe limits on the independence of individual member states to determine their own fiscal policies. The regional consequences of the progression towards greater economic and monetary union therefore need to be carefully monitored.

European Community institutions are well aware of the possibility that progress towards EMU could have harmful consequences on the peripheral regions, and there are moves afoot in the Inter-Governmental Conferences to strengthen EC regional policy still further in order to allay the fears of member states on the geographical periphery of the EC, such as Spain. The latter is particularly anxious to ensure that greater economic and monetary union does not have detrimental effects on its less prosperous and more vulnerable regions. The same level of anxiety has not yet been expressed in the UK.

The next development in EC regional policy is likely to be the creation of a Committee of the Regions (proposed by the Regional Commissioner, Bruce Millan). This new body will keep a close watch on the regional effects of the move towards greater EMU during the 1990s and will have to be consulted on all regional policy matters including any sectoral EC policies which have regional implications. The progression towards EMU is inevitably raising the status of regional policy in the EC.

Several other factors may be expected to influence the economic performance of regions. There are regional disparities in the quality of the workforce, as reflected by educational qualifications, skill levels and the types of skill acquired. The South East, for example, is able to attract a far higher proportion of newly qualified graduates than any of the northern regions. This is not surprising in view of the high concentration of R & D establishments in the south. There is a distinct bias in government expenditure towards the South East, and not only because of the high concentration of civil servants in the capital. Recent research on the regional distribution of defence expenditure, which shows that 55% of all jobs associated with government spending on defence equipment in 1986/87 were located in the South East and South West. (This compares very favourably with their 40% share of the UK workforce.)

Consequences of regional disparities

Regional economic disparities persist for very long periods of time, and serious economic and social problems can arise as a result. Significant regional disparities in living standards cause dissatisfaction and resentment. This is most strongly felt by those whose job prospects are poor through no fault of their own. School leavers in Liverpool and Sunderland, for example, have far poorer employment prospects than their counterparts in the Home Counties. This is particularly true for those school leavers who are poorly qualified. The glib response from free market economists and right wing politicians that the unemployed should move to the Home Counties is simply not good enough, since it fails to recognise the financial and human constraints which prevent migration.

The second harmful consequence of regional disparities is the massive waste of resources in some regions, the clearest example of this being the persistently high rates of unemployment in the north compared to the south. If unemployment could be reduced in the high unemployment areas of the north without reducing jobs in the south, the whole country would be better off. The unemployed would be producing output and taxpayers would not have to support the unemployed. The north is also well endowed with industrial and commercial sites which could be brought into use without encroaching on

Britain's increasingly precious greenfield areas in the South East. The potential benefits are enormous.

It needs to be recognised that regional disparities in unemployment are a direct result of a massive geographical mis-match between labour demand and labour supply. This is best illustrated by the fact that during the late 1980s, when labour markets in the South East were experiencing severe labour shortages, many parts of the UK still had unemployment rates well in excess of 10%. The problem is compounded by a skill mis-match between the demand for labour and the supply of labour: the north may have an excess supply of workers but they may have skills which are inappropriate for the new growth industries. Policies are therefore required to reduce both the geographical and the skill mis-match.

M25 madness

The third way in which regional disparities inflict economic costs on the national economy is through the excess demand for social capital in the south - exactly the opposite situation to the one prevailing in the north. Land, buildings, roads, rail networks and airports in the South East are all under increasing pressure. The persistent congestion that results from this pressure on social overhead capital in the South East causes an immense loss of time for travellers and commercial transport and attempts are perpetually being made to relieve the pressure by large-scale public investment. The prime example is the M25, London's orbital motorway. Within three years of its opening in 1987, the government announced a £1,000 million plan to add a fourth lane to all sections of the motorway; and only a few months later, a further plan announced the addition of a fifth lane along several sections to ease traffic congestion.

Government policy therefore fails to tackle the problem at its roots. Instead of trying to reduce congestion by reducing the demand for social overheads, the government consistently responds by increasing the supply. This results in a never-ending spiral whereby demand chases supply. Breaking this spiral, however, is an immensely difficult task since the government is under intense political pressure to relieve congestion wherever it occurs. Regional policy offers policymakers an alternative way of dealing with congestion in the South East. If other parts of the UK were more attractive to investors, the persistent increase in the demand for social overheads in the South East would slow down. There would be simultaneous gains to both the north and the south.

A fourth way in which a reduction in regional economic disparities would reap benefits for the whole economy is by reducing inflationary pressures. Persistent regional disparities in the unemployment rate mean that when a significant upturn in the economy occurs, as it did during 1985-88, inflationary pressures build up very rapidly in the low unemployment regions due to the intense competition for scarce labour. This leads to an increase in wage inflation as firms raise their wage offers in order to attract more labour (or to hold on to their existing workforce). Wage increases are then transmitted to other regions through inter-plant bargaining within firms and by national wage agreements.

Firm evidence in support of the argument that it is labour shortages in the South East which determine the pace of wage inflation in the UK as a whole is hard to come by. This is partly because wage increases are transmitted across regions very quickly. What cannot be disputed is that labour markets in the south are invariably more favourable to workers than they are in the north and this must give southern workers more power in wage negotiations than their counterparts in the north. There is also no disputing the fact that the higher demand for labour in the south results in greater pressure in other markets - the housing market being the prime example. The fact that land and houses are in fixed supply in the short run means that excess demand for labour transmits itself to the housing market: low unemployment is associated with high house prices. One of the consequences of high house prices in areas of low unemployment is that a move from a high unemployment area to a low unemployment area may not be possible for many workers (particularly the unemployed) due to the house price differential. Relieving the tight labour markets of the south through labour migration is consequently stifled.

Reducing regional economic disparities will help to achieve a more equitable distribution of employment opportunities between regions, a higher national level of employment and output, a more efficient utilisation of social overhead capital, and a lower level of inflation.

But how can policymakers actually reduce regional economic disparities? Two distinctly different routes can be taken. The first is to try to make markets work more efficiently by removing the sources of market failure. The alternative is for direct government involvement. These alternative approaches are considered in the next chapter.

2

Regional policy options

If markets were efficient, the theory goes, regional economic disparities would be corrected automatically by market forces.

Labour would migrate from low-wage areas to high-wage areas and from high unemployment areas to low unemployment areas. Regional disparities in wages and unemployment would consequently fall. Firms would move from high-wage to low-wage areas, again reducing regional disparities in wages and unemployment, and wages would fall in areas of high unemployment, thereby inducing an increase in the demand for labour as firms within these areas become more competitive and as new firms move into these areas to take advantage of the lower wages.

Unfortunately, the reality is different. Wages do in fact respond to a limited extent to geographical variations in unemployment, and migration does respond to regional unemployment disparities, but the adjustment process is far too slow to eliminate regional disparities in income and unemployment.

There are two main reasons for this failure. First, neither labour nor capital is perfectly mobile. Low-paid workers, for example, are immobile because the financial costs of moving are high - especially for the unemployed. Many of the unemployed live in subsidised housing and such benefits cannot be guaranteed if they move to other areas. The unemployed are also less knowledgeable about employment opportunities in other regions and are reluctant to migrate because of the consequent uncertainty. Similar arguments apply to firms. They exhibit a strong preference for the certainty of their present location rather than the uncertainty and disruption costs which result from a move to other regions. This geographical inertia is particularly powerful in small firms since they normally have close economic links with other firms in their own locality. The incentive to move away from home base is very small.

The second reason why market forces fail to make a significant impression on regional economic disparities is that wages fail to respond to local labour market circumstances. Successive Conservative Governments since 1979 have argued that regional unemployment disparities are the result of wages failing to respond to market forces. Only by reducing wages will the high unemployment areas be able to win markets and hence jobs. It has been argued that three main factors are responsible for the lack of responsiveness of wages to market forces: industry-wide collective agreements on wage rates, the fixing of minimum wages at levels above the market-clearing wage by statutory Wages Councils, and levels of unemployment benefit and other income support which are 'too high'. The consequence of these three factors is that the unemployed are prevented from undercutting the wage rate in areas of high unemployment.

The free market solution to this problem is to remove the' market rigidities' which prevent wages from falling to their market-clearing levels. The knee-jerk response is predictable: get rid of all forms of national wage bargaining and minimum wage controls and replace these with local wage bargaining in both the public and the private sectors. In addition, it is argued that income support measures should be devised so that they do not encourage 'idling on the dole'.

Yet national wage bargaining has been in decline since the 1950s and the process has accelerated during the 1980s. The decline of national wage bargaining has not, however, been the result of a desire by firms to take account of local labour market conditions when negotiating wage increases. A shift from national to plant level bargaining has occurred as a result of firms decentralising their activities to profit centres so that wages are tied more closely to the profitability of individual production units within the organisation. If a unit is highly profitable, this will lead to higher wages even in areas of high unemployment. High levels of local unemployment may therefore have a negligible impact on wage setting.

Since there is no obvious way in which the government can induce firms to take local labour market conditions into account in their wage-setting activities, several alternative policies have been proposed for helping to reduce the impediments to market forces. These include:

- a reduction in housing subsidies in order to encourage greater labour mobility;
- the relaxation of planning controls in the South East in order to reduce house prices and encourage the construction of cheaper accommodation;
- the construction of more public housing in the South East to encourage inward migration;
- the imposition of congestion taxes on firms in the South East in order to encourage firms to move to less congested areas.

One of the problems, of course, with encouraging labour to move to the labour-scarce South East in order to relieve the labour shortage is that the migrants will themselves create extra demand for the already over-utilised social overhead capital. Encouraging an influx of people into areas already suffering from congestion is madness. Imposing congestion taxes on those already in the South East makes more economic sense. A tax on the use of space will reduce the demand for it, thereby reducing congestion.

Encouraging inward investment

Alternative approaches to regional policy are based on direct government intervention rather than trying to overcome market failure. The first serious attempt to induce industry to move from areas of low unemployment to areas of high unemployment was made in the immediate aftermath of World War II, when strict controls were imposed on the location of industry. Location controls remained the main instrument for directing industry to the assisted areas until the 1960s, when investment and then labour subsidies were used on a substantial scale. The primary purpose of this carrot and stick policy was to achieve a better geographical match between labour demand and labour supply so that unemployment could be reduced in areas of high unemployment while simultaneously reducing inflationary pressures in the labour-scarce South East.

Detailed statistical research into the effect of location controls and financial incentives indicates that these policy instruments succeeded in creating many thousands of jobs in assisted areas. However,these earlier policies had several flaws. First, much of the expenditure on automatic investment incentives (ie the Regional Development Grant) went to capital-intensive projects and this led to reductions in employment in some cases. A more logical approach would be to introduce marginal labour subsidies in areas of high unemployment in order to encourage producers to take on extra workers. This relates to the second criticism: investment incentives were directed, in the main, at the manufacturing sector even though employment in this sector had been declining since the late 1960s. Little attention was paid, until the 1984 reform of regional policy, to the potential importance of the service sector as a generator of jobs. Thirdly, investment grants were often paid to firms which would have invested in the assisted areas even without these grants. This deadweight spending appears to have been particularly substantial in capital-intensive industries such as chemicals and steel. Fourthly, controls on the location of industry were heavily criticised, in spite of research findings which indicated that this policy instrument was very effective in diverting industry from the South East to the assisted areas in the 1960s and 1970s. These location controls were abandoned on economic efficiency grounds, however, in 1982 since policymakers believed that they were discouraging investment as well as encouraging firms to locate in areas which those firms considered to be less desirable.

These are forceful criticisms. But they should not go unchallenged. First, the apparently high cost of the investment subsidies per job created is misleading since the direct jobs created in the plant receiving the subsidy are typically only a proportion of the total jobs created. Extra jobs are created in other industries in the same locality due to increased household expenditure on locally produced goods and services. In addition, there may be induced investment effects in related industries. A further problem with the cost per job estimates is that they refer to the gross Exchequer costs, which will exceed the net costs to the Exchequer if entirely new jobs are created, as in the case of some inward investment from overseas. To calculate the net costs to the Exchequer, it is necessary to deduct from the gross costs any reduction in government spending (eg due to lower unemployment benefit payments) and any increase in taxation accruing from higher employment and higher household expenditure. Secondly, it needs to be realised that investments which save existing jobs are just as valuable as investments which create entirely new jobs. Jobs saved should be counted alongside jobs created in the cost per job calculation, as in the recent estimates by the DTI of the cost per job of Regional Selective Assistance. The DTI study estimates that 56,000 permanent jobs were created or safeguarded in the assisted areas at a net cost to the Exchequer of £650 million, a cost per permanent job of £11,600 (at 1988 prices). Thirdly, investment subsidies help to maintain and enhance an area's competitiveness since new plant and machinery will incorporate the latest technology. Raising an area's technological capability will improve its image and make it a more attractive location for further inward investment.

Stimulating indigenous growth

The second strategic approach to reducing regional economic inequalities is to get the assisted areas to create their own growth rather than relying on inward investment. This is exactly what happened in the 1980s as traditional 'redistribution of industry' policy was downgraded and as policies were introduced to encourage local firms to invest in their own localities. Though this policy switch was partly a consequence of the Conservative Government's infatuation with creating a more entrepreneurial environment, there were more pragmatic reasons for the downgrading of redistribution of industry policy. First, investment fell sharply in the early 1980s, particularly in manufacturing, and the consequence was a dramatic slump in potentially mobile investment. Secondly, all regions were experiencing high unemployment in the early 1980s which meant that redistributing industry from non-assisted areas to assisted areas was simply shuffling jobs between regions. No new jobs were being created. The resulting shift in regional policy to an indigenous growth strategy was complemented by the growing interest and involvement of local authorities in local economic development (despite the persistent opposition of consecutive Conservative Governments to these valuable initiatives).

The switch towards an indigenous growth policy was bolstered by the increasingly popular view that Britain's economic future depended very largely upon the success of small and medium-sized enterprises. Policies were introduced to stimulate new firm formation as well as encouraging the expansion of small firms. The Loan Guarantee Scheme, for example, was introduced to encourage the banking sector to lend more freely to new and small businesses while the Business Expansion Scheme was designed to attract small scale investors to buy equity in small firms by offering tax incentives. Neither of these schemes has been very successful, however, in generating jobs in the assisted areas.

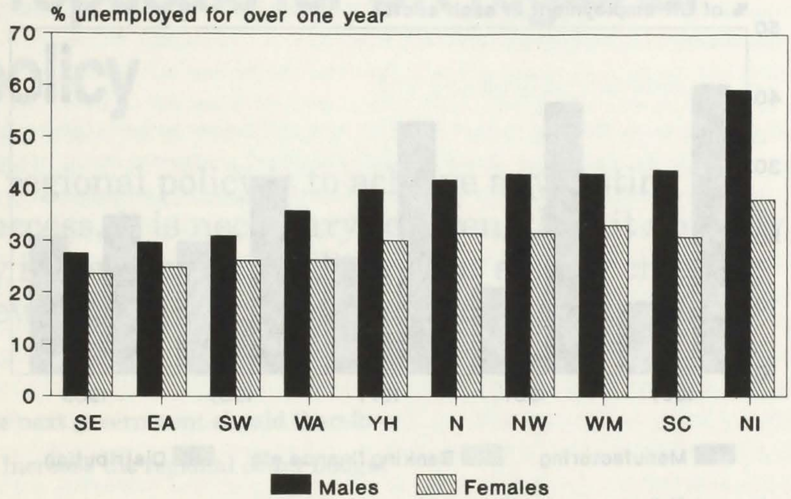
The major drawback of relying on small firms to create jobs is that small firms generally remain small. Very few small firms grow to any significant size and a high proportion go out of business within a year of their establishment. Moreover, the economic environment is far more favourable for new and small firms in the south than in the north. It is not therefore surprising to find that the south has benefited far more than the north from the government's small firms policy. If anything, small firms policy has led to a widening of regional economic disparities.

Improving the economic infrastructure

The third main arm of regional policy is public investment in the infrastructure of depressed areas. It is vitally important to improve both the physical infrastructure and the socio-economic fabric of the assisted areas. Investment in the physical infrastructure ranges from rejuvenating derelict sites (such as the Albert Dock scheme in Liverpool) to improving transport networks, housing stock, educational facilities, recreational amenities and the physical environment more generally. Improving the physical environment acts as an important signal to the private sector since it demonstrates the Government's commitment to reviving depressed areas and acts as a confidence booster for private sector investors. This is the main principle, for example, underlying urban regeneration schemes which are aimed at levering private sector investment into inner city areas. Public investment in the physical infrastructure also makes depressed areas better places in which to live and work, thus helping these areas to retain and attract a highly-skilled workforce.

Public investment is also needed to upgrade the skills of workers in depressed areas. The absence of growth industries and the higher incidence of long-term unemployment in northern regions (see figure 2) has had a detrimental effect on workforce skills, thus reducing the attractiveness of these regions to employers. In addition, depressed areas suffer from the out-migration of their most highly educated workers to regions which offer better career prospects. Considerably more public investment is needed in further education and in training if skill levels in depressed areas are to be raised significantly. The current employer-led policy of delivering training through the Training and Enterprise Councils fails to recognise that private sector employers will not provide enough financial support unless they are coerced into doing so. Far greater investment in training is required than the

Figure 2: Long-term unemployment in UK regions, 1989

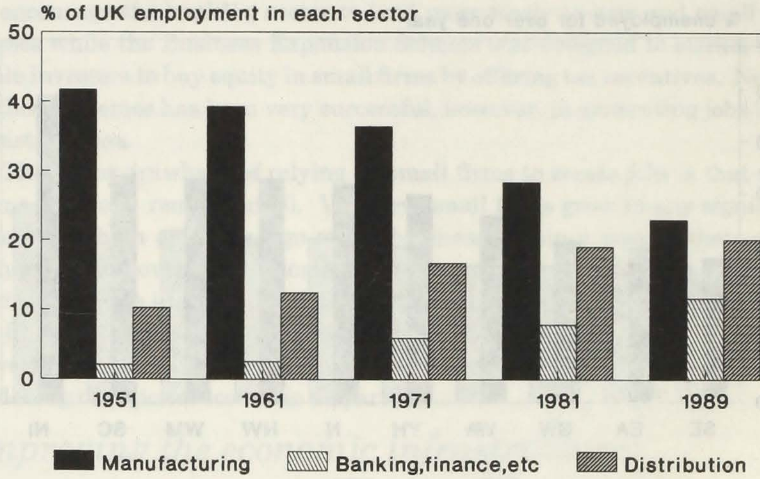


private sector is willing to pay for voluntarily. Labour's proposal for the creation of a National Training Fund, to which all employers who refuse to train would have to contribute, should be vigorously pursued.

The approach to solving regional problems changed dramatically during the 1980s, not only in the UK but throughout the European Community. There has been a switch from automatic investment grants to discretionary assistance, the primary example of this in the UK being the abolition of the Regional Development Grant (RDG) in 1988. The purpose of getting rid of the RDG was to target financial assistance on projects which would be more likely to create jobs so that the cost effectiveness of regional investment grants could be improved. Recent research, however, indicates that the attachment of a cost per job limit (of £10,000) to the RDG in 1984 proved to be very effective in improving the cost effectiveness of this policy instrument. The abolition of the RDG in 1988 was therefore a mistake.

The second major change to regional policy in recent years has been the increasing use of 'soft' policy options. Regional financial incentives are no longer restricted to supporting investment in plant, machinery and buildings. There now exists a wider range of policy instruments designed to stimulate the growth of small and medium-sized enterprises through subsidising consultancy, training schemes, new production methods and new products. The introduction of 'soft' financial incentives is partly a response to the underlying structural changes occurring in Britain (see figure 3) and elsewhere in the EC. The Consultancy Initiative, for example, provides grants to firms employing under 500 workers towards expenditure on consultancy advice. The regional

Figure 3: Structure of UK economy



differential, however, is small; assisted area firms receive a grant of up to 67% to offset the cost of up to 15 days of consultancy compared to 50% elsewhere.

Thirdly, old-style"work to the workers' policies have been supplemented by focusing far more on inducing the assisted areas to 'grow from within' by targeting expenditure more directly on small and medium-sized firms and by including several service sector activities in the list of industries eligible for assistance. Small and medium-sized firms in the assisted areas have been targeted through the Regional Enterprise Grant. This takes two forms: the Regional Investment Grant covers up to 15% of the cost of fixed assets up to a maximum of £15,000; and the Regional Innovation Grant covers up to 50% of eligible project costs up to a maximum of £25,000 to develop new products and new processes. Both schemes are intended to alleviate the difficulties faced by small firms in raising finance to cover start-up costs, growth or innovation. Firms must also employ under 25 workers and are eligible for only one investment grant and one innovation grant. Recent evaluation of these two grants indicates that they have both been successful as far as their cost effectiveness is concerned.

Proposals for UK regional policy

3

If regional policy is to achieve any lasting success, it is necessary to strengthen it not only by increasing expenditure but also by creating new policy instruments and new institutions.

The next government should therefore:

- Increase the regional policy budget

The most important requirement is to reverse the dramatic fall in regional policy expenditure which has occurred since the early 1980s. In only seven years, government expenditure on regional preferential assistance to industry fell from £1500m to £750m (at 1988/89 prices). In per capita terms, regional financial assistance fell from £26 per head of population (per year) in 1982/3 to £13 per head in 1988/89. This adverse trend affected all of the UK's assisted areas. Comparison with other member states of the European Community indicates that the UK government spends considerably less on regional assistance (per head of population) than either Italy or Ireland and not much more than either Belgium or the Netherlands, whose regional problems are less severe than those of the UK. The one silver lining in expenditure on regional policy in the UK has been the increase in investment grants committed by the European Regional Development Fund, though this has not been large enough to offset the sharp decline in the UK government's regional policy spending. The planned doubling of expenditure on restructuring depressed areas by the European Commission between 1988 and 1993 is a commitment which should be complemented by a corresponding response from the UK government. It is vitally important that policymakers should not regard EC funding as a substitute for UK government funding, as was the case during the 1980s.

Although such a commitment to increase the regional policy budget would be highly desirable, it is clear that simply returning to the levels of expenditure of the early 1980s (£1,500 million per year at 1988/89 prices) would still represent only a minute fraction (0.3%) of GDP. The EC's contribution would probably raise this to £2,500 million (or 0.5% of GDP). This figure can be put into perspective by comparing it with the expected cost of £1000 million for adding a fourth lane to the M25. A far greater financial commitment by central government (£3000 million per year would be a healthier target) will be needed if any real and permanent progress is to be made in reducing regional economic disparities in the UK.

- Restore automatic investment grants

If the downward trend in regional policy expenditure is to be reversed, it is important to be clear how the increased financial resources could be most efficiently utilised. There is no shortage of ideas. Restoring automatic investment grants is an obvious starting point. The abolition of the revised Regional Development Grant in 1988 was a mistake and needs to be reversed. Automatic grants have many advantages, especially for small and medium-sized enterprises, and it would be foolish to continue to ignore them. The criticism that automatic grants are not cost effective can be overcome by imposing a cost per job limit on the grant awarded, as was done in the 1984 reforms to regional policy. The cost per job limit ought to be raised, however, from £10,000 to £20,000 to allow for inflation and to make it more attractive to potential investors. In addition, the grant rate should be raised from 15% to 25% in areas where unemployment rates are particularly high.

The restoration of the Regional Development Grant should not, however, lead to a downgrading of Regional Selective Assistance (RSA) since there is convincing evidence that RSA has been very effective in inducing inward-investment into the assisted areas. US and Japanese-owned firms, in particular, have been attracted into the UK's assisted areas, partly because they have been keen to establish production facilities in Europe in anticipation of the benefits expected to flow from the '1992 process'. Regional financial incentives have played a significant role in inducing foreign-owned firms to choose locations in the assisted areas. This is reflected by the high concentration of Japanese branch plants locating in areas of high unemployment. Wales and the North have done particularly well in attracting Japanese firms. Together, these two regions had 37% of all workers employed in Japanese manufacturing firms in 1990 compared to under 10% of the UK's manufacturing employees.

- Provide more help to small and medium-sized enterprises in areas of high unemployment by concentrating a greater proportion of expenditure on small firms in the assisted areas.

Existing grants do not adequately bridge the funding gap faced by small and medium-sized firms in the assisted areas. This gap could be filled by providing cheaper and more readily available finance. Much more needs to be done for small firms in the north to help to offset the distinct advantages conferred on southern firms by the geographical concentration of venture capital institutions in London and the South East. Over 60% of all investments made by venture capital firms in 1987, for example, were in the South East. Larger and cheaper loans to small firms would also help to offset the inherent disadvantages of lower wealth in the north compared to the South East, a factor of great importance in determining new firm formation rates.

More direct financial aid to small firms could be provided by raising the upper limit on the maximum amount of grant from its present £15,000 to £30,000 for the Regional Investment Grant. The grant rate should also be raised from 15% to 25%, and the eligibility limit of 25 employees is far too small and should be raised substantially. Recent research on the effectiveness of the Regional Investment Grant indicates that this policy instrument has been successful in levering private sector investment into the assisted areas (achieving a private/public investment ratio of around 2:1). Raising the grant limit on the Regional Innovation Grant from £50,000 to £100,000 would also be a useful way of inducing higher investment in product and process innovations in the assisted areas. Raising the grant limits on both of these grants can be justified not only because they are proving to be effective in generating more private investment spending, but also because the total expenditure on these grants has so far been derisory (under £6 million in 1989/90 and expected to increase to £18 million in 1991/92).

- Set up regional development agencies in all regions

Regional development agencies already exist for Scotland and Wales and similar organisations are needed for the English regions, as Labour proposes. The overriding aim is to transfer responsibility for regional economic development from Whitehall to the regions themselves. Three questions need to be addressed. Why do we need to decentralise regional policy functions to the regions? What functions would the newly established development agencies have? What organisational form should the regional development agencies take?

One of the main advantages of decentralising regional policy powers to the regions is that regional development agencies would fight for their own region's interests more vigorously than can be expected of Whitehall. Secondly, the responsibility for economic development within each region will rest squarely on the shoulders of the region itself. Thirdly, regional development agencies are in a better position to draw upon the vast reserves of local knowledge and will be more tuned in to local needs and local priorities than Whitehall will ever be. All these factors will result in a greater sense of involvement and the development of a spirit of self-reliance in finding solutions to regional problems rather than persistently relying on central government hand-outs.

Regional development agencies could undertake a wide variety of tasks, including spelling out the region's economic and social problems, identifying economic opportunities, setting public investment priorities and constructing economic development programmes in cooperation with public and private sector investors. They could apply for EC funding for development programmes, promote the region to induce national and multinational firms to invest, encourage locally-based firms to invest and expand. They could develop training programmes for school-leavers, workers and managers in conjunction with colleges, universities and locally-based training agencies, and encourage the creation and growth of financial institutions within the region in order to attract savings which flow automatically from the regions into the London capital market. They could promote the cluster of activities where there are significant external economies of scale, monitor the region's economic developments and evaluate development strategies so that their effectiveness can be improved. Finally, they could ensure that economic development is environmentally friendly.

Decentralising the DTI

The regional development agency should be the grant-awarding body within the region, taking over this function from the Department of Trade and Industry. Finally, the regional development agency would have the important job of coordinating the activities of government departments, local authorities and other local agencies (such as enterprise trusts and enterprise boards) within each region so that the various organisations pull in the same direction. Synchronising the activities of these various organisations will be an essential function of the regional development agencies.

What should be the organisational form of the regional development agencies? Initially, an English Development Agency could be established along the lines of Scottish Enterprise and the Welsh Development Agency. This would support a set of development agencies created for the English regions. The funding would come mainly from the central government and the EC, and the regional allocation of these funds would be determined for a rolling five-year period within an indicative range set for each region (similar to the European Regional Development Fund). The central authority could then respond to the quality of the bids put forward by the individual regional development agencies. This financing system would give the individual regional development agencies a greater incentive to discover the most efficient and most effective ways of using public money. The English Development Agency would also need to take a close interest in the way that funds were being used since competitive bidding between regions for mobile investment would result in a waste of public funds. Cooperation across regional boundaries might also require mediation from the English Development Agency.

Over the longer term, responsibility for the regional development agencies could be transferred to regionally-elected assemblies (or councils) if such bodies are eventually created. Exactly how the regional development agencies will be financed over the longer term, however, will depend on the new fiscal structure adopted once regionally-elected assemblies come into being. An alternative organisational structure would be to create public companies along the lines of the enterprise boards set up in the early 1980s by several local authorities, as recommended by the Institute for Public Policy Research.

- Prevent takeovers which are potentially harmful to depressed areas

Although the consequences of mergers and takeovers of depressed areas are uncertain, recent research indicates the need for at least some protection to be given to the depressed areas. In particular, any potential takeover of companies with plants in areas of high unemployment should be referred to the Monopolies Commission if there is any chance that the takeover is not in the interests of the locality in question. Predators could be made to undertake firm commitments about future levels of investment and employment in the company being acquired (for say at least seven years); and firms with a poor track record of closing down recently-acquired plants in order to eliminate spare capacity would simply not be allowed to make further acquisitions in high unemployment areas for a fixed period of time. Such a policy would help to prevent further damage being inflicted on depressed areas by companies which have no commitment to these areas. What commitment, for example, would the Hanson Trust have to those localities in the north of England which are currently totally dependent upon ICI? The dismemberment of ICI after a successful takeover bid could have serious long-term consequences for several northern localities.

- Relocate civil service jobs from London to the assisted areas

In 1988, 22.6% of all civil service jobs were located in London, which had 12.2% of the UK workforce at this time. By contrast, northern England and the midlands had 32.8% of all civil service jobs compared to 41% of the UK workforce. Much of the routine work undertaken by Whitehall could be transferred to provincial towns and cities without any loss of efficiency. Indeed, lower labour costs in the high unemployment areas could result in substantial reductions in public spending on the civil service over the longer term. Some redistribution of civil service jobs from London to the north could therefore yield substantial benefits. The main stumbling block is the adjustment cost incurred by those involved in the relocation. But this is simply a short-term problem which would quickly disappear. Past successes in decentralising the civil service, such as Social Services to Newcastle and Employment Training to Sheffield, need to be extended to other departments (eg the Ministry of Defence, the Department of Environment and the Treasury).

- Reduce the skills gap by increasing investment in education and training

The supply of qualified labour is one of the most vital factors in determining the competitiveness of depressed regions. This is one of the findings from a survey of around 9,000 companies in the European Community published by the European Commission. The implication is clear. Investment in education and training is essential if the competitiveness of high unemployment regions is to be significantly improved. This is particularly important for the UK since the proportion of adolescents in education and training is very low compared to several of our European partners. Less than 60% of the UK's adolescents, for example, are in education and training compared to over 90% in Germany and the Netherlands. The UK ranks alongside Spain, Italy and Ireland. According to recent research, the lack of vocational training for 16-19 year olds contributes significantly to the UK's low productivity compared to our wealthier European partners.

What needs to be done to raise the skill level of UK workers? Experience with the Training and Enterprise Councils (TECs) provides clear evidence that the nation's training cannot be left entirely in the hands of the private sector. If workforce skills are to be significantly improved, far more resources will be required than are currently being made available through public and private sector initiatives. Labour's proposed National Training Fund, to which employers would have to contribute a proportion of their pay-roll, could support training schemes wherever they met the required standards. This would help to reduce the free-rider problem while simultaneously providing workers with on-the-job training. The need for publicly-funded training schemes is particularly acute in the northern regions since it is in these areas where long-term unemployment is at its most severe, especially for males. With more resources, the TECs would be in a far better position to reduce the skills gap which currently exists not only between the UK regions but between the UK and its more prosperous European partners such as France and Germany.

- Make the tax system more regionally discriminating

The introduction of the Uniform Business Rate in 1990 means that high-value properties pay a higher tax rate than low-value properties. This will offer obvious benefits to the north which will become more attractive to firms currently located in the south. The Uniform Business Rate is a potentially powerful regional policy instrument since it will be possible to introduce locally-differentiated tax rates in order to reduce the attractiveness of locations in the south and increase the attractiveness of northern locations. This would be an efficient way of reducing congestion and inflationary pressures in the south by inducing firms to locate in areas where the pressure on resources is much lower.

This attack on inflationary pressures in the south could be supplemented by introducing a regionally-discriminating tax on labour, the most obvious vehicle being the employer's national insurance contribution. The latter could be reduced in areas of high unemployment and raised in areas of low unemployment. The purpose would be to encourage firms to divert their demand for labour from labour-scarce areas to labour-abundant areas, thus helping to relieve wage pressures in the South East. The creation of more employment opportunities in the north would also help to stem the flow of migrants to the south, thus helping to reduce demand for resources in the South East more generally. The policy would pay for itself.

- Monitor the impact of all government expenditure and taxation and target government purchasing on sectors and localities in depressed areas which have the greatest potential for growth

Very little is known about the regional impact of government expenditure and taxation. It is clear from the sparse information that is available, however, that the south benefits from government spending to a far greater extent (per head of population) than the Midlands and northern England. Scotland, Wales and Northern Ireland fare somewhat better because they have their own government departments and cabinet ministers. Ideally, each government department should be required to estimate the impact of its activities, and any planned changes in these activities, on regional income and employment so that regional policy objectives can be taken into consideration when expenditures are being planned. At an absolute minimum, estimates of the regional impact of the massive expenditure by the central government would encourage questions to be asked about the desirability of the planned regional distribution of this expenditure. A more active approach would require government departments to plan their expenditure in such a way that regional policy objectives are taken into account. The geographical distribution of government expenditure, for example, should take into account the impact of this expenditure on inflationary pressures in the South East.

- Improve the co-ordination between UK regional policy and EC regional policy

There is substantial discontent at the way in which EC funding of local and regional development in the UK is currently administered. The most serious criticism concerns the issue of additionality. For example, EC grants earmarked for declining industrial areas can too easily be absorbed into central government funds. Whitehall can reduce its own expenditure on infrastructure projects in depressed areas in line with the grants awarded by the EC. In other words, EC money is used as a substitute for central government funding. This is why the EC is redoubling its efforts to ensure that its own funding is *additional* to existing funding, but it is a policy which is difficult to enforce due to the lack of transparency in the accounting system in Whitehall.

A related problem is that EC grants to local authorities to support infrastructure projects cannot always be spent due to the expenditure controls imposed on local authorities by the central government. This has happened increasingly in recent years, the consequence being that infrastructure projects are seriously delayed (at best).

EC regional policy does not exist in order to help to finance the UK government's general revenue account. Unless this is accepted by Whitehall, the UK's depressed areas will be the ultimate losers, since the Commission, which has the responsibility to ensure that the money is spent in the regions intended, is becoming increasingly irritated with the UK government on this issue. One way of ensuring that EC grants to support regional economic development end up at their intended location (rather than being swallowed up by the Treasury) is for all regional policy functions to be transferred to regional authorities. The EC currently has to deal with individual local authorities whose own expenditure on economic development is strictly controlled by Whitehall. This system compares unfavourably with the situation in other member states. Germany, for example, has the Lander which are able to negotiate directly with the relevant bodies in the EC on a much more even footing.

Economists of all persuasions have argued that the UK economy would be healthier if regional economic disparities were less severe. Reducing regional disparities in unemployment, for example, would help to reduce inflationary pressure and national unemployment simultaneously - two benefits for the price of one. It is also clear that regional disparities in economic performance have led to an intensification of congestion in the South East, which continuously cries out for more public investment to relieve the ever-increasing pressure on its over-used infrastructure. Moreover, regional disparities in the UK are likely to intensify after 1992 . If the creation of a single market in 1992 is buttressed by the adoption of a single currency later in the decade, the poorer regions of the EC will have little option but to increase their underlying competitiveness if they are to survive economically in the absense of exchange rate flexibility. Despite efforts by the European Commission to devise a regional policy for the entire Community, there is still much that needs to be done by the UK itself.

Related Fabian Publications

Economic Short Termism: a cure for the British disease *David Pitt-Watson.* Pamphlet No 547. July 1991. £3.50 If the problem of Short-termism in British industry is to be solved, we must first tackle the failings of both the City and industrial management. This pamphlet puts forward 16 specific recommendations of the Labour Finance and Industry Group.

Regulation and Ownership of the Major Utilities *Michael Waterson.* Discussion Paper No 5. May 1991. £10.00 Regulation is necessary to prevent abuse of national monopolies but the type of regulation appropriate depends on the specific industry. For telecommunications, light touch regulation is sufficient, but for other privitised utilities US-style regulatory commissions should be tried.

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A public services pay policy *William Brown and Bob Rowthorn.* Pamphlet 542. November 1990. £3.00 Calls for a Pay Advisory Commission, on the model of ACAS, to provide the data on which comparability exercises and pay negotiations can be carried out.

Sustainable development: greening the economy *Michael Jacobs.* Pamphlet 538. July 1990. £3.00 Sustainability requires a new set of economic objectives, and constraints on the market economy. Government action is required to achieve change on the scale required, and to mitigate inequitable effects.

Income and wealth in the 1980s (1990 edition) *Thomas Stark.* July 1990. £15.00 Stark uses government statistics to contradict claims that the poor have done well out of economic growth under the Conservatives.

Reviving the regions

Regional economic disparities in Britain have become accepted as a fact of life. But the economic and social costs are great, and the creation of the single European market after 1992 will make the situation worse, unless positive steps are taken to revive the less prosperous regions.

Professor Jim Taylor of Lancaster University looks at the causes and effects of regional economic disparities, and analyses why over fifty years of regional policy have failed to make a bigger impact on the problem. He argues that no policy will succeed unless central government is willing to commit extra funds - some of which could be diverted away from the futile attempts to overcome congestion in the South East - but that increased public expenditure is not a sufficient condition for regional revival. His proposals include:

- preventing takeovers which are potentially harmful to depressed areas;
- relocating the Ministry of Defence, the Department of the Environment and the Treasury to the regions;
- making the tax system regionally discriminating, for example through levying different rates of national insurance
- improving co-ordination between British and EC regional policy.

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