Regional Economic Performance

Progress to date

December 2006

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Communities and Local Government

Regional Economic Performance

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CONTENTS

1 INTRODUCTION

1.1 The Government's central economic objective is to raise the rate of sustainable growth and achieve rising prosperity and a better quality of life, with economic and employment opportunities for all. An essential element of that objective is to improve the economic performance of every part of the UK. Unfulfilled economic potential in every nation, region, city and locality must be released to increase the long-term growth rate of the UK.

1.2 The Government's commitment to the regional dimension of its economic policy is set out in a Public Service Agreement (PSA) target to "*make sustainable improvements in the economic performance of all English regions by 2008, and over the long term reduce the persistent gap in growth rates between the regions, demonstrating progress by 2006.*"[1] The Devolved Administrations in Scotland, Wales and Northern Ireland work in partnership with the UK Government to promote economic development in their territories.

Regional Policy Framework

1.3 The Government's approach to enhancing regional economic performance involves:

- maintaining macroeconomic stability to help businesses and individuals plan for the future;
- implementing microeconomic reforms to tackle market failures in the underlying drivers of growth – skills, investment, enterprise, competition, innovation and employment; and
- devolving decision making to the local and regional levels to ensure that policy design and delivery is responsive to the particular opportunities and challenges of each area.

Regional Development Agencies

1.4 Since 1997, the Government has taken significant steps to enhance the regional economic policy framework, including devolving decision making to the regional and local levels. To drive growth in the English regions, the Government set up nine Regional Development Agencies (RDAs) in 1999. The RDAs are responsible for setting out the shared growth priorities for each region and local area in Regional Economic Strategies. The Government has increased resources, responsibilities and flexibilities for the RDAs to enable them to respond to the opportunities and challenges in their regions. The RDAs' single programme budget will increase to £2.3 billion by 2007-08.

Northern Way

1.5 In the North of England, the Government has supported the three northern RDAs and other local and regional partners in establishing the Northern Way Growth Strategy. The Northern Way has an ambitious vision to establish the North of England as an area of exceptional opportunity, combining a world-class economy with a superb quality of life. The Growth Strategy sets out how the North will build upon its current assets – and build new assets – to close the £30 billion output gap between the North of England and the rest of the UK.[2]

Local Authorities

1.6 Alongside action at the regional level, the Government has introduced reforms to enhance Local Authorities' contribution to economic development and regeneration.

[1] HM Treasury, Spending Review 2002, July 2002 set out this target for HM Treasury, DTI & DCLG.

These include new powers for local authorities to improve the economic well-being of their area and new trading and prudential borrowing powers. The Government has also introduced incentives for local government to encourage innovation and growth, through the Local Authority Business Growth Incentives scheme, the Local Enterprise Growth Initiative, (supported by the creation of the fourth economic block of Local Area Agreements), Business Improvement Districts and through Urban Regeneration Companies, local strategic partnerships and enterprise areas.

Local Government White Paper

1.7 The Government set out further steps to develop the Local Authority role in the Local Government White Paper.[3] This proposes measures to strengthen Local Authority leadership and to streamline performance management, with an enhanced place-shaping role for Local Authorities through Local Area Agreements and Sustainable Community Strategies. The Government will also take forward discussions with cities and towns on how to develop their role in economic development. Specific measures within the White Paper include reform of Passenger Transport Authorities and Executives to enable a more coherent approach to be taken to transport in major cities; development of Multi-Area Agreements to facilitate cross-boundary collaboration; and consultation on guidance to promote city development companies.

Greater London Authority

1.8 The creation of the Greater London Authority (GLA) in 2000 demonstrated the Government's commitment to devolution in London, improving strategic planning for the capital and making regional government more accountable to Londoners. In July 2006, the Government announced the devolution of further powers to the GLA, covering new lead roles for the Mayor on housing and adult skills in London; a strengthened role over planning in the capital; and additional strategic powers in a wide range of policy areas including waste, culture and sport, health, climate change and appointments to the boards of the functional bodies. The ability of the London Assembly to scrutinise the activities of the Mayor was also enhanced.

The economic importance of cities

1.9 The Government has also recognised the importance of city-regions to regional economic performance. *Devolving decision making: 3 – Meeting the regional economic challenge: The importance of cities to regional growth* set out the Government's assessment of the role that cities and their wider economies play in driving forward regional and national growth.[4] This built upon analysis in the economic strategies of the RDAs and the Northern Way which recognised the importance of enhancing the economic performance of cities and city-regions to deliver on the Government's regional economic performance target.

Sub-National Review of Economic Development and Regeneration

1.10 The 2007 Comprehensive Spending Review is an important opportunity for developing the Government's regional economic performance and devolving decision-making agenda further. To increase economic prosperity and tackle deprivation in all regions and localities, the Government announced in Budget 2006 a Review of Sub-national Economic Development and Regeneration. The review is exploring opportunities for further releasing the economic potential of England's regions, cities and localities, and to respond more effectively to the ongoing challenge of tackling pockets of deprivation.

[3] *Strong and Prosperous Communities*, DCLG, October 2006

[4] *Devolving decision making: 3 – Meeting the regional economic challenge: The importance of cities to regional growth*, HM Treasury, DTI, ODPM, March 2006.

REGIONAL ECONOMIC PERFORMANCE PROGRESS REPORT

1.11 As an important contribution to the review, the Government has assessed progress to date on its regional economic performance PSA target. The 2004 Technical Note for the target set particular policy measures to address regional disparities in the key drivers of growth, and committed to demonstrating progress by 2006. This report fulfils that commitment.

1.12 In particular, this interim report sets out the Government's progress on:

- headline performance against the target including changes in disparities in the key drivers of growth; and
- the implementation of the measures outlined in the 2004 Spending Review Technical Note on the target.[5] This is set out in Annex A.

1.13 It is important to note that this interim assessment of progress is based on annual changes in Gross Value Added (GVA) data for each region. Given the potential impact of the economic cycle, the 12-18 month time-lags on publication of regional data and the long-term nature of this target and the policy measures, a full assessment of progress against the target will not be possible until the current economic cycle is complete. The Government recognises that only a limited assessment of progress against the target is possible with year on year data.

1.14 However, evidence of progress against the target to date in summary suggests:

- there is emerging evidence of progress on narrowing the gap in growth rates between the regions. GVA per head data for 2003 and 2004 show that the North, Midlands and South West regions narrowed the gap in growth rates with London, the South East and Eastern regions;
- progress is underpinned by stronger employment performance in the North, Midlands and South West regions than in London, the South East and East of England, and there is evidence of a narrowing in the skills gap; and
- further progress in the North, Midlands and South West regions is required on the other drivers of productivity to reduce the persistent gap in growth rates between the regions.

MEASUREMENT OF THE TARGET

1.15 Regional GVA per head statistics can be presented in three ways:

- in nominal terms (current prices);
- in real terms. For this to be calculated, a regional deflator series is needed. This is not currently available although ONS are committed to publishing a regional deflator series in line with delivering on the recommendations in the Allsopp report.[6] This will enable the Government to measure the target in real terms as required by the technical note; and
- in adjusted terms. With this measure, the national deflator is applied to regional GVA growth figures. This does not pick up difference in input and

[5] HM Treasury, *Technical Note for HM Treasury Public Service Agreement (PSA) 2005-08*, 2004

[6] Christopher Allsopp, *Review of Statistics for Policymaking*, 2004

output prices across the regions, but will be a closer approximation of real regional GVA than nominal GVA and is more meaningful than nominal GVA in looking at changes in GVA over time.

In this report, where GVA growth is referred to, this means adjusted GVA has been measured unless otherwise stated.

Make sustainable improvements in the economic performance of all regions by 2008

1.16 To measure performance against the target, growth rates in GVA per head for each region will be estimated for the period 2003-2008. The headline measure for the regional economic performance PSA target is the average annual rate of growth in GVA per head. This is measured on a residence basis.

1.17 As annual GVA per head is only available after a 12-month lag, performance against this part of the target for the full period will be reported in 2010. GVA performance over this period will be compared with average annual growth rates for the baseline period between 1990 and 2002.

1.18 The target for making sustainable improvements in economic performance will have been met successfully if for every region the annual average rate of growth in GVA per head measured over the period 2003-2008 is higher than the baseline.

1.19 An interim assessment will look at year on year changes in GVA per head. In 2006, GVA per head data is available for 2003 and provisional data is available for 2004. Actual 2004 and provisional 2005 data is scheduled for release by ONS in December 2006.

Reduce the persistent gap in growth rates between the regions

1.20 The gap in growth rates will be measured by comparing the average growth rate of regions that had above average GVA per head with the average growth rate of regions that had below average GVA per head in the base period. This measurement involves comparing a single average growth rate for London, South East and East (the top three regions) with a single average growth rate for North East, North West, Yorkshire and the Humber, West Midlands, East Midlands and South West (the bottom six regions), weighted by population.

1.21 Given the longer-term nature of this part of the target, the technical note specifies that the gap in average growth rates will be measured using the average annual GVA per head growth rates for each region estimated for the period 2003-2012.

1.22 As the baseline data shows, GVA per head growth in the baseline 1990-2002 period in the three leading regions (Greater South East)) was 2.4 per cent, and 1.9 per cent in the six lagging regions (North East, North West, Yorkshire & Humber, West Midlands, East Midlands, South West). The gap in growth rates was therefore 0.5 percentage points. This has been revised down from the provisional 0.75 percentage point gap in growth rates set out in the technical note of the PSA target due to revisions in ONS data after its publication.

1.23 Between 2003 and 2004, GVA per head growth rates in the six poorer performing regions (North, Midlands and South West) were 1 percentage point higher than in the three leading regions (Greater South East), showing a reversal of the gap in growth rates compared to the baseline period.

Improving the regional evidence base

1.24 Having set out how the target is measured and areas where data on regional economic performance remains limited, it is important to highlight the Government's plans to improve the quality of the regional evidence base. The recommendations of Sir Christopher Allsopp's Review are at the core of improving the quality of economic data at the regional level. [7]

1.25 The RDA network and the Office for National Statistics (ONS) have agreed to work in partnership to deliver a full regional statistical presence by March 2007. ONS have also committed to deliver regional deflator series to enable more accurate comparisons of regional growth rates. The Allsopp recommendations also mean that regional GVA will be calculated using output –based as opposed to income-based measures.

1.26 The Government also publishes and updates data on key regional economic indicators.[8] These indicators were set out in a consultation document*, Productivity in the UK 5: Benchmarking UK Productivity Performance*, in March 2004. This set out proposals on how a set of productivity indicators can be utilised at the regional level.[9] The Government responded to this consultation in October 2004 and has since reported outturn data on a Government website.[10]

1.27 The Government has also taken steps to improve the quality of regional spending data, in response to the McLean study of the Government's regional spending statistics. Building upon the recommendations of the McLean report, more and better quality regional spending data was published in Public Expenditure Statistical Analyses (PESA) 2004.[11] A further detailed breakdown of regional spend has been made available in the 2006 PESA publication.[12]

1.28 Improving the regional evidence base also requires action at the regional level. RDAs lead in the development of the regional evidence base through their Regional Economic Strategies. Six of the nine RDAs have recently reviewed their Regional Economic Strategies, resulting in a stronger focus on the evidence base, a clearer market failure approach to intervention, a better appreciation of the unique challenges and needs of the region and sharper policy prioritisation than previous iterations. In the North of England, the Northern Way has developed its analysis and evidence through its long-term growth strategy.

[7] Christopher Allsopp, *Review of Statistics for Economic Policymaking*, March 2004

[8] This can be found at http://62.73.191.157/regind/default.asp

[9] HM Treasury & DTI, *Productivity in the UK 5: Benchmarking UK productivity performance (A consultation on productivity indicators)*, 2004

[10] HM Treasury & DTI, *Benchmarking UK productivity performance: The Government's response to the consultation on productivity indicators*, 2004

[11] Nuffield College and Office of the Deputy Prime Minister, *Identifying the flow of Domestic and European expenditure into the English regions*, 2003

[12] Available at http://www.hm-treasury.gov.uk/economic_data_and_tools/finance_spending_statistics/pes_publications/pespub_pesa06.cfm

1.29 The Government recognises that it needs to enhance its understanding of what drives economic growth at the regional level and the links between these drivers. In particular, there is further to go in developing a better understanding between national and local partners of what polices could be best promoted in different places and at different spatial levels.

2 PROGRESS AGAINST THE TARGET

Summary

2.1 As set out in Chapter 1, the full achievement of the regional economic performance PSA target will only be measurable over a complete economic cycle. To date, there are only two years of Gross Value Added (GVA) data available. Progress so far in summary suggests:

- an early indication of a narrowing in the gap in growth rates as shown by GVA per head data for 2003-04;
- the narrowing of regional gaps is likely to be as a result of stronger employment performance in the North, Midlands and South West regions than in London, the South East and East of England. A narrowing in the gap in Level 2 qualifications may also have played a part;
- however, there remains a significant challenge to address productivity differentials between the top three regions and the bottom six; and
- it is too early to say whether this recent narrowing reflects a narrowing in underlying trend growth. [1]

2.2 On each part of the target:

- the growth rate of GVA per head increased in five regions between 2003 and 2004, shown in chart 2.1; and
- the bottom six regions grew on average by 1 percentage point more than the top three regions. [2]

GVA per head performance

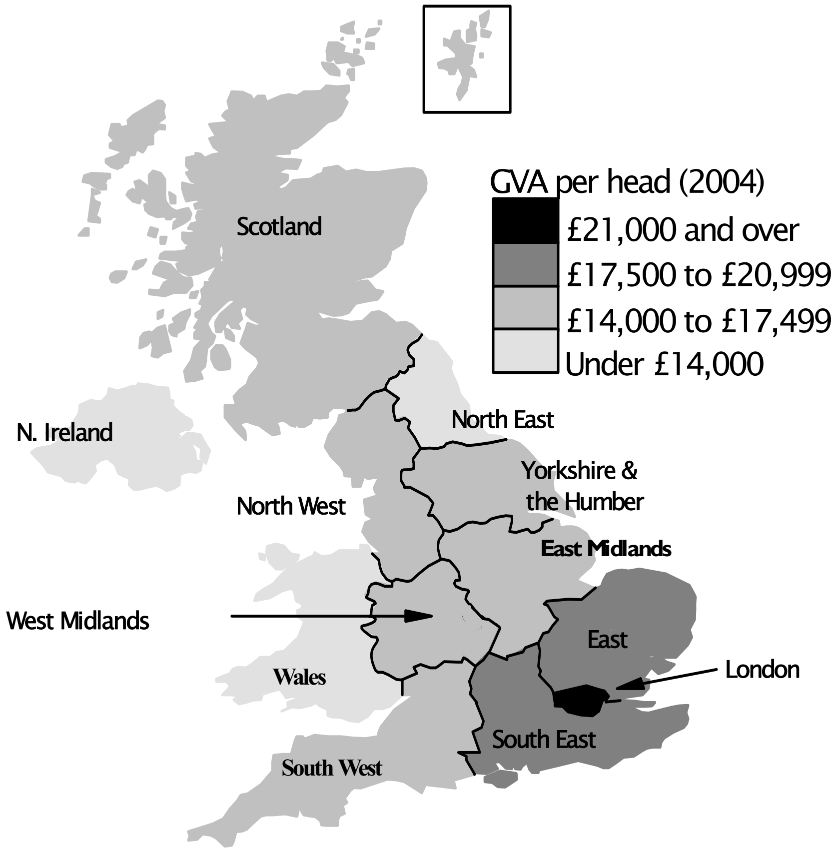
2.3 The current distribution of GVA per head by region is shown in Figure 2.1. Historically, GVA per head has been higher and has, over the long run, grown faster in the Greater South East, (London, South East and East regions), than in the economies of the other six English regions, (North East, North West, Yorkshire and Humber, West Midlands, East Midlands and the South West).

2.4 Chart 2.1 shows this for the 1990-2002 baseline period compared to 2003-2004. The disparity in GVA growth rates between the best and worst performing regions has persisted for over 80 years. Reducing this persistent disparity will be a significant challenge for the Government and for local and regional delivery partners. There is evidence that the top three regions, the Greater South East, are ahead of others in their economic cycle; this cyclical effect explains London's lower growth in 2003 and 2004, demonstrated in chart 2.1. Additionally, GVA growth rates in London display more year on year volatility than in the other regions. These factors mean that year on year changes in GVA data, and in the regional growth rate gap, should be treated with some caution.

[1] There is some evidence that 3 top performing regions are ahead of the others in their economic cycles, so the recent narrowing may be partly a cyclical effect

[2] Deflated using a national deflator in the absence of regional GVA deflators

Figure 2.1: Nominal regional GVA per head (2004)3

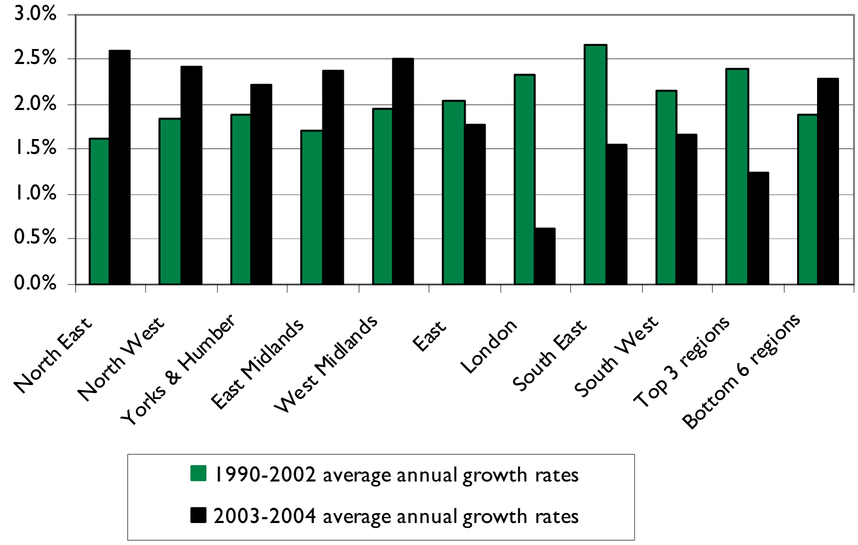


Source: ONS

2.5 During the 1990-2002 baseline period, GVA per head in the Greater South East grew at an average rate of 0.5 per cent per annum above the average of the North, Midlands and South West regions. Chart 2.2 shows that the difference in growth rates between the bottom six and top three regions has also changed over time. This difference was broadly negative in the baseline period, despite three years in which the gap was positive. Where this gap is positive, there is convergence between the Greater South East and the remaining six regions and where it is negative, there is divergence. GVA per head growth rates between 2003 and 2004 show that there was some convergence between the regions at the beginning of the current economic cycle. This is shown in chart 2.2.

[3] Provisional data

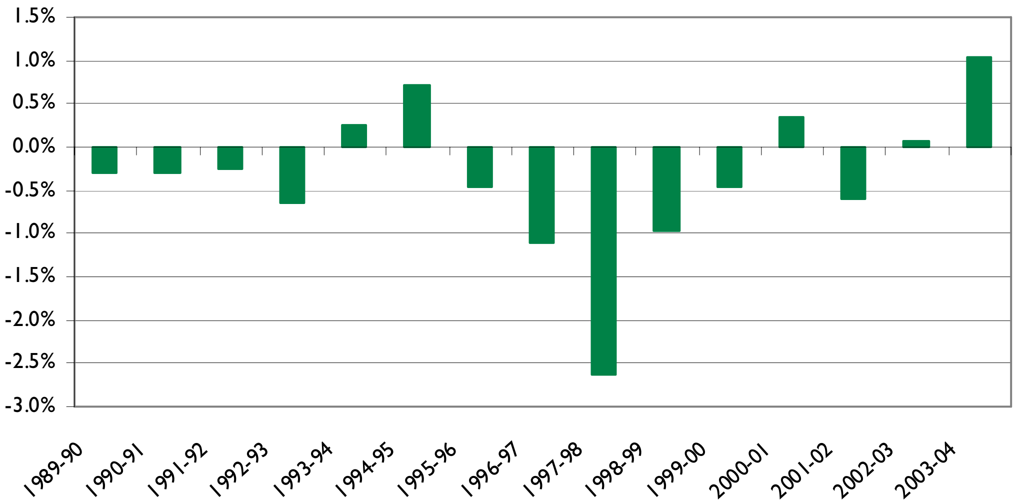
Chart 2.1: GVA per head growth rates



Source: ONS

2.6 The nominal regional GVA data shows that on average the Greater South East grew by 3.5 per cent in 2004, compared to an average of 4.6 per cent for the North, Midlands and South West regions.

Chart 2.2: Difference in GVA per head growth rates (NMW/GSE)



Source: ONS

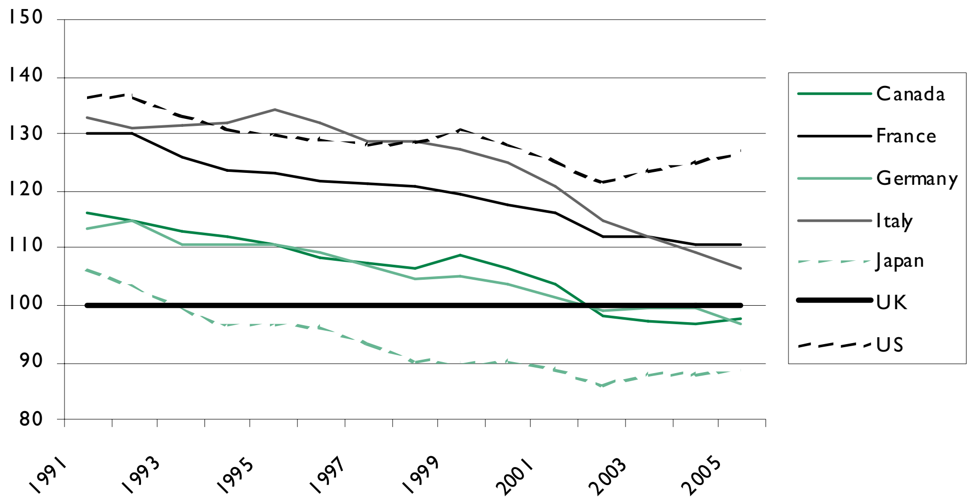
2.7 Since 2003, GVA per head growth rates have narrowed between the regions, although not all regions have outperformed their past trend, partly due to the recent slowdown in the Southern regions. The graphs above show that in 2003-2004, the Northern, Midlands and South West regions not only narrowed the growth rate gap with the Greater South East but actually grew faster. In that year, adjusted GVA per head grew at 2.3 per cent in the Northern, Midlands and South West regions compared to 1.2 per cent in the Greater South East.

PRODUCTIVITY IN THE REGIONS

2.8 Productivity growth underpins strong economic performance and sustains increases in living standards. Raising the productivity of every locality and region is therefore a key challenge for the Government and local and regional partners. There remains a challenge for the Government to improve further its understanding of what drives productivity improvements at the regional level.

2.9 There is some evidence of rising UK productivity performance. Output per hour productivity growth was 2.6 per cent in the first half of the current economic cycle (1997–2001) compared to 2 per cent in the previous two economic cycles. There is also evidence that since 1991 the UK has made progress in narrowing the productivity per worker and per hour worked gaps with other G7 countries, although the gap with the US remains large, as demonstrated in chart 2.3.[4]

Chart 2.3: International Productivity, output per worker, UK= 100

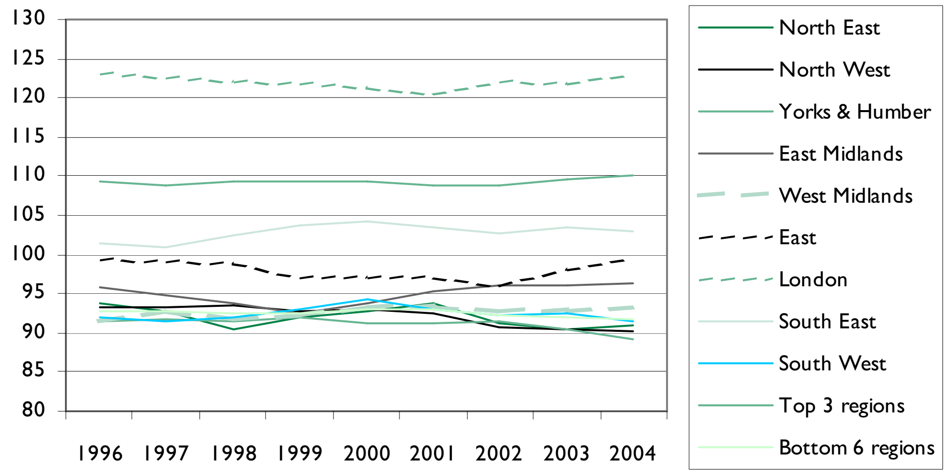


Source: ONS

2.10 However up to 2004, there appears to be little change in the gap between the Greater South East and the North, Midlands and West on productivity performance on the per job filled basis as shown below, with London significantly outperforming all the other regions.

[4] HMT-DTI, *Productivity in the UK 6: Progress and new evidence*, 2006

Chart 2.4: Output per filled job (England=100)



Source: ONS

2.11 While securing productivity improvements is a long-term goal, in the short-term structural changes in the labour market can temporarily impact on average productivity as new workers, like the long term inactive or newly qualified, take time to adjust to the labour market and to gain skills.[5] This could be the case in the North East where if the recent upturn in employment is as a result of reductions in long-term inactivity, this could well have constrained productivity growth.

Place based influences on productivity

2.12 A number of place based factors will be important to raising productivity. As outlined in the *Devolving decision making: 2* publication, these factors may impact on accessibility to support and on employment opportunities.[6] For instance, assets and economic histories of different areas will lead to different sector and skills mixes across the regions which will lead to diverse productivity performance.

2.13 The continuing regional disparities in productivity could be explained by relative weaknesses in the five drivers of productivity in the under-performing regions – skills, investment, enterprise, competition and innovation– which are examined in more detail below. Employment, a driver of growth, but not of productivity is also a factor which is likely to underlie the recent narrowing of the GVA per head growth rates between the Greater South East and the North Midlands and South West regions. Trends in employment are also explored in the following section.

Skills

2.14 The skills profile of all regions is clearly changing, with the proportion of the economically active with no qualifications falling steadily and skills levels rising at all levels. However the UK's human capital remains poor in relation to international comparator countries. For instance, the proportion of adults in the UK without a basic school leaving qualification is double that of Canada or Germany, and although the UK

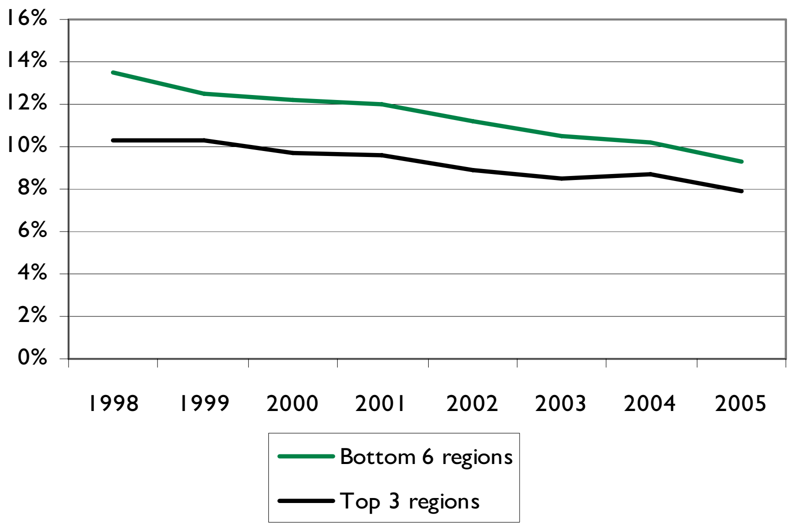
[5] HM Treasury, DTI, *Productivity 6 – Progress and new evidence*, 2006

[6] HM Treasury, DTI, ODPM, *Devolving decision-making: 2- Meeting the regional economic challenge: Increasing regional and local flexibility*, 2004

is just above the OECD average in the proportion of adults with degrees, the US, Canada and Japan are still in a superior position.[7]

2.15 However, there has been a reduction in the Greater South East/North Midlands and West gap in the proportion of economically active adults with no qualifications (see chart 2.5). In 1998, 13.5 per cent of economically active adults in North, Midlands and West regions had no qualifications compared to 10.3 per cent in the Greater South East regions. Between 1998 and 2005 this gap has reduced from 3.1 percentage points to 1.4 percentage points. For the years in which the target is measured, between 2003 and 2005, this proportion fell from 2 percentage points to 1.4 percentage points.

Chart 2.5: Proportion of economically active adults with no qualifications



Source Labour Force Survey

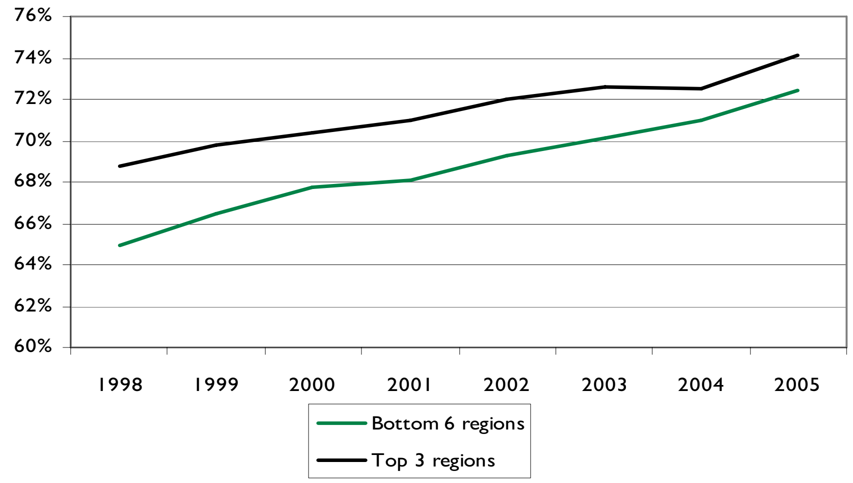
2.16 Similarly, gradual improvements in the Greater South East and the North, Midlands and West regions, which had higher proportions of economically active with Level 2 qualifications, were augmented by substantial improvements in the other regions where performance on Level 2 qualifications had been less strong.[8] This is illustrated in chart 2.6.

2.17 In terms of the proportion of the economically active adults qualified to at least Level 2, the difference between the Greater South East and the North, Midland and West regions has reduced to 1.7 percentage points in 2005 compared to 3.8 percentage points in 1998. Between 2003 and 2005 this figure fell from 2.5 percentage points to 1.7 percentage points. Skills data is available until 2005, whereas overall GVA per head data is only available until 2004. Whilst more recent data for 2005 is available, there may still be a time lag on when workers with new qualifications will become more productive.

[7] Leitch Review of Skills, *Skills in the UK: The long-term challenge Interim Report*, 2005

[8] Level 2 qualifications defined as 5 or more GSCE A*-C grades, NVQ level 2 or equivalent

Chart 2.6: Proportion of economically active adults qualified to at least Level 2



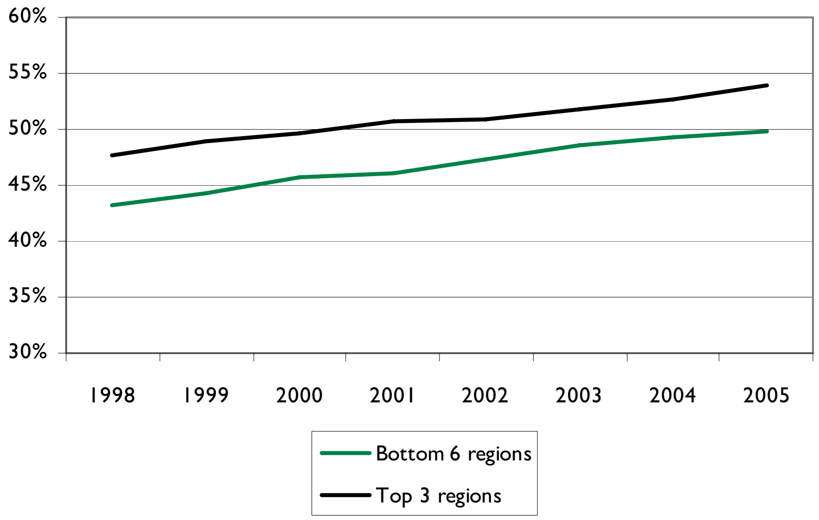
Source: Labour Force Survey

2.18 The regional gap on the proportion of economically active adults qualified to at least Level 3 has narrowed slightly from a gap of 4.5 percentage points in 1998 to around 4.3 percentage points in 2005 (see chart 2.7).[9] The gap on economically active adults qualified to at least Level 4 has widened slightly between the Greater South East and other regions from 6.4 percentage points in 1998 to 7.0 percentage points in 2005. Improved schools performance, particularly pupil attainment at level 2, is likely lead to progression to higher skills levels in the future.

2.19 Migration also provides an additional source of skilled labour. Migrants have been an essential source of new skills. Skilled internal migrants are especially important, because they operate within a national labour market and can quickly respond to any changes to skills demand in specific areas.

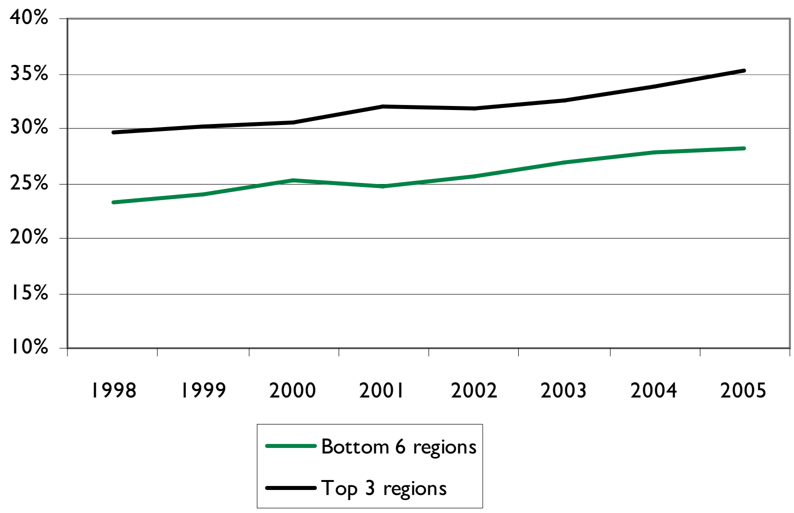
[9] Level 3 qualifications defined as more than one A Level, NVQ level 3 or equivalent

Chart 2.7: Proportion of economically active adults qualified to at least level 3 skills



Source: Labour Force Survey

Chart 2.8: Proportion of economically active adults qualified to at least level 4 skills



Source: Labour Force Survey

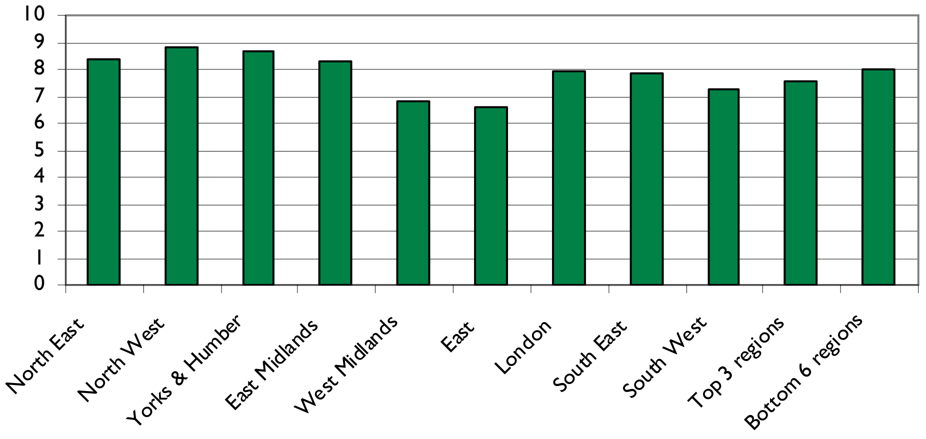
Investment

2.20 The accumulation of physical capital through investment is an important determinant of an economy's productivity performance. Physical capital stock is closely correlated with productivity performance, as it directly influences how much a unit of labour can produce. Total investment in fixed capital in the UK economy, incorporating investment by businesses and government, and investment in housing, has been low relative to comparable economies over long periods of the UK's post-was history.

2.21 However, indicators of business capital investment do not show consistent weakness across the lagging regions. Recent analysis suggests that differences in capital investment are to do with variations in sector mix between regions, rather than general barriers to investment in particular regions, and are therefore not thought to be significant in explaining regional disparities. This will be kept under review should new data or evidence emerge.

2.22 The proportion of net capital expenditure by businesses as a proportion of regional GVA in the top three and bottom six regions is shown in chart 2.9. This shows that firms in the bottom six regions invested more in capital than firms in the top three regions in 2004.

Chart 2.9: Net capital expenditure by businesses as a proportion of regional GVA, 2004



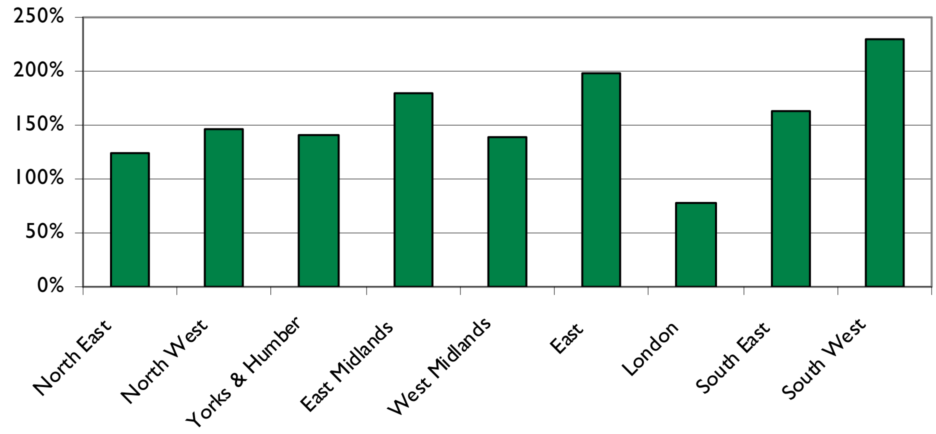
Source: Annual Business Inquiry

2.23 Another important determinant of the overall level of investment is the level of public sector investment in each region. Public Expenditure Statistical Analyses details public spending in each region from 1998 onwards.[10] Chart 2.10 shows proportionate growth in public sector capital investment between 1998 and 2004 by region. Public spending on capital has risen significantly in all regions – and has more than doubled in all the bottom six regions – to support improvements in regional economic performance.

2.24 Public investment is crucial to building an efficient infrastructure system. Infrastructure provides a base for economic output and other forms or investment, including from the private sector. There are multiple channels through which infrastructure boosts growth, including lower production costs and improved use of time as travel and transit times reduce.

[10] 1998 is the first year in which the regional breakdown follows Government Office regions

Chart 2.10: Growth in public sector capital expenditure, 1998-2004



Source: PESA

Enterprise

2.25 Enterprise is the combination of initiative, foresight, and willingness to take risks required to make a success of starting a new enterprise and growing and running an existing business. At a national level, the UK performs well on enterprise, and the OECD has rated the UK as having the lowest barriers to entrepreneurship of any major economy.[11] The increase in entrepreneurial activity has been constant for many years and currently stands at 4.3 million enterprises in the UK. Employment in Small and Medium sized Enterprises (SMEs) also continues to increase with a 7% increase in employment in SMEs since 2000.[12]

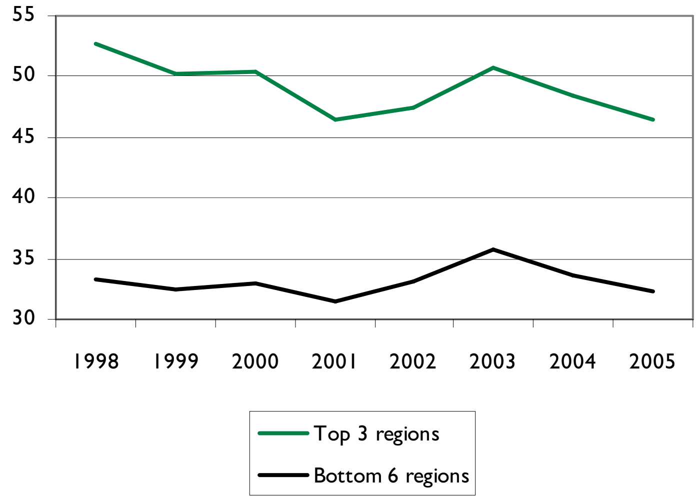
2.26 At the regional level, London and the South East have the highest levels of entrepreneurial activity and the three Northern regions have consistently had the lowest. There is evidence to demonstrate a narrowing in the enterprise gap between the Greater South East and other regions. However, this may be in part due to evidence suggested by some indicators that entrepreneurial activity in the Greater South East declined slightly after a peak in 2003. VAT registration rates, a measure of the number of businesses being set up, stayed fairly constant in all regions over the 1998-2005 period, as in chart 2.11.[13]

[11] HM Treasury, *Productivity in the UK 6: Progress and new evidence*, March 2006

[12] Small Business Service SME Statistics,2005

[13] This measure does not take account of de-registrations

Chart 2.11: VAT registrations per 10,000 population

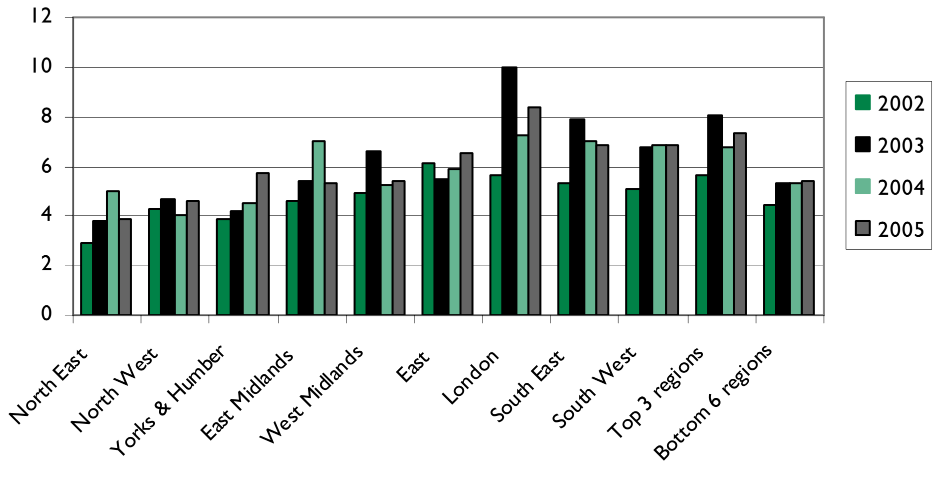


Source: DTI

2.27 Total entrepreneurial activity (TEA) data is collected independently by the Global Entrepreneurship Monitor (GEM) and incorporates more dynamic measures including people who are thinking about starting a business and have taken active steps towards making it happen. In addition, VAT registrations record businesses only once they reach a certain size (the VAT threshold) whereas TEA includes business start-ups below this size.

2.28 TEA data shows that enterprise activity grew in every region between 2002 and 2005, shown in chart 2.12. The time lag between the actual start of trading and VAT registration would explain why VAT registrations show a smaller change between the regions than the TEA figures. Latest TEA data show a slight improvement in entrepreneurial activity from 2004, which has been driven by improvements in TEA for London and the East. However in both the VAT and the TEA indicators the performance of the North, Midlands and West has remained fairly constant.

Chart 2.12: Total Entrepreneurial Activity (percentage adult population involved in such activity)



Source: GEM

2.29 There is still a significant gap between entrepreneurial activity in deprived areas and more prosperous areas in all regions. However there have been recent signs of progress. In the year ending May 2006, of all the people of working age living in the 15 percent most deprived wards in England, 6.4 per cent were self-employed. This was the highest rate seen in the last six years.[14]

Competition

2.30 Competition takes place in markets – which could be local, national or global – and is regulated by a national and EU wide competition and merger control framework. The UK fares very well in assessments of its competition regime, with a 2005 assessment by the Global Competition Review putting the UK regime second only to the US. Although the regulatory framework does not vary regionally, it has been suggested that competitive forces may vary regionally influenced for instance by the degree of openness of regional economies to international trade.[15] Ideally, an indicator of this would include both exports and imports to each region, but it is difficult to allocate UK trade to regions due to the 'headquarters effect'. Regional export data is gathered in such a way as to mitigate against this but only includes trade in goods.

2.31 In the context of weaknesses in global markets, there has been little difference in the performance of the individual regions in terms of participation in international trade for goods (apart from London and to a lesser extent, the West Midlands), with the trends in goods exports for both regional groups moving together closely. The value of exports as a percentage of regional GVA for both the Greater South East and the North, West and Midlands averaged 17 per cent between 2001 and 2005. However, these figures may hide significant differences in the exports of services, the quality of trade flows and the degree to which firms can capture the value-added.

[14] ONS Labour Force Survey

[15] HM Treasury, DTI, *Benchmarking UK productivity performance: The Government's response to the consultation on productivity indicators*, 2004

Innovation

2.32 Innovation as a driver of productivity involves the development of new ideas and their economic application as new products or processes. The capacity to innovate is underpinned by the skills levels of workers, who are more able to adapt to changing economic circumstances and to exploit the potential of new ideas and innovations. They are also complementary to other productivity-enhancing investments that firms may make, such as in Research & Development (R&D).

2.33 The UK as a whole has an excellent academic base, with 1 per cent of the world population producing 5 per cent of world science. However gross domestic expenditure on R&D as a percentage of GDP remains lower than the US, France and Germany.[16]

2.34 Although public investment in R&D continues to increase in real terms, business R&D as a share of GDP has yet to show similar progress at this early stage in the ten-year framework. There was a slight narrowing of the gap between the top three and bottom six regions in 2004, as in chart 2.13. This narrowed from 1 per cent in 1993 to 0.4 per cent in 2004. The Eastern region has increased business sector spend on R&D more than others between 1993 and 2004, spending 0.5 per cent of regional GVA on R&D in 1993 and 3 per cent in 2004.

2.35 The Government has set out its long-term science and innovation strategy in *Science and innovation: working towards a ten year investment framework.*[17] The second Annual Report on the ten-year framework sets out that, two years into implementation, the programme is on course.[18]

2.36 Gross domestic expenditure on R&D is dominated by business expenditure but also includes expenditure by Government and the HE sector. UK R&D expenditure tends to be concentrated in larger firms. Most international differences in R&D spend can be attributed to differences in industrial structure, and R&D intensities also vary by sector within the UK, with the highest concentrations found in the manufacturing sector and in particular, pharmaceuticals, aerospace, and radio, TV and communications equipment.[19]

2.37 Chart 2.14 shows that three regional groupings have emerged around gross domestic expenditure on R&D. East of England and South East (dominated by HQs and the pharmaceutical industry) are the regional leaders, followed by the North West, East Midlands and the South West, with the other four regions lagging behind. This was a pattern is expected to continue in 2004.

2.38 However, UK innovation surveys suggest that R&D accounts for only around a third of all innovation expenditures, and it is closely related to sectoral differences.[20] For instance, London is dominated by the services sector (particularly financial services) where R&D activity tends to be at a lower intensity than other sectors, but this does not mean that London business is not innovative. Other innovation related expenditures include design, training, marketing and acquisition of machinery and equipment will be important even where the proportion of spending is low. Hence, it is

[16] HM Treasury, *Productivity in the UK 6: Progress and new evidence*, 2006

[17] HM Treasury, DTI, DfES, *Science and innovation: working towards a ten year investment framework*, 2004

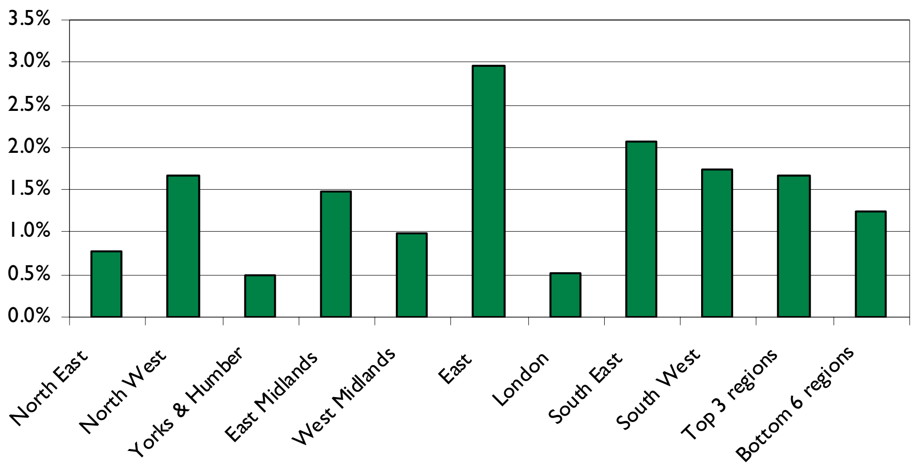
[18] HM Treasury, DTI, DfES, *Science and innovation investment framework 2004-2014: Annual Report 2006*, 2006

[19] HM Treasury, DTI, *DTI Economics Paper 11 - R&D Intensive Businesses in the UK*, 2005

[20] DTI, *Occasional Paper No.6 – Innovation in the UK: Indicators and Insights*, 2006

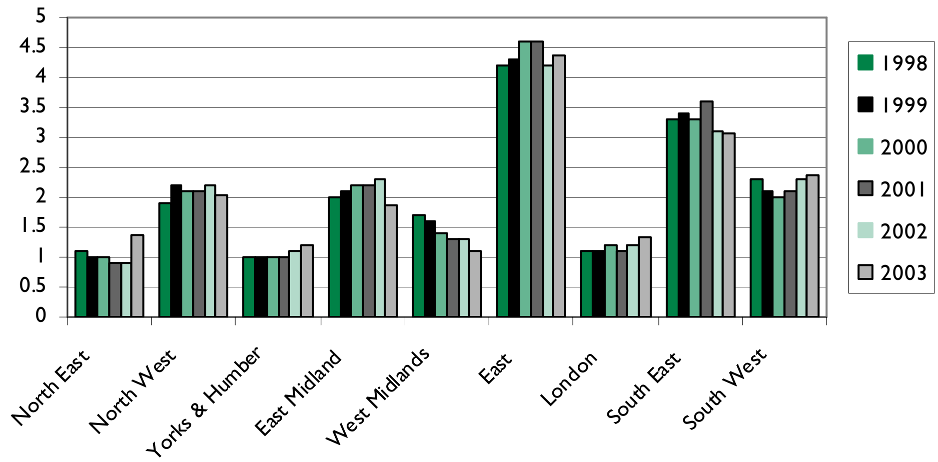
not clear to whether or to what extent the large regional gaps in R&D spend reflects a more general pattern of regional innovation gaps.

Chart 2.13: Business expenditure on R&D as a percentage of regional GVA, 2004



Source: ONS

Chart 2.14: Gross domestic expenditure on R&D as a proportion of regional GVA

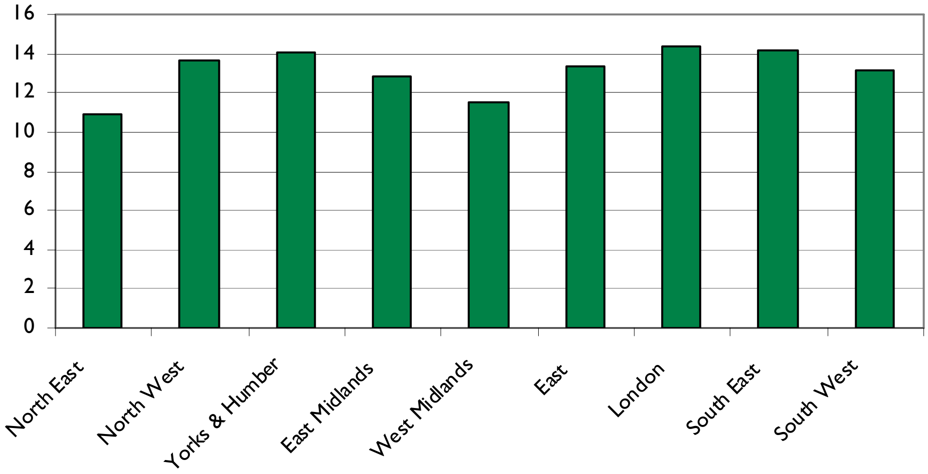


Source: ONS

2.39 Another indicator of innovation is the proportion of a firm's sales which are accounted for by products which are new to the market, or improved or new to the firm. The average firm in the three regions of the Greater South East has the highest proportion of sales accounted for by products which are new to the market. The picture for products which are improved or new to the firm is more varied although the Greater South East collectively outperforms the other regions.

2.40 Cooperative arrangements are a response to the inability of innovating firms to recoup all of the benefits from innovating activity, as well as pooling financial resources and risk on large-scale projects. The chart 2.15 below shows that the proportion of innovative firms involved in cooperation agreement is broadly similar for seven regions, but there is a lower proportion of such arrangements in the North East and West Midlands.

Chart 2.15: Percentage of businesses with co-operative arrangements on innovation activities. 2002-2004



Source: Community Innovation Survey

2.41 The three indicators taken together suggest that regional innovation performance is more complex than the picture suggested by R&D expenditure alone, with some regions performing well on one indicator but poorly on others. Although these still do not capture all aspects of innovation (for example, business process innovation), it is striking that the Greater South East regions collectively outperform the other six regions on all these measures, suggesting that regional innovation performance and industrial structure are factors in explaining regional economic performance and disparities, albeit a smaller one than the R&D expenditure alone might suggest.

EMPLOYMENT

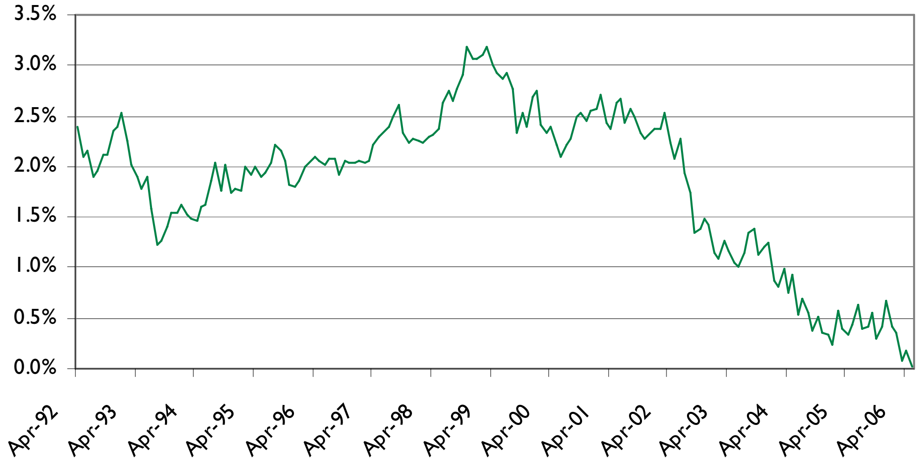
2.42 Employment is a key determinant of economic growth. Employment in the UK has risen by nearly 2.5 million since 1997, making a significant contribution to higher living standards. The UK's employment rate is now the highest of the G8 countries.[21]

2.43 Historically, there have been long-standing disparities in employment rates between the regions. However, regional employment data for 1992 - 2006 shows that the employment rate in every region has risen since the early 1990s, with a narrowing of regional differentials. Chart 2.16 demonstrates that this narrowing of regional differentials began in 2001. In 1992, the employment rate in the Greater South East was 73.1 per cent whilst it was 70.6 per cent in the other regions. The North East and

[21] Department for Work and Pensions, *A New Deal for Welfare: Empowering People to Work*, 2006,

London have consistently had the lowest employment rates, while the South East and South West have had the highest.

Chart 2.16: Difference in employment rates between Greater South East and North, Midlands and West regions

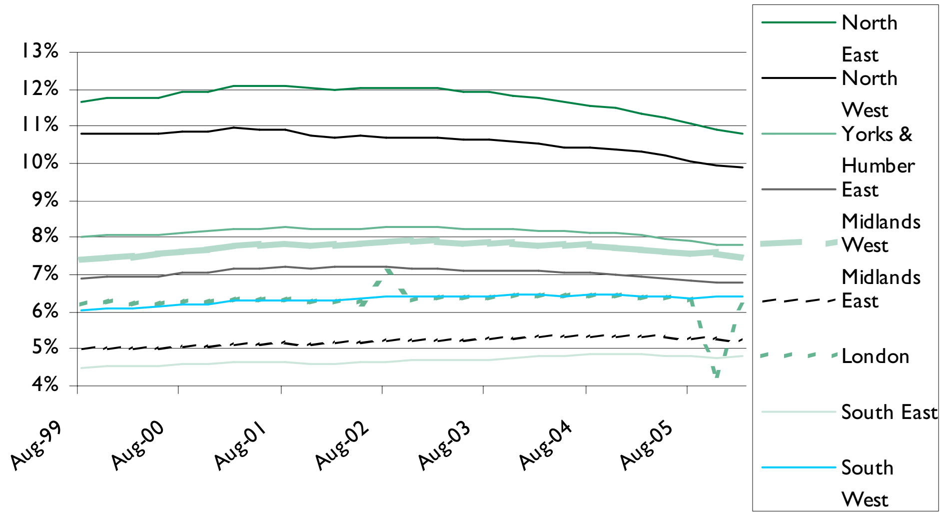


Source: Labour Force Survey

2.44 Rising employment rates and the reduction in regional disparities in employment are the main explanation for the narrowing in regional GVA growth rate disparities in 2003 and 2004 outlined above. By May 2006, the average employment rate for the North, Midlands and South West regions had broadly equalised to the average employment rate in the Greater South East. This compares with an average gap of around 2.5 percentage points in 2001, although some of the narrowing is due to poor performance in London and the South East.

2.45 Unemployment measures those people looking for or considering taking a job. Those not participating in the labour market at all are considered inactive instead of unemployed. There are lower participation rates in the bottom six regions, demonstrated in chart 2.17 – mainly due to much higher rates of Incapacity Benefit (IB) claimants - and those who are in the labour market tend to work shorter hours.

Chart 2.17: Percentage of the workforce claiming Incapacity Benefit/ Severe Disablement Allowance



Source: DWP

2.46 Reducing inactivity is therefore key to achieving the Government's regional economic objectives. This is a challenge faced by many OECD countries. There is evidence to suggest that one million IB claimants would like to move to employment at some point in the future. There is also evidence that between 80 per cent and 90 per cent of new IB claimants are planning on working in the future.[22]

2.47 The Government's long-term goal is employment opportunity for all, with the long-term aspiration of achieving an employment rate equivalent to 80 per cent of the working-age population. This will require further increases in employment rates in every region.

[22] Department for Work and Pensions, *A New Deal for Welfare: Empowering People to Work*, 2006

3 Conclusion

3.1 The Government remains committed to ensuring that all parts of the UK can contribute to and benefit from sustainable growth in economic performance. To continue to improve the economic performance of all regions, whilst over the long term reducing the gap in growth rates between the regions, the Government's approach is to:

- maintain macroeconomic stability to help businesses and individuals plan for the future;
- implement microeconomic reforms aimed at tackling market failures in the underlying drivers of growth; and
- devolve decision making to the local and regional levels to ensure that policy design and delivery meets regionally and locally set priorities.

Progress to date

3.2 This approach has succeeded in delivering some progress to date on regional economic performance, as demonstrated by the emerging evidence set out in this report. In particular:

- recent GVA per head outturn data provides emerging evidence of progress on narrowing the gap in growth rates between the regions;
- differences in regional employment rates have significantly narrowed since 2001 due to strong employment growth in the North, Midlands and South West regions;
- skills data demonstrates a significant reduction in all regions of the proportion of economically active adults with no qualifications and a narrowing of the gap between the bottom six and top three regions. Regional differentials in Level 2 qualifications have also narrowed;
- however, significant further progress in the bottom six regions is required on the other drivers of productivity, particularly with regard to levels of enterprise, innovation and private sector investment.

3.3 It is too early to provide a full assessment of performance against the target with only two years of data for the target period. Moreover, it is not possible to assess trend growth performance until completion of the economic cycle. Improvements to regional economic data by the ONS will also enrich assessments of performance against the PSA target. The Government also recognises the need to develop its understanding of what drives productivity improvements at the regional level.

Scale of the challenge

3.4 It is important to recognise the scale of the challenge that the Government has set itself in aiming to improve the performance of all regions and narrow the gap in growth rates. The UK has experienced long-standing economic disparities, which have persisted for more than 80 years and will require significant and sustainable improvements in all the underlying drivers of growth to address.

3.5 Alongside improvements on employment and skills, regions need to develop further a vibrant and competitive private sector, with businesses based on the delivery of innovative, high value-added goods and services. Regional economies need to be refreshed and stimulated by the entry of new businesses which have the potential for growth, and regional infrastructure needs to support the development of this economic growth.

3.6 The long-term challenges and opportunities of globalisation and technological change mean that each region faces more intense global competition. Flexible and innovative sub-national bodies are critical to harnessing indigenous regional strengths, overcoming long-term regional disparities, and responding to short-term shocks. The Government has devolved significant resources and responsibilities to the nations, regions and localities of the UK since 1997.

2007 Comprehensive Spending Review

3.7 The 2007 Comprehensive Spending Review is an important opportunity for developing the Government's regional economic performance and devolving decision-making agenda further. Each region and the Northern Way have submitted advice to the Comprehensives Spending Review, in response to a request from Government, on how to utilise better public expenditure and policy interventions to enhance regional growth and regeneration.

Sub-National Review

3.8 In preparation for the Comprehensive Spending Review, the Government is conducting a review on how to improve the effectiveness and efficiency of existing sub-national structures in England – including governance, incentives and powers – and identifying options going forward to maximise value for money and deliver changes on the ground, in order to:

- strengthen economic growth so that the Government achieves its ambitions as set out currently in the regional economic performance PSA target; and
- deliver regeneration and neighbourhood renewal to meet the Government's objectives for tackling disadvantage as set out in the neighbourhood renewal PSA target.[1]

3.9 Work within the review has considered the Government's understanding of the drivers of growth at the sub-national level, and the potential impacts of globalisation and technological change. This analysis reiterates the need for further devolution of responsibilities for economic development and regeneration so that all regions, localities and neighbourhoods can benefit from the move to a more knowledge- based economy.

3.10 The review is considering how to improve accountabilities and governance arrangements for economic development, regeneration and neighbourhood renewal. One of the objectives is to achieve more effective engagement by the private sector in local economic development. Reforms are also likely to be needed to give greater flexibility to regional and local levels, greater alignment of funding streams, and more consistency between strategies. Greater cooperation is also likely to be needed between regions and sub-regions.

3.11 The Leitch review of skills and employment, the Eddington Transport Study, the Barker review of land use planning, and the Lyons Inquiry into local government will all have important implications for sub-national economic development. The Government will take the conclusions of each of these reviews into account in the sub-national review, the findings of which will inform the 2007 Comprehensive Spending Review.

[1] HM Treasury, *Spending Review 2004*, 2004

A UPDATE ON 2004 TECHNICAL NOTE MEASURES

A.1 The 2004 Spending Review committed the Government to report progress against key measures introduced to support delivery the target. These are set out in the Technical Note for the 2004 Spending Review. The table below lists the Technical Note measures and summarises progress to date.

Policy measures

Measure	Progress to date
	Devolving decision making
Devolving Decision Making to the RDAs	Since April 2002, Regional Development Agency (RDA) funding has been delivered through a single cross-departmental framework, known as the Single Pot, giving RDAs flexibility to target their resources in the way they consider most effective to deliver their targets. The size of the Single Pot will increase to £2.3 billion by 2007-08. RDAs have set out the shared growth priorities for their region and sub-regions in Regional Economic Strategies. Of these strategies, six have been refreshed in 2006. In these strategies, there have been improvements to the regional evidence bases and there are focused actions targeted on identified market, co-ordination and other failures. In April 2005, the Government introduced a new 'tasking framework' for the RDAs, ensuring that stretching targets are aligned to the priorities identified in the Regional Economic Strategies as well as the most relevant Government PSA targets. To improve the evidence base on RDA impact ahead of the 2007 Comprehensive Spending Review, the RDAs have completed an Impact Evaluation Report that assesses their interventions to promote economic growth in the regions. Moreover, an RDA Independent Performance Assessment led by the National Audit Office has been introduced to assess the management and performance of the 8 RDAs outside London. (As a functional body of the Greater London Authority, the LDA is subject to assessment by the Audit Commission).
The Northern Way	The Northern Way is a long-term strategy for economic growth focussed on narrowing the £30 billion output gap between the North and the UK average. The three Northern RDAs have jointly identified ten key investment priorities to help accelerate the process of economic growth in the North. These include bringing more people back into work, strengthening the regions knowledge base and meeting employers' skills needs. In addition, 8 city-regions in the three Northern regions are developing city regional development plans to set out how they can collaborate most effectively to raise economic performance and participation. The Northern Way has recently submitted advice to the Government on how to enhance regional economic performance within existing levels of resources. The Government is considering the advice as part of the Comprehensive Spending Review process.

Measure	Progress to date
	Skills
Leitch Review of skills	Responding to the skills challenge for the economy set out in Lord Leitch's report, and the important independent report on the role of Further Education recently published by Sir Andrew Foster, the 2006 Further Education White Paper sets out a further programme of change to adult skills provision. [1]
Train to Gain	The Government and partner organisations have a range of programmes in place to tackle adult skills gaps in the regions, and which should contribute to narrowing regional disparities. These include Train to Gain (the national employer training programme), the entitlement to free tuition for a first full level 2 qualification, Adult Learning Grants. RDA action on skills, skills targets in Local Area Agreements, Sector Skills Councils and Sector Skills Agreements.
Regional Skills Partnerships	Regional Skills Partnerships (RSPs) have been operational in all regions since April 2005. These bring together the RDAs, LSC, JobCentre Plus, Small Business Service, Skills for Business network and other partners to co-ordinate skills provision within the region. The Government is keen to ensure that skills provision is responsive and linked to demand. The new delivery arrangements for the European Social Fund include a strong strategic role for the regions in determining allocation of spend for the 2007 to 2013 period.
Sector Skills Councils	Sector Skills Councils (SSCs) are developing sector qualifications strategies to help target public funds towards the most relevant qualifications. The SSC network is a key member of each RSP. 23 of the 25 SSCs have had Sector Skills Agreement project proposals approved by the Sector Skills Development Agency.
Testbed learning communities	Testbed Learning Communities have been developed in 28 areas across England, trying out new approaches to tackling issues of intergenerational deprivation and low achievement, of which skills are only one aspect. An evaluation of this work found that community-based learning is helping the Skills Strategy achieve its objectives; and that learning communities can help reduce the gap between disadvantaged communities and the national average.
Selective Finance Investment in England	The programme of Selective Finance for Investment in England (SFIE) is a financial incentive that supports capital investment, employment training and productivity growth in the 'Assisted Areas'. An evaluation of the scheme is currently being undertaken. Emerging results show that there are positive and significant effects on employment arising from SFIE investments.

[1] DfES, *Further Education: Raising skills, improving life chances*, 2006

Measure	Progress to date
	Investment
Regional Funding Allocations	The Government published long term indicative regional budgets for transport, economic development and housing in July 2005 to enable each region to improve coordination between policy interventions and strategies..[2] Each region submitted advice to the Government on its priorities in January 2006. The Government responded in full to this advice including on regional transport priorities in July 2006.
Transport Innovation Fund	The Transport Innovation Fund (TIF) was announced in 2004. TIF will enable funds to be directed towards two key objectives - tackling congestion and improving productivity. While some pump-priming funds are available in 2005-06 and 2006-07, the main fund will become available from 2008-9 and is forecast to grow from £290 million in 2008/9 to over £2 billion by 2014-15. Guidance for accessing the fund was issued in January 2006.[3]
Route Development Funds	Route Development Funds (RDFs), allow regional and local bodies to support the establishment of new direct business links from regional airports. The Government has received state aid approval for an RDF scheme for England and Wales. An RDF has been set up by ONE North East.
Public Service Obligations	Under EU law, it is possible for the Government to impose a Public Service Obligation (PSO) on airlines to protect routes vital to economic development in peripheral or development regions. Guidance on using PSO's to protect regional air access to London was published in December 2005.[4]
Eddington Study	Sir Rod Eddington is publishing his study that seeks to explore the long term impact of transport decisions on the UK's productivity, stability and growth within the context of the Government's commitment to sustainable development.
Planning	Kate Barker is publishing her review of land use planning that sets out how planning policy and procedures can better deliver economic growth and prosperity in England alongside other sustainable development goals. The Government will give a substantive response to this report in the Spring 2007.

[2] HM Treasury, DTI, DCLG, *Regional Funding Allocations: Guidance on Preparing Advice*, 2005

[3] DfT, *Transport Innovation Fund Pump Priming Criteria – Round 2*, May 2006 available at http://www.dft.gov.uk/stellent/groups/dft_about/documents/divisionhomepage/038808.hcsp

[4] DfT, *Guidance on the protection of regional air access to London*, December 2005 available at http://www.dft.gov.uk/stellent/groups/dft_aviation/documents/divisionhomepage/610687.hcsp

Measure	Progress to date
	Enterprise
Business Link	The Government devolved responsibility for delivery of the Business Link services to RDAs in April 2005. Going forward, the Chancellor has announced a simplification of business support services, reducing the number of such services from over 3,000 to less than 100 by 2010.
Enterprise Insight Campaign	Action is being taken to boost the enterprise culture in all regions through programmes of enterprise education and support for young entrepreneurs in schools, colleges and universities. In particular, four regional campaign hubs for the Enterprise Insight Campaign led by RDAs and other regional bodies, have been developed in Liverpool, Coventry, Wakefield and Lowestoft with Small Business Service (SBS) support. This campaign aims to promote enterprise and influence young peoples' career choices. A further three sectoral hubs will be fully operational and self-funding by March 2008. In addition, the Government has made available £60 million for 3 years until March 2008 for all schools to provide enterprise education at Key Stage 4.
Enterprise Promotion Fund	The Small Business Service has also sponsored pilot projects that take an innovative approach to raising enterprise awareness through a £1million Enterprise Promotion Fund. A review of the Fund was published in August 2006 and sets out that pilots targeted at children, young people and the wider community have been most successful. [5].
Phoenix Fund and Local Enterprise Growth Initiative	Research and Development grants and the Phoenix Challenge and Development Funds have been devolved to RDAs. Phoenix legacy funding has been provided to the Regional Development Agencies to support Community Finance Development Institutions until 2008. The Phoenix Fund has been successful to date in stimulating enterprise in disadvantaged areas and under-represented communities. Going forward, the Local Enterprise Growth Initiative (LEGI) is intended to support locally developed proposals in the most deprived areas (determined by the Neighbourhood Renewal Fund areas) to stimulate economic growth through enterprise development. The LEGI fund will be £50 million in 2006-2007, and is expected to rise to £150 million per year by 2008-2009.

[5] Centre for Enterprise and Economic Research, *Review of the Enterprise Promotion Fund*, August 2006 available at http://www.sbs.gov.uk/SBS_Gov_files/researchandstats/EPFReviewFinalReport.pdf

Measure	Progress to date
	Innovation
Higher Education Innovation Fund	The Government is on course to deliver an increase in Higher Education Innovation Fund (HEIF) to £110 million a year by 2007-8. This provides for the development of universities' infrastructure for collaboration with business and the public sector, building on the structures and best practice in knowledge transfer developed through previous funding rounds. This has enabled the academic base to link more proactively with business, which particularly benefits Small and Medium sized Enterprises not based near the major universities.
Lambert Review	Following the recommendations of the Lambert Review, RDAs have been given an enhanced role in promoting business-university collaboration and regional innovation. Responsibility for enhancing business-university interaction was devolved to RDAs in April 2005. The three northern RDAs have committed to aim to enhance their current plans to support business-university collaboration by over £100 million by 2010. RDAs have flexibility on how to deliver increased levels of collaboration. One mechanism is through the deployment of regional technology advisors to build networks within and between regions, signposting business to the best sources of advice.
Science Cities	In the 2004 Pre-Budget Report the Government welcomed plans by the RDAs to develop three Science Cities (in York, Manchester and Newcastle), and a further three Science Cities were announced in Budget 2005 (in Nottingham, Birmingham and Bristol). The aim of Science Cities is to provide a clearer focus for investment in science and innovation, concentrating on existing centres of excellence; and to encourage RDAs, local authorities, Higher Education Institutions and business to work more closely together in formulating a coherent strategy that will attract a critical mass of innovative businesses into the city. The RDAs are currently working together with local authorities, higher education institutions, and industry to draw up detailed delivery plans for the six Science Cities.

Measure	Progress to date
	Employment
Pathways to Work	The Government has a range of policies and targets to promote employment, These include the various New Deal schemes, as well as the Pathways to Work programme which is designed to assist those on Incapacity Benefit (IB) who want to return to work. Evidence on the performance of the Pathways to Work Pilots is very encouraging. There are indications of around an 8 percentage point increase in the IB off-flow rates in the Pilot districts. It is not yet possible to be certain that these additional exits from benefit all relate to entries to employment. There is also no evidence that the additional off-flows are disproportionately caused by transfers to other benefits. [6]
Welfare Reform Green paper	The Welfare Reform Green Paper outlined a number proposals to help in increase employment confirmed in the Government's consultation response published in June 2006, including: • work Focused Interviews for lone parents; • support for older workers returning to the labour market though greater work related activity, and support for employers offering flexible working for older workers; • reform of Incapacity Benefit to a new Employment & Support Allowance that will provide more support for the inactive to move from welfare to work; • the roll-out of the Pathways to Work programme across the country; and • continuing work to tackle inactivity in cities. [7]

[6] DWP, *Working Paper No 26, Incapacity Benefit reforms –Pathways to Work Pilots performance and analysis*, 2006

[7] DWP, *A New Deal for Welfare: Empowering people to work Consultation Report*, 2006

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