European Challenges: Scotland

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I Scotland: Demographic Background

Scotland is the second largest of the four constituent countries that make up the United Kingdom, but the population is small compared with its southern neighbour and, at just over 5 million, comprises less than 9 per cent of the total British population. It has a substantial land area, about a third of the whole United Kingdom, and is in consequence sparsely populated by European standards: 65 persons per square kilometre, more comparable with Ireland or Sweden than with England, which has 364 persons per square kilometre.

The low population density is mainly a consequence of the large proportion of the country that is mountainous. The bulk of the population lives in the relatively small lowland area of the Central Belt between the Highlands to the north and the Southern Uplands to the south (see Map). In comparison with other countries and regions of Europe, Scotland is unusual in having a 1991 population that was fractionally less than in 1945. The population grew slightly to 1971 but from 1971 to 1991 has slowly declined. This contrasts with a growth of 20 per cent in England during the same time and 18 per cent for the United Kingdom as a whole. Even these rates of growth are low by European standards, the population of the Netherlands having grown by 60 per cent, of France and the former West Germany by over 40 per cent and Spain by 51 per cent since 1945 (see Table 1). Even the slower growing countries, Italy, Sweden and Ireland had population growth in excess of the United Kingdom and all were well above their population levels of 1945.

[1] The author would like to thank officials of the Scottish Office for help in supplying statistical material for this paper, but they are not, of course, responsible either for the interpretation put on the data or the conclusions drawn.

TABLE 1

Demographic Background

	Population 1993 000s	as a % of 1945
Scotland	5,120	99
United Kingdom	58,191	118
France	57,379	144
Germany	81,187	125
West Germany	65,534	142
Italy	57,190	126
Spain	39,141	151
Netherlands	15,298	160
Sweden	8,712	130
Ireland	3,563	121

Source: Annual Abstract of Statistics, Scottish Abstract of Statistics, U.N. Demographic Yearbook, Statistisches Jahrbuch.

This lack of population growth is the result of emigration. Net emigration, not only to the rest of the United Kingdom but overseas, principally to countries of the British Commonwealth, has been a feature of Scotland's demography for many years, in the same way as it has of Ireland's. And the large number of people of Scottish origin already living abroad helps to facilitate the continuing flow. In the early post war decades emigration equalled about a half the natural increase in population, but since the mid 1970s, although net emigration has been somewhat lower, falling birth rates have resulted in a steeper fall in the rate of natural increase, causing the population as a whole to decline.

Lack of sufficient growth in job opportunities at home is the primary cause of the continuing population outflow. For more than fifty years the Scottish economy has been going through a major transformation from older industries employing large amounts of labour to modern high technology, capital intensive manufacturing and services. Despite considerable success in achieving this change, the new employment opportunities have largely replaced those that have been lost, with no overall employment growth. Emigration and unemployment rates that, until the 1990s recession, always tended to be above the British average, have therefore been continuing features of the Scottish economy.

As a result of these trends, the share of the population aged 65 and over has been rising and is expected to increase further - from 11.9 to 12.8 per cent for males by the year 2000 and from 17.7 to 18.4 per cent for females. At the same time the numbers in the 16-18 year age group have fallen by 36 per cent since 1981 and, although a slight recovery is expected, it will remain well below the levels of earlier decades.[2]

II The Characteristics of the Economy

Unlike some of the other countries and regions on the periphery of the European Union, Scotland industrialised early. The primary sector - agriculture, forestry and fishing - employed only 7 per cent of the working population in 1950; and, although this had reduced to less than half by 1990, the scale of the exodus from this sector was modest by the standards of most other European countries. Abundant coal at very low prices provided the power for industrial growth in the 19th century and this continued to form the main source of energy until the end of the 1950s. Heavy industries, particularly steel, shipbuilding and associated heavy engineering, were originally based largely on local raw materials and resources. The same applied to woollen textiles, but not, of course, to cotton and jute, which were also important in the Scottish economy. With the exception of woollen textiles, which was more widely distributed, these industries were concentrated in Scotland's Central Belt. The economy of this area therefore bears similarities to the North East of England and to the older industrial areas of northern France, the Walloon region of Belgium and parts of Germany. Only in the Scottish Highlands and Islands was there a problem of under-development, comparable to Ireland or the peripheral regions in Southern Europe.

II.1 A Changing Economic Structure

The change in Scotland's economic structure over the last half century has been immense. In the late 1940s there were 113 coal pits in production, half a dozen or more steelworks producing a wide range of products, 25 shipyards and associated engineering works on the Clyde and others on the Forth, Tay and at Aberdeen. Today there are only two coal pits, although there is a substantial opencast coal operation; the steel industry has virtually

[2]The Scottish Office (1991). *Scotland: An Economic Profile,* Edinburgh, pp. 7-9.

gone; the shipbuilding industry is reduced to four yards on the Clyde (one of which is exclusively a naval yard and another builds only oil rigs and modules), the Rosyth naval repair dockyard, now threatened with run down, and some small boat-building yards for the fishing industry. Table 2 shows what has happened to the main sectors. In manufacturing there has been a major loss of employment in all sectors, with the exception of electrical and instrument engineering, where the growth of electronics has been an important factor. Even those sectors that remain important in Scotland, such as food and drink, woollen textiles and mechanical engineering, have witnessed a colossal fall in employment, though it should be emphasised that a significant part of this is the result of higher productivity and does not necessarily imply a loss of output. Overall manufacturing employment in 1993 was only 303,000, compared with over 653,000 in the 1952. The manufacturing sector peaked at 685,000 in 1956 and returned to this level 1966. Since then it has declined with the fall becoming especially rapid in the 1980s and 1990s.

TABLE 2

Structural Change in Scottish Employment+

Selected Industries
000s

	1952	1993	1993 as % of 1952
Agriculture, forestry, fishing	114	38	33
Coal Mining	92	3	3
Oil & Gas extraction	-	17	-
Other energy & water	29	19	66
Manufacturing	653	303	46
Chemicals	27	16	61
Metals & Minerals	58	14	24
Metal Goods	42	14	33
Shipbuilding	59	10	18
Other transport equip	36	12	34
Mechanical engineering	104	33	32
Elec. & Inst. engineering	32	54	170
Textiles, leather, clothing	129	42	33
Food, drink, tobacco	81	57	70
Paper, printing, publishing	46	28	62
Other manufacturing	38	23	61
Building & Construction	155	125	81
Transport Services	157	80	52

Post & Telecom	39	34	87
Wholesale & Retail dist.	259	270*	104
Hotel & Catering	64	108*	169
Financial & Business Services	57	172*	302
Education	69	144	209
Health	68	246**	361
Public administration/defence	120	133	111
TOTAL	**2035**	**1984**	**98**

\+ excluding self employed
* Because of classification changes 1989 figures are used for some service sectors
** including social work services
Source: Scottish Office, Scottish Digest of Statistics, Scottish Economic Bulletin No. 52, Mar 1996.

The major employment growth has been in North Sea oil and gas extraction, and their related service activities, and in services generally, apart from transport and communications where changed technology has resulted in major productivity improvement. Financial and business services have undergone a particularly striking expansion (over 300 per cent), as have professional services, including health and education. In employment terms, the expansion of the services sector has broadly compensated for the loss in manufacturing. Indeed it is striking that, despite the reduction of about 50 per cent in manufacturing employment, there has been a remarkable stability in the total numbers employed at around 2 million for most of the last 45 years, falling below this level significantly only in the 1990s recession.

II.2 GDP, Growth and Exports

As Scotland's share of the British working population has fallen, its share of UK GDP has also slightly reduced: from 9.3 per cent in 1951 to 8.8 per cent in 1994 (Table 3). GDP per head, on the other hand which was 88 per cent of the UK average in 1961, rose to 98 per cent in 1976 during the oil boom years, and after falling to a low point of 94 per cent in 1988 rose again almost to equal the UK average (99.9 per cent) in 1994. This was the highest figure Scotland's GDP per head had attained relative to the UK as a whole since GDP figures were first compiled in the 1950s.[3] Indeed, if the wealthy South East region of England is excluded, Scotland's GDP per head is now above the average for the other

[3] see my (1965) *Scotland's Economic Progress 1951-60*, London: George Allen & Unwin, for estimates of Scotland's GDP in the 1950s. Official estimates of Scotland's GDP since 1960 have been published in Scottish Office, *Scottish Economic Bulletin*, twice annually.

British regions. As Diagram 1 shows, however, the improvement in Scotland's GDP per head in the relation to the rest of the UK since 1989 is largely a consequence of Scotland's less sharply rising unemployment; the figure for GDP *per person employed* fell slightly in relation to the UK during the 1980s and early 1990s and then rose to 97 per cent of the UK average by 1994. As Diagram 2 shows, with the improvement in Scotland's GDP per head in relation to the United Kingdom as a whole, it is now only about 2 per cent below the average for the EU. It is broadly comparable with Italy, the Netherlands, Sweden and Finland (though GDP per head in the latter two countries has fallen sharply in relation to the average in the last few years); Scotland is clearly not as well off as Luxembourg, Belgium, Germany or France, but still well ahead of Spain, Ireland, Portugal and Greece.

TABLE 3

Scottish Gross Domestic Product

	1951	1961	1966	1971	1976	1981	1984	1988	1991	1994
As a % of the UK	9.3	8.6	8.5	8.8	9.2	8.9	8.7	8.4	8.6	8.8
GDP per head as % of UK	92	88	89	94	98	97	96	94	97	100

Source: Scottish Economic Bulletin
McCrone, G. (1965) Scotland's Economic Progress 1957-1960, George Alllen & Unwin for estimates of GDP in the 1950's.

Note: 1994 figures are provisional.

Growth of output has kept broadly in step with the rest of the United Kingdom. But there have been periods when Scotland has done less well: notably the late 1950s, when the traditional industries began to decline after the war; and the middle to late 1980s, when Scotland, partly as a result of a slump in oil prices, did not share in the boom that affected the rest of Britain. There have also been periods when Scotland has done better: the early 1960s, when regional policy was much strengthened; the years of North Sea oil development in the 1970s; and the early 1990s, which were not a period of much growth but when the recession was much less severe in Scotland than in England.

The economy has always been strongly export oriented and this characteristic has remained as the structure of industry has altered. Scotland's own domestic market is too small to provide an adequate base for most industries; and, for international investors in particular, a Scottish location is more likely to be attractive for products that can be exported over a wide area than for those that are aimed only at the British market. Exports (outwith the UK) per employed person were 40 per cent above the British average in 1994.[4] In the 1950s North America and the countries of the British Commonwealth provided the main market, with less than 20 per cent of exports going to Europe. Today this pattern is reversed, with 55 per cent of Scottish exports (outwith the UK) going to other member states of the European Union in 1994 (Table 4). Ships and marine engineering are no longer major export industries, but whisky and, to a lesser extent, mechanical engineering products remain important. Apart from whisky, as Table 5 shows, office machinery and computers, electrical engineering, and chemicals now dominate Scotland's export trade, making up 75 per cent of the total. Oil is also a major export, though much of it goes direct from the installations offshore and is therefore not included in the Scottish statistics.[5]

[4]Scottish Council Development & Industry, *Export Surveys*, Edinburgh.
[5]The Continental Shelf is treated for statistical purposes as a separate region of the UK.

TABLE 4

Scotland's Manufactured Exports in 1994 by the Top 10 Export Markets

	£m (current prices)	% of total
France	2,338	16.4
Germany	1,563	11.0
USA	1,530	10.7
Netherlands	1,381	9.7
Italy	800	5.6
Spain	529	3.7
Switzerland	511	3.6
Belgium	502	3.5
Japan	491	3.4
Sweden	463	3.2
All of the above	10,108	70.9
European Union (12)	7,843	55
All countries	14,264	100

Source: Scottish Council Development and Industry: Annual Export Survey 1994

TABLE 5

Scottish Exports by Sector 1994

	Value at current prices £m	Percent of Total
Office Machinery/Computers	4,852	34.0
Whisky	2,191	15.4
Electrical and electronic engineering	2,122	14.9
Chemicals	1,465	10.3
Mechanical engineering	871	6.1
Transport equip/ex motor vehs)	475	3.3
Other food, drink & tobacco	425	3.0
Paper, printing publishing	393	2.8
Textiles	373	2.6
Processing rubber & plastics	286	2.0
Footwear & clothing	140	1.0
Metal manufacturing	135	0.9
Motor vehicles & parts	135	0.9
Metal goods	90	0.6
Instrument engineering	78	0.5
Other	130	1.2
	14,264	100.0

Source: Scottish Council Development & Industry, *Export Surveys*

A striking feature of the last 20 years, however, has been the weak performance of the industrial production and construction sector as a whole, and especially manufacturing, compared with the rest of the economy. In earlier decades growth of GDP and growth of manufacturing production tended to move broadly in step, with the latter sometimes outstripping the former. For example from 1963 to 1973 the output of the manufacturing sector increased by 53 per cent compared with 42 per cent for GDP as a whole. But after reaching a peak in 1973, manufacturing production fell and even in 1979 had not fully returned to its 1973 level. It then fell sharply once more in the early 1980s and did not regain its approximate 1979 level until 1988 (Diagram 3a). In contrast GDP, after falling in the recession of 1979-1981, quickly resumed its upward trend. By 1993 manufacturing output was 11 per cent higher than in 1979, but by then GDP was 25 per cent above its level in the same year. While the failure of manufacturing output to keep pace with GDP growth since 1973 is striking, Diagram 3b shows that the United Kingdom's experience was similar to that of Scotland; indeed manufacturing output in the United Kingdom suffered an even bigger fall in the early 1980s.
(see Diagrams 3a and 3b)

These figures have to be interpreted with caution, because of the very large changes in the composition of manufacturing output over the years, which inevitably make comparison over a long period difficult. But the main point is clear enough, and part at least of the explanation for the disappointing performance of manufacturing in the first half of the 1980s lies in the tight monetary policies pursued by the British Government at that time, coupled with the effect on the balance of payments of North Sea oil. This combination led to an exceptionally high exchange rate, the pound reaching DM 5 and \$2.40 in 1981: at this rate many firms were unable to compete with their counterparts in other countries, whether in export markets or against imports at home. Since manufacturing was the sector most exposed to foreign competition, it suffered the greatest losses of output and reductions in capacity.

II.3 Productivity in Manufacturing

The feature of Scotland's economic performance that is perhaps most striking is the growth of productivity in manufacturing. As Table 6 shows the growth of labour productivity in manufacturing has exceeded that of the United Kingdom as a whole in each of the last three decades. Output per head in Scottish manufacturing industry is above the United Kingdom average in 9 out of 14 sectors and is now 9 per cent above the

British average for manufacturing as a whole (Table 7). In part this is a consequence of the structural change already referred to. Industries in decline that were labour intensive have been replaced by new economic activity that is capital intensive. It is also because progress has been made in overcoming the widespread overmanning problem that affected much of British industry, not least in Scotland, in the decades before 1980. But the Scottish figures are particularly influenced by the important part played by the electronics industry, where technological change was so rapid that there has been an enormous increase in output per employee. The result of this is seen in the output per employee in electrical and instrument engineering in Table 7, which is 49 per cent above the British average. Since 1980 the output of the electronics industry has risen by 556 per cent, while employment has risen only from 42,000 to 47,000, an increase of about 12 per cent.[6]

TABLE 6:

Manufacturing Productivity Growth

Average annual % change	**1960-70**	**1970-80**	**1980-90**
Scotland	**4.1**	**2.0**	**5.2**
UK	3.1	1.6	4.7
US	3.5	3.0	4.1
Japan	8.8	5.3	3.2
Germany (West)	4.1	2.9	2.3
France	4.5	3.2	3.1
Italy	6.2	2.5	2.9
Canada	3.4	3.0	2.8
G7 economies	4.4	3.2	3.5

Sources: HM Treasury and Scottish Office Education and Industry Department

[6]Information supplied by the Scottish Office and from Scottish Office, *Statistical Bulletin, Industry Series*, Edinburgh.

TABLE 7:

Output per Employee in Scottish Manufacturing in 1992

	Output per employee GVA[1](£)	**Output per employee (per cent of UK)**
Metal Manufacture	16,468	63
Extraction of Minerals	46,547	114
Non-metallic Mineral Products	26,884	114
Chemicals & Man-made fibres	40,357	94
Manufacture of Metal Goods (nes)	18,647	96
Mechanical Engineering	25,444	106
Electrical and Instrument Engineering	35,685	149
Transport Equipment	26,896	106
Food, Drink and Tobacco	29,257	106
Textiles, Footwear, Leather and Clothing	15,982	108
Timber and Wooden Furniture	17,019	101
Paper and Printing	28,838	94
Process of Rubber and Plastics	27,593	112
Other Manufacturing	17,334	95
All Manufacturing Industries	**27,121**	**109**

Source: CSO-1992 Annual Census of Production/Monthly Sales Enquiry

Note 1: GVA: Gross Value Added: profit (including taxes) ie total sales adjusted for stock minus the cost of all purchases of industrial and non industrial services/duties.

When compared with the rest of the EU, Britain's labour productivity in manufacturing grew more slowly than any of the other Group of Seven countries in the decades 1960-70 and 1970-80 but more rapidly than any of them in the last decade, 1980-90. Although Scotland's performance has been better than that of the United Kingdom as a whole, it was still below the average for the Group of Seven countries in the first two decades (Table 6). But, if performance in the last decade is encouraging, it still has to be seen in the context of absolute levels of productivity in British manufacturing that are below France and Germany. A recent study shows that, although productivity in the British economy as a whole in 1992 was only 8 per cent lower than West Germany and 2 per cent higher than in France, productivity in manufacturing was still at least 20 per cent below the levels achieved in these two countries[7]. It appears that, although the leading manufacturing firms in Britain compare well with their competitors elsewhere, there is still a tail of businesses with indifferent performance.

One of the ironies of this strong improvement in Scottish manufacturing productivity is that for a given growth in output the additional employment is less than it would be otherwise. Diagram 4 contrasts the performance of Scottish manufacturing output with that of employment and illustrates clearly the dramatic fall in employment in this sector. The gap between the trends for output and employment demonstrates how much more productive the sector has become. But it also shows why, with only a modest growth in output and major increases in productivity, there has been a continuing unemployment problem.
(see diagram 4)

II.4 Unemployment

Unemployment has been a problem of the Scottish economy for much of the last half century, although the rates of unemployment in the 1950s and 1960s, while significantly higher than for the United Kingdom as a whole, would seem very satisfactory when compared with present levels. In earlier decades the decline of the traditional industries was the most obvious cause of this problem, not only in Scotland but in the other Development Area regions of the United Kingdom. Over the last decade, however, unemployment has risen generally, becoming more widespread in Britain, as well as elsewhere in Europe, and has been much less the consequence of decline in a few key sectors. It is therefore perhaps not surprising that Scottish rates have moved closer to the British average. Indeed in 1992, for the first time since the First World War Scottish unemployment, although as high as 9 per cent of the workforce, was below the British average, reflecting the much greater impact of the recession in the south of England. At the time writing (April 1996) it is 8 per cent and on the latest monthly figure once again above the UK rate for the first time for four years. As recovery gathers momentum it is

[7] Oulton, N. (1994). *Labour Productivity and Unit Labour Costs in Manufacturing: Scotland, the UK and 12 Major Competitors,* ESU Research Paper 35, Edinburgh: Scottish Office Industry Department.

likely to be stronger in the south, where the recession was also more severe, and this position is therefore likely to be sustained.

II.5 Regional Policy and Inward Investment

The problem of unemployment is far from uniform throughout Scotland, being concentrated especially in Strathclyde, Fife and the Dundee area of Tayside. British regional development policy for many years has therefore given priority to these areas, through the provision of grants under the Industrial Development Act 1982, and also to the rural areas of the Highlands and Islands and South West Scotland. For the structural funds of the European Union, the Highlands and Islands are now an Objective 1 area, the South West, Objective 5b, and the areas of industrial conversion in Central Scotland, Objective 2. egional policy has undoubtedly assisted the restructuring of these areas and helped to bring about the creation of a substantial number of new jobs. [8]

There has been notable success in the attraction of inward investment from overseas, especially from North America and Japan. Overseas firms accounted for about 28 per cent (83,000) of the employment and 35 per cent of the gross value added in Scottish manufacturing industry in 1992. The proportions vary considerably between the sectors, from 59 per cent of employment and 62 per cent of gross value added in electrical and instrument engineering to 9 per cent and 13 per cent respectively in food, drink and tobacco.[9]

But despite these successes, the essential problem of the Scottish economy remains: a rate of economic growth that has been insufficient to absorb the labour resources available to the economy or to maintain, let alone improve, Scottish living standards in relation to other countries of the EU. Resolving this problem requires higher levels of investment in new productive activity than the economy has been able to generate, even with the help of regional policy. And, since inward investment is already making as substantial a contribution as can probably be expected, the issue is how to achieve more growth and more investment from within the British and particularly the Scottish economies.

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[8] The most comprehensive review of the effects of regional policy is contained in Moore, B., Rhodes, J. and Tyler, P. (1986) *The Effects of Government Regional Economic Policy*, Department of Trade and Industry, London: HMSO. See also the same authors (1977) *The Impact of Regional Policy in the 1970s,* Centre for Environmental Studies Review, No 1; Moore, B and Rhodes, J. (1974). *Regional Policy and the Scottish Economy,* Scottish Journal of Political Economy, vol. 21; and Marquand, J. (1980) *Measuring the Effects and Costs of Regional Incentives*, Government Economic Service Working Paper 32, London: Department of Trade & Industry.

[9] Scottish Office (1995). *Statistical Bulletin: Industry Series,* Edinburgh.

III Prospects for the Main Economic Sectors

The future prospects for the Scottish economy will be affected by a wide variety of factors, some particular to Scotland, but many the consequence of the policies of the European Union and Britain's relationship with the Union. Space does not permit a comment on every sector, but the following paragraphs highlight the most important issues that are likely to affect key sectors.

III.1 Primary Industries

Although the agriculture, forestry and fishing sector is comparatively small in relation to the economy as a whole, accounting for only 2.6 per cent of GDP in 1993 and approximately the same proportion of the workforce in employment (about 60,000 or 2.7 per cent including self employed farmers and fishermen), it is still of major importance to the prosperity of large rural areas.[10] Agriculture in Scotland is efficient, as it is in the rest of the UK, with relatively large holdings unaffected by the problem of fragmentation that is a feature of many other EU countries. Labour productivity is therefore high. But there are special problems arising both from the nature of the terrain and the climate. Although there are areas of very good land, there are also large amounts of marginal land with poor quality soils, high altitude and adverse climate, suitable mainly for livestock, particularly sheep.

Traditionally Britain has not been a country of high agricultural protection and the deficiency payments system that operated before Britain became a member of the EU generally gave less protection, especially to grains, than the Common Agricultural Policy (CAP). Scotland has done well from the CAP, and it has also been well treated under the measures for CAP reform. In addition a by-product of leaving the ERM in 1992 was an increase in the sterling value of the prices farmers received under the intervention arrangements. But in the longer term a policy that has helped to generate a European food surplus must carry anxieties for Scotland. If, as might seem rational, reforms resulted in marginal land going out of production first, Scotland could be disproportionately affected. So far this has not happened and measures to ensure the protection of less favoured areas combined with a concentration on sheep farming, which is less threatened by surpluses than production of grains or other livestock, may adequately safeguard Scotland's position. But pressure to further reform the CAP is likely to intensify; and the problem of food surpluses may increase, especially if countries with considerable agricultural potential in Central and Eastern Europe join the EU. The prospects for agriculture

[10] Scottish Office (1995). *Scottish Economic Bulletin*, No 50, Edinburgh: HMSO; employment including self-employed from *Scottish Abstract of Statistics*, Edinburgh: HMSO.

therefore remain subject to uncertainty, which could have important consequences for the rural areas of Scotland.

In 1990 fish landings in Scotland were 78 per cent of the total for the United Kingdom, and, with an extensive, heavily indented coastline, Scotland clearly has exceptional resources for this industry by the standards of most European countries.[11] It is a small industry, giving direct employment to only 7,600 full-time plus 1,410 part time, but with a further 16,000 employed on-shore in fish processing and other activities dependent on fishing. These figures, however, understate the importance of the industry in the eyes of most Scots, because it is an indigenous Scottish industry, which for generations has been virtually the sole source of livelihood for many of the most remote communities. The Common Fisheries policy was agreed shortly before Britain became a member of the European Community in 1973, but was the subject of lengthy negotiations intended to meet British, including Scottish, concerns. Problems nevertheless remain and it continues to be an issue that not only gives the EU a great deal of adverse publicity but is very damaging to support in Scotland for the European Union.

The essence of the problem is the balance between the intensity of fishing activity and the conservation necessary to ensure a future for the industry, which is compounded by the access permitted to the fleets of other EU member states. A basic principle of the policy is common access, but even with safeguards for local fleets and quota systems, the very high technical efficiency of modern fishing methods means that more fish can easily be caught than the resource can sustain. The future of the industry is therefore threatened and the livelihood of local communities dependant on fishing put at risk. This increased technical efficiency means that there would be a conservation problem and a need to restrict fishing effort even if Scotland had very extensive territorial limits exclusively reserved for its own fishermen. But the principle of common access does nothing to make this problem easier to handle. It provides an opportunity to put the blame on other countries for something that would need remedial action in any event, and is certainly seen in Scotland as giving benefit to the fleets of other EU countries at the expense of Scottish fishermen.

The position is sometimes compared, especially in fishing communities, with what might have obtained if Scotland, like Norway, Iceland or Faroe, was not in the EU and able to extend and safeguard more fully its territorial limits. There would appear to be no more reason why common access should have been a basic principle of EU fishing policy, than it is with the exploitation of offshore hydrocarbons, which are subject to a tight system of

[11]Scottish Office (1991). *Scotland: An Economic Profile*, Edinburgh, p. 31.

licensing. While it must be unlikely now that any change would be made in this principle, there is nevertheless, anxiety about the future of this industry and the disproportionate effects its decline would have on remote communities.

III.2 Oil and Gas

Britain's resources of offshore oil are overwhelmingly concentrated in the northern and Shetland basins of the North Sea, off the Scottish coast. There are substantial resources of gas as well, although these also occur in the southern North Sea basin, off the east coast of England. The development of this major industry has been a major engineering achievement and one of the outstanding successes of the British economy in the last 25 years. Production technology has had to be developed and tested to the limit of its capacity in a more hostile offshore environment than had been attempted before. The scale of the operation is immense: British crude oil, which was negligible in the early 1970s, reached a peak of just over 127 m tonnes in 1985 and 1986, with net exports worth more than £8 billion. After a period of slight decline, 127 m tonnes of output was again achieved in 1994, well in excess of the domestic requirement of about 78m tonnes. And although the price of oil had fallen since the mid 1980s, net exports were worth £4.3 billion.[12] Production is now expected to decline slowly but will remain at a high level well into the next century. Gas production from the northern North Sea is likely to continue to increase until the early years of the next century at least.[13]

The economic benefits of this industry can be divided into two categories: those which have a direct local impact in Scotland, and the macroeconomic effects on the United Kingdom economy as a whole. The benefits to Scotland arise from the employment on the offshore installations, the demand for Scottish manufactured components and goods of all kinds, and servicing activity involving provision of general supplies and maintenance. In the early years there was also substantial economic activity generated by the requirement for greatly increased and improved infrastructure, in particular harbours, airports, roads and housing. Estimates of employment generated show that in 1995 some 63,000 people in Scotland are employed in on-shore businesses that are wholly or predominantly oil and gas related; and if the indirect effects are taken into account, including business that is partly oil-related and allowing for the multiplier, the total employment arising from North Sea oil and gas activity in Scotland may be put at around 97,000. By far the largest part of this activity (85 per cent of the directly related employment) is concentrated in the

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[12]Department of Trade and Industry (1995). *Energy Report*, London.
[13]Kemp, A. (1995). *Prospective Activity Levels in the UK Continental Shelf under Low Oil Price Scenarios,* Scottish Economic Bulletin No 50, Edinburgh: HMSO

Grampian Region.[14] The effect has been to make the Grampian Region one of the areas of lowest unemployment (only 4.6 per cent in 1995) and one of the wealthiest, with a GDP per head in 1991 more than 30 per cent above the average for the United Kingdom.[15] But there has also been an effect on the figures for Scotland as a whole: although oil and gas production off-shore is not included in the Scottish figures, on-shore oil-related activity is one of the principal factors in the narrowing of the gap between UK and Scottish GDP per head.

Potentially the wider macroeconomic effects are of greater magnitude than the direct effects, as the example of Norway shows, but they are more diffused, being spread throughout the British economy, rather than confined to or even predominantly in Scotland. They arise from the taxation revenue generated and the impact on the balance of payments. Both of these depend on the price of oil, which is capable of large fluctuations and has varied between \$10 and \$40 a barrel since 1975. The tax revenue is around £2.3 billion a year (1995-96), just under 1 per cent of total UK tax revenue, (compared with 9 per cent in 1984-85, when the oil price was much higher).[16] The balance of payments effect is much larger: assuming all production is either exported or is import replacement, the gross value of the production was approximately £14 billion in 1994, though very sensitive to changes in the oil price. In the early days of North Sea oil, when the United Kingdom was considered to have a balance of payments constraint on the rate of growth the economy could sustain, the consequence of easing this was expected to be substantial. And it should, in any event, permit a higher level of imports to be sustained, thereby benefiting the standard of living.

But the effects have not always been so beneficial. As explained in Section 1 of this paper, such a major increase in exports (or import saving) taking place in a relatively short time has an impact on the exchange rate; and in the early 1980s, when this effect was at its largest, the Government was also pursuing an extremely tight monetary policy. The result was exceptionally and unrealistically high exchange rates for sterling, which adversely affected the competitive position of other tradable goods produced in the economy. This was a major factor in the recession of those years and helped to precipitate the loss of industrial output and capacity at that time. That North Sea oil, which had the potential to provide great benefit for the British economy, should have been allowed to have such an adverse effect, was a major opportunity missed for Britain. A proper strategy for handling

[14]Scottish Office (1995). *The 1994 Oil Related Survey Employment Results: Final Report,* ESU Research Paper No. 37, Edinburgh: The Scottish Office Industry Department.
[15]Scottish Office (1995), *Scottish Economic Bulletin,* No. 50, p. 84, Edinburgh: HMSO.
[16]H.M.Treasury (1995). *Financial Statement and Budget Report 1996-97,* London: HMSO.

the macroeconomic effects was required to ensure that upward pressure on the exchange rate was contained and investment in the productive potential of the economy increased. Such a strategy is not easy to devise or implement, although Norway has had some success in doing so. Unfortunately the British Government of the early 1980s did not believe in the type of interventionist approach that would have been required. The adverse consequences of this have had long run implications for the British and Scottish economies, but with a lower oil price and the expectation of gradually reducing levels of production, it is unlikely that the situation of the early 1980s will be repeated, either as regards the opportunity it offered or the damage that was caused.

Scotland's future prosperity will nevertheless be much affected by the prospects for offshore oil and gas. The industry has a finite life, depending on the exploitable resources that remain; and at some time its decline will require a major, and probably difficult, restructuring of the Scottish economy. But this is unlikely to be a major problem until well into the next century. There is a wide margin of error in any predictions, because prospects depend upon three factors: the scale of future discoveries, advances in technology that permit presently unexpoitable resources to be recovered, and the price of oil. Territory remains to be explored, particularly in the deeper water to the west of Shetland and the Scottish mainland. But price is crucial in determining whether fields in an area as expensive to develop as the Scottish offshore are economic. Recent research has shown that at $18 a barrel, with a minimum required internal rate of return (IRR) of 10 per cent, production might be expected to fall from its present level of approximately 4 million barrels of oil equivalent a day to about 3 million in year 2008. If, however, the price were only $12, it would be likely to fall to less than 2 million; and with an IRR of 20 per cent to just over 1 million.[17] At such levels the benefits both to income and employment would be greatly reduced.

III.3 Manufacturing Industry

Manufacturing accounted for 18 per cent of Scottish employment in 1994 and about 20 per cent of GDP. As noted already the structure of the sector has undergone enormous change. Employment has greatly contracted and output, although now at an all time high, has changed radically in composition. The new growth has taken place in a wide range of sectors, but particularly in high technology and science based industries. For example the output of pharmaceuticals has increased by 145 per cent since 1980, and health care products by 130 per cent; most remarkable of all, as noted earlier, the output of the

[17] Kemp, A. (1995). op. cit. Scottish Economic Bulletin No 50.

electronics industry has risen by 556 per cent.[18] Yet despite this achievement, there are several features of the situation which give rise to concern.

The proportion of both employment and GDP accounted for by manufacturing has declined in most countries. This is the result both of a switch in consumption expenditure to services and of productivity rising more rapidly in this sector than in the rest of the economy. In consequence the employment required to meet consumption demand for manufactured goods is reduced. But Scotland, like the rest of the UK, has experienced a particularly large fall (Table 8). Manufacturing accounted for about 32 per cent of total employment in 1960 (and a similar proportion of GDP). In Germany manufacturing employment accounted for about 34 per cent of total employment in 1960, very similar to Scotland, but it was still in 1993 above 30 per cent compared with Scotland's 15 per cent; in France it has fallen from 26 per cent to 19 per cent and in the United States from 26 per cent to 18, but in Japan it has risen from 21 to 24 per cent.[19] In Scotland, as in the rest of Britain, this fall in manufacturing employment was particularly marked in the first half of the 1980s, when as already seen, output in the sector fell very sharply. What these figures clearly indicate, is that the productivity gains, which were otherwise a welcome feature of the 1980s, came through more in reduced employment than in increased manufacturing output; and, if it is accepted that sterling was overvalued in the early 1980s and again in the 1990s before leaving the ERM, this is perhaps not surprising.

Scotland's future prospects therefore depend on whether this faster than average decline in the share of manufacturing in the economy is likely to continue. There are reasons for thinking that it may not. First, the overvaluation of the currency, at least to the extent which applied in the early 1980s, is unlikely to recur: with greatly reduced prices, North Sea oil no longer has such a major impact, nor is monetary policy now pursued without regard to its effect on the exchange rate. Sterling has been very competitively valued since leaving the ERM in 1992, and export-led growth of manufacturing is presently a welcome feature of the British economy.

[18]Scottish Office (1995). *Index of Industrial Production and Construction*, (using 1980 SIC), Edinburgh.
[19] information supplied by the Scottish Office.

TABLE 8

Scottish Employment

000s

	1951	1961	1971	1981	1985	1991	1993
Total	2074	2116	2003	2002	1907	1997	1984
Manufacturing	669	672	646	463	375	322	303
Manufacturing as % of Total	**32**	**32**	**32**	**23**	**20**	**16**	**15**

Source: Scottish Office
Scottish Economics Bulletin, Digest of Scottish Statistics.

Secondly, one of the most perplexing features of the British (including the Scottish) economy in the 1970s was the low average labour productivity in manufacturing compared with other countries. As was shown earlier the gap has narrowed considerably compared with twenty years ago and there is little or no gap in new plant, especially that run by inward investors. Unit labour costs on the other hand are still much lower than in many Continental countries, and this should put the economy in a very favourable position for faster growth in the manufacturing sector.[20]

But, as a proportion of GDP in manufacturing, investment is not as high as in most other European countries, a feature that has typified not only Scotland but the whole British economy for much of the period since the 1950s; and without the major contribution of foreign owned companies it would be even lower. The attraction of these companies to Scotland has been a policy priority, which has been achieved with outstanding success, making Scotland one of the leading locations for American and Japanese firms in the European market. The role of the inward investors is important precisely because investment from domestic sources is so far short of adequate. This is not through lack of

[20]This is partly because wage costs are lower than, for example, in France and Germany but also because non-wage labour costs are much lower than in most other EU countries (See *Competitiveness: Forging Ahead*, Cm 2867, London: HMSO. 1995.)

funds, since the flow of investment funds from Britain to other countries is even larger than the volume of inward investment. It would therefore seem more to imply a lack of entrepreneurship or conditions favourable to entrepreneurship in the economy.

A related problem is that the very success of electronics has made the Scottish economy highly vulnerable to the future fortunes of this industry. It is an industry in which technological change is taking place at an exceptionally rapid rate. Products which are today's best sellers may be overtaken tomorrow, and the rapidly changing fortunes of individual companies reflect this. While the contribution of this industry is greatly to be welcomed and is rightly regarded as an achievement by those responsible for industrial promotion in Government, it would therefore be more reassuring if Scotland's manufacturing growth were more broadly based.

The dependence of the economy on inward investment and the lack of sufficient growth from domestic sources are related to the low levels of new firm formation and inadequate growth from the small firm sector. The British economy tends to be more dominated by large firms than other countries, with which it also compares poorly in the rate of new firm formation and survival. But Scotland has an even lower rate of small firm start-up than other British regions. Research by Keeble, covering the years 1980 to 1988, shows a clear division between the performance of the regions in the south of Britain and those in the north (Table 9). Scotland's rate of new firm registration per 1000 employees was only 60 per cent of the UK average in the economy as a whole and 68 per cent in manufacturing.[21] Research for Scottish Enterprise gives a similar result. This shows that per 1 million population Scotland had 77 companies with 50 or more employees operating in 1990 that had started since 1978.[22] This figure compared with 86 for the West Midlands and 117 for the South East of England. The comparative figure for Massachusetts was 333. These new ventures created 125,000 jobs in Scotland over the same period, but if Scotland's performance had matched that of the West Midlands 70,000 more jobs would have been created, and if it had equalled the South East, 195,000 more.

[21]Keeble, D. (1990). *New Firms and Regional Economic Development: Experience and Impact in the 1980s,* Cambridge Regional Economic Review, Cambridge: Department of Land Economy.
[22]Scottish Enterprise (1993). *Improving the Business Birth Rate: A Strategy for Scotland*, Glasgow: Scottish Enterprise / Insider publication; and the accompanying research paper *Scotland's Business Birth Rate.*

TABLE 9

New Business Registrations 1980-88

	Rate per 1000 employees	
	Production Industry	All Industries and Services
Greater London	44.8	83.0
Rest of South East	21.4	96.0
East Anglia	28.9	89.4
South West	28.5	95.1
West Midlands	20.7	68.7
East Midlands	20.8	73.2
Yorkshire & Humberside	16.8	65.9
North West	19.0	65.4
North	12.5	52.9
Wales	20.4	76.4
N Ireland	19.2	64.7
Scotland	14.3	51.5

Source: Keeble, 'New Firms and Regional Economic Development', Cambridge Regional Economic Review 1990.

This rate of new business formation is particularly disappointing, given Scotland's past history of entrepreneurship and innovation. However the problem has long been recognised both in Britain and in Scotland and several attempts have been made to address it: the formation of ICFC (now 3i), the Business Expansion Scheme (now replaced by Venture Capital Trusts), the Small Business Division of the Scottish Development Agency and now the Local Enterprise Companies (LECs) of Scottish Enterprise have all made a contribution. Explanations range from a lack of suitable funding for small business (the equity gap and lack of long-term fixed rate loans), to an inability to translate good research ideas into successful development and the disappearance of an enterprise culture, which is sometimes blamed on the educational system.

Whatever the explanation, it is clear that a more substantial contribution to Scotland's growth is needed from domestic investment and that a particular weakness is the low rate of new business start-ups and growth from the small firm sector. This is particularly important in manufacturing and is essential if Scotland is to become less dependant on attracting investment from foreign owned firms.

III.4 Finance and Business Services

The importance of this sector to Scotland is shown by its employment, which increased from 194,000 in 1981 to over 282,000 in 1995.[23] Within this total, banking, finance and insurance have increased over the same period from 59,000 to 75,000. Apart from the three Scottish banks, the most distinctive components of the sector are the life assurance companies, many of which have their headquarters in Scotland, and the investment fund managers, most, but not all, of whom are based in Edinburgh and Glasgow. As a financial centre Scotland is limited by the absence of a separate currency and money market; but a considerable reputation has been built up in asset management and the volume of funds handled is very large - nearly £136 billion in 1994, an increase of 97 per cent since 1989.[24] This makes Scotland one of the major centres in Europe for this particular financial service.

In looking to the future Scotland starts with the benefit of this reputation. Modern electronic means of communication have greatly reduced any disadvantage that there once was in a peripheral European location. Firms also see cost advantages in operating in an uncongested environment. Over the last decade the deregulation of the UK financial sector has greatly increased competition and has led to substantial restructuring from which Scotland has so far emerged well. But the sector is vulnerable to change. The independance of two of Scotland's three banks is of major importance to the economy (a point which was successfully argued in front of the Monopolies Commission at the time of the two take-over bids for the Royal Bank in 1981.[25] They form the centre of Scotland's financial sector and provide a much wider range of functions and employment in Scotland than they would as subsidiaries of organisations with headquarters elsewhere. Given the British economy's propensity for take-overs, a repeat of that battle at some time cannot be ruled out; and, while the objections to take-over from a Scottish standpoint remain, there can be no certainty that the case against take-over would prevail on a second occasion.

The fund managers have always been vulnerable to the take-over of investment trusts. Over the years many have been taken over, especially when the price of their shares involved a substantial discount on their underlying asset value. Generally the creation of

[23]These figures, according to the latest classification, include financial intermediation, real estate, renting and business services. Because of this wider definition they differ from those covering the period 1952 to 1989 in Table 2.

[24]information supplied by the Scottish Office.

[25]Monopolies and Mergers Commission (1981). *The Hong Kong and Shanghai Banking Corporation and Standard Chartered Bank and the Royal Bank of Scotland Group: A Report on the Proposed Mergers,* Cmnd 8472, London: HMSO.

new trusts has more than made good those that have been lost, and the threat of take-over is at present much reduced, as share prices now generally value the trusts fully and in some cases stand at a premium.

The life assurance companies are mostly mutual companies; indeed Standard Life is the largest mutual insurance company in Europe. Hitherto this has commonly been regarded as providing a protection against take-over, making it unlikely that they would go the way of the composite insurance companies, which were lost to Scotland in the take-overs of the 1960s. But the example of the reorganisation of the building societies, also mutual organisations, now makes this less certain. Few of these, and none of the very large societies, have their headquarters in Scotland, but competition following deregulation has brought about their restructuring and a sharp reduction in their numbers, regardless of mutual status. If circumstances were right, the same pressures could be felt among the life offices. It is possible that the growth of telephone and televisual insurance services, as already seen in motor and house insurance, could be the instrument of such a restructuring, with implications which could be serious for Scotland, unless the existing companies are adequately prepared for such competition.

The creation of a single market in finance was one of the principal aims of the European Single Act. National regulations and exchange controls had ensured that this sector was one in which non-tariff barriers greatly restricted competition between member states of the European Union. Indeed the studies undertaken for the European Commission showed that substantial cost reductions could be obtained by opening up the financial market to greater competition.[26] At present the British financial market is more deregulated and much more open to competition than that of France or Germany, and it will take time for the measures set in train by the Single Act to take effect. While some businesses may increasingly draw finance from institutions in member states other than their own, exchange risk is bound to limit this process in the absence of a single currency, and for the individual it is unlikely to take place at all.

Nevertheless the ultimate objective of a single European financial market is clear; and, even if Britain stands aside from a single currency, the financial sector is bound to be affected by it. It may be that competition will lead to the stronger financial centres in Europe gaining at the expense of the weaker.[27] If so, for the services that they provide, the Scottish institutions are highly developed and should be in a position to gain. But that

[26]Cecchini, P. (1988). *The European Challenge !992,* Aldershot: Wildwood House.
[27]Begg, I. (1990). *The Completion of the EC Internal Market for Financial Services,* Glasgow: Scottish Foundation for Economic Research.

depends on them being fully aware of those opportunities and being ready to take advantage of them. Both major banks have had significant European involvement already and are well seized of the situation, both its difficulties and opportunities. But it is less clear that this is so with the other institutions, many of which have been more involved with North America and the Far East than with Europe.

IV Shaping Factors for the Future

Apart from the issues that affect the prospects in individual sectors, there are some major questions, the handling of which could profoundly influence Scotland's prosperity and future development. The remainder of this paper considers four: location, regional policy, relationship with the rest of the European Union, and the impact of parliamentary devolution to Scotland as part of the constitutional reform of the United Kingdom proposed by the Opposition political parties..

IV.1 Location

That Scotland has a peripheral location in relation to Europe is widely recognised and commonly regarded as a disadvantage. It is important, however, to see this in perspective. In direct air miles, Glasgow is no further from Brussels than Bordeaux, Copenhagen or Vienna, although Central Scotland, having no substantial economic hinterland to its north or west, may be regarded as more isolated. Studies do not show that costs associated with a Scottish location are a significant disadvantage for firms that are based there. Indeed other aspects of operating in Scotland, such as availability of skilled labour and competitive labour costs are recognised by inward investors as fully compensating for any disadvantage there is. If the European Union takes in countries further to the east, it may be that the centre of gravity will move towards Central Europe, but there is still no reason to suppose that a Scottish location need be a serious handicap. In so far as it is so regarded, the effect is often more psychological than real and more associated with time spent in personal travel than the cost of transporting goods.

Nevertheless there are certain types of activity, for which Scotland, because of its location, is not well suited. For example, few major companies now have their head offices in Scotland. In part this is a consequence of the UK's tendency to centralisation (in comparison, for example, with Germany) and the Anglo-Saxon enthusiasm for mergers and take-overs. But just as Scotland is not a natural location for the siting of major European Union institutions, so it is not a likely choice for a new corporate headquarters intended to be the centre of a European operation. Equally, there are certain types of manufacturing process for which Scotland is not an appropriate choice: examples are industries where the product is bulky or heavy in relation to value and depend on a market much larger than Scotland, or those which involve the assembly of bulky components drawn from other countries or regions. What Scotland can do, as the success of numerous firms has demonstrated, is to provide an excellent location from which to export low bulk, high value added products that require skilled labour at competitive rates. At the risk of over-generalisation it may perhaps be said that Scotland is less obviously suited as a location for firms that regard the market for their products as mainly confined to the United Kingdom than for those producing the type of product that seeks a European or a world-wide market. It is therefore not so surprising that Scotland exports (outwith the United Kingdom) a higher proportion of its GDP than Britain as a whole.

It is, however, important to reduce such disadvantage as there is in Scotland's location. This requires investment in transport infrastructure and communications, and concentration of the promotion effort on industries that are suited to a Scottish location. The infrastructure has been greatly improved over the last 30 years. Airports have been rebuilt, railways electrified and the trunk road system to the south is at present being further upgraded. More could and should be done, in particular to encourage more direct flights to European centres, to further speed up the rail network to the south and to make an early improvement in the rail links to the Channel Tunnel. Direct ferry services for goods vehicles from Scottish or North of England ports, such as the new service recently started from Newcastle to Denmark, Germany and Benelux, could also be important, if the cost to users is competitive with the drive through England. The congestion in the south of England, through which the bulk of Scottish traffic to Europe has to pass, which is already bad and likely to get worse, is probably now more of problem for Scottish trade with Europe than any inadequacies of infrastructure in Scotland itself. There is increasing and understandable resistance to further road building in the south of England, but the more that can be done to speed traffic through this area, perhaps by greater use of rail, or avoid it altogether, the greater the benefit for Scotland.

IV.2 Regional Policy

Regional development policy has played a major part in bringing about the restructuring of the Scottish economy over the last thirty years. A large number of the firms that have come to Scotland and are now operating successfully, would not have come if regional investment incentives or some other measure of regional policy had not been used to induce them to consider a Scottish location. Competition for inward investment is intense among European countries, and in Scotland's case Ireland is a formidable competitor, able under the EU competition rules to offer higher levels of incentive. For an area so heavily dependant on inward investment as Scotland has become, the maintenance of these measures is therefore essential. Regional policy is also important for the encouragement it gives to investment by companies already in Scotland, whether domestic or foreign owned, since they too have the choice of expanding elsewhere, or, if the prospects are not sufficiently attractive, not expanding at all.

No recent estimates of the effects of regional policy have been made. But a study by Moore and Rhodes in the mid 1970s showed that between 1960 and 1971 some 70-80,000 jobs in Scotland could be attributed directly and indirectly to the measures. A more recent and more detailed study by the same authors for the Department of Trade and Industry showed that for the British Development Areas as a whole regional policy measures accounted for the creation of some 450,000 jobs between 1960 and 1981, excluding those which had been created but failed to survive at the end of the period. Allowing for the multiplier effect in the service sector the total number of jobs created and surviving in 1981 was estimated at 630,000.[28] A very rough apportionment of these jobs to Scotland on the basis that Scotland accounted for about a quarter of the Development Areas in Britain would give an estimate of 157,000.

Since that time a substantial number of manufacturing jobs have been lost, especially in the recessions of the early 1980s and the 1990s and expenditure on regional policy has been greatly reduced, as Table 10 show. The 1994/5 expenditure on all forms of regional assistance in Scotland was £134 million, in real terms only about 28 per cent of expenditure in 1983/84.[29] In view of this, it is perhaps surprising that there has not been a more marked impact on Scotland's economic performance. That this has not occurred may be due to the increased professionalism of the approach to inward investment, which has in part compensated for reduced incentives, and to the spread of more difficult

[28] Moore,B. and Rhodes, J. (1974) *Regional Policy and the Scottish Economy,*Scottish Journal of Political Economy, vol. 21; and Moore, B., Rhodes,J. and Tyler,P. (1986) *The Effects of Government Regional Economic Policy,* Department of Trade & Industry, London: HMSO.

[29]For the UK as a whole the reduction in regional policy expenditure was equally sharp, see Gudgin, G. (1995) *Regional Problems and Policy in the UK,* Oxford Review of Economic Policy, vol. 11, no. 2.

economic conditions to other parts of the United Kingdom, especially in the 1990s recession. This has reduced regional disparities by worsening conditions elsewhere. In the longer term, however, the maintenance of an effective regional policy will remain of prime importance for Scotland, so long as the volume of investment is not sufficient to provide a rate of growth which can absorb the labour resources available. Scottish Enterprise, Highlands and Islands Enterprise and the local enterprise companies(LECs) are part of this policy and continue to be important in assisting and shaping Scotland's development.

Scotland has, of course, been a substantial beneficiary of the regional policy measures of the EU, and in contrast to national spending the expenditure from the EU structural funds has greatly increased, especially as a result of the reforms of 1988, which doubled the funds available, and the further increase from 1993. There have been problems about the extent to which this expenditure adds to the effort that would otherwise be made by the national authorities, the so called 'additionality' problem. Expenditure from the EU still has to be contained with the United Kingdom's planned public expenditure totals, although as a result of a dispute over the RECHAR scheme, the offsetting reduction in

TABLE 10:

Expenditure on Assistance to Industry in Scotland

	£ million	**in constant 1993/4 prices**(1)	**Index**
1983/84	228.6	470.2	100
1984/85	187.2	300.8	64
1985/86	197.0	300.1	64
1986/87	242.4	358.5	70
1987/88	153.2	215.1	46
1988/89	151.2	199.1	42
1989/90	143.9	177.0	38
1990/91	159.2	181.3	34
1991/92	122.8	131.6	28
1992/93	103.4	106.5	23
1993/94	121.2	121.2	26
1994/95	134.5	130.2	28

Source: Scottish Abstract of Statistics
Scottish Economic Bulletin

Note (1): Deflated using financial year GDP deflator at market prices.

government funding is now general, so that it permits benefit to be given to the specific project. It is clearly in Scotland's interest that the regional policy effort both of the national Government and the EU should be maintained and that as much of the latter should be 'additional' as possible, rather than simply being used as a vehicle for the reimbursement of Treasury funds.

IV.3 Scotland and the European Union

Because of the greater dependence of her economy on exports, Scotland's prosperity, even more than that of the United Kingdom as a whole, is heavily dependent on continued and unrestricted access to the European market. And the dependence of the economy on inward investment makes this even more essential. If Britain's position in Europe were seriously in question, the effects in Scotland would therefore be extremely damaging. Not only would the flow of new international investment drop sharply, but firms presently operating in Scotland could be expected to take steps to move their operation elsewhere. Many have plants in several European countries and Scotland would immediately begin to lose out to other locations in investment planning, if not from actual closures. The last decade has seen several hard fought battles in which a Scottish plant or location has been in direct competition for investment with a subsidiary of the same multinational in another EU country. The present posturing of the so called Eurosceptics therefore carries considerable dangers for Scotland, if it were to lead potential investors to expect that Britain might at some stage become less than a full member of the Union, and particularly if that created a threat of possible imposition of barriers to trade.

The issues that have done most in recent years to provoke disagreement about Britain's position in Europe have been the forced exit of sterling from the exchange rate mechanism (ERM) in 1992 and the debate over the proposals in the Maastricht treaty for monetary union (EMU). Although, ironically, Britain is better placed than many countries to meet the required convergence criteria for EMU by 1999, if a core group of countries then move towards implementation of a single currency, the issue has become so politically divisive, that participation is unlikely, certainly under a Conservative Government and probably under any alternative administration.

The strongest economic case for a single currency is that, without it, it may be difficult to make a reality of the Single Market. When currency values are a reflection less of the underlying economic strength of individual countries than of speculative pressures and

Government manipulation, strong resistance to the dismantling of non-tariff trade barriers can be expected. From Scotland's point of view, the essential point is that firms operating from a Scottish base should be able to maintain their competitive position in relation to the rest of Europe and that restrictions on trade should be removed as provided for in the Single Market legislation. This could best be achieved if Britain both met the convergence criteria in full and joined the single currency. Assuming that the single currency were stable and well managed, so that it commanded more confidence than most of the present national currencies, interest rates would be likely to be lower; and for those participating a fully integrated market would not be in question.

But, if the convergence conditions are not met, or if low inflation compatible with them could only be met at the cost of a prolonged deflationery fiscal policy, the Scottish economy would lose its attraction for inward investors and domestic investment would remain weak. In these circumstances retention of a separate currency with an exchange rate that can be adjusted, at least until the convergence criteria can be more comfortably met, would be a less bad option and would better meet Scotland's need to ensure that its export industries operated from a base that was fully competitive. If that is the course that a British government chooses, it will be essential to ensure that it is not interpreted as the first move in a deliberate distancing of Britain from Europe.

IV.4 Constitutional Reform

No consideration of Scotland's economic prospects would be complete without some comment on the implications of the current proposals for parliamentary devolution. The Conservative Party is now the only party in Scotland that argues for the constitutional *status quo.* The Scottish National Party stand for outright independence within the European Union. The implications of such a change would, of course, be far reaching and in many respects unpredictable; much would depend on the terms agreed for separation, on whether such agreement could be reached amicably and on what the relationship would actually be with the European Union. The risks would be high and the potential for economic damage substantial, if these matters were not satisfactorily and smoothly resolved. But it seems unlikely that there would be sufficient political support to make such a major constitutional change a reality in the foreseeable future. It is therefore not considered in this paper. Both the Labour Party and the Liberal Democrats, however, are firmly pledged to implement some form of parliamentary devolution to Scotland within the United Kingdom. In view of the Government's present standing in the opinion polls and the pledge by the Labour party to legislate within one year of taking office, there must therefore be a high expectation that it will be implemented after the next general election.

In contrast to independence, devolution is unlikely to make a major difference to the environment in which business has to operate in Scotland. Indeed for most firms any uncertainty over Britain's relationship with Europe is likely to be much more damaging than the prospect of parliamentary devolution to Scotland.[30] Devolution should be seen as a move towards a federal constitution, but it is not properly federalism because the Westminster parliament would retain ultimate sovereignty. It would merely delegate certain legislative powers to a Scottish parliament and administration, which theoretically, however unlikely in practice, could be revoked.

Under the proposed system the Scottish Government would be given responsibility for the wide range of functions presently carried out by the Secretary of State for Scotland. In the economic sphere these include the development agencies (Scottish Enterprise and Highlands and Islands Enterprise) and the administration of regional assistance to industry and services. But these powers would have to be exercised within the framework of British and EU regional policy, in particular adhering to the maximum levels of assistance permitted under EU competition rules and provided under British policy for other comparable Assisted Areas in the United Kingdom. Responsibility for macroeconomic management, including exchange rate policy, monetary policy and fiscal policy would remain with Westminster, just as in Germany it rests in Bonn. On present plans the Scottish Government's taxation powers would be extremely limited, significantly less than in many federal states. While the proposed powers to vary policy and to decide priorities in public expenditure would be significant, they would therefore remain less important as a means of influencing the Scottish economy than those retained at Westminster.

There are nevertheless several ways in which devolution could have both a positive and a negative effect on Scotland's economic prospects. On the positive side, by making a Scottish Government responsible for many of the decisions which affect Scotland, it can be argued that policy would have more regard to local conditions and circumstances and would in consequence be more effective. In addition it is claimed that responsibility would itself engender commitment and enthusiasm in Scotland, which could spill over to the economy, increasing confidence and providing dynamism. It is hard to know how to evaluate these arguments. They should not be under-rated, but their force depends greatly on the scheme of constitutional change being judged to be a success.

[30]Hood, N. (1995). *Inward Investment and Scottish Devolution: Towards a Balanced View,* Fraser of Allander Institute Quarterly Economic Commentary, vol. 20, no. 4.

The potentially adverse consequences are more tangible, since they concern the level of public expenditure; but they might do little more in the longer run than reinforce a trend that is already taking place. As one would expect in a unitary state, no attempt is made to balance public revenue and expenditure by region: some regions contribute less per head in revenue than others, depending mainly on their level of income, and some receive higher levels of public expenditure, the intention being that it should be distributed mainly in accordance with need. Satisfactory figures on these interregional revenue and expenditure transfers are hard to obtain, but recent research has shown that the region that benefits most is, as might be expected, Northern Ireland, but Scotland, Wales, the Northern Region of England and the South West are also beneficiaries, while the South East, East Anglia and the East Midlands are the main net contributors.[31] In Scotland's case public revenue per head (excluding tax revenues arising form off-shore oil and gas from the Continental Shelf, which are classified separately) is approximately equal to the average for the United Kingdom, but the distribution of locally identifiable public expenditure (about 75 per cent of total General Government Expenditure) is strongly favourable to the extent that Scotland receives about 10.3 per cent of United Kingdom spending, although its share of population is only 8.8 per cent. The result is that identifiable public expenditure in Scotland in 1993-94 was 17 per cent above the average for the United Kingdom and 21 per cent higher than in England.[32] Comparable figures for identifiable public expenditure in the other constituent countries of the United Kingdom are 34 per cent above the average in Northern Ireland, 9 per cent in Wales and 3 per cent below in England.

As compared with a strict population share the difference in favour of Scotland is about £3.1 billion a year or £603 per head. Such public spending is the product of a series of historical decisions, originally argued on the basis of need but also reflecting the political weight that successive Secretaries of State for Scotland have been able to exert with the Treasury and in Cabinet. However work undertaken by an interdepartmental group of officials at the time of the last Labour Government's devolution proposals in 1979, although concluding that a higher level of spending in Scotland than in England could indeed be justified on the basis of need, also found that the full extent of the difference then existing was excessive. The group estimated that relative need supported a difference of 16 per cent in favour of Scotland.[33]

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[31]Blake, N. (1995). *The Regional Implications of Macroeconomic Policy,* Oxford Review of Economivc Policy, vol. 11, no. 2.
[32]Scottish Office (1995). *Government Expenditure and Revenue in Scotland 1993-1994,* Glasgow: Economics and Statistics Division and supplemented by information from the Scottish Office.
[33]H.M. Treasury (1979). *Needs Assessment Study - Report,* Report of an Interdepartmental Study, London.

Since that time, the Scottish share of annual increases and decreases in public expenditure has been determined by a formula, originally based on the 1979 population ratio.[34] This was intended to narrow the gap gradually, to bring expenditure closer to the level that could be justified by relative needs assessment. The gap has been reduced, but only from 28 per cent above the English expenditure per head in 1977-78 to 21 per cent in the latest study. In the meantime there has been no further needs assessment, but it is likely that Scotland's public expenditure still exceeds what could be justified in this way. A revision to the formula was made in 1992 to take account of the changed population ratio since 1979; this can be expected to narrow the gap more rapidly, and it appears that it is the Government's clear intention to do so.

Devolution would make this issue central to the annual public expenditure and revenue negotiations between the Scottish and United Kingdom Governments, instead of, as now, being an internal negotiation between two Ministers in the same Government. It will therefore be exposed to public scrutiny in both England and Scotland in a way that it is not at present. So long as the United Kingdom remains a single state, there is no case for restricting Scottish spending to the funds that can be raised from revenue in Scotland or for basing it on a strict population ratio, as some anti-devolution politicians argue. States that have central and subsidiary parliaments normally always provide for transfers between their component parts. But the expectation must be that, after a Scottish parliament comes into being, any advantage that Scotland may have in higher public expenditure per head would have to be more closely justified on comparative need. The clear indications are that this would mean a reduction in the present level of provision with unavoidably poorer standards of service, unless there were a significant increase in the provision in England. Whether this would happen more rapidly than if the present arrangement continues is open to question. But since it would be a major public issue between two governments, not necessarily of the same party, it seems reasonable to conclude that the pressure to narrow the gap would be intensified. On the other hand, an assessment of comparative need is not a precise calculation that can be carried out entirely objectively. There would be room for much argument and negotiation, and any Westminster Government that was concerned to preserve the integrity of the United Kingdom would also have to have regard to the political implications of whatever settlement was reached.

[34]known as the 'Barnett Formula' after the Chief Secretary to the Treasury in the Labour Government of 1974-79.

If the result of this difficult situation was a more rapid reduction in Scotland's public expenditure advantage, this would, of course, affect the economy. The public sector is a large employer and many of those in the private sector also depend on public contracts. Reducing Scotland's present public expenditure advantage over England of 21 per cent to, say, 16 per cent, if a fresh needs assessment confirmed the results of the one in 1979, would involve a cut of some £890 million. Even spread over several years and assuming a gradually rising trend in expenditure for the rest of the United Kingdom, this would be a painful adjustment to make. A reduction in service provision, particularly in the major expenditure areas of health and education, would seem to be unavoidable with consequent loss of jobs.

V Conclusion

Scotland has made a difficult transition over the last 40 years from an economy that was dependent for much of its income and employment on heavy capital goods industries and on textiles to one in which modern high technology industry plays a substantial part. Services have developed and expanded to replace most of the employment lost in manufacturing. Labour productivity in manufacturing rose more rapidly in the decade 1980-1990 than in other European countries and is above the UK average. But problems remain: even with an outstanding record in attracting industry from abroad, the level of investment has been insufficient to bring about economic expansion on a scale sufficient to employ Scotland's labour resources; and the continuing high unemployment levels and net emigration are the consequence.

For the future, Scotland's prospects are in some respects much more promising than in earlier decades. The traditional industries have largely gone and can no longer drag down the economy's overall performance. Those that have taken their place have brighter prospects. North Sea oil and gas will remain an important element in the economy well into the next century. Expanding demand for electronics, health care products, pharmaceuticals and important parts of the service sector can be expected to continue. But a means must be found of raising the level of investment in the economy from domestic sources to match the success of inward investment, and of achieving more growth from new and small firms. Furthermore, as a major export location, Scotland's economy depends on its access to markets. Since Britain joined the European Community in 1973, the European market's importance has become dominant. Scotland's prosperity in the years ahead will therefore be greatly influenced by Britain's relationship with the rest of the European Union and by a satisfactory resolution of Scotland’s constitutional position within the United Kingdom.

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