

# Productivity in the UK:

## 3 – The Regional Dimension

November 2001



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# **Productivity in the UK: 3 – The Regional Dimension**

November 2001

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This is the third in a series of Productivity in the UK papers

Other papers in the series include:

1 – The evidence and the Government's approach (published with Pre-Budget Report 2000)

2 – Progress towards a productive economy (published with Budget 2001)

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# FOREWORD

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Four years ago the Government set out its central economic objective of achieving high and stable levels of growth and employment. To achieve that objective the Government has put in place a programme of economic reform to secure macro-economic stability, ensure employment opportunity for all and narrow the productivity gap with our principal competitors.

For this programme of reform to succeed in its ambition we must ensure that it reaches every part of the United Kingdom. For far too long the economies of too many regions and countries of the United Kingdom have been allowed to fall behind. This has wasted talent and opportunity. The Government believes that regionally balanced growth, led by the regions themselves, is not only desirable in its own right but also essential to deliver economic prosperity and employment for all.

However, any regional economic policy that is consistent with those overall ambitions for the economy cannot simply be about re-distribution of existing economic activity. Instead it must focus on increasing and realising the potential of all localities – towns, cities and rural areas – with the ambition of raising the performance of under performing areas to that of the best. The challenge of improving the performance of every region and nation is immense, but it is one in which we must succeed if we are to secure long term prosperity for all.

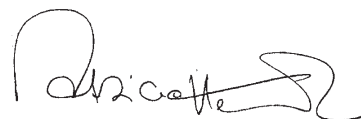
That is why in the last Parliament devolved administrations were established in Scotland, Wales and Northern Ireland with substantial autonomy over economic and enterprise policy, alongside their other wider responsibilities. In England the Deputy Prime Minister established Regional Development Agencies who as strategic leaders in regional and local economic development, are the key agents to drive forward this agenda.

In this Parliament the Government intends to build on these fundamental changes. We will ensure that in every part of the United Kingdom the institutions and resources are in place to allow regions to fulfil their economic potential, both by building on their own indigenous strengths and developing new ones within the right national framework.

This document sets out the scale of the challenge we face alongside an economic analysis of the reforms needed to build a new regional economic policy for all of the countries and regions of this United Kingdom.



Rt Hon Gordon Brown MP  
Chancellor of the Exchequer



Rt Hon Patricia Hewitt MP  
Secretary of State for Trade and Industry



# INTRODUCTION

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## THE COUNTRIES AND REGIONS OF THE UNITED KINGDOM

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The Government's central economic objective is to achieve high and stable levels of growth and employment. Improving the economic performance of every country and region of the UK is an essential element of that objective, firstly for reasons of equity, but also because unfulfilled economic potential in every region must be released to meet the overall challenge of increasing the UK's long-term growth rate.

This document sets out the economic analysis that underlies the Government's approach to regional economic policy and the institutional framework necessary to deliver it.

## REGIONAL ECONOMIC PERFORMANCE

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The Government has put in place a radical programme of macro- and micro-economic reform to improve the United Kingdom's economic performance. A new macroeconomic framework has been established; changes to tax and benefit rules and the introduction of the New Deal have put in place the conditions to create employment opportunity for all; and further changes have been made to the corporate tax framework to encourage business investment and innovation. Building on this, in June 2001, the Government announced its intention to put improving productivity and enterprise at the heart of its economic objectives for this Parliament.

However, to achieve these objectives productivity and employment must improve in every part of the UK – not just those countries and regions that historically have had the highest growth.

### Regional economic differentials

There are significant and persistent differences in economic performance between and within UK regions. The UK's poorest countries and regions, Northern Ireland and the North East, had a GDP per capita nearly £7,000 or 40 per cent below that of London, the richest. Both the size of differentials and relative ranking of regions has been very persistent.

The impact of this untapped potential could be very significant. If all lagging UK countries and regions improved their productivity performance to at least that of the current average then the average person in the UK would be around £1000 a year better off. To put it another way, the UK's overall growth rate over the last twenty years would have increased by around 0.4 per cent per annum. This is why any regional economic policy must be focussed on raising the performance of the weakest regions rather than simply re-distributing existing economic activity. Real economic gain for the country as a whole will only come from a process of 'levelling up'.

Underlying these regional economic differentials are a number of key factors including differences between regions in the provisions of skills, investment, innovation, enterprise, and competition. Labour mobility, particularly of low skilled workers, also affects the ability of localities to respond to economic shocks.

Agglomerations or 'clusters' of firms and skilled workers also have important implications for regional economic performance. Clusters of firms gain from spill-over effects from other firms' innovative activity, the existence of advanced or 'thick' local labour markets, and market benefits both in terms of overall market size and through linkages between firms up and down the supply chain. These effects can help create virtuous circles for successful regions whilst locking in economic decline in less successful ones.

The challenge for Government therefore is to help tackle these failures, so as to allow those less successful regions to build the conditions for economic success, whilst ensuring that more successful regions and countries continue to flourish.

### **The Government's approach**

This document sets out the framework for tackling this challenge by promoting productivity and employment improvements across the English regions, and the UK. This framework is based around two key elements:

- creating an economic environment which provides a stable macro-economy and tackles market failures in national, regional and local markets through microeconomic reforms; and
- building the capability of regional and local institutions to deal with regional and locally specific issues and deliver reforms.

The Government believes that a successful regional and sub-regional economic policy must be based on building on the indigenous strengths in each locality, region and country. The best mechanisms for achieving this are likely to be based in the regions themselves. The Government's role is to enable regional and local initiatives to work, by providing the necessary resources within a national framework to ensure that every region and country has the opportunity to match the economic performance of the most successful. This regional and local policy approach must complement the role of national policies – for example in taxation and the competition regime – to create the conditions for sustained economic growth.

The Government has introduced a number of institutional reforms to take forward this new regional economic agenda. These include the introduction, in England, of the Regional Development Agencies (RDAs) and the London Development Agency and, at a local level, the introduction of Local Strategic Partnerships. Similarly in Scotland, Wales and Northern Ireland the Devolved Administrations have set up or in some cases further developed their own regional and local economic bodies designed to tackle these market failures.

The Regional Development Agencies are the key agents in driving forward this new regional industrial policy. As the strategic leaders in regional and local economic development their Regional Economic Strategies set out shared visions of the challenge each region faces.

The Government has strengthened the RDAs' ability to tackle these issues through substantial increases in resources, from £1.2 billion in 2000-1 to £1.7 billion in 2003-4. It has significantly increased flexibility over how they use those resources with the introduction of a single cross-departmental budget from April 2002, and the ability to carry resources forward from one year to the next. This increased flexibility is, however, being matched with increased accountability both through national targets and strong and effective Regional Chambers.

At Budget 2000 the Deputy Prime Minister and the Chancellor announced the allocation of additional 'capacity building' resources to the Regional Chambers to help ensure that they can carry out the scrutiny role effectively. Strong and pro-active Regional Chambers will help make the RDAs more credible and effective. The Government is keen to encourage their further development.

At the sub-regional and local level the Department for Transport, Local Government and the Regions has put in place further institutional reforms designed to tackle economic disadvantage and promote growth. The new Local Strategic Partnerships (LSPs) will provide a strategic and coordinating function at the local level across a wide range of public services. One of their primary aims will be to increase enterprise and innovation in their areas.

Working in partnership with the Government, RDAs and other local and regional economic bodies have put in place a substantial programme of policies designed to tackle economic failure – at every geographical level – and deliver sustained improvements in the UK's economic performance. These include:

- Regional Venture Capital Funds to tackle gaps in regional equity markets for small and growing firms;
- the introduction of the Small Business Service to coordinate and provide local support to SMEs and champion enterprise in disadvantaged areas (in England) and the launch of the network of Business Link Operators as the main gateway to advice and business support for SMEs; and
- establishment of the Local Learning and Skills councils that will work in parallel with the RDA's to deliver regional skills strategies;

The forthcoming Spending Review provides an opportunity for the Government to consider the lessons of the first few years of this new regional economic policy. The Government will consider how these new regional institutions can further play their part in building economic growth and whether they need further flexibilities or institutional changes to deliver that agenda.

In addition the Deputy Prime Minister will set out further detailed Government's proposals for devolution in the English regions.



# THE ECONOMIC PERFORMANCE OF THE UK'S COUNTRIES AND REGIONS

## INTRODUCTION

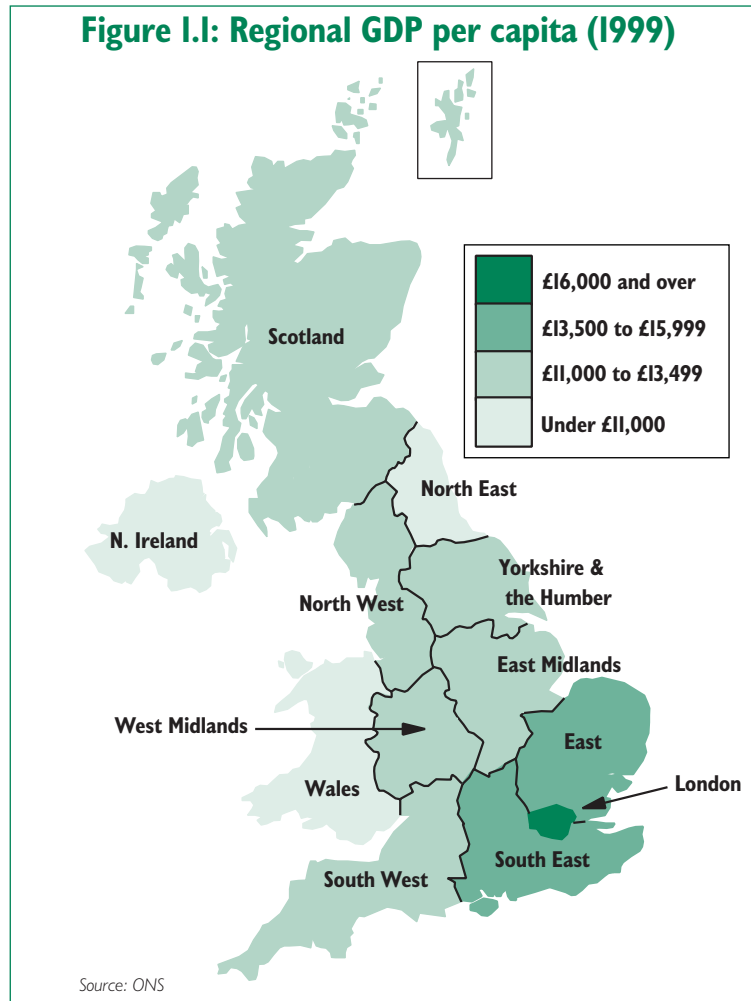
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**1.1** The Government's central economic objective is to achieve high and stable levels of growth and employment. To achieve this, the Government has put in place a programme of macro- and micro-economic reform to improve the UK's economic performance, including independence for the Bank of England and reforms to the labour market to ensure employment opportunity for all. Building on this, in June the Government stated that its primary economic ambition for this Parliament would be to achieve a sustained improvement in the UK's productivity.

**1.2** However, to achieve this goal, productivity and employment need to improve in every part of the country – not just those countries and regions that have historically had the highest growth. This is important because as a matter of fairness the Government believes that no country or region can be allowed to fall permanently behind. It is also important because, unless the UK can allow the unfulfilled potential in every region to be released, it will not be possible to meet the challenge of increasing the UK's long-term growth rate.

**1.3** The impact of this untapped potential could be very significant. If all lagging UK countries and regions improved their productivity performance to at least that of the current average, then the average person in the UK would be around £1000 a year better off. To put it another way, the UK's overall growth rate over the last twenty years would have increased by approximately an additional 0.4 per cent per annum. This is why any regional economic policy must be focussed on raising the performance of the weakest regions rather than simply re-distribution. Real economic gain for the country as a whole will only come from a process of 'levelling up'.

REGIONAL ECONOMIC PERFORMANCE



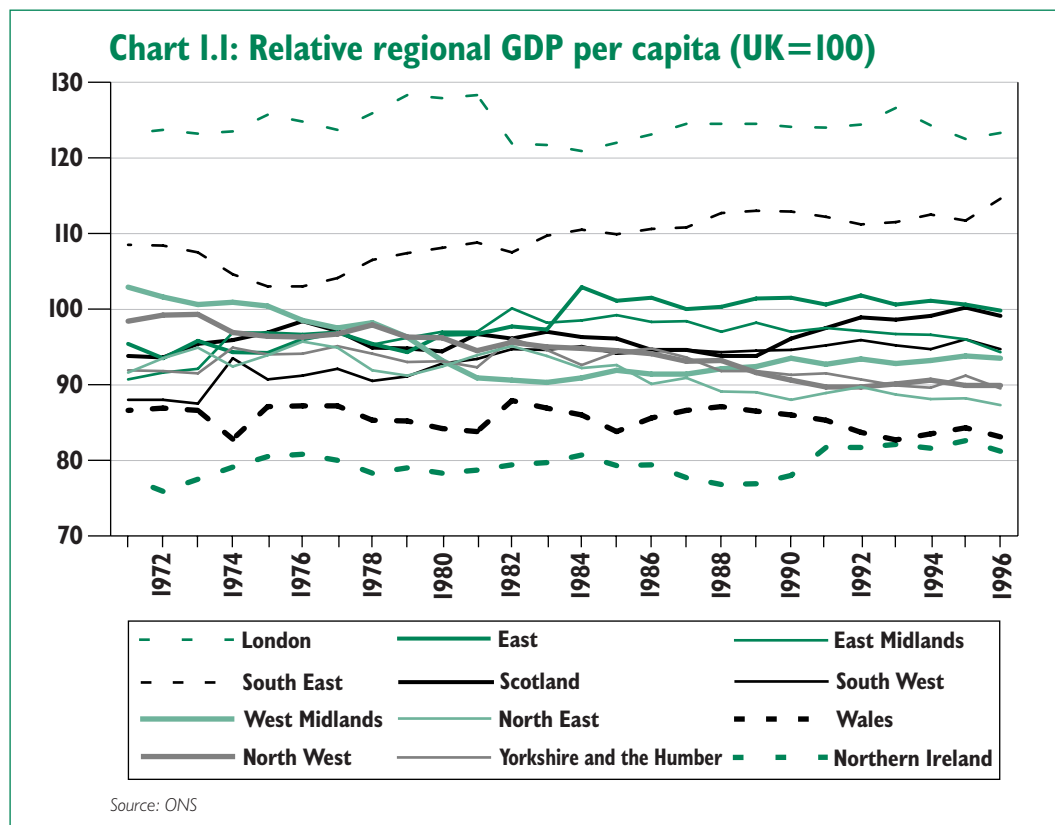
**1.4** The broadest indicator of economic performance of a region, or country, is GDP per capita. Figure 1.1, above, shows that variations in regional GDP per capita are substantial across the United Kingdom. In 1999, the UK's poorest regions, Northern Ireland, Wales and the North East, had a GDP per capita nearly £7,000 or around 40 per cent below that of London, the richest region.<sup>1</sup>

**1.5** The regional GDP figures used throughout this document are in current prices. Were regional GDP deflators available this would allow for the construction of real regional GDP estimates, and more reliable estimates of regional GDP per capita and productivity differentials. Particularly in the short-run it is possible that there are significant regional price divergences. This publication uses data on GDP levels, rather than growth rates, to help alleviate this problem. The relativities between regions, as well as the approximate magnitude of differentials, should not be unduly misleading. So while there are statistical issues regarding estimates, the broad message concerning persistent regional differentials remains clear.

**1.6** The available regional GDP per capita data for 1971-99 shows that both the size of differentials and relative ranking of regions has been persistent. This is set out in Chart 1.1 below.<sup>2</sup> Notable exceptions are the South East, which has steadily been improving its relative performance since the mid-1970s, and the East and Scotland, which experienced a rapid improvement of their relative position in the mid and late-1980s. The North East, in contrast, has continued to steadily fall behind.

<sup>1</sup> GDP per capita figures are residence-based.

<sup>2</sup> The regions used for these comparisons are based on the old Standard Statistical Regions (SSRs), for which data is only available up until 1996.



**1.7** Historical data is patchier, but evidence suggests that the existing pattern of regional economic activity emerged during the 1920s. During this period the decline of many traditional industries disproportionately affected output and employment in northern regions. The differences that emerged then persisted for the rest of the century.<sup>3</sup>

**1.8** The high degree of persistence of regional differentials points to significant problems in under-performing regions. Growth theory would suggest that market forces should result in convergence of regional GDP per capita over time.<sup>4</sup> A lack of convergence in the medium to long-term is therefore a likely indicator of serious market failures in a number of UK regions or countries. This suggests that there may be substantial unrealised economic gains in large parts of the UK economy.<sup>5</sup>

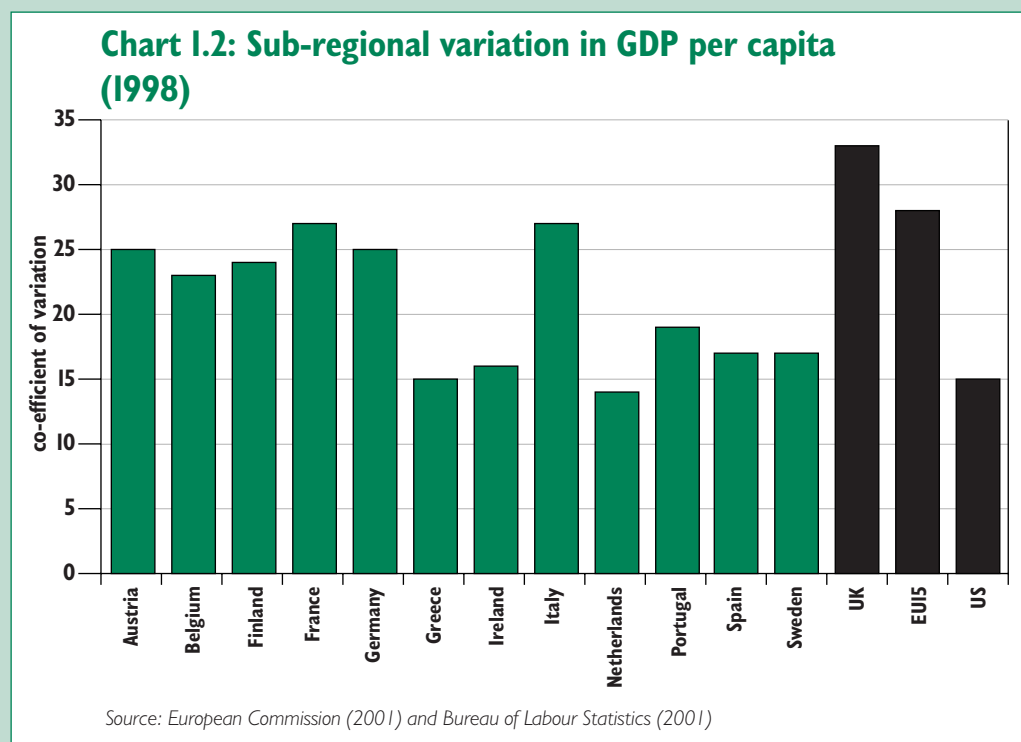
<sup>3</sup> Feinstein, Matthews and Odling-Smee (1982).

<sup>4</sup> Barro and Sala-i-Martin (1995), Obstfeld and Rogoff (1998) and Armstrong and Taylor (2000). Convergence will be conditional on factor endowments and technology.

<sup>5</sup> Cabinet Office, *Sharing the Nation's Prosperity* (1999).

**Box 1.1: International Comparisons**

Research suggests that UK variation in sub-regional GDP per capita is large by international standards, in particular compared to the US.<sup>1</sup> Chart 1.2 shows that in 1998 at the sub-regional level (NUTS 2) the UK had the highest variation in GDP per capita of any EU country, as measured by the coefficient of variation – the standard measure of dispersion.<sup>2</sup>



In contrast with Europe, the US has comparatively small variations in both GDP per capita and unemployment levels between States, significantly below those of the UK and nearly all EU countries. This may be because the US has better adjustment mechanisms, in particular higher labour mobility, leading to slow but steady convergence in income levels across States.<sup>3</sup>

<sup>1</sup> The European Commission, the OECD and the European Investment Bank make international comparisons at the level of NUTS 2 standard classification, because they provide the best basis for regional comparisons across EU countries. NUTS 2 areas broadly correspond to UK counties and groups of counties. They are therefore at a lower level of disaggregation than the UK regions and devolved countries used elsewhere in this document. The US figures are based on the 50 US States.

<sup>2</sup> Regional dispersion is measured as the coefficient of variation at the level of NUTS 2 areas. Output is measured at workplaces, population is based upon residence. Hence, substantial cross-border commuting, especially into the centres of major cities – for example Inner London – will distort these figures. In addition, these numbers are sensitive to the exact administrative boundaries used. Additional work needs to be done in this area.

<sup>3</sup> Blanchard and Katz (1992) and Barro and Sala-i-Martin (1995).

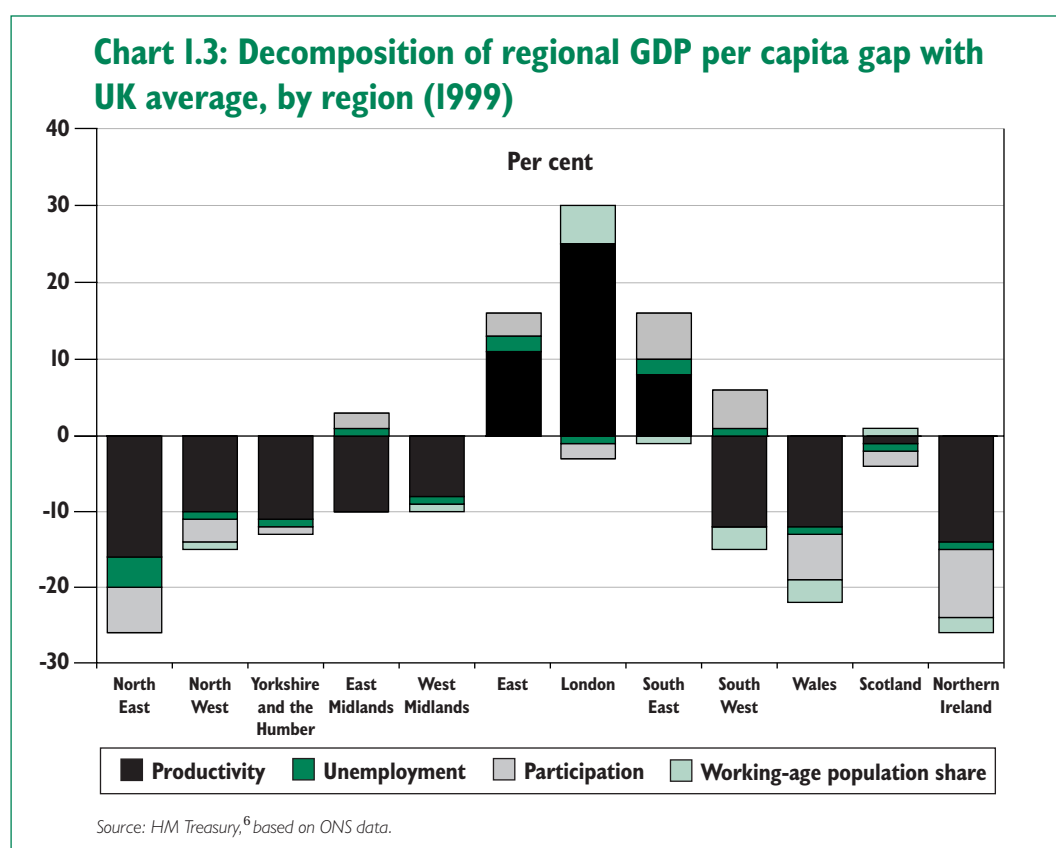
**THE FACTORS THAT UNDERLIE REGIONAL ECONOMIC DIFFERENCES**

**1.9** Understanding the factors that underlie these regional differentials is the first step in formulating a strategy to tackle them.

**I.10** At the most fundamental level, national, regional or sub-regional differentials in GDP per capita will be a function of regional variations in:

- i) *Productivity*: the output each worker produces; and
- ii) *Employment*: the number of people who are working, depending in turn on:
  - demographics (the working-age population);
  - labour market participation rates; and
  - unemployment rates.

**I.11** Regional disparities in GDP per capita should therefore be accounted for by a combination of these four factors. Statistical analysis of output, employment and productivity data for each UK region or country can help separate out these factors. Chart 1.3 depicts such a statistical decomposition for all UK regions and countries.



**I.12** This analysis of regional disparities suggests that, on average, productivity differentials account for around 60 per cent of regional GDP per capita differentials. Variations in participation and unemployment rates and working-age population share generally account for a significant proportion of regions' GDP per capita gap with the UK average.

**I.13** Both regional participation rates and working-age population shares seem to be correlated with regional productivity levels. This suggests that highly productive regions may attract more people who wish to participate in the labour market. It could also be indicative of a higher proportion of workers leaving the labour force in low productivity regions. This suggests that policies should tackle both productivity and labour market weaknesses if they are successfully to affect regional GDP per capita gaps.

<sup>6</sup> Statistical discrepancies are captured in the productivity component of the decomposition. Hence, the productivity numbers depicted here are not identical with the ONS numbers presented in Chart 1.4.

**I.14** The relative importance of each factor varies across regions. In all regions, apart from Wales and Scotland, differences in productivity are the largest contributor to the regional GDP per capita gap with the UK average. Economic performance in Wales, Northern Ireland, the North East and North West also suffers from particularly poor labour market performance (low participation rates and high unemployment). In addition, Wales, the South West and Northern Ireland also have unfavourable demographics (low working-age population shares). Strong economic performance in the South East and East results from a combination of high productivity, high participation and low unemployment. London, in contrast, suffers to some extent from poor labour market performance (high unemployment and low participation rates), but is the richest region in the country due to its exceptionally high productivity levels and a high working-age population share.<sup>7</sup>

**I.15** The rest of this Chapter will look in greater detail at three of the key components of GDP per capita differences – productivity, employment and unemployment.

**I.16** The analysis also looks at sub-regional economic differentials. These are likely to be at least as important as regional differentials in explaining variations in economic performance. Within-region variations in economic performance are often larger than between regions; as such they are of substantial social and economic policy concern. *'Sharing the Nation's Prosperity'*, a report to the Prime Minister by the Cabinet Office published in December 1999, set out the scale of some of these intra-regional differentials.<sup>8</sup> The report found that disparities within regions are at least as great as those between them, and that poor economic or social conditions are not confined to any one part of the United Kingdom but are in fact found in every region or country.

## PRODUCTIVITY

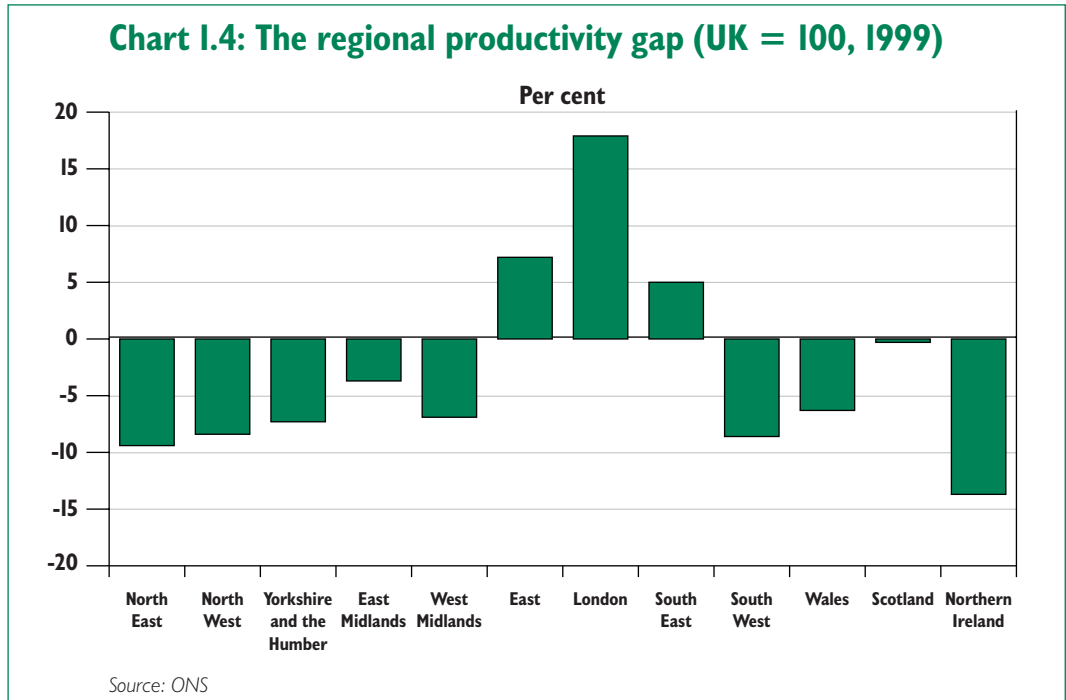
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**I.17** Regional estimates of output per worker are shown in Chart 1.4. There are large and significant variations in productivity, measured as output per worker, amongst UK regions. London has the highest output per worker, with the East and South East trailing by over 10 per cent and all other regions by 15 to 25 per cent. These productivity differentials are likely to be caused by a number of factors, varying skills composition and innovation rates being amongst the most important. Chapter 2 discusses these effects in detail.

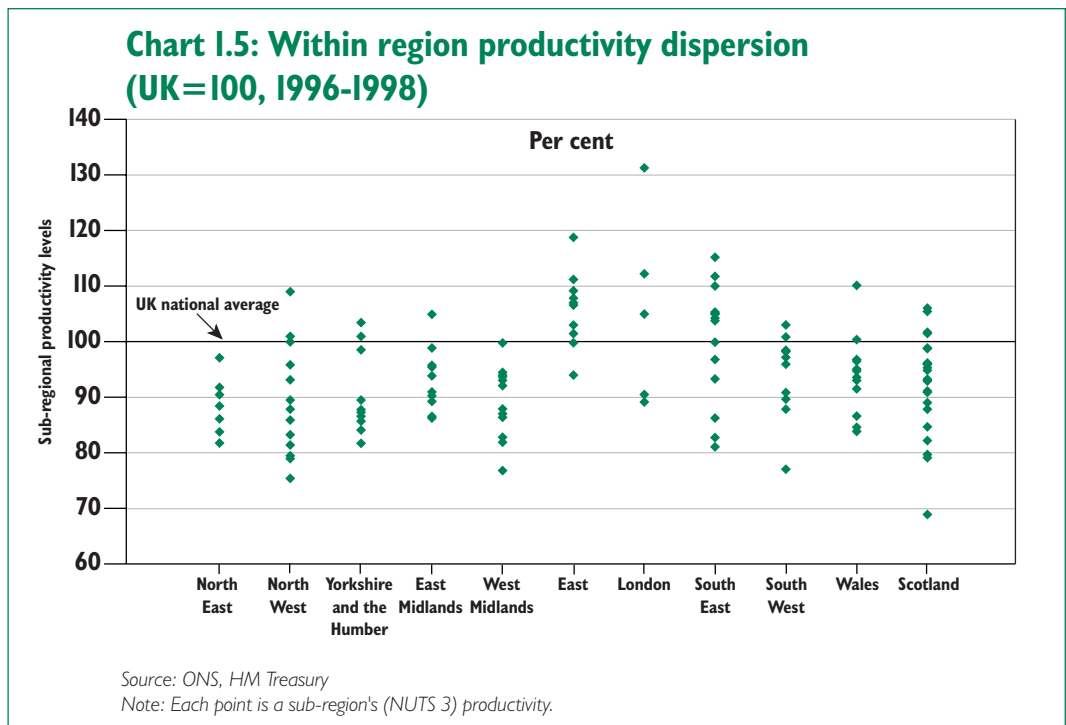
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<sup>7</sup> The importance of productivity in explaining regional differentials is confirmed by Estaban (2000), who finds that on average across the EU interregional inequality in productivity accounts for two-thirds of per capita income differentials, despite a significant convergence of productivity levels during the 1980s. In the US, by contrast, most of the interregional inequality in per capita income can be attributed to differences in employment rates.

<sup>8</sup> For example, in Yorkshire and Humber GDP per capita in 1995, with the UK average scaled to 100, ranged from 127 in York to 65 in Barnsley, Doncaster and Rotherham. In the South East GDP per capita in 1996 ranged from 138 in Berkshire to 74 in East Sussex.



**I.18** In addition, large productivity differentials exist at the sub-regional level. Chart 1.5 plots sub-regional productivity levels within each British region.<sup>9</sup> For example, productivity levels within the South East range from around 20 per cent below the national average in Brighton and Hove to around 15 per cent above the national average in Berkshire and Portsmouth. In the North East all sub-regions have productivity levels below the national average, ranging from 80 per cent of average UK productivity in Sunderland and Tyneside to South Teesside with productivity levels just under the national average.



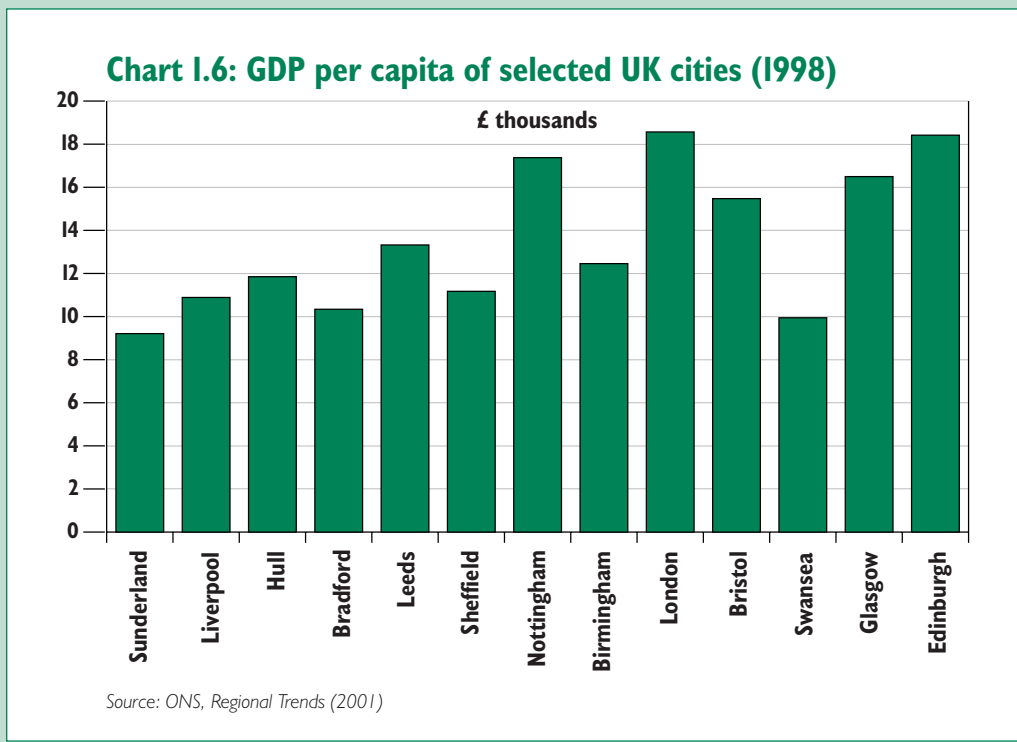
<sup>9</sup> The sub-regional administrative units at which productivity levels can be calculated are individual counties and unitary authorities. The official description for these sub-regional administrative units is NUTS 3 areas (see Regional Trends, 2001 for further details), there are 93 such areas in England. Data is currently not available for Northern Ireland.

**I.19** It is clear from Chart 1.5 that the degree of dispersion within regions varies significantly. Yorkshire and the Humber, the East Midlands and West Midlands, the East and the North East all have significantly lower levels of dispersion of productivity than the rest of the country. This data does, however, need to be treated with caution since statistical problems increase with a higher level of detail.<sup>10</sup>

**I.20** Further econometric analysis of this data shows that both between- and within-region differences in productivity are significant. Any particular area's economic performance can therefore probably be attributed to both region-specific and locality-specific effects. For example, localities in London, the South East and East have on average significantly higher levels of productivity than the UK average, both because of region and locality-specific factors.<sup>11</sup>

**Box I.3: The Economic Performance of UK Cities**

In the UK there are significant variations in the economic performance of the larger cities. Large conurbations outside London have had generally poor labour market performance and have also fallen behind other urban and rural areas' productivity. In particular, the cities of northern England generally have a significantly lower level of GDP per capita than London or Edinburgh. For example, GDP per capita in London is over twice that of Sunderland (see Chart I.6). It should be noted that cross-border commuting patterns will significantly distort some of these results.<sup>1</sup>



<sup>10</sup> Thisse (2000).

<sup>11</sup> McCormick and Redding (2001).

The economic performance of cities is an important driver of the UK's overall output, because a significant proportion of the UK population lives in a city.<sup>1</sup> In addition, there are strong links between the economic performance of cities and their surrounding regions, with the prosperity of surrounding regions significantly correlated to that of the central city. Recent academic work suggests that cities can underpin the success of regional economies as a whole.<sup>2</sup>

One factor in this may be that cities seem to have the potential to be particularly successful at providing the “proximity factors” that attract and retain a critical mass of innovative organisations, leading to the clustering of economic activity. The proximity factors which most influence the location decisions of innovative organizations include:<sup>3</sup>

- institutions specializing in the creation and/or commercial application of innovations in technology and work practices;
- good transport links;
- access to risk and venture capital; and
- a life style that may attract highly-mobile knowledge workers.

Face-to-face knowledge exchange and analysis is a critical feature of successful innovation (these issues surrounding the clustering of economic activity will be further discussed in Chapter 3). Cities can play an important enabling role in this process.

In the UK, London has been able to achieve a greater agglomeration (clustering) of these proximity factors than any other city.<sup>4</sup> Other large conurbations in the UK have been far less successful at doing so.<sup>5</sup> Edinburgh is a notable exception, it has successfully transformed itself into a flourishing service sector economy. Business, professional and financial services now account for over a quarter of all jobs in the city. Edinburgh is forecast to be the fastest growing UK city over the period 1999-2005.<sup>6</sup>

Other OECD countries have had greater success in creating multiple growth centres around high performing cities.<sup>7</sup> For example, in Germany the city-regions of Stuttgart, Oberbayern (Munich) and Darmstadt (Frankfurt) each have between 130 and 170 per cent of average EU GDP per capita. This compares favourably with Greater Manchester at 91 per cent, the West Midlands at 95 per cent and South Yorkshire at 77 per cent of average EU GDP per capita.<sup>8</sup>

It is clear that improving the economic performance of the poorer performing UK cities would enable these cities to play a much more dynamic role in revitalising their surrounding regions and stimulating overall UK productivity.

<sup>1</sup> DETR (2000)

<sup>2</sup> Bouchard (2001) and Courchene (2001)

<sup>3</sup> Porter (1998 and 2001), Black and Henderson (1999) and Sheffield City Council (2000)

<sup>4</sup> London's historic role as the location of central government functions is likely to have been helpful in this process (Henderson, 2000).

<sup>5</sup> Henderson (2000), Rowthorn (2000) and DETR (2000)

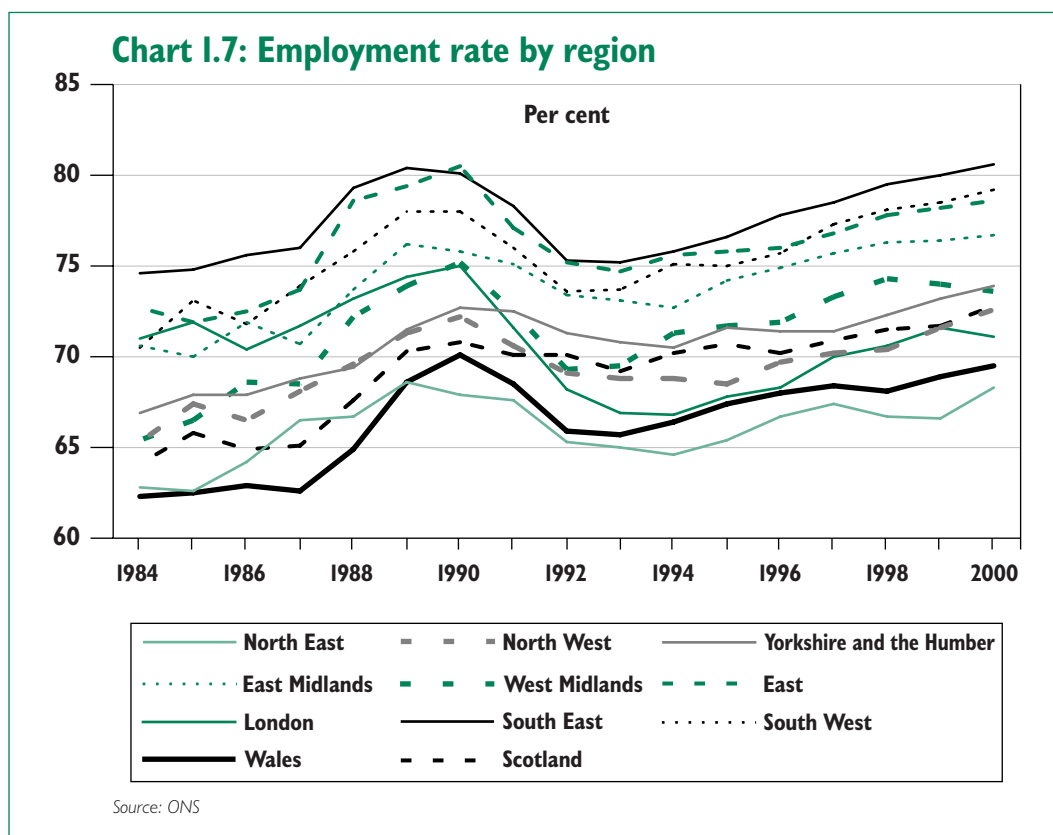
<sup>6</sup> Cambridge Econometrics (2001)

<sup>7</sup> Von Meyer and Muheim (1996), OECD (2000), Katz (2000) and Glaeser (2000).

<sup>8</sup> Eurostat (2001)

## EMPLOYMENT

**1.21** Regional and sub-regional employment rates vary significantly. The variation in regional employment rates rose during the early 1980s and, as Chart 1.7 shows, despite a steady rise in the proportion of each region's workforce in employment, regional employment differentials have remained fairly stable since then.<sup>12</sup>



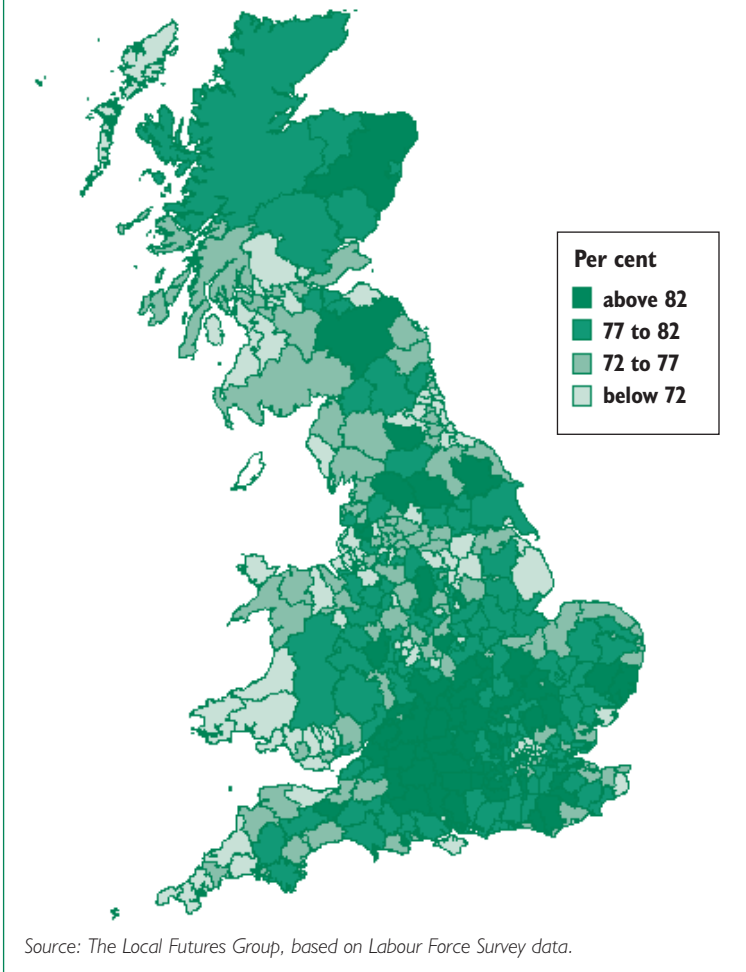
**1.22** Within-region differentials in employment rates are generally larger than between-region differentials. London, the North East, the North West and Scotland have the largest within-region dispersion in employment rates in the UK.<sup>13</sup> Figure 1.2, below, maps employment rates for local authority districts in the English regions, Scotland and Wales. It shows that, for example, in Wales employment rates varied from around 80 per cent in Powys to under 60 per cent in Neath Port Talbot and Merthyr Tydfil.<sup>14</sup> In the South East employment rates vary from 87 per cent in West Berkshire and Bracknell Forest to around 71 per cent in Portsmouth and the Isle of Wight.

<sup>12</sup> Regional Studies Association (2001), Jackman and Savouri (1999) and Fothergill (2001).

<sup>13</sup> McCormick and Redding (2001).

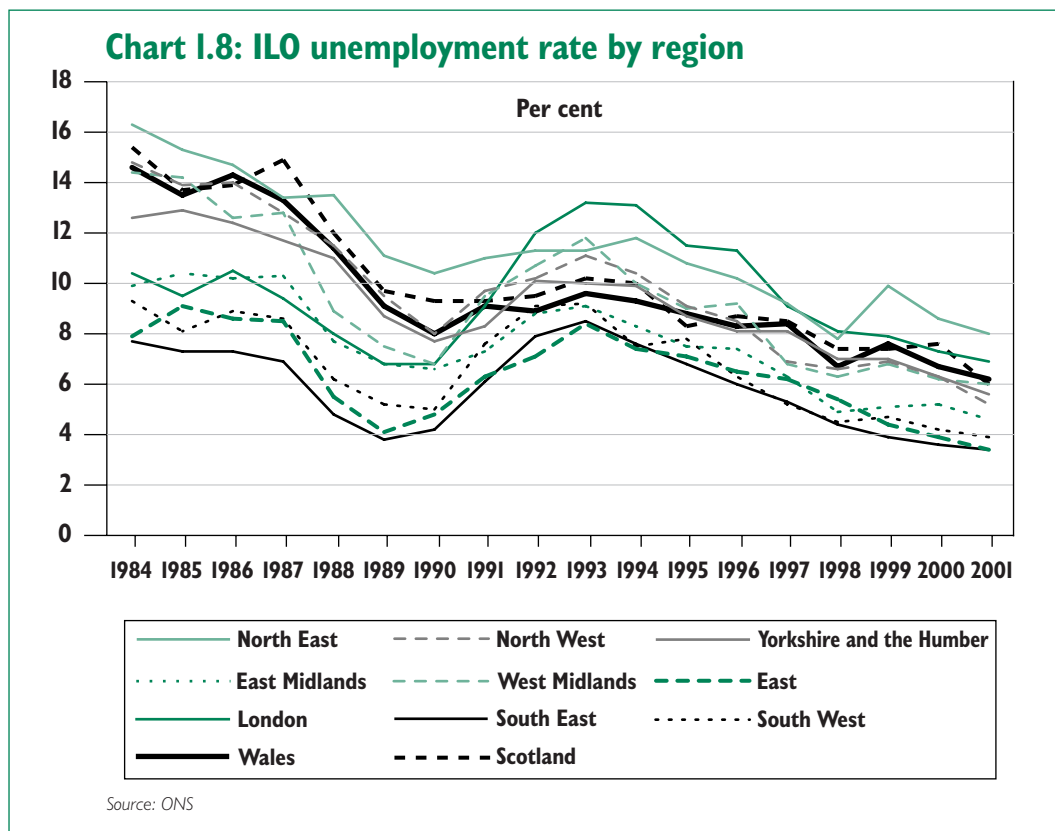
<sup>14</sup> Employment rates are measured as a proportion of the working-age population over the period March 1999 to February 2000.

Figure I.2: Employment rate (2000)



## UNEMPLOYMENT

**I.23** Unemployment statistics suggest a slightly different picture to the employment statistics. They show both falling unemployment and a narrowing of differences between regions over the last twenty years (see Chart 1.8 below). The existing pattern of regional unemployment rates, however, has remained fairly persistent since the 1920s.<sup>15</sup>



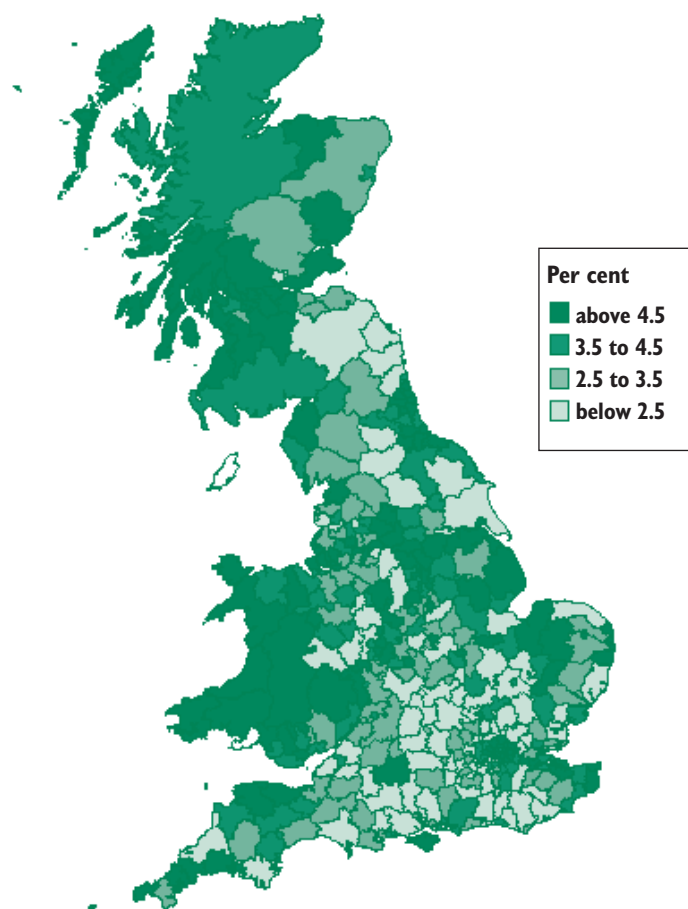
**I.24** Local variations in unemployment are large and significant. Indeed, within-region differentials in unemployment are larger than between region differentials.<sup>16</sup> London and the North East have the highest within region dispersion rates in the UK. In contrast, the East Midlands, West Midlands and the East of England have relatively low within-region unemployment differentials.

**I.25** Figure 1.3, below, shows ILO unemployment rates<sup>17</sup> at the sub-regions level for the English regions, Scotland and Wales. It shows for example, that unemployment rates vary in the North East from around 18 per cent in Middlesborough to around 3 per cent in Northumberland. In Yorkshire and the Humber unemployment rates vary from around 13 per cent in Hull to around 3.5 per cent in North Yorkshire (Hambleton, Harrogate and Scarborough). Indeed, unemployment is frequently a high localised phenomenon with high levels of vacancies coexisting with high-levels of unemployment in the same travel-to-work areas.

<sup>15</sup> Feinstein, Matthews and Odling-Smee (1982).

<sup>16</sup> Cabinet Office, *Sharing the Nation's Prosperity* (1999) and HM Treasury, *The Goal of Full Employment* (2000).

<sup>17</sup> Employment rates are measured as a proportion of the working-age population over the period March 1999 to February 2000. Due to small sample sizes sub-regional ILO unemployment rates can be volatile and estimates should be taken as indicative rather than precise.

**Figure I.3: ILO unemployment rate (2000)**

Source: The Local Futures Group, based on Labour Force Survey data.

**I.26** In absolute terms, regional differences in unemployment rates are smaller than those of employment rates. This is because regional and sub-regional variations in inactivity are similar to those for unemployment, hence compounding variations in employment. In 1998, when the overall inactivity rate peaked, inactivity across the UK varied from 17.5 per cent in the South East (outside London) to 30.3 per cent in Merseyside. This pattern of inactivity is mirrored by the geographical distribution of workless households. In 1998, a quarter or more of households in Tyne and Wear, Merseyside and Strathclyde were workless. At the other end of the spectrum, the prevalence of workless households was around half this rate in East Anglia, and the South East, outside London. The variation in inactivity is even greater at local authority district level.

**I.27** The forthcoming HM Treasury and Department for Work and Pensions Paper “*The Changing Welfare State: employment opportunity for all*” will contain further details on economic inactivity, and how the Government will continue to look at ways of getting more people into work.

**I.28** The evidence clearly suggests that labour market performance, as measured by employment and unemployment rates, varies both at regional and sub-regional level.

## CONCLUSIONS

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**I.29** This Chapter has described how the countries and regions of the United Kingdom have suffered persistent differentials in terms of their economic performance. The productivity of the worst performing areas has persistently lagged that of the best. Similarly, relative labour market performance has been remarkably stable since the interwar period.

**I.30** Tackling the gap between regions and localities in the UK has a crucial role to play if the UK is to address the productivity gap with its main competitors.<sup>18</sup> The persistent underperformance of certain regions and localities suggests that there is substantial unfulfilled potential in large parts of the country. Tapping this potential would offer the prospect of very significant improvements in the UK's overall growth and employment rates and its overall standard of living.

**I.31** Since regions differ in their degree of sub-regional economic variation, the extent to which the difficulties they face are best tackled at the regional or local level will vary. For example, local productivity differentials are substantially lower in the West Midlands or the North East than in the South West and South East. This suggests that the issues facing regions vary across the country and so a regional approach to economic development is appropriate.

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<sup>18</sup> Productivity in the UK: the evidence and the Government's approach. HM Treasury, 2000.

# 2

## THE REGIONS AND THE FIVE PRODUCTIVITY DRIVERS

### INTRODUCTION

**2.1** The evidence set out in Chapter 1 shows that there are significant and sustained differences in regional GDP per capita. This Chapter sets out a number of the underlying factors that are associated with economic growth and provides a more detailed insight into why regional economic differentials may arise.

**2.2** There are a number of factors that underlie any economy's productivity. These five key drivers of growth were set out in "*Productivity in the UK: The evidence and the Government's approach*" published alongside the 2000 Pre-Budget Report, which describes the UK's productivity performance in a national context. They are:

- skills;
- investment;
- innovation;
- enterprise; and
- competition.

**2.3** The performance of the UK's regions against each of these drivers is set out below. Differences in regional performance against each of these factors will have an impact on regions' relative economic performance, and may give some indications of why certain regions may fall short of their productive potential.

### SKILLS

**2.4** Human capital is a key determinant of economic growth.<sup>1</sup> Higher-skilled workers are essential to both introducing and operating advanced production techniques. They adapt faster to new innovations, play a key role in knowledge creation, and are more able and likely to receive training at work. An increasing proportion of jobs in the economy require a higher level of skills. This trend looks likely to continue.<sup>2</sup>

**2.5** There are large variations in the skills composition of the workforce across the UK's countries and regions (see Chart 2.1). London's working-age population, for example, contains almost three times as many graduates as that of the North East. In Northern Ireland, meanwhile, over one-quarter of the workforce is without any academic qualifications, compared to barely one in ten in the South East. Local variations in workforce qualifications are even greater. For example, the proportion of the workforce that is "unqualified" is up to four times greater in some areas than others.<sup>3</sup>

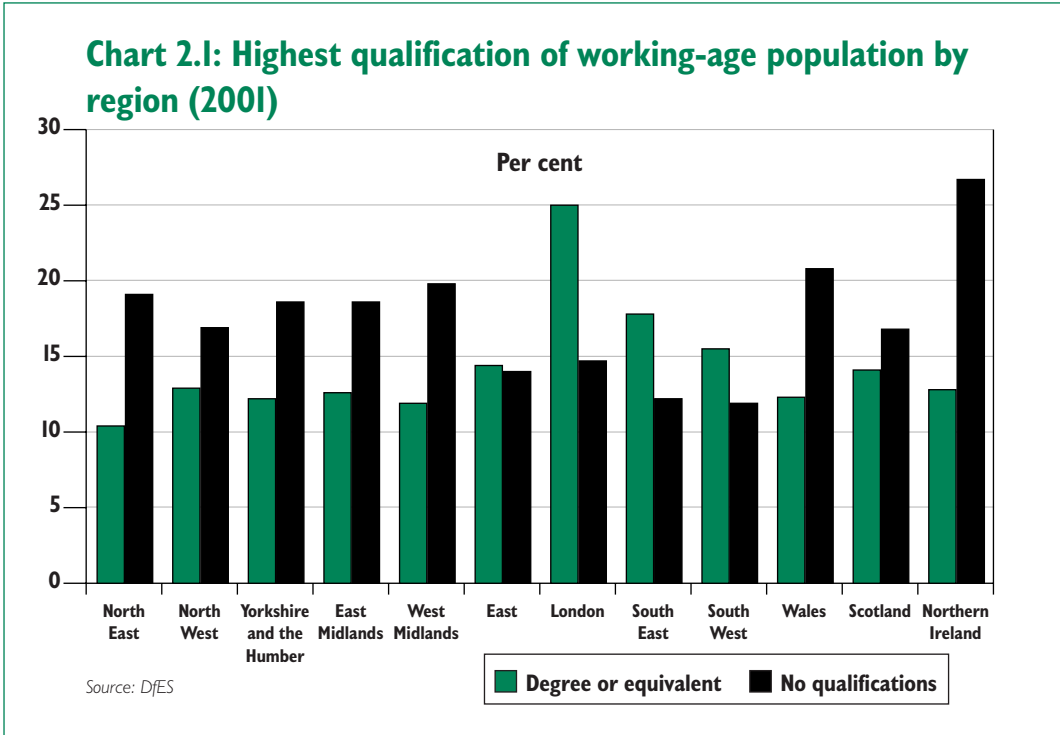
**2.6** Recent studies conclude that these variations in the UK regions' skills composition are the major factor in explaining regional variations in productivity.<sup>4</sup> Understanding why regions and localities vary in their skills composition is therefore central to an understanding of regional and local economic performance.

<sup>1</sup> Mankiw, Romer and Weil (1992), Benhabib and Spiegel (1994), Aghion and Howitt (1998), Temple (2000) and Bassanini and Scarpetta (2001).

<sup>2</sup> Campbell, Chapman and Hutchinson (2000) and Atkinson (1998).

<sup>3</sup> Campbell, Chapman and Hutchinson (2000).

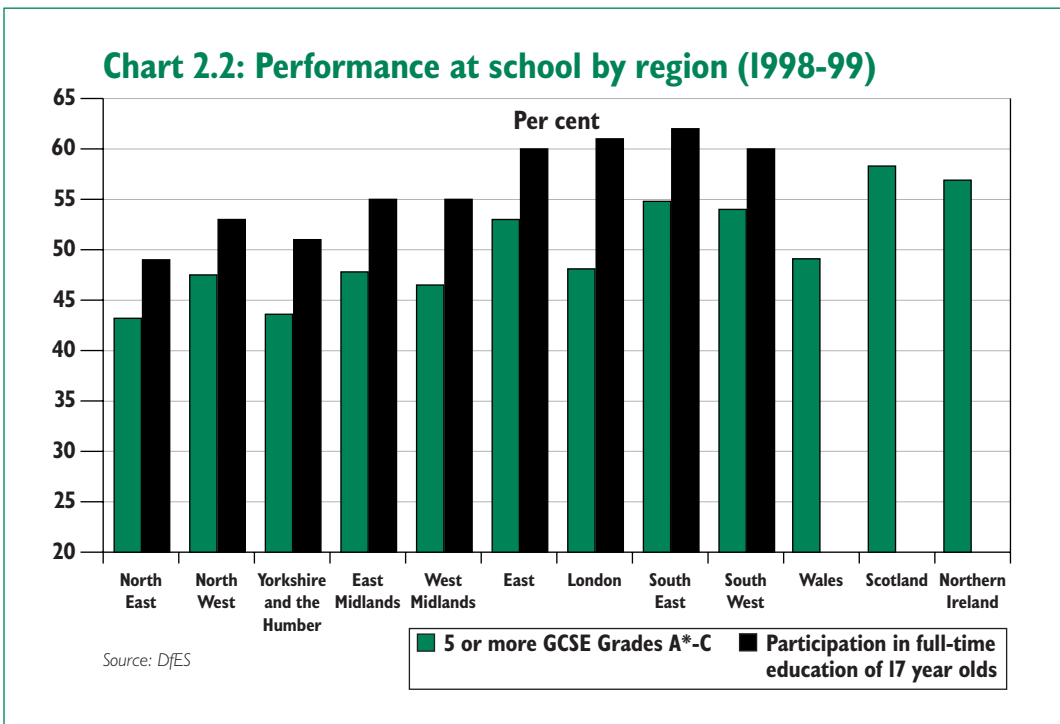
<sup>4</sup> Blackaby and Murphy (1991, 1995), Harris and Trainor (1997), Campbell, Chapman and Hutchinson (2000), Vanhoudt, Matha and Smid (2000) and Duranton and Monsastiriotes (2000).



2.7 The skill levels of the workforce in a region (or locality) will depend on:

- production of skills in that region through education and training; and
- movement of workers into and out of the region.

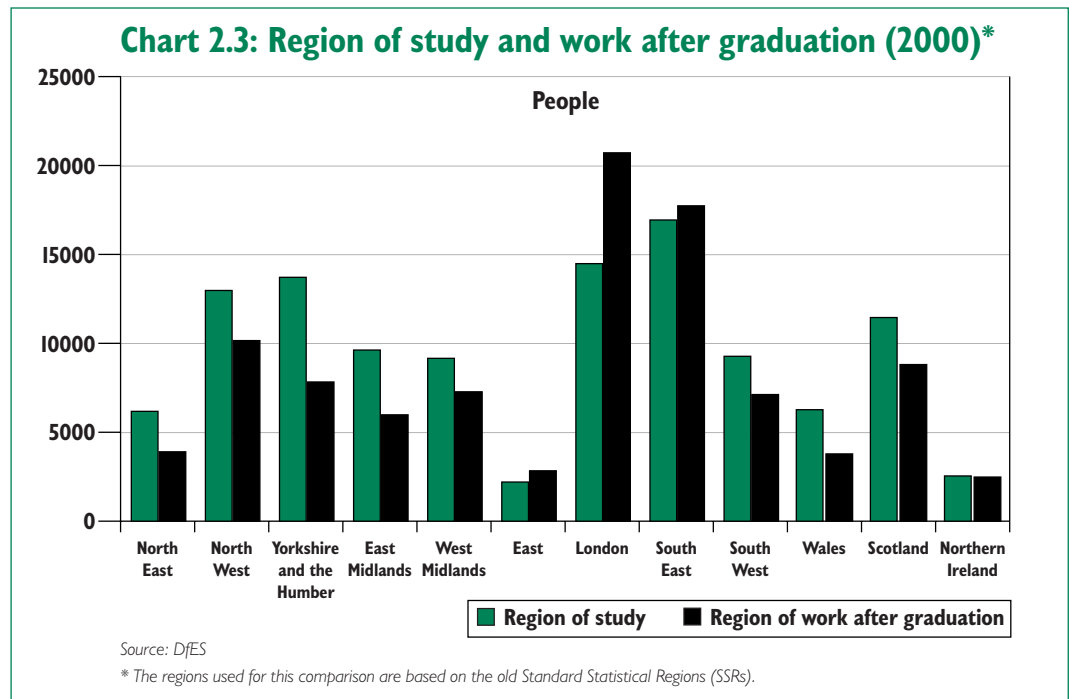
2.8 There are significant variations in educational attainment between regions and localities amongst every age group. These are shown in Chart 2.2 below. For example, the percentage of pupils in their last year of compulsory schooling with 5 GCSEs at grades A\* to C



varies from 43 per cent in the North East to 58 per cent in Scotland. Similarly, participation rates in full-time education after compulsory schooling (age 17) range from over 60 per cent in London and the South East, to under 50 per cent in the North East.

**2.9** Equally, differentials in educational attainment within regions are very large.<sup>5</sup> For example, in the East Midlands the percentage of pupils in their last year of compulsory schooling with 5 GCSEs at grades A\* to C varies from under 30 per cent in Nottingham to over 60 per cent in Rutland.<sup>6</sup> These variations in educational performance during schooling may be on account of a number of factors, including socio-economic background, household structure and parental unemployment.<sup>7</sup>

**2.10** The average educational attainment of those in under-performing regions falls behind during compulsory schooling. These differentials are reinforced after students graduate from university, leading to the systematic under-performance of certain regions and localities.<sup>8</sup> Highly-skilled labour, especially recent university graduates, is by contrast relatively mobile and will often relocate to regions and localities with more highly paid jobs.<sup>9</sup>



**2.11** The evidence suggests that a large number of graduates move from poorer regions to wealthier regions, in particular London, the East and South East. In 2000, over 40 per cent more graduates were employed in London than studied there. In contrast, around 40 per cent less graduates work in Yorkshire and the Humber, the North East, East Midlands and Wales than were educated there. Chart 2.3 above graphically illustrates the extent of these differentials.

**2.12** This analysis of the importance of skills to regional and local economic development leads to two main conclusions. First, the skills of regions and localities' workforces are essential to achieving high levels of productivity and employment. Improving human capital in lagging regions is therefore a key factor to enable those regions to catch up.

<sup>5</sup> Campbell, Chapman and Hutchinson (2000).

<sup>6</sup> ONS, Regional Trends (2001).

<sup>7</sup> Bradley and Taylor (1996) and Rice (2001).

<sup>8</sup> Campbell, Chapman and Hutchinson (2000).

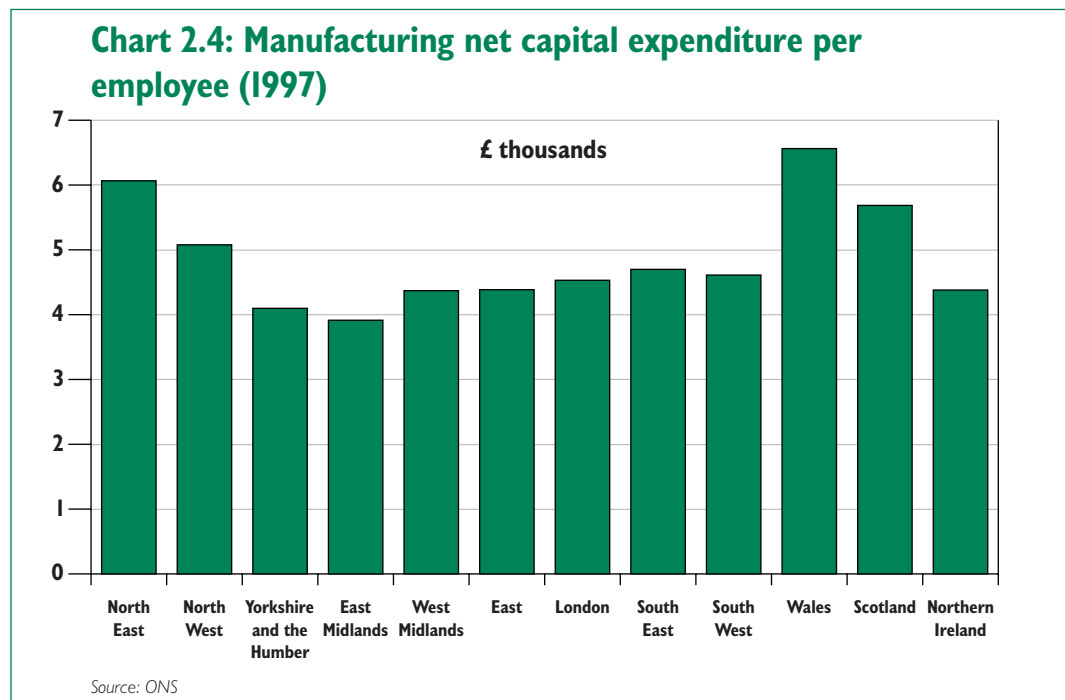
<sup>9</sup> McCormick (1997) and Braunerhjelm et al (2000).

**2.13** Second, measures that increase educational attainment in an area, whilst important for the UK as a whole, will not necessarily lead to improvements in the skill levels of the local workforce. Regions and localities face the problem that high-skilled workers, like firms, are mobile both within in the UK and internationally, and will seek out the most rewarding employment opportunities wherever they occur. This means that regions can be vulnerable to virtuous and vicious circles: high productivity locations can attract skilled workers, which in turn attracts new firms. Conversely, areas with declining, low productivity firms may find it difficult to retain the highly skilled necessary for future development. It is therefore crucial that a region or locality can sustain high-wage jobs, which make it attractive for high-skilled workers to locate there.

## INVESTMENT

**2.14** Investment in physical capital is a key factor underlying a country's growth performance.<sup>10</sup> The UK as a whole has a relatively small capital stock compared to its major competitors. The US has 56 per cent more capital services per hour worked than the UK, France has 48 per cent, and Germany has 32 per cent more.<sup>11</sup>

**2.15** Similarly, one would expect investment in physical capital to also be a key factor in determining a region's growth potential. Unfortunately, there is little regional capital stock or investment data available. Net capital expenditure per employee in manufacturing shows that investment rates in manufacturing vary considerably across the UK. However, the existing data does not suggest that there is general under-investment in physical capital in the poorest performing regions of the UK (see Chart 2.4 below). To get a better indication of the disparities in regional performance one needs to look at investment at a sectoral level, both within manufacturing as well as in the service sector, in each region



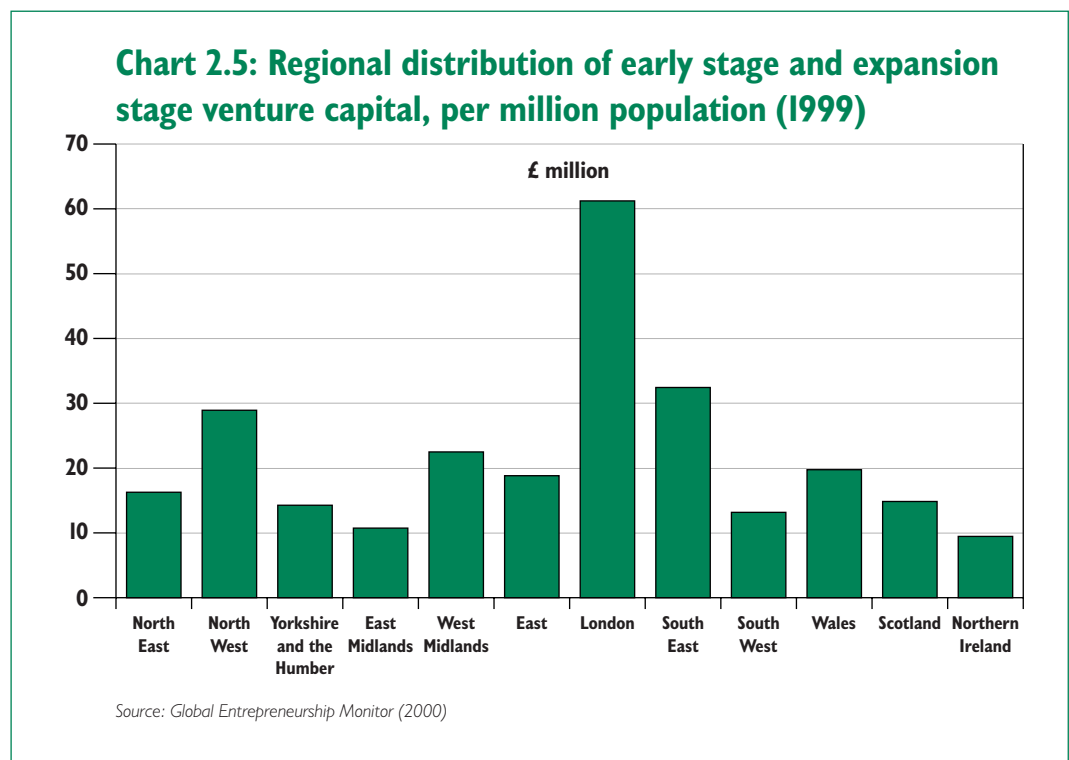
<sup>10</sup> Numerous studies have identified physical capital as a key driver of productivity and growth, including: Delong and Summers (1991), Dougherty and Jorgenson (1997) and Oulton (2001).

<sup>11</sup> O'Mahony and de Boer (2001). Capital services weights asset types by their user costs rather than the value of the stocks. In practice this amounts to placing a higher weight on short lived assets, such as ICT, which depreciate rapidly.

**2.16** Furthermore, it is widely documented that people and firms in deprived communities often find it more difficult to gain access to finance in order to start or grow their businesses. For example, low property values make it difficult for entrepreneurs to provide collateral to secure business loans necessary for investment.<sup>12</sup>

**2.17** Venture capital is one important form of finance for new firms. Chart 2.5 below, shows that venture capital spending per person is significantly higher in London than in any other region.

**2.18** Foreign direct investment can also play an important role in stimulating economic performance in an area. On average foreign-owned firms have higher productivity levels than domestic owned firms. They can also provide positive spillover benefits to firms located in the same area by introducing new technologies and working-practices, as well intensifying competitive pressures.<sup>13</sup> The UK as a whole accounts for 30 per cent of the total inflow of foreign direct investment in the European Union.



**2.19** A regional breakdown shows that in the past years London and South East have received an increased share of foreign direct investment projects. For example, over the last five years London has increased more than six-fold the number of projects recorded by Invest.UK, the inward investment arm of British Trade International. London and the South East now attract almost a third of all investment projects (249 of 757 projects in 1999–2000), from less than one fifth in the mid-1990s.<sup>14</sup> The rest of the UK accounts for two-thirds of new investment projects, with the next highest concentrations in the West Midlands, North West and Scotland, which have high concentrations of manufacturing employment.

<sup>12</sup> Black et al (1996), Enterprise and Social Exclusion, HM Treasury (1999) and Bank of England (2000).

<sup>13</sup> Girma, Greenaway and Wakelin (1999), Oulton (2000) and Girma and Wakelin (2000).

<sup>14</sup> Invest.UK.

**2.20** In summary, investment in physical capital is an important determinant of economic growth in the economy as a whole. The available data on net investment in manufacturing, however, suggests that variations in business investment are unlikely to be very important in explaining regional GDP per capita differentials. At the sub-regional level, in contrast, poor access to finance in deprived local areas is likely to have a significant detrimental impact on productivity and employment in those areas.

### Box 2.1: Does industrial composition constrain future growth?

UK regions vary in their industrial composition. The southern parts of the UK are relatively more specialised in service sector activities, whilst the northern regions rely more heavily on manufacturing (see Figure 2.1 and Figure 2.2, which show the share of industry and service sector output as a proportion of GDP in each region).

The mix of different industries in a region plays a key role in determining the skills, investment and technology requirements of that region. Industrial composition is therefore likely to play an important role in understanding regional and local economic dynamics.

There is as yet no extensive academic work on the issue of industrial composition and productivity growth at the regional level. Such research that there is, however, has some interesting findings. First, there is evidence that at the EU level, regional specialisation appears to have a very minor role in explaining interregional inequality in productivity. Interregional productivity differences are common across all sectors in a region and there seem to be uniform productivity shortfalls in poorer regions.<sup>1</sup>

Figure 2.1 Industrial production as a proportion of GDP by region

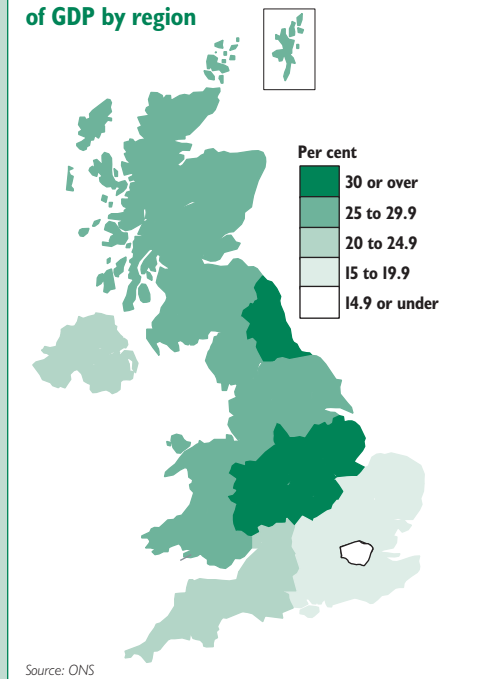
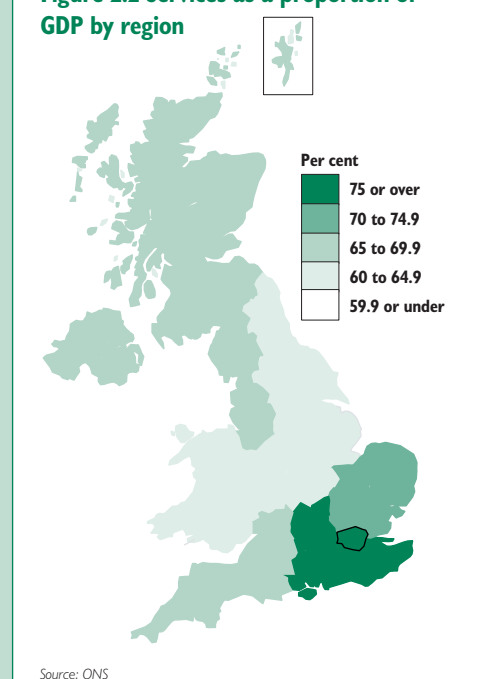


Figure 2.2 Services as a proportion of GDP by region



More recent work by the Bank of England provides support for this view.<sup>2</sup> It finds that the broad manufacturing/services split explains little of the difference in outputs between UK regions. However, at the sub-sectoral level, especially within the service sector, differences in structure can be important in explaining differences in growth performance.

Similarly, there is evidence that a region's initial sectoral composition does not predetermine its future growth path. European regions with similar initial sectoral specialisation in the early 1980s subsequently had very different economic outcomes.<sup>3</sup>

Whilst more work needs to be done on the issue these findings suggest a few tentative conclusions. First, a region's industry mix plays some role in explaining individual regions and localities' economic problems. However, on the whole it does not critically constrain a region's growth potential. A region's industry-mix evolves over time, governed by technological change, consumer preferences and the underlying resource base. Many regions are able to either adapt their industrial composition to attract higher value added activities or improve their productivity in those sectors.

This suggests that, in order to close the productivity gap between more and less developed regions, development policies should tend to focus on providing the conditions in which regions and localities can successfully take advantage of new technological opportunities and structural change. This points towards policies focused on factors uniformly affecting the productivity of poorer regions, such as skill composition or competition policy.

<sup>1</sup>Estaban (2000)

<sup>2</sup>Morris (2001)

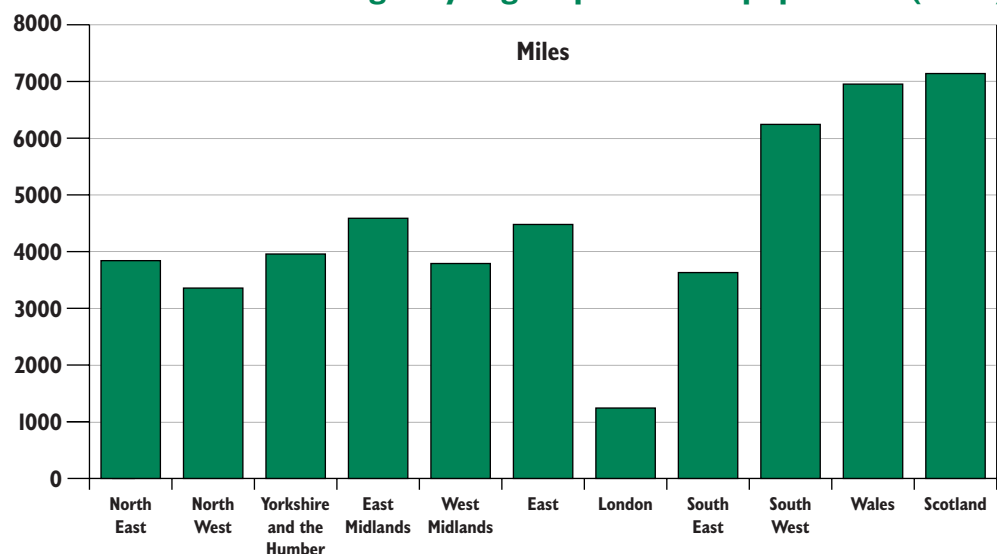
<sup>3</sup>Overman and Puga (1999)

## Infrastructure Investment

**2.21** Improvements in transport infrastructure have historically played a major role in enhancing economic performance. The integration and enlargement of, in turn, the canal, railway, and road systems are prime examples of how improvements in infrastructure helped economic growth, by reducing the cost of trade and factor inputs across regions and helped to integrate national markets.<sup>15</sup>

**2.22** Investments in infrastructure have a direct economic effect by reducing transportation costs for firms, workers and consumers. Falling transportation costs also increase the effective size of regional and local markets. This creates new growth opportunities for

**Chart 2.6: Road length by region per million population (2000)**



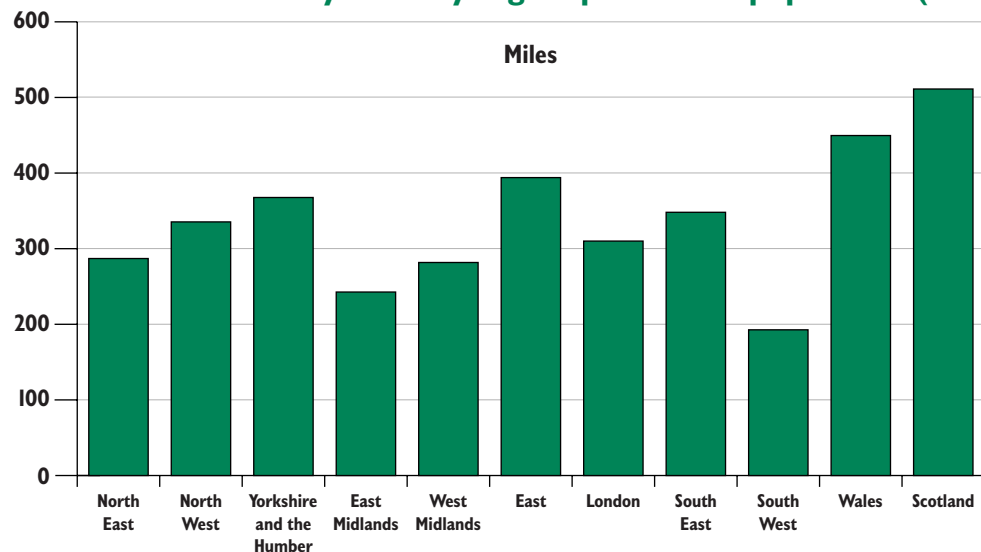
Source: DTLR

<sup>15</sup>Fernald (1999) and DETR (1999).

successful companies and intensifies competition, thereby encouraging greater efficiency and innovation. In particular remote regions rely on significant investment in transportation infrastructure.<sup>16</sup>

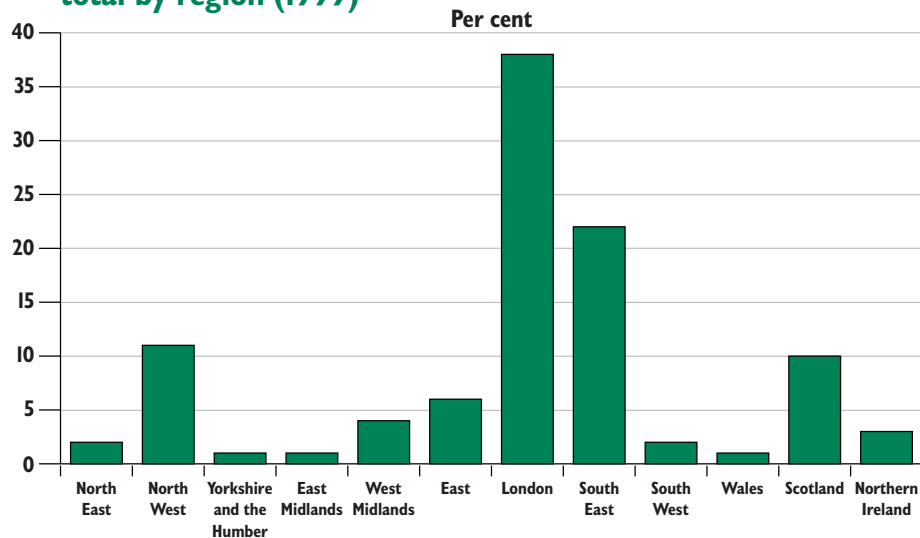
**2.23** The main forms of physical transport infrastructure in any region are roads, rail and airports. Demand for infrastructure depends on a number of factors, including size of region, population density and how the population is distributed within the region. Chart 2.6 shows length of roads per million inhabitants. Large regions, particularly those with lower population densities, such as Scotland, Wales and the South West have a higher level of road infrastructure per person than regions with densely populated areas, such as London. Most other regions in England have very similar levels of road infrastructure per inhabitant.

**Chart 2.7: Railway track by region per million population (2001)**



Source: Railtrack, London Underground, DTLR

**Chart 2.8: Airtravel passenger numbers as proportion of UK total by region (1999)**



Source: Civil Aviation Authority

Note: Heathrow airport is in London, Gatwick and Luton are in the South East, Stansted is in the East.

<sup>16</sup>Scotchmer and Thisse (1992).

**2.24** Chart 2.7 shows length of railway track per million inhabitants in each region. The two regions with the lowest population densities have the highest rail provision.

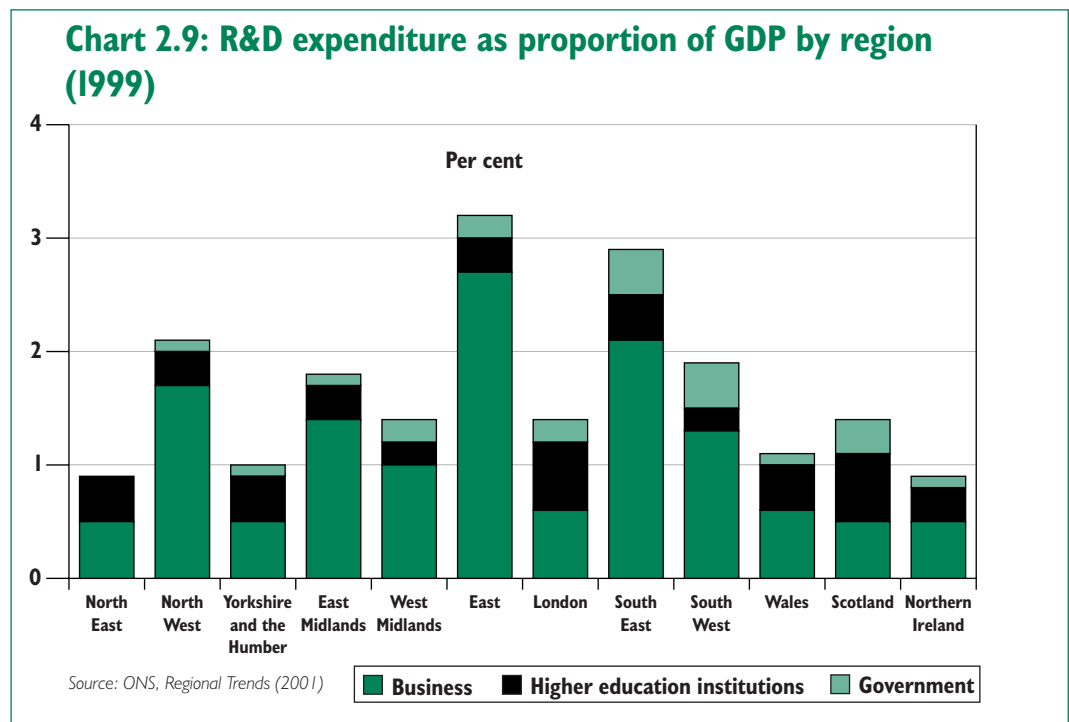
**2.25** Air traffic passenger numbers by region show London and the South East have substantially more airport infrastructure. These are shown in Chart 2.8 above. Despite the concentration of air traffic in the London area, other regions have seen very high growth in passenger numbers. The number of passengers flying from outside the London area has risen from 18 million in 1980 to just over 64 million in 1999. Manchester airport, for example, has increased its passenger volume nearly sevenfold over the last twenty years.<sup>18</sup>

**2.26** Transport infrastructure is clearly of significant importance to economic growth. Whether infrastructure investment alone is an effective economic development tool in depressed areas is questionable though.<sup>19</sup> Indeed, investment in transport infrastructure may be more effective in response to increasing demand from firms and workers.<sup>20</sup>

## INNOVATION

**2.27** Innovation – the invention and application of new technologies, products and production processes – is a key driver of productivity growth. Innovation has accounted for around two-thirds of UK economic growth in the post-World War II period.<sup>21</sup> Furthermore, a majority of the UK's productivity gap with the US can be accounted for by differences in the level of innovation.<sup>22</sup>

**2.28** Most research suggests that genuinely new technologies and cutting-edge production processes are produced by a few world-leaders (companies and research institutions) in relatively few countries. These are then disseminated and adopted by other firms and across other countries and regions.<sup>23</sup>



<sup>18</sup> Civil Aviation Authority.

<sup>19</sup> Arzeni and Pellegrin (1997), Martin (1999), OECD LEED (1999) and Braunerhjelm et al (2000).

<sup>20</sup> Vanhoudt, Matha and Smid (2000).

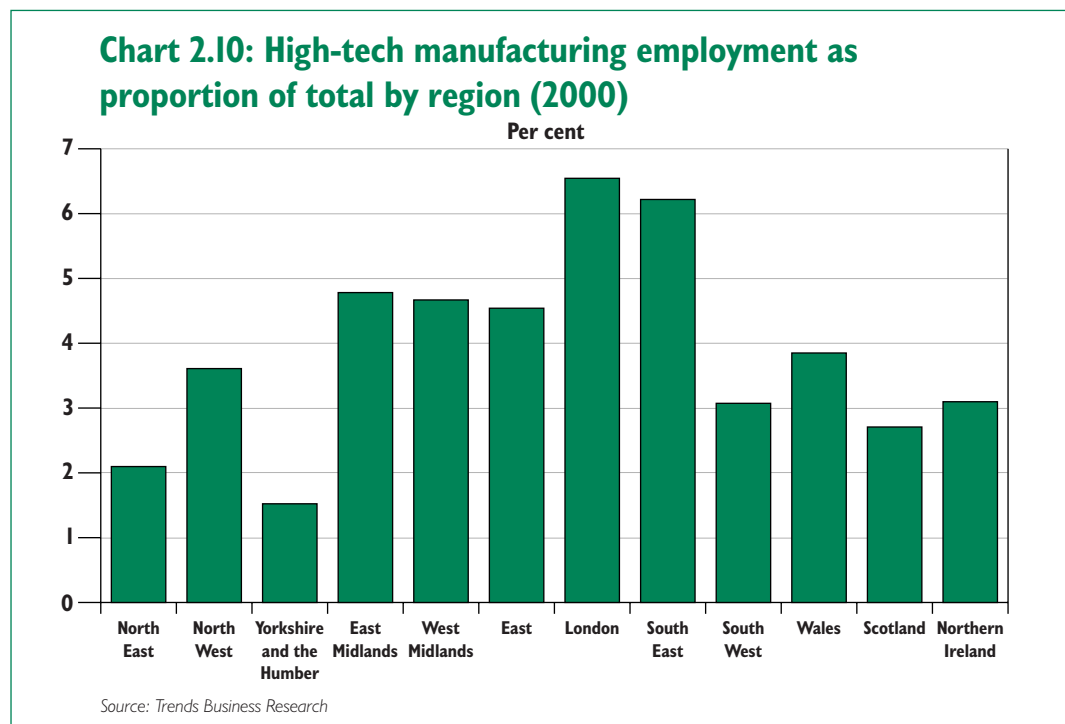
<sup>21</sup> O'Mahony (1996). The economic measure of the degree of innovation, or efficiency, is total factor productivity, a concept pioneered by Abramovitz (1956) and Solow (1957).

<sup>22</sup> Crafts and O'Mahony (2001) and *Productivity in the UK: the Evidence and the Government's Approach*, HM Treasury (2000) for a more extensive discussion.

<sup>23</sup> Scherer (1984) and Griliches (1996). Caselli and Coleman (2001) call this the 'World Technology Frontier', technological leaders are pushing this frontier outwards, the followers are inside the frontier striving to catch-up.

**2.29** However, a number of studies suggest that there are important barriers that prevent the effective dissemination of technology, not only between developed and developing countries, but also between OECD countries and firms, so that the spread of more innovative and efficient ideas is sometimes highly localised.<sup>24</sup> This poor dissemination of knowledge could therefore be a key cause of a lack of convergence between countries and regions.<sup>25</sup>

**2.30** Expenditure on research and development (R&D) is one proxy for how much firms invest in the production or adoption of innovation.<sup>26</sup> Chart 2.9, above, shows that there are substantial variations in the amount of R&D expenditure amongst UK regions. In 1999 R&D expenditure totalled around 3 per cent of regional GDP in the East and South East, but only 1 per cent in the North East, Yorkshire and the Humber, Wales and Northern Ireland. Around two-third of R&D expenditure in the UK is by businesses; only in London and Scotland is R&D in higher education institutions as, or more, important.



**2.31** Another indicator of the ability of UK regions to adopt new technologies is the share of jobs in high-technology sectors in total employment.<sup>27</sup> The proportion of jobs in high-technology industries varies from over 6 per cent in London and the South East to 2 per cent and below in the North East and Yorkshire and the Humber (see Chart 2.10 above).

**2.32** Studies have shown that under-performing regions and localities have particular problems in absorbing new technologies.<sup>28</sup> This is likely to be a key explanation for regional variations in their innovative performance. New innovations are not always readily transferable, but need to be adapted to industry, country and region specific circumstances. For example, if technological progress requires highly-skilled workers, firms in regions with a poor skills base may not be able to take full advantage of new technologies.<sup>29</sup>

<sup>24</sup> Keller (2000) and Girma and Wakelin (2000).

<sup>25</sup> Grossman and Helpman (1991) and Feenstra (1996).

<sup>26</sup> Rodriguez-Pose (2001).

<sup>27</sup> High-tech activity is defined using the standard US classification, which includes communications, internet, computers, computer-related, semi-conductors and other electronic-related, biotechnology and medical instruments and devices. This definition therefore includes only high-tech manufacturing activity – excluding services entirely.

<sup>28</sup> Girma and Wakelin (2000) and Rodriguez-Pose (2001).

<sup>29</sup> Atkinson and Stiglitz is the principal work in this field, see Acemoglu and Zilibotti (2001) for a recent example and Caselli and Coleman (2000) for an empirical test of this hypothesis.

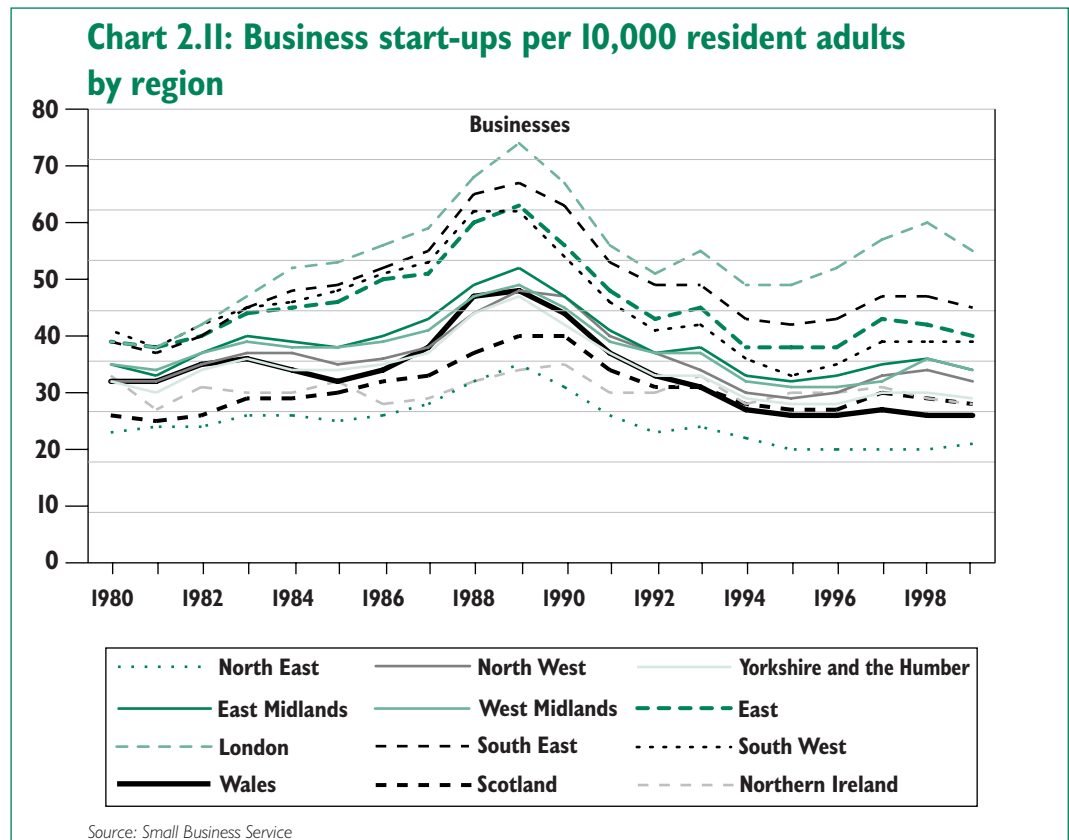
**2.33** Improving the ability of under-performing UK regions and localities to adopt new innovations is likely to be crucial in enabling them to improve their productivity level to those of the best-performing regions. Key factors that improve a region's ability to adopt new technologies include the skills of the workforce and investment in appropriate R&D and physical capital, including information and communications technologies and new machinery.<sup>30</sup>

## ENTERPRISE

**2.34** Enterprise is a key driver of productivity growth in the economy. Growth of new firms is often associated with the introduction of new technologies, innovative ways of working and increased competitive pressure on other firms. Research has shown that new firms and plants entering the market account for a significant part of total productivity growth.<sup>31</sup>

**2.35** There are large regional differences in business start-up rates across the UK. People in London and the South-East of England are much more likely to start a business than their counterparts in other regions of the UK, particularly the North East of England, Scotland and Wales. Business creation rates in 2000 ranged from 21 new VAT registrations per 10,000 resident population in the North East, to 65 per 10,000 in London.<sup>32</sup>

**2.36** As Chart 2.11 shows, this is by no means a recent phenomenon, but a feature of at least the last two decades. In fact, the gap in start-up levels between the regions with the highest and lowest rate of new VAT registrations has actually widened over the last twenty years.

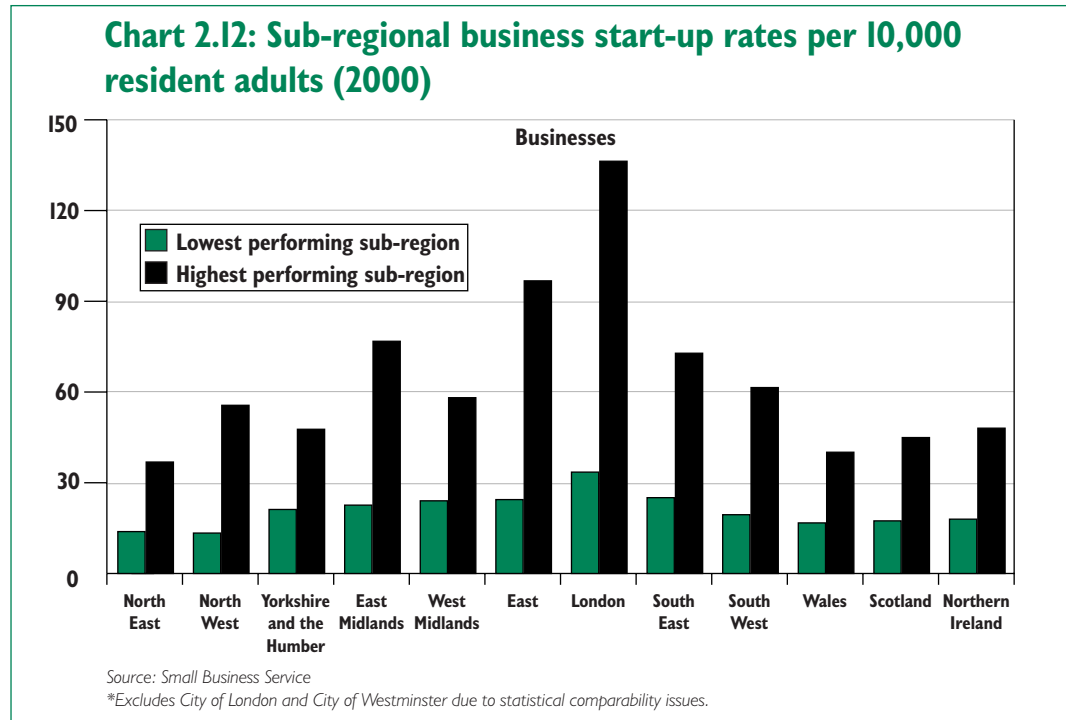


<sup>30</sup> Audretsch (1997) and Storper (1997).

<sup>31</sup> Barnes and Haskel (2000), Griffith (2001) and Bartelsmann, Scarpetta and Schivardi (2001).

<sup>32</sup> ONS, Regional Trends (2001).

**2.37** There are also large variations in sub-regional business start-up rates. In 2000, business creation in the local authority districts with the highest rates was more than six times the rate of the lowest.<sup>33</sup> Chart 2.12 below shows the local authority districts with the highest and lowest start-up rates in each region. For example in the North East region, 37 out of every 10,000 adults in Tynedale registered new businesses for VAT in 2000, compared to only 14 in every 10,000 resident adults in Redcar & Cleveland.



## COMPETITION

**2.38** Competition plays a central role in driving productivity growth by providing strong incentives for firms to innovate and adopt new technologies and working practices. It helps reduce slack in organisations and is crucial in the reorganisation of market structures, by reallocating resources away from inefficient firms or declining sectors, to more efficient firms and growing sectors.<sup>34</sup>

**2.39** The level of competition in an economy may vary significantly across regions and localities. In sectors where goods and services are not easily traded transport costs, poor information and differences in consumer tastes will segment markets. Where markets are regional or local, in particular in poorer or more remote regions, they may become dominated by only a few firms. In contrast, firms in large and densely populated regions with good access to markets are more likely to experience higher levels of competition. Not only can these markets support a greater number of competitors, but also firms and consumers are likely to have comparatively easy access to a wide choice of suppliers.<sup>35</sup>

**2.40** One indicator of intensity of competition in a market is the number of competitors in that market. In addition, markets with low barriers to entry are more likely to create competitive pressures on incumbent firms.<sup>36</sup> Since 1980 the higher start-up rates in London

<sup>33</sup> St Albans had the highest rate outside of London of 97 per 10,000 residents, Barrow-in-Furness had the lowest with 13 per 10,000 residents.

<sup>34</sup> Porter (1990), Geroski (1990), Caves and Barton (1990), Blundell, Griffith and Van Reenan (1995) and Nickell (1996).

<sup>35</sup> Scotchmer and Thisse (1992), Krugman, Venables and Fujita (2000) and Competition Commission (2000).

<sup>36</sup> Baumol, Panzer and Willig (1986).

and the South East have increased the local business stock by more than a third, meaning more businesses per head of population, and greater local competition. By contrast, the North East of England, Scotland and Wales have seen only marginal net growth in the size of their business communities.<sup>37</sup> These differences in competitive pressures may go some way to explain the stronger growth performance in London and the South East over the past decade.

**2.41** In summary, varying levels of competitive intensity across the UK may play an important role in explaining regional and local productivity differences. Firms in poorer and more remote regions may face less competition, and hence fewer incentives to cut costs and innovate.

## CONCLUSIONS

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**2.42** The evidence about the factors underlying regional and sub-regional economic performance suggests that skills, innovation, investment, enterprise and competition are the key factors driving productivity growth in UK regions and localities. The evidence on skills in explaining regional economic differentials is particularly strong.

**2.43** These factors, however, do not work in isolation. For example, a firm's ability to use best-practice techniques relies on all its employees being familiar with technology and having the capacity to translate this knowledge into improved work practices. Skilled workers' ability to adopt the latest technologies is essential to this process, and research at the firm level finds strong complementarities between the rate at which firms adopt new technologies and workforce skills.<sup>38</sup>

**2.44** Government policy can therefore not simply focus on one of these drivers to improve the performance of the UK regions and countries. Instead intervention is required on a number of policy fronts and will vary according to the different conditions within each region and locality.

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<sup>37</sup> Small Business Service.

<sup>38</sup> Downs, Dunne and Troske (1997) and Nickell and Nicolitsas (2000).



## INTRODUCTION

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**3.1** Chapter 1 of this document has described the large and persistent differentials in economic performance between and within regions. These substantial economic differentials are associated with variations in the underlying factors driving growth: skills, physical capital, enterprise, innovation, and competition, as set out in Chapter 2. The size of economic differentials shows that there is significant economic underperformance in large parts of the UK.

**3.2** The persistence of these differentials over large parts of the last century, points to significant market failures in under-performing regions and localities. If the economic processes driving growth were working effectively, we would expect these differences to disappear over time. New technologies and best practice would diffuse from the leading regions to the followers. Firms would discover new investment opportunities in the lagging regions. The additional investment in human and physical capital, coupled with the adoption of new techniques, would generate relatively faster growth in the lagging regions and stimulate a catching-up process. That this has not occurred, points, among other things, to market failures in the under-performing regions and localities. This creates a strong case for well-judged government intervention to correct for such market failures.

**3.3** There are a number of potential sources of regional and local underperformance – macroeconomic instability, market failures in the underlying productivity drivers described in Chapter 2, barriers to labour mobility and failures that affect the clustering of economic activity. This Chapter will discuss these issues in detail. It concludes with an assessment of whether regional economic differentials are inevitable, or whether convergence in productivity and employment levels between regions can be reasonably expected.

## MACROECONOMIC STABILITY

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**3.4** Macroeconomic stability is an essential pre-condition for creating an environment in which underperforming regions can increase their sustainable rate of growth. Macroeconomic instability has increased regional inequalities frequently in past recessions, particularly in the 1930s and the early 1980s. The uncertainty created by macroeconomic instability can prevent firms and workers from making efficient long-term decisions about investment, in physical and human capital, as well as research and development. This will have a detrimental impact on all countries and regions, as economic resources are under-utilised.<sup>1</sup>

**3.5** Regional inequalities in themselves may also exacerbate overall macroeconomic volatility. Workers and firms in high-growth regions are likely to suffer from a greater degree of financial exposure to inflated asset prices and increased debt repayment. Furthermore, if economic growth is focussed in only a few regions of the country, firms are likely to run into bottlenecks, for example due to labour shortages, more quickly. This will lead to inflationary pressures emerging more quickly than necessary, making a more volatile business cycle likely.

**3.6** This may have occurred in the UK during the 1980s. A period of rapid economic growth in the South East and London was accompanied by slower relative growth rates in other regions of the country. Consequently, inflationary pressures and high levels of debt of households and investors in the South East and London turned a rapid expansion in the late 1980s into a severe recession.<sup>2</sup>

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<sup>1</sup> OECD (2000) and Armstrong and Taylor (2000).

<sup>2</sup> Blackaby and Manning (1992), Taylor and Bradley (1994), Ashworth and Parker (1997), Aghion, Caroli and Garcia-Penalosa (1999) and Aghion and Howitt (1998).

**3.7** In summary, macroeconomic volatility is likely to have had a detrimental impact on aggregate UK economic growth and, in key periods, widened regional inequalities. Furthermore, unequal economic growth across the UK regions is also likely to have been a contributing cause to past economic instability.

## MARKET FAILURES IN THE FIVE PRODUCTIVITY DRIVERS

**3.8** The November 2000 publication “*Productivity in the UK: The Evidence and the Government’s Approach*” identified five key drivers of economic growth: investment in human and physical capital, innovation, enterprise and competition and discussed these in an national context. Chapter 2 of this paper discussed these at the regional and sub-regional level.

**3.9** “*Productivity in the UK*” identified that efficient functioning of all markets – product, labour and capital markets – is essential to high levels of productivity and employment.<sup>3</sup> The functioning of these markets can be constrained by a series of market failures with a detrimental impact on the “five drivers”. These market failures can arise at the regional and local level, as well as at the national.

**3.10** Regional and local market failures, as distinct from those at the national or international level, can persist because markets are not always national in scope. These markets are instead segmented to a varying degree by distance, transportation costs and other factors such as consumer tastes or preferences. As a consequence, market failures may lead to shortfalls in investment in human and physical capital, the adoption and creation of new technologies and best-practice. They may also lead to sub-optimal levels of competition and enterprise.

**Skills 3.11** Chapter 2 documented differences in skills composition and educational attainment by region. These can in part be attributed to failures in the regional and local production of skills. Incentives to acquire human capital are reduced in low-growth regions by the lack of high-skilled jobs in such regions. In addition, market failures may exist in the matching of workers and their skills in a travel to work area. These may be compounded by constraints on labour mobility.

**Investment 3.12** Efficient investment decisions by entrepreneurs, banks, venture capital providers and other source of investment finance, require region and locality specific information. Depressed and remote areas may suffer from poor access to capital on account of a lack of information and uncertainty about investment opportunities in those areas. Creditors may find it hard to disentangle good and bad investment opportunities in low-growth regions and hence undersupply funds for investment in these regions.<sup>4</sup>

**Innovation 3.13** The dissemination of knowledge of best-practice and new technologies decreases with distance, suggesting that there is an important regional and local dimension to innovation. Tackling market failures in the adoption and creation of new technologies and best-practice techniques, on account of, for example inadequate product market competition or information failures, is vital to productivity growth in an area.

**Enterprise 3.14** The size of labour, capital and product markets are all constrained by geography. High levels of entrepreneurial activity in every region and locality are essential for high levels of competition, innovation, investment and skills in an area – and hence for job creation and productivity.

<sup>3</sup> *Productivity in the UK: the evidence and the Government’s approach*, HM Treasury (2000).

<sup>4</sup> Capital market imperfections in poorer regions are exacerbated by regional imbalances, whereby an economy’s funds are disproportionately channelled towards the wealthier regions.

**3.15 Competition:** Markets can have an important regional and local dimension as they are segmented by transportation costs and consumer tastes. Ensuring that markets are competitive in every region and locality is essential in ensuring firms face incentives to innovate, keep prices down and minimise their costs of production.

## LOCATION DECISIONS OF FIRMS AND WORKERS

**3.16** The extent to which there is convergence or divergence in productivity and employment levels between regions broadly depends on the location decisions of firms and workers.<sup>5</sup>

**3.17** Movements of firms and workers in smoothly functioning markets should in theory, tend to equalise productivity (output per worker) and employment across the UK. This is because workers will tend to move from depressed, low-wage regions to high-growth, high-wage regions in response to differentials in wage-levels and employment opportunities. This will increase the supply of labour, and depress wages, in high-wage regions (the opposite happens in the low-wage region). This process should lead to a convergence of regional wage differentials.

**3.18** Similarly, firms may move away from regions with high levels of economic activity into relatively depressed regions because of the following factors:<sup>6</sup>

- *Wages, prices and competition:* firms producing in a region with many other firms face strong competition in product and labour markets. This tends to lower their profitability, incentivising firms to move apart. Product market competition lowers profitability by driving down output prices, whilst competition for workers lowers profitability by increasing wage-levels.
- *Land, natural resources and low worker mobility:* The availability of some factors, such as land, natural resources and to a certain extent workers, may be specific to certain locations. This creates a tendency for economic activity to be dispersed. On the demand-side, if consumers are dispersed, at least some production, for example of certain services, will have to be dispersed so as to locate close to consumers. From a supply-side perspective, some of the production must go where workers and natural resources, including land, are located.
- *Congestion and pollution:* Increased concentration of firms and workers creates externalities. Congestion and pollution are typical examples of negative externalities that geographically concentrated agents impose on their environment. This will increase the cost of production (or lower living standards) and encourage dispersion of firms and workers.

**3.19** However, there are a number of factors that work towards convergence between regions. Inflexible prices, or other rigidities, can reduce the incentives for relocation. In particular, regional wage rigidities may diminish the incentives for firms to invest in those regions. Furthermore, barriers to labour mobility increase the costs of relocation. Finally, the presence of benefits to firms from clustering together (or agglomerating), whilst frequently economically efficient, will constrain firms' willingness to move away from high-growth regions.

**3.20** The next two sections discuss in greater detail the factors that may explain the location decisions of both labour and firms, and in particular, how both decisions may be affected by the phenomenon of industrial agglomeration or clustering.

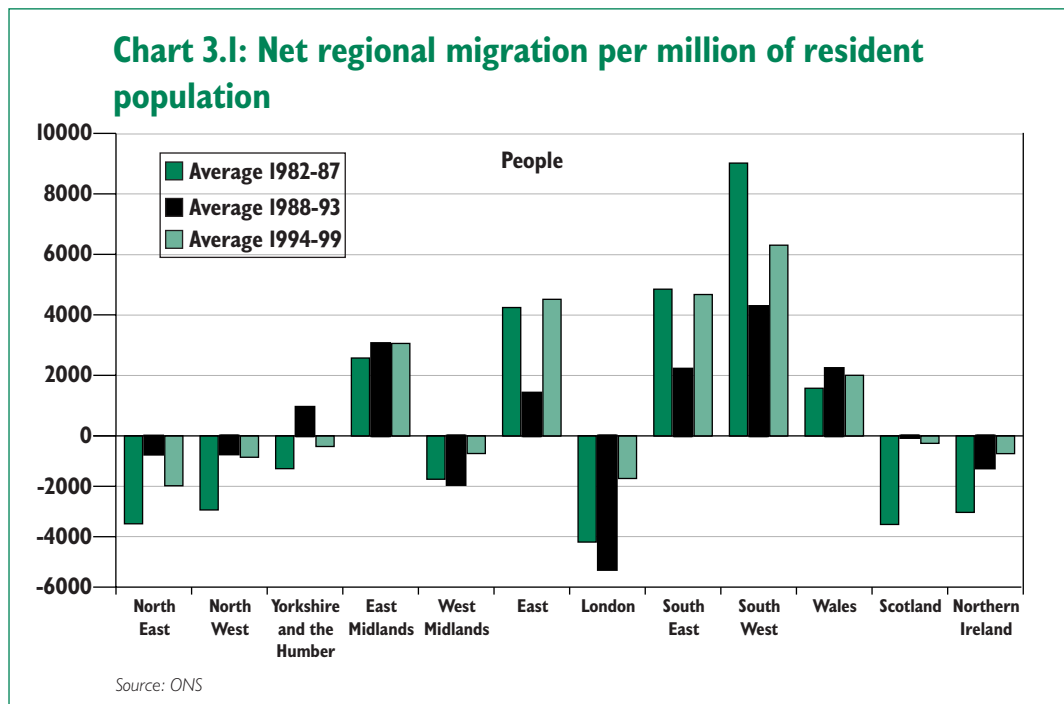
<sup>5</sup> Braunerhjelm, et al (2000).

<sup>6</sup> Fujita, Krugman and Venables (2000) and Ottaviano and Puga (1997).

## LABOUR MOBILITY

**3.21** High levels of productivity and employment require efficient matching of workers and jobs at the local and regional level, as well as between regions (and even countries). Workers tend to move from economically depressed regions, with lower wages and high levels of unemployment, to high-wage, low unemployment regions. A well-functioning UK labour market is therefore important for tackling regional and local productivity and employment problems. With high levels of vacancies in every region, matching can frequently occur within travel to work areas – but more efficient inter-regional labour movements may also be desirable.

**3.22** Frictions in the labour market may reduce the effectiveness of labour mobility as a regional adjustment mechanism. This may result in low productivity, as workers' skills and jobs are inadequately matched, and high unemployment as vacancies and workers are poorly matched. Poor labour mobility may be important in explaining high levels of unemployment in low-growth areas, and similarly it may also seriously constrain the economic potential of high growth areas.<sup>7</sup>



**3.23** Empirical evidence confirms that, as theory would lead us to expect, workers' location decisions are in many circumstances responsive to wage differentials, i.e. workers are more likely to move from low-wage to high-wage regions.<sup>8</sup> However, there are also a number of indications that there are labour market failures acting as a constraint on labour mobility as an effective local and regional adjustment mechanism. These include:

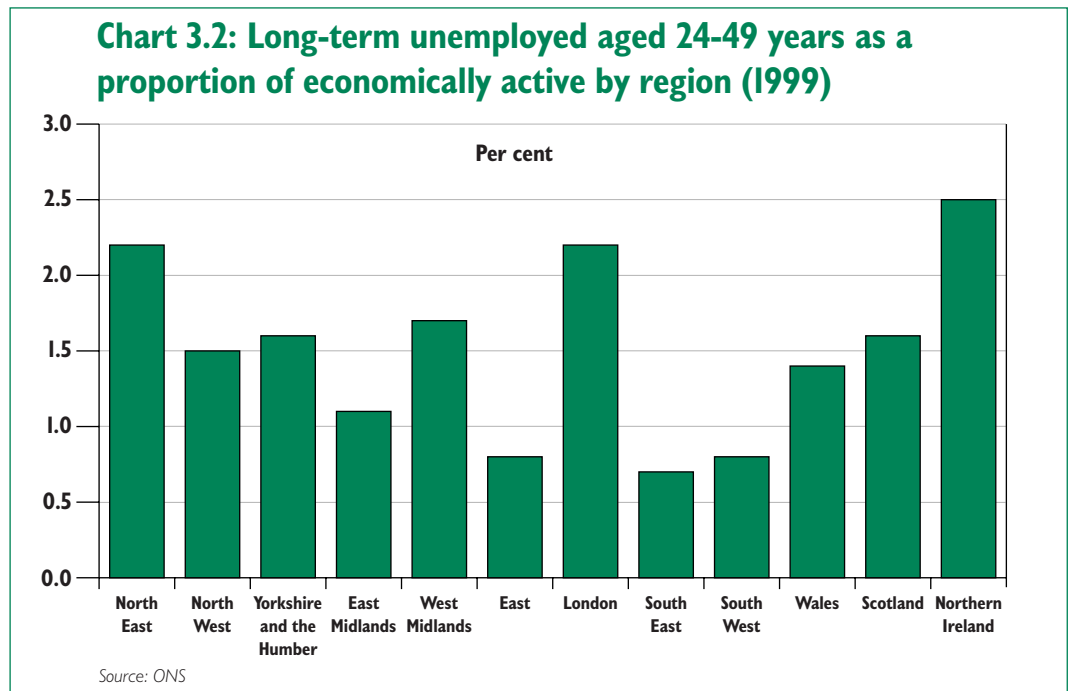
**3.24 Low mobility of low-skilled workers** – on average interregional household mobility in the UK has been around 1 per cent per annum. Broadly, this has resulted in net population outflows from London, the North East, North West and West Midlands and net inflows into the South East, South West and East (see Chart 3.1 above).

<sup>7</sup> It should be noted that labour mobility is not in all circumstances economically efficient. As discussed in Chapter 2, the presence of a high-skilled worker in a region has a beneficial effect on other workers. On relocating that worker does not take into account the detrimental effect this has on those left behind. Under certain conditions workers inability to coordinate location decisions can therefore have detrimental overall effects (Martin, 2000).

<sup>8</sup> Martin (2000), McCormick (1997) and Braunerhjelm et al (2000).

**3.25** These average mobility figures disguise large variations in mobility rates between skill groups. Broadly, skilled workers have a high propensity to move and seem to operate in a national labour market. Low-skilled workers, however, are very unlikely to move between regions and generally seem to look for work in a local labour market. In the US, in contrast, migration rates of manual workers are slightly higher than those of non-manual workers.<sup>9</sup>

**3.26 Varying long-term unemployment rates** – theory would predict that relative unemployment rates have a significant impact on inter-regional migration, as unemployed workers should move to where jobs are available. However, whilst in the UK the unemployed are more likely to migrate than the employed this effect is small.<sup>10</sup> The low propensity of unemployed workers to relocate in search of a job constrains a key labour market equilibrating mechanism and may contribute to the significant regional and sub-regional variations in long-term unemployment that are set out in Chart 3.2 below. Whilst potentially reducing regional disparities, it is not clear whether greater inter-regional migration would have a significant impact on UK long-term unemployment rates. Labour market mismatches are pronounced within local areas – high levels of vacancies frequently coexist with high levels of unemployment.<sup>11</sup>



**3.27** Long-term unemployment rate figures suggest that these labour market mismatch problems are particularly pronounced in the North East, Northern Ireland, the West Midlands, London and Wales. In contrast, the South East and East of the country may be constrained in their growth potential by a lack of inward migration.

## Barriers to labour mobility

**3.28** The indicators set out above, suggest there may be significant barriers to labour mobility due to labour market failures. Factors that may underlie these labour market barriers include:

<sup>9</sup> McCormick (1997) and Braunerhjelm et al (2000).

<sup>10</sup> The propensity of unemployed workers to relocate increases from around 1 per cent (for employed workers) to around 2 per cent per annum (McCormick, 1997).

<sup>11</sup> The Goal of Full Employment, HM Treasury (2000).

- *Inflexibilities in the housing market* including:
  - high, rising and regionally divergent house prices that can reduce the ability of workers to relocate;
  - housing assistance programmes that rely on non-portable dwelling subsidies, such as rent controls, which can curtail the ability of low-income households to move; and
  - high levels of home-ownership that may have a negative impact on labour mobility because of the high fixed costs involved in buying houses. The empirical evidence is inconclusive on the issue though.
- *Imperfect information* – workers often rely on local, informal networks of friends and relatives and contacts to find a job. Limited information about vacancies in other regions and prevalent informal family support, is likely to be significant in explaining low mobility.
- *Low skill levels* – if there are important market failures in workers skills acquisition, both from formal education and on-the-job-training,<sup>12</sup> this will also have implications for worker mobility. As discussed there is evidence that in the UK low-skilled workers have particularly poor mobility, at least compared to the US. Hence, education and training policies will have important follow-on effects.

**3.29** Constraints on labour mobility, both between and within regions, can undermine the efficiency of labour markets. However, one needs to be cautious about the ability of inter-regional migration flows to provide a solution to an area's economic problems. Frequently, areas of high unemployment are within travelling distance of labour markets with high levels of vacancies. If people in deprived areas are unable to compete successfully for existing nearby vacancies, increased regional migration may only have a limited effect on aggregate UK unemployment rates. In addition, some of the productivity effects of increased labour mobility are unclear. For example, when skilled workers move out of an area they have an unintended negative impact on the economic performance of those they leave behind.

**3.30** Nevertheless, where constraints on labour mobility between or within regions exist, they will tend to have a detrimental impact on aggregate UK productivity and employment by preventing labour mobility acting as an effective economic adjustment and skills matching mechanism.

## FIRM MOBILITY: AGGLOMERATION EFFECTS AND COORDINATION FAILURES

**3.31** Recent work suggests that agglomerations, or clusters, of firms and skilled workers may be one of the key drivers of economic growth in localities, cities and regions.<sup>13</sup> Successful clusters may be crucial to a region's success in attracting and retaining high productivity firms and workers. Agglomeration, whilst beneficial in itself, could therefore be a force for divergence as successful clusters attract increasing amounts of firms and workers.

**3.32** In addition, since the basis of agglomeration is the presence of beneficial externalities between firms and between firms and workers, the development of new clusters is subject to numerous coordination and market failures. These can seriously constrain a depressed area's ability to exploit the benefits of agglomeration. They may prevent the recovery of areas from low productivity and employment equilibria and thereby result in the permanent underdevelopment of certain regions and localities. Market failures may therefore constrain the efficient size and distribution of clusters amongst the UK regions.

<sup>12</sup> Market failures in skills acquisition occur on account of imperfect information and subsequent capital market failures, as well as distorted incentives on account of externalities to education and training. See Becker (1973), Stevens (1999) and Finegold and Soskice (1988).

<sup>13</sup> Braunerhjelm et al (2000), Midelfart-Knarvick et al (2000), Haaland et al (2000), Amiti (1997) and Audretsch (1998).

**3.33** Clusters emerge in a region or locality as firms exploit one or more of the advantages that location near their competitors can bring:<sup>14</sup>

- **Knowledge spillovers:** knowledge spillovers are especially strong amongst firms that locate in the same geographic region. Informal networks and the movement of skilled labour and management are important for disseminating best-practice techniques and tacit knowledge. Firms that rely on innovation for their success may therefore experience substantial advantages from locating close to each other.
- **Market size and linkages:** firms benefit from locating both close to their consumers and to their suppliers, including both suppliers of physical goods and those providing business and other services. Firms will therefore tend to cluster close to their suppliers and in areas of high demand.
- **Sophisticated or ‘thick’ labour markets:** employers benefit from locating in areas with an abundance of labour with the skills they require. Similarly, workers can more easily find a job in a location with a lot of firms requiring their skills. Hence, clusters of high productivity firms tend to be supported by thick labour markets, especially for skilled labour and specialised management. Empirically, skilled labour has been found to be the most important determinant of firm location decisions, especially in R&D intensive activities.

**3.34** These forces that drive clustering rely primarily on the existence of “spillovers” between firms and other costs or benefits, that firms or workers do not internalise, to take effect. To exploit the benefits derived from agglomeration requires firms, and workers, to coordinate their location decisions.

**3.35** However, there are few coordination mechanisms by which firms and workers can exploit the benefits of clustering. Indeed, by the very nature of agglomeration, firms are unable to fully internalise, or realise, the benefits arising from the increased returns associated with clusters. Clustering entails market failures, as firms and workers do not take into account positive (e.g. knowledge) or negative (e.g. congestion) spillovers from their location decisions. Furthermore, there may be poor information amongst workers and firms about the costs and benefits of location decisions.

**3.36** The inability of firms and workers to coordinate is likely to lead to a persistence of economic differentials by preventing the economic recovery of under-performing regions and localities. First, as described above, firms may be attracted to existing successful clusters because of the benefits they bring.

**3.37** Second, if a region does experience a negative economic shock, perhaps caused by changes in technology or shifts in consumer demand, cluster effects can in some circumstances “lock-in” the impact. The shock will lead to a loss of jobs and a fall in GDP per capita. Such a shock is only temporary if a region is sufficiently flexible, and has a sufficient depth of resources to adjust to changed circumstances and restructure its economy, taking advantage of new opportunities and technologies.

**3.38** In contrast, insufficient flexibility in labour, capital and product markets, or a lack of initial resources, may mean that the region is unable to recover. As firms go bankrupt and unemployment rises the benefits of staying in the area decrease. This creates further incentives for firms and workers to leave the area, and frequently the most skilled workers and highest value-added jobs leave first.

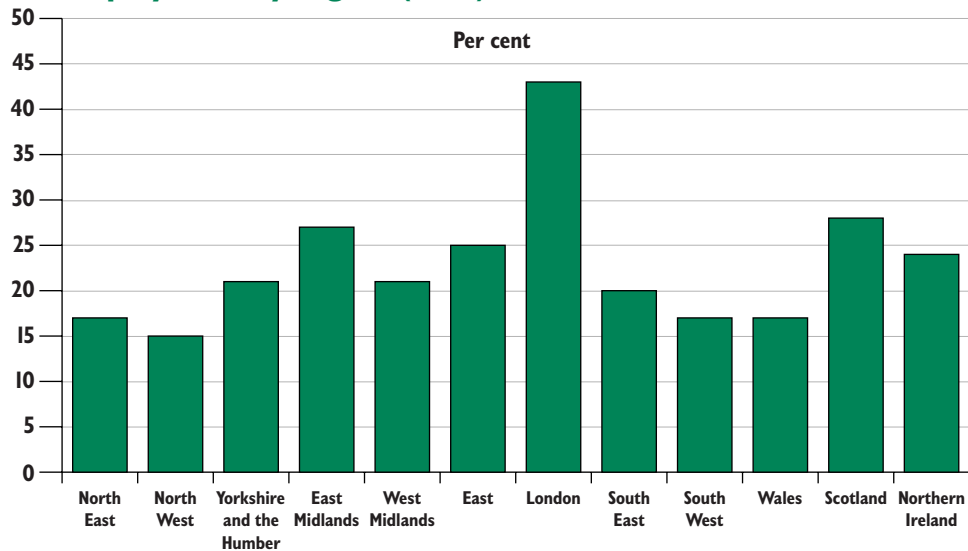
<sup>14</sup>Fujita, Krugman and Venables (1999) and Ottaviano and Puga (1997).

**Box 3.1: Clustering in the UK**

Clusters in the UK vary in terms of their industry, size, geographical scale and depth, as well as in how successful they are in generating high productivity jobs. Clusters play a key part in the success of London, the South East and East. There are also successful clusters in other UK countries and regions, however, on average these regions currently do not seem to have the same success at exploiting the benefits of agglomeration. The DTI report “*Business Clusters in the UK*” provides a detailed analysis of UK clusters.<sup>1</sup>

The importance of clusters varies significantly between regions as Chart 3.3 shows. In London 43 per cent of the workforce is employed in clusters. The comparable figures for the North East and North West are 17 per cent and 15 per cent respectively.

**Chart 3.3: Employment in clusters as a proportion of total employment by region (2001)**



Source: DTI (2001)

The clusters in the southern regions tend to be more in service-sector industries, most notably the financial services cluster in London, and R&D intensive industries, for example, biotechnology and pharmaceuticals in East Anglia, and ICT technology in the Thames Valley. In the other regions there are large manufacturing clusters, for example, the automotive clusters in the Midlands, metals in Yorkshire and Humber, chemicals in the North East and shipbuilding and engineering in Scotland.

London and the South East have a concentration of deep clusters, which possess a comparatively larger number of industrial, institutional and other linkages. These clusters are supported by thick labour markets of skilled workers, organised both around specific products and industries, as well as around specific functions, such as research and development. Those in the other English regions and Wales tend to be shallower, with fewer linkages.

Differences in type, depth and breadth of clusters across the country seem to lead to significantly varied outcomes. In London, the South East and the East clusters' job creation performance is significantly better than the regional average. In contrast, in the rest of the country, cluster job creation performance is no better than the regional average and in some cases significantly worse. London and the South East also have a higher proportion of the UK's internationally significant clusters.

<sup>1</sup>DTI (2000).

**3.39** The situation may be further exacerbated as declining relative levels of economic activity can lead to a breakdown of public infrastructure and increasing amounts of vacant land. Poverty and unemployment are accompanied by a deterioration of social infrastructure, including a rise in crime, falling health standards, and lower citizen participation in the wider community.

**3.40** Economic recovery would require that firms and skilled workers return to the area, but this requires a coordinated effort. Without such a coordinated effort economic under-performance in a region or locality may become permanent, as has been the experience of many northern conurbations and former coalfield areas.<sup>15</sup> Hence, large parts of the UK may lose out on the important economic benefits of clusters, or be stuck with clusters in low productivity and employment industries (see Box 3.1 above).

**3.41** In theory, the size of clusters is limited by a number of factors that favour the dispersion of economic activity, and hence promote a convergence of economic activity between and within regions. Hence, one might expect economic activity in high-growth areas to spillover into other areas.<sup>16</sup>

**3.42** In practice, this may be occurring in the UK in areas such as London and the Thames Valley. However, as discussed above, the ability of low productivity areas to attract economic activity will depend on their indigenous capacity to support virtuous cycles of growth and sustain high-levels of economic activity. Otherwise coordination failures may prevent relocation of economic activity out of high growth clusters, or if dispersion does occur, firms may relocate abroad, rather than to other parts of the UK.

### Summary

**3.43** In summary, clustering or agglomeration effects are crucial to the ability of a region, city or locality to sustain high levels of productivity and employment and contribute significantly to the success of London, and parts of the South East and East.

**3.44** Exploiting the benefits of agglomeration, however, requires clusters of high productivity firms and workers. Coordination failures may have been preventing large parts of the UK from acquiring the necessary minimum threshold of economic activity to support such clusters and hence higher levels of productivity and employment. Coordination failures are therefore likely to be a main cause of the significant and persistent economic differentials presented in Chapter 1 of this publication.

## CAN REGIONS' ECONOMIC PERFORMANCE CONVERGE?

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**3.45** This Chapter has outlined the forces that promote either the convergence or divergence of productivity and employment levels between UK regions and localities. Chapters 1 and 2 have shown that there has been significant persistence of regional economic differentials, and hence a shortfall in UK GDP per capita and living standards. The question remains whether this inevitable?

**3.46** Academic work on regional convergence suggests that regional differentials can be successfully tackled, but success and convergence is by no means certain.<sup>17</sup> This section discusses this issue in greater detail.

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<sup>15</sup> Armstrong and Taylor (2000) and McCormick and Redding (2001).

<sup>16</sup> Norman and Venables (2001).

<sup>17</sup> Hurst, Thisse and Vanhoudt (2000).

### International evidence

**3.47** Empirical evidence at the level of the nation state suggests that convergence is occurring across OECD countries. Poorer OECD countries have been catching-up with richer countries over the past 40 to 50 years.<sup>18</sup> Similarly, there has been convergence in GDP per capita amongst US States.<sup>19</sup> Evidence also now shows that GDP per capita of the poorest EU regions was converged upon the EU average, and they have typically closed the gap with the EU average by around 10 percentage points over the last decade.<sup>20</sup>

**3.48** However, over recent decades GDP per capita inequalities between regions have remained broadly constant from an aggregate point of view. During the last twenty years there was a high degree of persistence of differentials for many EU regions, although a sizeable number managed to improve their relative performance, others declined.<sup>21</sup>

### Future prospects

**3.49** Looking forward, new technologies and falling transportation costs may allow some economic activities to move out of existing centres and create employment in lower wage regions. Reduced communication costs are allowing firms to reorganise their production and outsource certain aspects of their production to more peripheral, low-wage regions. Economic activity may therefore disperse to more peripheral regions. In the UK context a good example of this is the development of call centres from which the North East, North West and Scotland have benefited. This also seems to be the case in other European countries such as Germany and Sweden.<sup>22</sup>

**3.50** At the same time, other activities, particularly those in the service sector and knowledge based industries, are becoming more prone to clustering. Notably, knowledge-based industries, such as information, communication and biotechnology industries, are highly clustered in a few centres around the world. Silicon Valley (USA) is the most famous such cluster, the Boston (USA), Cambridge (UK) and Oulu (Finland) high-technology clusters work on similar principles.<sup>23</sup>

**3.51** The overall impact of these technological changes is as yet unclear. Crucially, whether convergence or divergence is likely to occur depends on the speed at which lagging regions adopt new technologies. If they are slow at the adoption of new technologies productivity differences are likely to reinforce themselves; if the rate of adoption is relatively fast then convergence is more likely to occur.<sup>24</sup> In practice, recent work suggests that the rate of technological diffusion, i.e. the rate and extent to which other regions adopt new technologies, is increasing and are becoming more global.<sup>25</sup> This gives some cause for optimism about the ability of currently lagging regions to catch-up.

<sup>18</sup> See Barro and Sala-i-Martin (1995), European Commission (1996), Braunerhjelm et al (2000) and De la Fuente (2000).

<sup>19</sup> Barro and Sala-i-Martin (1995) and more recently Braunerhjelm et al (2000).

<sup>20</sup> Mucque (2000)

<sup>21</sup> Quah (1996 and 1997), Mucque (2000) and European Commission (2001). This overall assessment also disguises differing patterns over time. Convergence amongst and within, with the exception of the UK, EU countries seems to have been strong in the period 1945 to 1974. From 1974 to the mid-1980s there was little to no convergence. After the mid-1980s convergence resumed, but at a slower pace, Dignan (1995) and European Commission, (2001).

<sup>22</sup> Gillespie et al (2000).

<sup>23</sup> McKinsey (2000).

<sup>24</sup> Grossman and Helpman (1991) and Feenstra (1996).

<sup>25</sup> Keller (2000).

**3.52** There are several reasons why the rate of technological diffusion may have increased in recent decades. First, rapid improvements in information and communication technology and a reduction in the cost of travel have decreased barriers to knowledge diffusion. Furthermore, increasingly integrated capital markets and improved information and monitoring opportunities for investments is likely to have improved capital market access for lagging and more peripheral regions. Third, increased globalisation has intensified competitive pressures on firms improving their incentives to adopt new technologies and working-practices and catch-up with market leaders.<sup>26</sup>

**3.53** On balance, the direction of technological change and increased globalisation is creating new opportunities for currently lagging regions. The forces for the convergence of regional productivity levels are therefore likely to increase. But, as in the past, success is by no means guaranteed.

### The role of government policy

**3.54** Whilst there is some reason for optimism, previous chapters have highlighted the existence of substantial market failures that constrain the growth of lagging regions and localities. Effectively tackling these market failures will increase overall UK growth and lead to convergence in productivity and employment levels between regions. There may be a role for the Government policy to play in tackling these market failures.

#### **Box 3.2: Regional policy – case studies**

There is an substantial body of research into case studies of regional and local economic development.<sup>1</sup> It comes to a number of conclusions.

Large-scale public infrastructure investments, despite providing a short-term demand boost, have frequently failed to stimulate long-term regional economic growth.<sup>2</sup> For example, substantial investment in public transport infrastructure in Italy during the 1950s in the Mezzogiorno and Sicily failed to launch the rejuvenation of those regions. Instead the infrastructure was underutilised, leading to its rapid decay.<sup>3</sup>

In contrast, demand driven investment programmes have been rewarded with success. For example, the construction of international airports in Crete (Greece), to support the growing tourist industry, and inter-regional motorway construction in Abruzzo (Italy), to improve market access for a network of local industries, both proved critical to those regions economic revival.

The use of automatic financial incentives to subsidise capital investments, for example in large-scale manufacturing plants in the UK and Italy during the middle of the last century provided poor incentives for companies to raise employment, and may have been detrimental to long-term productivity levels. Market forces were further stifled in the UK by the use of Industrial Development Certificates (IDCs), which were used to control and influence the location decisions of large manufacturing plants. The evaluation of evidence on Regional Selective Assistance, by contrast, has showed that it has made a positive contribution to regional employment. Wage-subsidy policies and large-scale public enterprise investment distorted regional wages in Sicily and the Mezzogiorno (Italy) and in Galicia (Spain). Wages became unresponsive to productivity differentials discouraging inflows of private investment.<sup>4</sup>

<sup>26</sup>Baily and Gersbach (1995).

Capital subsidies and other forms of regional support have frequently been used in an attempt to cushion structural change by protecting stagnating and declining industries. However, changes in industrial composition are a key factor in driving regional economic growth and convergence.<sup>5</sup> Hence, such policies frequently sacrifice long-term regional productivity and employment growth for short-term gains. For example, industrial coal and steel subsidies in the Ruhr Valley (Germany) and measures to protect domestic industries in Japan have resulted in serious productivity shortfalls in the affected regions and industries.<sup>6</sup>

Key to the success of regional and local economic development programmes, in a number of countries, are efforts to create comprehensive policy packages. Programmes to build regional economic capacity and human and social capital are complemented by policies to build a network of firms capable of sustaining high levels of growth, without persistent government finance.<sup>7</sup>

In Ireland, for example, rapid increases in spending on education and training were combined with policies to build a local network of firms around large-scale foreign direct investment.

Frequently, poor regional and local economic policy design has been compounded by ineffective government institutions. The success of policies implemented in the well-performing regions is to a substantial extent attributable to better administrative incentives. The importance of region and locality specific knowledge and the need for integrated and coordinated policy solutions means that incentives for government institutions charged with regional and local economic development policy are crucial.<sup>8</sup> Chapter 4 will discuss this issue in further detail.

<sup>1</sup>See work by the OECD LEED programme and the European Investment Bank.

<sup>2</sup>Vanhoudt, Matha and Smid (2000).

<sup>3</sup>Helg, Peri and Viesti (2000) and Braunerhjelm et al (2000).

<sup>4</sup>Regional Studies Association (1983); Hurst, Thisse and Vanhoudt (2000); Rodriguez-Posse (2000), Armstrong and Taylor (2000); Helg, Peri and Viesti (2000) and Braunerhjelm et al (2000).

<sup>5</sup>Caselli and Coleman (2001) and Overman and Puga (2000).

<sup>6</sup>Baily and Gersbach (1995).

<sup>7</sup>Arzeni and Pellgrin (1997), Davies (1997), OECD LEED (1999), Illouz-Winicki and Pallard (2000) and Braunerhjelm et al (2000).

<sup>8</sup>OECD LEED (1999) and Hurst, Thisse and Vanhoudt (2000).

**3.55** Indeed, there is a broad consensus in the academic literature that government policy is a key determinant of the growth performance of poorer regions and can make the difference between stagnation and success. However, past regional and local development policies have had very mixed outcomes.<sup>27</sup> The evidence of between-country convergence, but frequent persistence of within-country differentials, suggests that in many countries the design and implementation of government policy has failed to tackle region and locality specific problems.<sup>28</sup> Overall, the evidence suggests that a narrowing of persistent regional differentials is possible, but only if the policy framework is correct.

<sup>27</sup>Hurst, Thisse, and Vanhoudt (2000) and Mucque (2000).

<sup>28</sup>Brannerhjelm et al (2000) discuss this phenomenon in some detail.

**3.56** The available evidence suggests that regional and local policies have often failed because they have taken a short-term perspective and not taken account of the complex interrelationships between the factors that are essential to economic success. Such failed policies usually combine one or more of three types of policy failures:<sup>29</sup>

- *Attempts to freeze existing patterns of economic activity*, through protectionist measures and large-scale support for failing industries;
- *Isolated policy interventions that simply inject resources into an area* without taking into account the inter-relationships and strategic complementarities between the various factors associated with growth; and
- *Flawed design of government institutions charged with regional and local economic development*, imposing policies upon an area instead of building on its indigenous strengths.

## CONCLUSIONS

**3.57** This Chapter has discussed how persistent shortfalls in productivity and employment are the likely result of coordination failures that prevent under-performing regions from taking advantage of the benefits of agglomeration. In addition, regions and localities will suffer from market failures – in product, capital and labour markets – and poor adjustment to shocks in labour markets on account of barriers to labour mobility.

**3.58** These market failures are detrimental to overall UK economic growth and constrain productivity and employment levels in lagging regions. International evidence and recent technological change provide some grounds for optimism that regional convergence and increased UK growth can be achieved. However, success is far from certain, and past government policies have frequently failed to address the underlying economic challenges facing lagging regions.

**3.59** The lessons for policy, both from case studies and academic research, suggest a number of key features of successful regional and local economic development policies:

- macroeconomic stability is an essential precondition to economic growth in all regions;
- economic development policies need to tackle market failures and build on region's and localities' indigenous strengths; and
- policy interventions need to be coordinated and market-based. Institutional design is crucial to the successful design and implementation of such policies.

**3.60** These themes will be developed in the next Chapter, which sets out the framework for the Government's regional and local economic policy.

<sup>29</sup>Hurst, Thisse and Vanhoudt (2000), Puga (2000) and OECD LEED (1999).



**4.1** The Government's central economic objective is to achieve high and stable levels of growth and employment. To fulfil this objective every part of the country needs to attain high levels of productivity and employment. Chapter 1, however, shows that many regions and localities under-perform, in terms of productivity and labour market performance, and hence fall short of their economic potential. Underlying the regional and local productivity differentials, as discussed in Chapter 2, are significant variations in skills, investment, innovation, enterprise and competition.

**4.2** Chapter 3 suggests that market failures are a key cause of regional differentials and prevent the economic recovery of poorer regions and localities. Market and coordination failures arise in the location decisions of firms and workers, reinforcing the existing patterns of production. If Government can effectively tackle these, then convergence in productivity levels between regions should be possible, and such policies will also increase the UK growth rate.

**4.3** This Chapter sets out the Government's regional economic strategy to tackle these gaps, and create an environment in which all regions can reach full employment levels and where firms and workers in all regions can achieve their productive potential. At the same time, it sets out the policy measures the Government has put in place at different levels – national, sub-national and local – to tackle the existing effects of disparities between and within regions and bring the least well-performing areas up to the level of the rest.

#### **Box 4.1: The long-run focus - an ambition for regional economic policy**

**Regional economic policy should be firmly placed within the Government's overarching national economic aim of raising the rate of sustainable UK growth. At a regional level the Government's target is to improve the economic performance of all regions measured by the trend in growth of each region's GDP per capita (the joint DTI/DTLR Public Service Agreement).**

**This implies that attempts to address regional differentials must be done by a process of levelling-up, not levelling down. An effective long-term regional economic policy should therefore focus on addressing market and coordination failures to increase the national growth rate. Such market failures are likely to be greatest in the weakest regions. Therefore, whilst regional economic policy must aim to strengthen the indigenous growth potential of all regions, the focus should be on the weakest regions, without constraining growth in the strongest.**

**Within the context of the Government's wider economic goals, the analysis in this paper underpins the Government's target to raise the rate of sustainable UK growth by increasing the trend rate of growth of GDP per capita in all regions. By focusing on correcting market failures, particularly in the weakest regions where such failures are likely to be greatest, the Government's long-term ambition therefore is to reduce the persistent gap in performance between the regions.**

## THE ECONOMIC FRAMEWORK

**4.4** The analysis set out in Chapter 3 identified market and coordination failures as the likely cause of the shortfall in the productive potential of localities, countries and regions in the UK. These market failures can arise on account of both macroeconomic instability and microeconomic inefficiencies.

**4.5** Based on this analysis, the Government's strategy to make markets work in all parts of the UK has two key components:

- creating an economic environment which provides a stable macro-economy and invests to tackle market failures in regions and localities; and
- building the capability of regional and local institutions to deliver these reforms.

**4.6** This strategy complements the national productivity framework outlined in the November 2000 Publication "*Productivity in the UK: The Evidence and the Government's Approach*" and will be pursued at every level, regional and local, rural, urban and metropolitan.

### Macroeconomic stability

**4.7** An essential pre-requisite for any attempt to tackle the economic underperformance of the UK's countries and regions is the achievement of macro-economic stability. Economic instability makes it difficult for individuals and firms to plan, save and invest. The high volatility of output in the UK over the last 30 years has held back long-term economic growth. Past policies may have facilitated short-term gains but they deterred firms and individuals from investing in the future.

**4.8** The Government's first priority on taking office was to establish a more stable framework for macroeconomic policy. Monetary and fiscal policy is now highly transparent, based on clear rules and targets, and underpinned by legislation. As a result, the Government has created a platform of economic stability upon which the economy can grow.

### Microeconomic reform

**4.9** Efficient markets are the best means of ensuring that the economy's resources are allocated efficiently, that firms use the most efficient production techniques available and that they have strong incentives to innovate.<sup>1</sup> Well-functioning markets provide strong incentives, rewarding firms that do well with increased growth and profits, and rewarding workers for their endeavours with wages that reflect their productivity.

**4.10** However, as Chapter 3 set out, there are a number of potential market failures that exist in the UK's countries and regions. These include market failures in:<sup>2</sup>

- **Product markets** where a lack of competitive pressure can impact on efficiency and prices, and reduce the incentives for innovation;
- **Capital markets** where gaps in provision can result in under-investment in innovation and human and physical capital across all parts of the UK; and
- **Labour markets** where inflexibility, low labour mobility and poor incentives to invest in human capital can restrict workers' and firms' ability to take advantage of new opportunities.

**4.11** In addition, the coordination failures described in Chapter 3 can exacerbate the positive and negative effects of clustering as regions become locked into vicious or virtuous cycles. This can prevent poorly performing regions and localities from taking advantage of the benefits of clustering.

<sup>1</sup>The fundamental theorems of welfare economics provide the conditions under which a competitive economy is efficient.

<sup>2</sup>See "*Productivity in the UK: the Evidence and the Government's Approach*", HM Treasury (2000), for further details.

**4.12** Efficient markets provide the best means of ensuring high levels of economic growth and living standards in all parts of the UK. The Government's strategy is to tackle market failures at every level and in all parts of the country. Since these market failures are likely to be most severe in the under-performing regions and localities of the country it is likely that the largest gains are achievable there. Chapter 3 set out the national framework for improving the functioning across all markets based on five underlying productivity drivers. These five drivers are likely to be key factors underlying regional and local economic performance as well:

- skills;
- investment;
- innovation;
- enterprise; and
- competition.

## THE INSTITUTIONAL FRAMEWORK

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**4.13** Delivering economic growth and prosperity in every part of the country requires a strong institutional framework for delivery and formulation of regional and local economic policy. Effective regional and local institutions are essential to building regions in which workers want to live, and invest in their skills, and where successful business can flourish, generating high levels of growth and employment.

**4.14** Regional and local flexibility can help maximise the effectiveness of economic development policy by:

- allowing policies to draw on the expertise and knowledge of local and regional agents, including stakeholders from the local community, local businesses and non-profit organisations;<sup>3</sup>
- improving the ability of Government to design locally differentiated solutions and better target policy delivery in every region and locality; and<sup>4</sup>
- increasing the ability to benchmark regional and local performance – which improves monitoring of these agencies by the electorate and other parts of Government. This can improve incentives to increase efficiency of public service delivery and encourage the adoption of innovative policy solutions.<sup>5</sup>

**4.15** Greater regional and local flexibility and accountability can lead to better-tailored and informed policies, as well as improved service delivery and a higher responsiveness and motivation to local citizens.

**4.16** To ensure that the division of responsibilities between national, regional and local government institutions is efficient, the incentives and information available to each layer of government needs to be considered alongside questions of administrative efficiency. The balance between these considerations will vary by policy and by the market failure one is seeking to address.

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<sup>3</sup>Olson (1969) and Seabright (1996).

<sup>4</sup>Oates (1990) and OECD (1999).

<sup>5</sup>Inman and Rubinfeld (1997), Tiebout (1956), Besley and Case (1995) and Donahue (2000).

## DELIVERING FLEXIBLE INSTITUTIONS

**The UK's countries** **4.17** The Government has put in place an ambitious programme of constitutional and institutional reform to deliver this economic reform agenda. In Scotland, Wales, and Northern Ireland the Devolved Administrations have substantial autonomy over economic development functions and over key productivity drivers such as skills and innovation. The Devolved Administrations have used these freedoms to strengthen their economic development bodies and respond to local priorities and opportunities.

**The English Regions** **4.18** In England the Government established the eight Regional Development Agencies (RDAs) to take leadership in formulating regional economic strategies. In London, the London Development Agency under the Greater London Authority fulfils the same role.

**4.19** The RDAs' work in partnership with local authorities, Local Learning and Skills Councils (LLSCs), the Small Business Service (SBS) and other local and regional bodies with economic responsibilities. They have drawn up Regional Economic Strategies to cover:

- economic development and regeneration;
- promotion of business efficiency, investment and competitiveness;
- promotion of employment; and
- enhancement, development and application of skills relevant to employment.

**4.20** The RDAs' role is to act as champions for economic development in their region. They exert strategic influence over the type, scale and combination of services delivered in their region. They are active in areas key to economic growth – employment, entrepreneurship, skills and regeneration – and are responsible for carrying out a detailed analysis of the region's particular strengths, weaknesses and needs. In response to that analysis, they have drawn up their Regional Economic Strategies and are working with other regional partners to supplement these with the Regional Employment and Skills Frameworks, the Regional Transport Strategies and the Regional Planning Strategies.

**4.21** The RDAs have been given considerable budgets (rising to £1.7bn in 2003-04) and – more importantly – unprecedented flexibility and autonomy to find the most effective way of meeting the targets which they have been set. Within their region, they will have the opportunity to decide how best to focus their attempts to fulfil their particular remit, in conjunction with other Government interventions at all the various levels – area-based, local, sub-regional or national. They need to take account of – and use their influence to shape – other initiatives and vehicles for Government policy being used in their region and make them coherent.

**4.22** This increased flexibility is being matched with increased accountability both through national targets and strong and effective Regional Chambers. In Budget 2001 the Deputy Minister and the Chancellor allocated additional 'capacity building' resources to the Regional Chambers, to help ensure that they can carry out the scrutiny role effectively. Strong and proactive Regional Chambers will help make the RDAs more immediate, credible and effective. The Deputy Prime Minister will set out the Government's future proposals for devolution in the English regions.

**Box 4.2: The RDAs' new flexibilities**

The Government has made a number of significant reforms to the RDAs' finance framework to ensure they have the flexibility they need to deliver their Regional Economic Strategies:

*The Single Pot* – From April 2002, RDA funding will be from a single cross-departmental framework, known as the Single Pot, giving RDAs far greater flexibility to target their resources in the way they consider most effective to deliver their targets;

*Relaxation of administration costs cap* – From April 2002, RDAs will not be required to maintain an artificially imposed cap on the amount they are allowed to spend on administration, but will be able to make their own assessment of administration costs, setting the projections out in their corporate plans;

*100% End-Year Flexibility* – In addition, RDAs will be entitled to carry over any unspent money from year-to-year within the period of their corporate plan, instead of being required to return unspent funding to the Treasury. This will mean real flexibility to manage their budgets as they see fit over the whole period covered by their corporate plans; and

*Earned Autonomy* – RDAs are given full flexibility over how they deliver their targets. They are able to reflect regional priorities within the corporate plans and targets Ministers endorse.

**4.23** At the sub-regional and local level the Government has put in place a number of institutional reforms designed to tackle economic disadvantage and promote growth. Boosting enterprise and employment in deprived neighbourhoods, for example, is a central aspect of the National Strategy for Neighbourhood Renewal.

**4.24** Nationally, this is based on “floor” PSA targets, which set key outcome levels below which no area should fall (see Box 4.3 below). This means that, as well as increasing overall performance, policy should focus on improving the performance of the worst performing areas. This means that Department of Trade and Industry and Department of Work and Pensions (DWP) policies and funding now have an explicit dimension related to increasing economic activity and employment in the poorest areas, supported by related policies, for example on educational attainment.

**Box 4.3: The PSA “floor” Targets**

**Dept of Work and Pensions:** Over the 3 years to 2004, taking into account the economic cycle, increase the employment rates of the 30 local authority districts with the poorest initial labour market position – and reduce the difference between their employment rates and the overall rate.

**Home Office:** Reduce domestic burglary by 25 per cent, with no local authority district having a rate more than three times the national average (by 2005)

**DfES:** Increase the percentage of pupils obtaining five or more GCSEs at A\*-C, with at least 25 per cent in every school by 2006 (20 per cent by 2004), with at least 38 per cent to achieve this standard in every local education authority.

**DoH:** To develop targets in 2001 to narrow the health gap in childhood and throughout life between socio-economic groups and between the most deprived areas and the rest of the country:

- Starting with Health Authorities, by 2010 to reduce by at least 10 per cent the gap between the quintile of areas with the lowest life expectancy at birth and the population as a whole.
- By 2010, to reduce the conception rate among under 18s in the worst quintile of wards by at least 60 per cent, thereby reducing the level of inequality between the worst quintile and the average by at least 26 per cent by 2010.
- starting with children under one year, by 2010 to reduce by at least 10 per cent the gap in mortality between manual groups and the population as a whole.

**DTLR:** Ensure that all social housing meets set standards of decency by 2010, by reducing the number of households living in social housing that does not meet these standards by a third between 2001 and 2004, with most of the improvements taking place in the most deprived local authority areas as part of a comprehensive regeneration strategy.

**Local Strategic Partnerships**

**4.25** Locally, the new Local Strategic Partnerships (LSPs) will provide a strategic and coordinating function at the local level across a wide range of public services. In the eighty eight local authority areas with the most significant concentrations of deprivation, LSPs are specifically responsible for drawing up local strategies for tackling neighbourhood deprivation – a central component of which is reducing isolation from the economic mainstream. LSPs bring together all the main service providers in an area, along with representatives of local communities, and voluntary organizations – and vitally for this aspect of their role, business. So they are well placed to address unemployment and lack of economic activity directly, and to tackle related issues like skills and transport.

**4.26** It is important that LSPs work with partners at sub-regional and regional level, including RDAs, Government Offices and sub-regional partnerships so that action at the neighbourhood level plays a part in strengthening the economic performance of the wider area, and programmes and initiatives for wider economic development play a part in ending the isolation from the economic mainstream which is a key characteristic of many deprived neighbourhoods

**Local PSAs**

**4.27** To strengthen further the delivery of local public services, local Public Service Agreements (PSAs) have been negotiated with twenty pilot local authorities that have committed to deliver more stretching outcomes in return for greater flexibilities, freedoms and financial rewards if they succeed. Local PSAs strengthen the links between central and local government, providing help for local authorities to deliver, while ensuring that national priorities are met. They have won widespread endorsement in local government and will now be rolled out to a further one hundred and thirty larger councils over the next two years.

## THE POLICY RESPONSE

**4.28** The Government's strategy of tackling market and coordination failures focuses on increasing the dynamic efficiency of markets and thereby increasing the long-term growth rate of regions and localities. Regions affected by large economic shocks, such as large-scale redundancies, and those coping with changes in their industrial structure require assistance in a short transitional period. Creating areas that are dependent on such assistance will, however, damage their long-term growth prospects and be detrimental to living standards in that area and the UK as a whole. Special assistance for the most deprived areas in the UK, or those suffering large-scale economic shocks, will only be effective if focussed on creating the foundations for higher long-term growth.

**4.29** The rest of this Chapter sets out in more detail how the Government, Devolved Administrations and, in England, the Regional Development Agencies have tackled this policy agenda at every level. The Government wants a bottom-up rather than a top-down approach within a national framework that allows regional and local initiatives to work. The DTI/DfES White Paper, "*Opportunity for all in a world of change*," published in February 2001, also sets out how the Government is working with RDAs and other local partners to raise regional economic growth.<sup>6</sup>

### Skills

**National policy** **4.30** Skill levels are one of the most important determinants of productivity. A more highly skilled workforce is not only better at innovating, researching and developing, but it is also more adaptable to change and better at utilising new technologies. However, there are significant skills gaps between different parts of the UK – these are exacerbated by much higher labour mobility in more highly skilled groups who tend to leave the poorer performing regions.

**4.31** To increase the level of skills in the economy overall, the Government will increase spending on education and training in the UK by over £10 billion between 2000-01 and 2003-04. This is a real increase of 5.4 per cent per annum over this time. The money will improve standards throughout the schools system as well as providing funds to make progress towards the Government's ambition that 50 per cent of those aged between 18 and 30 should have the chance by the end of the decade to enter Higher Education, and further improvements to the further education system.

**Regional policy** **4.32** The RDAs have been tasked with drawing up Regional Employment and Skills Frameworks, working closely with the Learning and Skills Council at national and local level. The Learning and Skills Council and Regional Development Agencies have announced their joint development of a Memorandum of Understanding. This agreement aims to enable UK businesses to recruit the trained and skilled employees required to ensure their ability to compete on a worldwide scale.

**4.33** The Memorandum of Understanding outlines a new relationship for the Learning and Skills Council and RDAs. They will now develop identical or complementary targets and budgets, where these were previously independent of one another, to be used in a manner that ensures an integrated approach to the development of strategies and plans. Furthermore, compatible formats for gathering and sharing information are to be developed and both organisations will work together within and across regions to ensure the implementation of local initiatives.

**4.34** This will ensure an integrated approach from the RDAs and the Learning and Skills Council. Their common goal is to develop an education and training system that provides individuals with the necessary skills to increase their employability. This will be achieved by

<sup>6</sup>DTI (2001).

focusing on a number of strategic issues at a national, regional and local level. These will include the development of a world-class workforce, identifying and supporting sector-specific skill needs, and further developing a culture of learning and enterprise.

### Investment

**4.35** Growth in the economy depends heavily on investment in physical capital and infrastructure. The UK overall has substantially under-invested both in the public and private sectors compared to its principal competitor countries. As Chapters 1 and 2 set out there also significant differences in investment between the UK's nations and regions. It is clear therefore that every nation and region of the UK needs to improve its investment performance.

**National policy 4.36** Improvements in macroeconomic stability should have an impact on investment across the UK. By reducing the cost of borrowing and providing more certainty about the future costs of borrowing the reforms should help to encourage businesses of all sizes to invest. Equally the Government's new fiscal framework has removed the historic bias against public sector capital investment – as a result the Government aims to double net public sector investment over the next three years.

**4.37** The Government has also acted to ensure the tax system encourages business investment by reducing the marginal rates of corporation tax, moving to a 30 per cent main rate and introducing a new 10 per cent starting rate for the smallest businesses. It also abolished in 1997 the system of repayable tax credits, which provided a tax driven incentive for firms to pay out their profits in dividends rather than reinvest them in the firm.

**Regional policy 4.38** There is a strong role for a regional investment policy where it can tackle particular regional market failures. The provision of equity capital for small growing firms is one such area. These firms' financing needs are sometimes no longer appropriate for traditional bank debt finance, but they are not yet large enough to attract, cost-effectively, the interest of the majority of venture capital and other private equity providers. To tackle this 'equity gap', the Government will establish Regional Venture Capital Funds (RVCFs). These are public – private partnerships with public sector investment on terms that will attract private sector funding and management. The aim is to demonstrate that private investors can make commercial returns on smaller investments. They will be managed day-to-day by professional fund managers, selected through open competition.

**4.39** The regional basis of the funds should allow fund managers to better control their costs of seeking, analysing, supporting and monitoring investments. Fund managers will work in partnership with the RDAs, who are sponsors for the RVCFs in the regions, supporting the fund managers in the set-up phase and providing links between them, local investors and other contacts. The funds will provide an incentive for private investors to participate in the market, thereby generating increased levels of economic activity.

**4.40** Negotiations are underway to finalise each fund, the Funds will be backed by up to £79 million of Government funding and up to €86m from the European Investment Fund. Indicative targets for each region have been set:

- £30 million for the North West;
- £20 million for the East of England;
- £30 million for the South East;
- £25 million for the South West;
- £25 million for Yorkshire and the Humber;
- £15 million for the North East;
- £20 million for the West Midlands;
- £50 million for London; and
- £20 million for the East Midlands.

**4.41** This initiative will be a major step towards achieving the £1 billion target that the Government set for public/private venture capital in Budget 2000. In addition, the Small Business Service is committing up to £50 million of new funding for start-ups and smaller growing businesses, to help meet the need for small amounts of risk capital at an early stage of company growth.

**Local policy 4.42** At the local level, the Government is working in partnership with local authorities and other bodies to provide investment needed in infrastructure and physical regeneration. For example, over £800m will be provided over the next three years to help kickstart the neighbourhood renewal process in the 88 most deprived local authority areas. Local Strategic Partnerships will decide how best to spend this money to bring about improvements in outcomes for local people.

### Innovation

**National policy 4.43** Innovations in technology and industrial processes are the essential driver of improved productivity performance. Successful R&D expenditure can provide firms with competitive advantages in existing markets driving down costs or increasing quality; R&D can also open up new markets for new products and services and improve the ability of firms to adopt new technologies.

**4.44** To encourage firms to invest in innovation, in April 2000, the Government introduced a new R&D tax credit, targeted on all small and medium-sized companies. The credit increases the 100 per cent relief for current spending on R&D to 150 per cent. So when added to the existing relief, the cost of R&D will be reduced by 30 per cent for a company benefiting from the small companies' corporation tax rate. The Government is taking forward an R&D tax credit for larger firms.

**Regional policy 4.45** The RDAs are working with universities, local authorities and other regional economic agencies to develop the innovative capacity of firms and research institutions in their areas.

**4.46** The £45 million University Challenge provides seed funding for 37 higher education institutions across the UK to help develop promising research from UK universities into projects that might attract commercial investment. The Science Enterprise Challenge provides funding to create centres of enterprise to stimulate entrepreneurship in universities across the UK. So far 12 Enterprise centres have been established. The winners of the second round of both University Challenge and Science Enterprise Challenge were announced in October. Both Funds represent a good example of how national policy priorities can be treated flexibly, to deliver regional centres of excellence.

**4.47** The new Manufacturing Advisory Service, with Manufacturing Centres of Excellence in every region, will provide practical, "hands on" help for smaller manufacturing firms who want to introduce world-class manufacturing practices and technologies. Furthermore, as a complement to the regionally delivered Manufacturing Centres, the Manufacturing Advisory Service (MAS) will be establishing a National Network of Centres of Expertise in Manufacturing, to include all of those organisations, throughout the UK, with expertise or activities of interest to manufacturing companies. The MAS website will also include a national database providing access to all of these centres of expertise.

### Enterprise

**National policy 4.48** Chapters 2 and 3 showed how a competitive environment is strengthened by the entry of new firms to put increased competitive pressures on incumbents. This requires individuals and entrepreneurs to be able to set up new businesses and to have the incentives to succeed.

**4.49** To improve incentives for enterprise, the Government has made significant reforms to the Capital Gains Tax (CGT) regime. The Government has introduced a more generous CGT regime that distinguishes between short and long-term investment. These changes aligned the system more closely with entrepreneurial investment cycles. In Budget 2000, the Government also widened the definition of business assets, to ensure that the full benefits of the CGT regime were available to a broader range of corporate investments.

**Regional policy 4.50** The Small Business Service (SBS) is a Government agency that works at a national, regional and local level to champion the interests of small businesses. Its vision is to help make the UK the best place in the world to start and grow a business. Its purpose is to help build an enterprise society in which small businesses can thrive and achieve their potential. The SBS aims to do this by:

- being a strong voice for small business at the heart of government – ensuring that Government is aware of the needs of small business;
- developing and maintaining a world class business support service to enhance competitiveness and profitability;
- championing entrepreneurship across society and particularly in under-represented and disadvantaged groups; and
- minimising the burden of regulation.

**4.51** Working alongside the SBS, RDAs have developed regional strategies for economic and social development, identifying needs for business support for the region as a whole, from all sources. The SBS manages local delivery of business support funded by central Government, through Business Link Operators. These are monitored by SBS Regional Directors, who are mostly collocated with RDAs, and who ensure quality of service to businesses within and between the regions.

#### **Box 4.4: EU Structural Funds**

The structural funds are the EU's main instruments for supporting social and economic restructuring across the Union. European money is match-funded by Government in recognition of particular needs within specific regions. The funds support projects in areas key to economic activity such as employment, regeneration, industry diversification, training and skills. Government Offices receive and assess the bids in liaison with the RDA.

Structural Funds provide regions with additional streams of funding within the discipline of competitive bidding. There is also the requirement placed on bidders to demonstrate that they have used appropriate local/regional partners to maximise the coverage and chances of success of the project for which funding is being sought. It is exactly this sort of regional partnership working that the Government seeks to replicate in its domestic regional policy.

In England the Government Offices and the RDAs work together to ensure that their region will get the maximum return on the effort and funding being put in. Assessing Structural Fund bids strategically across the region means that the projects supported by the Funds directly reflect the region's priority needs and directly address local weaknesses. Tying together European and domestic regional policy and funding ensures that people in the regions get a more coherent package of support and greater value for money. Central government, in turn, should see the regions delivering on their target of increased levels of productive economic activity.

**4.52** To encourage more business start-ups and growth firms across every English region, the Government has launched a new £75m incubation fund operated by the SBS with the RDAs. The SBS will commit up to £50m of new funding for start-ups and smaller growing businesses, to help to meet the need for small amounts of risk capital at an early stage of company growth.

**4.53** The Government is also working to ensure that every community build thriving businesses. Lack of support, advice and access to finance, can mean that entrepreneurs in disadvantaged areas experience even greater difficulties in launching their ideas than somebody starting a new enterprise generally faces.

**4.54** The Phoenix Fund helps new and existing businesses in deprived areas, including mentoring for pre- and early-stage start ups, encouraging innovative approaches to business support; and providing finance to Community Development Finance Institutions. It will also be funding pilot City Growth Strategies, to link regeneration more closely with enterprise in deprived towns and inner cities.

### Competition

**4.55** Competition between firms leads to increased innovation and greater efficiency – and in turn to increased productivity. Competition also ensures that consumers get a good deal, since it forces firms to reduce prices or increase the quality of their products to win their custom.

**4.56** To ensure the effective functioning of a single market across the United Kingdom, competition policy and enforcement is a responsibility that lies at the national level. Effective strong competition should drive improvements in productivity in every region.

**4.57** Recognising the link between competition and productivity, the Government is strengthening competition policy. A new Enterprise Bill will provide full independence for better resourced competition authorities who will now have a duty to promote competition across the economy. In addition, there will be further reforms of the regime for investigating markets that are not working well, and the introduction of criminal penalties for those individuals involved in cartels. Building on the measures the Government took in the last Parliament, these reforms will help ensure that competitive pressures drive improvements in productivity and consumer prices in every region of the United Kingdom.

**4.58** Although regional and local bodies have no formal role in competition policy they can still make an important contribution. For example local authorities trading standards departments have an important role in drawing competitive abuses to the attention of the Office of Fair Trading (OFT). Liaison between the OFT and local authority trading standards officers has increased substantially in recent years. By working together effectively, both bodies can deliver real benefits, throughout the UK, to help ensure that markets are working well for consumers.

**4.59** The OFT is also running an extensive small business education programme, to ensure that understanding of competition law and the benefits of competition are spread throughout the country. To further strengthen the regional profile of competition law and policy, the OFT is also developing a regional roadshow programme, informing local businesses and consumers about competition and consumer issues through a series of activities, such as presentations, workshops and radio interviews. The OFT will be running approximately eight roadshows a year in regional centres around the UK.

## THE WIDER AGENDA

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**4.60** This chapter has set out the Government's agenda for increasing productivity in the nations and regions of the United Kingdom. However, this framework is just one element in the Government's wider agenda to ensure that all countries, regions, localities and neighbourhoods share in the UK's economic opportunity and prosperity.

**4.61** The Government has put in place a raft of reforms to deliver on this wider agenda including wider devolution of public services in Scotland, Wales and Northern Ireland. At the core of this is the Government's long-term goal to establish world-class public services. However, it is not enough for the Government only to aim for an overall improvement in public services – it must also make sure that every nation, region, locality and neighbourhood benefits from these improvements.

**4.62** In England, the Government's Neighbourhood Renewal Strategy has committed to focussing the allocation of mainstream funding – for key services like health, education, housing – on those areas that at present fall furthest behind the rest of the country. The overall aim of this new approach is to close the gap between the worst neighbourhoods and the rest of the country so that within 10 to 20 years, no one is disadvantaged by where they live.

**4.63** To help kickstart this approach, the Government is providing over £800 million over three years, through the Neighbourhood Renewal Fund, to the 88 most deprived local authority areas.

**PSA floor targets** **4.64** To ensure delivery of real improvements in all areas, the Government has established new PSA “floor targets” covering the key public services (see Box 4.3). These targets ensure that Departments must focus on narrowing the gap between the most deprived areas and the rest of the country, rather than simply on improving the national average. The Government is publishing implementation strategies which show how these “floor” targets will be met.

**4.65** The rationale behind this new approach to spending in poor neighbourhoods is that much more substantial sums are spent through main departmental programmes, than could ever be spent on specific area based initiatives. The floor-target approach helps ensure that core public services take responsibility for disadvantaged areas, rather than just relying on special schemes to deliver improvements in the worst performing areas.

**4.66** This wider policy agenda therefore combines with the specific policies discussed in this Chapter, to provide a coherent framework to help meet the Government's long-term regional economic ambition and ensure that all the nations and regions of the UK share in its economic prosperity.

## THE NEW REGIONAL ECONOMIC POLICY

**5.1** This paper has set out the Government's policy framework for tackling the persistent differentials in economic performance across and within the countries and regions of the United Kingdom. The framework builds upon macroeconomic stability to invest in tackling market failures at the geographical level at which they occur: be it national, regional or local.

**5.2** The framework is built around tackling market failures in the five productivity drivers:

- skills;
- investment;
- innovation;
- enterprise; and
- competition.

**5.3** Improving performance in every region across these drivers will be essential if progress is to be made towards the Government's long-term ambition of reducing the persistent gap between regions by increasing the growth rate of the worst performing regions.

**5.4** This is why any regional economic policy must be focussed on raising the performance of the weakest regions, rather than the simple redistribution of existing economic activity. Real economic gain for the country as a whole will only come from a process of levelling up.

**5.5** At an institutional level the best mechanisms for achieving this are likely to be based in the regions themselves. So, the Government's response has been to develop targeted regional, sub-regional and local policies alongside flexible and empowered institutions to deliver them. To succeed, these institutions must exploit the indigenous strengths in each area and region. The Government's role then is to enable regional and local initiatives to work by providing the necessary resources within a national framework, to ensure that every region and country has the opportunity to match the economic performance of the most successful.

**5.6** In England, the Regional Development Agencies are the key agents in driving forward this new regional industrial policy. As the strategic leaders in regional and local economic development their regional development strategies set out shared visions of the challenge each region faces. The Government has strengthened the RDAs ability to tackle these challenges through substantial increases in resources and significantly increased flexibility over how they use these resources.

**5.7** In Scotland, Wales and Northern Ireland, policy responsibility for economic development functions and key productivity drivers has been substantially devolved to the Scottish Executive, Welsh Assembly and Northern Ireland Executive. The devolved administrations have used this freedom to strengthen their economic development bodies and respond to local priorities and opportunities.

### Next steps

**5.8** The 2002 Spending Review will reflect the Government's emphasis on the regional agenda and build on the analysis in this paper, by looking to make further progress towards the long-run regional economic policy ambition.

**5.9** The Review will look carefully at how main Departmental policies and settlements impact on regions and ensure that spending is fairly distributed and targeted at those regions, localities and neighbourhoods where it is needed most and will be most effective at delivering the Government's objectives. The Review will also look carefully at the performance of key regional institutions and programmes to ensure that both have the tools and resources they need to achieve their objectives, but also that they are delivering improvements where it matters most: on the ground.

**5.10** As part of the Review, the Government is also interested in regional input into the setting of national priorities. In the light of the analysis in this paper, regional institutions, such as the RDAs and the Government Offices, are being asked to consider what they see as the key strategic priorities for their regions to achieve increased productivity and economic development.

**5.11** Regional economic policy in the United Kingdom has been focussed for far too long on subsidy and failure rather than tackling market failures and building upon the indigenous strengths of regions and countries. The result has been the persistent economic differentials described here. The new regional economic policy set out in this document is, by contrast, focussed on policies to invest in tackling market failures and build on indigenous strengths at every geographical level, alongside providing strong and effective institutions needed to deliver these reforms.

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