

**ECONOMIC DEVELOPMENT COMMITTEE**

DATE: 18 October 2000

VENUE: Committee Room 1, National Assembly Building

TITLE: National Economic Development Strategy – Economic Analysis

**1 Introduction**

1. At the last Economic Development Committee meeting on 13 September a framework and timetable for the National Economic Development Strategy (NEDS) were presented. This paper will form the basis of the first major chapter as outlined in the framework for NEDS. It provides an analysis of the current state of the Welsh Economy.

**2 Discussion**

2. The Economic Analysis paper has received comment from the informal consultative group (Annex A), which met on 28 September. Comments have also been received on both the framework and the economic analysis chapter from a range of other individuals and organisations – over 50 have been contacted in all. The policy implications of our current economic position as set out in this paper will follow in other chapters of NEDS.

**3 Conclusion**

3. The Committee is invited to offer comments on the paper so that it can be established as the underlying analysis for the NEDS document. It is proposed to table an approved consultative draft of NEDS for discussion in the committee on 29 November 2000.
4. This paper has also been sent to other subject committees for information.

# National Economic Development Strategy

## Analysis of Welsh Economic Problems

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### 1 Introduction

- 1.1 The economy of Wales is made up of a number of both highs and lows. The performance in attracting inward investment has been excellent and the eastern half of Wales has economic output not dissimilar to the UK. Welsh manufacturing productivity is undoubtedly good and the workforce is flexible. Wales has a number of fledgling industries with great potential for the future, there are areas with good transport and other linkages, and natural features which make Wales an attractive place to be and do business.
- 1.2 Despite this, the performance of the Welsh economy has been poor relative to other UK regions on most objective indicators. We have fewer people employed and our skewed economic and occupational structure means that average productivity is lower than in other regions. Wales is still overly dependent on declining or low value-adding industries and there is a lack of head offices, R&D laboratories and local decision-makers. Certain skills are in short supply and a relatively high proportion of people are effectively excluded from the workforce. Economic disadvantage tends to be heavily concentrated in particular communities within Wales.
- 1.3 The Assembly's strategy to improve the performance of the Welsh economy stems from the existence of a set of problems that are both long-standing and difficult to remedy. This section provides a résumé of key difficulties and opportunities based on the latest available statistical information.

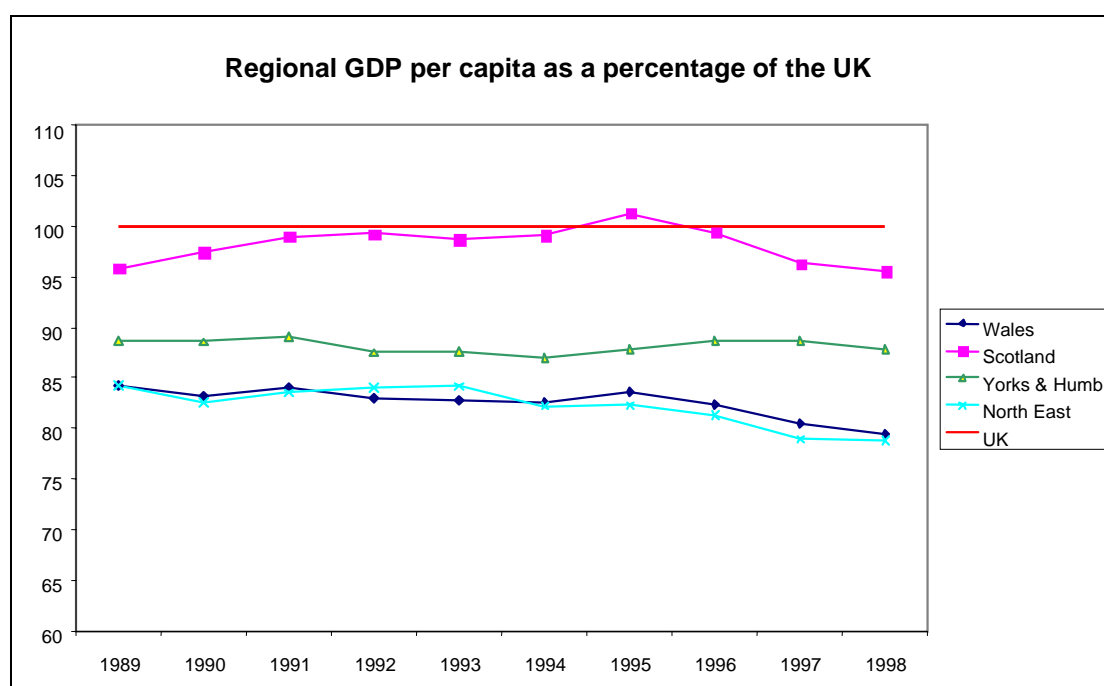
### 2 Welsh economic performance

- 2.1 GDP/head is the standard summary measure of economic performance. GDP/head in Wales, expressed as percentage of the figure for the UK as whole, has been in the low- to mid- 80s since at least the 1960s (diagram 1 shows the position over the last decade).
- 2.2 Whilst over the last five years the rate of growth of Welsh economic output per person has been below that for the UK as a whole, over the longer term the issue is more one of a long-established gap than of a differential rate of growth<sup>1</sup>.

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<sup>1</sup> Latest figures show a dip to 79.4% in 1998. These figures are part of a new series incorporating methodological changes and may be subject to revision.

**Diagram 1**



**Source**

Regional Trends and National Assembly calculations

2.3 Wales' performance can - perhaps more usefully - be compared to those regions that have inherited a similar industrial structure. On the basis of contribution of industrial sectors to GDP in the mid to late 70s, the regions "North East" (at that time part of the "North" region for statistical purposes) and "Yorkshire and Humberside" are the obvious comparators. Figures for these regions (along with results for Scotland) are also shown in diagram 1.

2.4 Whilst some comparator regions have also performed poorly, the record of Wales relative to the UK is clearly unsatisfactory. This poor performance has multiple manifestations, as illustrated by the data shown in tables 1 and 2.

**Table 1: The economy of Wales – a profile**

	Period	West Wales & Valleys	East Wales	Wales	UK
GDP per head# (1)	1996	73	100	84	100
GDP per workforce job# (2)	1996	89	101	94	100
Household disposable income per head (3)	1995	N/A	N/A	91	100
Economic inactivity (working age) (4)	1999/2000	28%	20%	25%	21%
Employment rate (5) (working age)	1999/2000	66%	75%	69%	74%
Claimant unemployment rate (6)	Aug 2000	5.4%	3.6%	4.6%	3.7%

Average hourly earnings** (7)	1999	86	90	88	100
Business density^ (8)	1999	230	277	247	318
Change in workforce jobs (FTEs) ~ (9)	1981 – 1995	-6%	+12%	+3%	N/A
Working age population with no qualifications (10)	Spring 2000	22%	16%	20%	16%

#### Sources

(1), (2) and (3) ONS Regional accounts and National Assembly calculations. (4) Labour Force Survey (LFS) (5) Department of Employment (6) Benefits Agency administrative system (7) New Earnings Survey (8) DTI and National Assembly calculations (9) Annual Employment Survey, Agricultural Census and National Assembly calculations (10) LFS.

#### Notes

# Most recent available figures for the sub-Wales areas. See also note 1 on page 1.

\*Results on the basis of the new NUTS boundaries are not yet available. West Wales is estimated to lie in the range 90-93. Figure given for "Valleys" is actually that for Mid-Glamorgan.

\*\*Average hourly earnings for all full-time employees. GB = 100.

^Businesses registered for VAT per 10,000 adult population, excluding agriculture.

~Results on the basis of the NUTS boundaries are not available. Figures given are for "best-match" old counties.

"West Wales" comprises the unitary authorities of Anglesey, Gwynedd, Conwy, Denbighshire, Ceredigion, Pembrokeshire and Carmarthenshire. "The Valleys" comprises the authorities of Swansea, Neath Port Talbot, Bridgend, Rhondda Cynon Taff, Merthyr, Caerphilly, Blaenau Gwent and Torfaen. Together, "West Wales and the Valleys" makes up the Objective 1 area. "East Wales" comprises all the remaining unitary authorities in Wales.

**Table 2: Contribution of sectors to GDP 1997**

	Wales	UK
	%	%
Agriculture etc	1.8	1.5
Mining and quarrying	0.6	0.6
Manufacturing	27.3	20.5
Electricity, gas & water supply	2.2	2.2
Construction	5.3	5.1
Wholesale and retail	10.2	11.8
Hotels and restaurants	3.4	3.1
Transport, storage and communication	6.0	8.0
Financial intermediation	3.5	6.1
Real estate, renting & business activities	14.2	19.4
Public administration and defence	6.2	5.3
Education	6.0	5.4
Health and social work	8.6	6.4
Other services	4.7	4.8
Total	100.0	100.0

#### Source

ONS Regional Accounts

#### Notes

Contributions are shown including certain subsidies. Agriculture is the sector most affected. It is estimated that removing the value of direct subsidies would reduce the contribution of agriculture by about 1% at both Welsh and UK levels. Removing the value of indirect support would further reduce the contribution by between 0.5 and 1.0% to effectively zero.

Excludes adjustment for Financial Services Indirectly Measured.

- 2.5 The main features highlighted by tables 1 and 2 include:
- 2.6 **Low activity rates. In recent times between one-third and one-half of the overall discrepancy in GDP per head has been a consequence of lower activity rates in Wales.** Much the largest part of this discrepancy is accounted for by differences in activity of the working age population, with differences in the proportion of pensioners making only a small contribution.
- 2.7 **Inactivity amongst the working age population concentrated in particular groups. Compared with the UK as a whole, Wales has high rates of inactivity for both men and women.** However, over a long period, activity rates have been rising for women. The Labour Force Survey (LFS) shows that high Welsh inactivity is largely attributable to high reported levels of long-term sickness, typically amongst the middle aged (45 plus) with few qualifications and from manual backgrounds. This problem is concentrated geographically, particularly in the ex-mining communities in the Valleys.
- 2.8 **Low pay and low productivity jobs<sup>2</sup>. Wales' poor relative performance in terms of output per job (except in manufacturing and certain other key sectors) results more from industrial structure and occupational mix (which tend to be related), than from lower productivity in equivalent jobs.** These same factors are reflected in relatively low wage levels. Average earnings in Wales are currently over 10% adrift of the UK average – and 4% short of the average for the UK excluding the South-East. (An example of the adverse industrial and job mix is provided by the low representation in financial and business services.)
- 2.9 **Variation within Wales. The variation in economic performance within Wales is significant. Two-thirds of the population of Wales lies within the Objective One region, “West Wales and the Valleys”, with an average GDP per capita just 73% of the UK average (Table 2).** In the Valleys area, activity rates, output per head, and average wage levels are all low compared both to Wales and the UK as a whole. In more rural parts of West Wales, activity and employment levels are generally higher than in Wales as whole (except in some of the coastal resort towns), but output per head and average wages remain low. This indicates that any job losses in agriculture may have been at least offset by gains in other sectors. Even within the more prosperous parts of Wales such as Cardiff and Newport, there are substantial concentrations of, low incomes, low economic activity and social exclusion.
- 2.10 **Low business density. Compared with the UK, Wales has low business density and low rates of business formation.** There is also some evidence of low levels of innovation. It is not clear whether these factors are simply a consequence of the economic and occupational structure or whether “enterprise culture” factors are affecting the Welsh economy even after allowing for structure.

### 3 Determinants of economic performance

- 3.1 It is important but difficult to distinguish the causes of poor economic performance from the symptoms. For instance, whilst the industrial structure is a proximate cause of low productivity, it is in turn shaped by factors such as the pattern of natural resources, the location of markets, and the skills of the

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<sup>2</sup> The problem is more one of low-pay employment rather than low value-added; value added may simply be a reflection of capital intensity.

workforce. However, analysis is complicated by feedback effects (so that, for example, low business density may itself contribute to a climate unfavourable to business formation) and the importance of inheritance (so that industrial structure can reflect accidents of history as well as more fundamental factors).

- 3.2 In addition to a stable macroeconomic environment, which is a prerequisite, there is a consensus that the ultimate determinants of economic performance include:
- 3.3 *Human capital.* Education and training, together with motivation, culture and natural abilities, shape the productive capacity of the population. For various reasons, the market system is not always well-suited to the role of supplying education and training. Many economists therefore regard human capital as the most important single variable affecting economic performance that is amenable to government intervention.
- 3.4 *Competition & Market Failure.* The general view is that the degree of competition and the openness of an economy to the rest of the world are critical factors in economic success<sup>3</sup>. Despite the fact that competition and the operation of free markets are good for economic development, the free market can fail to operate properly for a range of well-known reasons, and well-targeted remedial action by governments can improve outcomes. The persistence of regional disparities is itself a demonstration of the failure of markets. In competitive markets price adjustments and factor mobility would ensure regional convergence.
- 3.5 *Natural resources and geography.* Features such as the attractiveness of an area as a place to live and work and proximity to markets play an important role, and are probably now much more significant than factors such as mineral reserves and the fertility of the land. The perceived peripheral location of much, if not all, of Wales is likely to be an important factor in a firm's location decision, although improving transport links together with electronic communications are reducing actual peripherality (both Ireland and Scotland appear to have overcome their peripheral locations).
- 3.6 *Financial capital.* Investment is needed for economic growth to take place. In developed economies, the availability of capital is not usually a constraint on development, although it is sometimes argued that market failures affect particular sectors.
- 3.7 *Social capital.* The social context is a crucial influence on a region's capacity for economic development. The existence of a reliable legal framework is important as are attitudes, for example to labour market participation, innovation and enterprise. These attitudes can be affected by inherited economic and cultural factors leading to either a virtuous or vicious circle of growth or decline. The systems for the creation and transmission of knowledge, in which the public sector inevitably plays a major role, are vital. These intangible inputs of culture, knowledge, trust and enterprise are where the public sector can begin to have an impact on growth.

#### **4 Rationale for government action**

- 4.1 Government has an important role to play in ensuring that the preconditions for economic growth are in place. These include a reliable legal system, a stable macro-economic environment, the promotion of competition and

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<sup>3</sup> There may therefore be a danger in trying to create or preserve "national champions".

competitiveness, and the development of an effective and inclusive education system. In most of these areas, prime responsibility rests with either the UK or European government, but in others, particularly education and training, the National Assembly plays the key role.

- 4.2 Beyond this, the scope for governments to make specific interventions to improve economic performance is real, but limited. The opportunity arises mainly from situations where markets are missing or are not competitive for a variety of reasons including lack of information, uncertainty, wider social effects and lack of mobility
- 4.3 Governments can also act to correct perceived unfairness in the distribution of incomes or wealth and to help the economy adjust to structural changes. Both of these situations can occur even when markets are operating efficiently.
- 4.4 There is also a rationale for intervening to correct regional imbalances in economic activity. Evidence suggest that regional imbalances may negatively affect national economic growth and impose significant social costs thus justifying regional intervention to improve growth and competitiveness.
- 4.5 The National Assembly has an important role in initiating actions to promote economic development which:
  - respond to identified market failings;
  - are cost-effective;
  - are evidence-based;
  - aim to be self limiting and sustainable – i.e. put in place structures that are not dependent on further government action down the line;
  - are rigorously evaluated, with lessons learned, used to modify future programmes and develop the evidence base.
- 4.6 It may be unwise to seek to attempt simply to replicate features of more successful economies, unless there was evidence that (a) those features play a causal role in success, (b) market failures inhibit the generation of those features in Wales, and (c) government intervention can make things better. It does *not* follow that simply because successful economies have - for example - clusters of a certain kind, industrial structures that exhibit particular features, a high rate of small business formation, or a high usage of certain items of high-technology equipment, that policy should necessarily attempt to promote these characteristics.
- 4.7 Technological changes, and other factors that produce changes in the economic structure, do not alter these basis principles, but can affect the appropriate balance between policies of different kinds.
- 4.8 Developments in IT provide the most obvious current example of technological step change. Such developments have direct implications for skills development and might be expected to shift the balance of policy on access towards the provision of electronic data transmission infrastructure (perhaps at the expense of conventional transport infrastructure).
- 4.9 These developments could, in the future, render policies focused on supporting employment through subsidising property or capital equipment

less relevant. In so far as “new economy” companies are more geographically mobile, then the case for enhancing the attractiveness of particular locations (perhaps involving environmental improvements and other regeneration activities) could acquire additional weight. In addition, policies to encourage the development and application of knowledge will become key to economic development in the knowledge-based economy of the future.

## **5 Policy Response**

- 5.1 This analysis points to a number of policy areas where the Assembly and its partners can intervene and make a positive impact. The nature of the types of intervention available to governments in a market economy means that the policy emphasis is (inevitably) on the supply-side. This means ensuring that we have the people, infrastructure and knowledge to ensure we have competitive firms who can exploit markets both nationally and internationally.
- 5.2 It may no longer be sufficient to wait for markets to begin to work. There is an urgent need for forward thinking and analysis that can identify the broad markets and technologies from which future value can be derived. This is much less about picking winners than about predicting social and market conditions of the future and then ensuring that Wales has the infrastructure (including social and human capital) to be able to make the most of these opportunities.
- 5.3 Skills, training and education – the Assembly can act to fill gaps in provision, influence content and conduct research. This can be targeted not only on the employed to increase productivity (and wages) but also on the unemployed/inactive to reduce barriers to entering the labour market. Two key issues are reducing the proportion of the population with no formal skills/qualifications and ensuring that people acquire skills or are provided with training to enable them to adapt to changing requirements in the workplace. The education system should instil and nurture work-based skills to ensure that young people are suitably equipped to become good employees or entrepreneurs.
- 5.4 Knowledge economy/ICT – policy intervention may be necessary to assist start-up and growth firms in emerging markets with advice, finance, etc. where traditional support is lacking (often due to poor information about new products and markets). Infrastructure is another area which may require Assembly support, for example science parks, digital networks, incubator units. This could help in the creation of clusters of “new economy” industries.
- 5.5 Innovation/Entrepreneurship – Wales does not have a good record in these areas and assistance could be aimed at encouraging innovation (by providing training, advice, reducing costs of entry/exit), existing firms to grow (identifying markets, reducing recruitment & training costs) and encouraging inward investors. We need to back talent and those people with ideas by providing the support structure. Ideally this support would be focused on those businesses with growth potential in high value-added industries.
- 5.6 The severe shortage of commercial and industrial property at competitive rents in parts of Wales can inhibit economic development, for example by restricting the speed of response to inward investment opportunities.



- 5.7 There are also a number of more general areas where policy could be targeted to encourage economic activity. Policies to improve the environment (to make Wales a desirable place to live), to offer incentives to locate business in Wales, and to ensure that the spatial planning framework is business-friendly could all play a part.

## **6 Summary**

- 6.1 The role of government in promoting economic development lies mainly in creating and sustaining the preconditions for such development, and taking specific action to correct identifiable market failures. Responsibility in many of these areas lies with the National Assembly and its agencies.
- 6.2 We need to ensure that Wales has the proper conditions to gain its share of new, high growth industries and services. This will involve a whole range of social and physical infrastructure, education and business support.
- 6.3 The main implications of the analysis in this chapter are summarised in the form of a SWOT table (see Table 3).
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**Table 3: SWOT Summary**

**STRENGTHS**

- record of growth in east Wales
- growth poles in Cardiff and some other centres
- high quality natural environment, particularly landscape
- good accessibility and linkages to/from parts of Wales
- English language makes Wales an attractive EU business location
- Record of high productivity in manufacturing
- Flexible labour force
- Distinctive culture
- Range of FE and HE institutions
- in rural areas, loss of jobs in agriculture has been more than offset by gains in other sectors

**OPPORTUNITIES**

- improve and extend education and training
- increase active labour market policies to help reduce inactivity and social exclusion
- support innovation by building better links between academic institutions and business
- improve transport links between home and employment opportunities
- build on growth poles
- create “gateway” towns in rural areas
- use inward investors to achieve skills transfer and development of local supply chains
- increase support for business creation
- enhance environmental quality and remove blight to strengthen appeal of region
- selectively improve infrastructure to combat peripherality
- exploit “Welshness” as a marketing tool

**WEAKNESSES**

- low levels of basic skills and returns to those skills
- low levels of qualification attainment, both pre and post 16
- skills gaps affecting one-fifth of employers
- limited tradition of entrepreneurship, reflected in low business density, business start-ups, and self employment
- poor record on innovation
- variable performance across Wales, with 2/3 of the population in the Objective 1 region
- high levels of inactivity have led to de-skilling and discouragement
- inactivity has also contributed to a destructive cycle of low expectations, disaffection, and social problems
- locally concentrated areas of deprivation, even in generally affluent areas
- peripherality of parts of the region
- labour immobility
- incomplete transport links between places of residence and employment opportunities
- lack of suitable employment sites in parts of the region
- long-run decline of agriculture

**THREATS**

- increasing skills bottlenecks impact on business growth/survival
- inactivity, low expectations and poor skills become the norm
- restrictions on growth poles reduce overall prosperity
- pressures towards agglomeration further undermine more peripheral areas
- the “weightless” economy makes it harder to provide incentives for firms to relocate
- attempts to protect sectors in decline inhibits adjustment
- increasing competition from other countries erodes the attractions of a low cost base
- development is associated with environmental degradation

## **ANNEX A**

### **Attendance Members at First Informal Consultative Meeting**

Colin Jones	Welsh Local Government Association
Adrian Morris	Confederation of British Industry
Russell Lawson	Federation of Small Businesses
Kate Bennett	Equal Opportunities Division
Felicity Williams	Trades Union Congress
Steve Hill	Welsh Development Agency
Phil Jarrold	Wales Council for Voluntary Action
Prof Dylan Jones-Evans	University of Wales, Bangor
Rachel Jones	NAfW Special Advisor