Devolving decision making:

2 - Meeting the regional economic challenge:

Increasing regional and local flexibility

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OFFICE OF THE
DEPUTY PRIME MINISTER

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HM Treasury contacts

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www.hm-treasury.gov.uk

For further information on the Treasury and its work, contact:

Correspondence and Enquiry Unit
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 4558

Fax: 020 7270 4574

E-mail: public.enquiries@hm-treasury.gov.uk

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FOREWORD

The world economy is becoming increasingly more interdependent and, as a result, every nation and region of the United Kingdom faces more intense global competition. Faced with this challenge, flexibility at the regional level will be vital to harnessing indigenous strengths, overcoming long-term regional disparities and responding to short-term shocks.

For too long too many regions and countries of the UK have been allowed to fall behind. The economic disparities between the regions we see today can be traced back for generations. Overcoming these disparities will be central to ensuring that every region and locality of the UK performs to its full economic potential.

In the last Spending Review, the Government committed itself to making sustainable improvements in the economic performance of all English regions and over the long term reducing the gap in growth rates between the regions. It is not possible to do this using the one-size-fits-all approach that has so often failed in the past.

That is why, since 1997, the Government has pursued a new generation of regional economic policy that has created efficient, innovative and accountable sub-national institutions with real freedoms and flexibilities. Substantial power has been devolved to Scotland, Wales and Northern Ireland. London has a directly elected Mayor and Assembly. In the English regions, Regional Development Agencies have been established to help strengthen the building blocks of economic growth.

The White Paper *Your Region, Your Choice* set out proposals for directly elected regional assemblies in those regions that wish to have them. We have announced that the first referendums on whether to establish elected assemblies will take place in the North East, the North West and Yorkshire & Humberside this Autumn. These were the regions where interest in holding a referendum was high. If people vote yes, we expect the first elected assemblies will be up and running early in the next Parliament.

Alongside all of this is the proposal put forward by the three northern Regional Development Agencies to develop the idea of northern growth corridors. This recognises that establishing sustainable communities in the North is as much about economic growth and employment as it is in the South. The three northern Regional Development Agencies will work together to explore how they can exploit the untapped potential for economic growth along the existing transport corridors that connect the North. The Government has welcomed this idea and will work closely with the Regional Development Agencies, Government Offices and key stakeholders to develop it.

We recognise the need to evolve our approach further to ensure that regional and local institutions have the capability, capacity and confidence to overcome regional economic disparities. Increasing institutional flexibility around targets, funding and central guidance, tied to stronger accountabilities and performance incentives, will help national, regional and local institutions work better together.

The Regional Development Agencies, in particular, have an excellent understanding of what is needed to drive economic growth in the regions and how delivery organisations can co-operate more effectively to achieve this. Through their Regional Economic Strategies, they have set out a strategic vision for enhancing productivity and employment in each of the English regions and have worked with local Learning and Skills Councils, local authorities, the Small Business Service, Government Offices and Jobcentre Plus towards realising these Strategies.

That is why the Government asked the Regional Development Agencies to work together to identify the top ten institutional barriers that they believe are currently hindering effective co-ordination of policy decisions and service delivery in the regions as a contribution for the Devolving Decision Making Review. This paper sets out the Government's response to that contribution and establishes the next steps necessary to ensure that the institutional framework is focused on delivering enhanced economic outcomes in the regions and localities of the UK.

Rt Hon Gordon Brown MP
Chancellor of the Exchequer

Rt Hon John Prescott MP
Deputy Prime Minister

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

I

INTRODUCTION

I.1 The Devolving Decision Making Review was announced by the Chancellor in July 2003 with the following terms of reference:

"How best to achieve decentralised delivery and responsive local and regional services in a way that is consistent with equity and efficiency, against a clear framework of national standards."

I.2 The first instalment of the review, *Devolving Decision Making: 1 – Delivering Better Public Services; Defining Targets and Performance Management*, published alongside this paper, looks at how improvements to public service performance management over the past six years have enabled the Government to devolve greater responsibility to the front line in key public services such as education, health, crime and local government within an improved performance management framework.[1] It sets out the next steps that all organisations will need to consider in the run up to the 2004 Spending Review in order to build trust between the national, regional and local tiers, based on:

- further refined, outcome based Public Service Agreement (PSA) targets setting national standards and aspirations for key public services;
- significantly fewer targets not relating to PSAs set nationally and imposed on the front line, local government and regional organisations;
- stronger local accountabilities and incentives for delivering improvements in public services based on timely publication of performance data; and
- increased performance management capacity in the front line, local government and other intermediate tier organisations.

I.3 As part of the Devolving Decision Making Review, regions and local authorities were asked for their views about progress in delivering genuine devolution in policy-making responsibility. This second instalment looks at the delivery challenges facing institutions and policy makers at the regional and local level, and responds to the representations from the regions about the barriers to effective devolution of responsibility to sub-national institutions. This paper analyses historic and recent trends in regional economic performance and assesses progress in addressing regional disparities in productivity and employment. Against this background, the paper takes stock of progress in building effective regional and local institutions and describes how the Government proposes to develop further the framework to ensure that regional and local institutions have the flexibilities they need to achieve their ambitions.

The regional and local economic challenge

I.4 The Government's central economic objective is to raise the rate of sustainable growth and achieve rising prosperity and a better quality of life, with economic and employment opportunities for all. To achieve this goal it is essential that every nation, region and locality of the UK performs to its full economic potential. Currently, significant economic disparities exist between the regions and nations of the UK. The economic output per person of the poorest nations and regions – Northern Ireland, Wales and the North East – is around 40 per cent below that of London, the most productive part of the UK. In many cases, intra-regional differences are even wider than those between the regions. These geographical economic disparities present a cost to the UK economy both in terms of efficiency and equity.

[1] HM Treasury, Cabinet Office, *Devolving Decision Making: 1 – Delivering Better Public Services; Defining Targets and Performance Management*, 2004.

1.5 That is why the Government has set itself a PSA target to deliver sustainable improvements in the economic performance of all English regions, and reduce the persistent gap in growth rates between the regions.

1.6 Developing an improved understanding of the factors accounting for regional and local economic disparities was the Government's first task in developing its strategy towards achieving the regional economic performance PSA target. Disparities in economic performance can be explained by differences in productivity (the output each worker produces) and employment (the proportion of the working age population who are in work). This means that the key to addressing these disparities is to get more people into work and to make them more productive.

1.7 Chapter 2 sets out the latest evidence on regional and sub-regional economic disparities and demonstrates that significant challenges remain to addressing these disparities in each of the five drivers of productivity – competition, enterprise, innovation, skills and investment – and in employment rates. This paper updates and builds on the analysis in *Productivity in the UK: 3 – The Regional Dimension* and develops the analysis presented in *Full Employment in Every Region*. [2]

Increasing regional and local flexibility

1.8 The Government believes that the best way to overcome regional disparities in productivity and employment rates is to allow each nation, region and locality the freedom, flexibility and funding to exploit their indigenous sources of growth. Since 1997, the Government has therefore pursued a number of important developments driving forward devolution. The Government has devolved substantial power to Scotland, Wales and Northern Ireland, and created the Greater London Authority (GLA) and Regional Development Agencies (RDAs) in England, to ensure that all the nations and regions of the UK have the opportunity to decide for themselves how best to work to reach their full potential. The Government Offices (GOs) have continued to assist departments in the management and delivery of their programmes.

1.9 As these institutions have developed, the Government has sought to devolve greater freedom, flexibility and funding to them; for example, by increasing the funding and flexibilities available to the RDAs. These steps have been carried out on the basis that exploiting the indigenous strengths in each region best reinforces the drivers of long-term economic growth – innovation, investment, skills, enterprise, competition and employment. It is not possible either to run economic policy or to deliver strong public services that meet public needs from the centre, using a one-size-fits-all approach.

Scotland, Wales and Northern Ireland

1.10 Following devolution in 1999, each Devolved Administration is now wholly accountable to its own democratically elected representatives. The Devolved Administrations have wide-ranging powers in relation to public service delivery and economic development, although devolution is currently suspended in Northern Ireland. They have their own development agencies such as Scottish Enterprise, Highlands and Islands Enterprise, the Welsh Development Agency and Invest Northern Ireland. They also promote economic development through, for example, higher education institutions, local authorities and investing in improved infrastructure. The Devolved Administrations are introducing their own innovative approaches to economic development. In Scotland, Intermediary Technology Institutes have been established to cover energy, life sciences and communication

[2] HM Treasury, Department of Trade and Industry, *Productivity in the UK: 3 – The Regional Dimension*, 2001; HM Treasury, Department of Work and Pensions, *Full Employment in Every Region*, 2003.

technology; in Wales, the Modern Skills Diploma for Adults has sought to strengthen skills; and in Northern Ireland, the Reinvestment and Reform Initiative has been instrumental in promoting investment. The economic policies of the Devolved Administrations, working together with those of the Government, have contributed to producing large reductions in unemployment and have provided the foundation for improved prosperity for all in Scotland, Wales and Northern Ireland.

Regional Development Agencies

I.11 The English RDAs were established in 1999 (the London Development Agency (LDA) was created in 2000, under the GLA) to act as catalysts for economic development and regeneration in the regions. Since their creation, the RDAs have progressively been given more flexibility, including through the creation of an innovative Single Pot funding arrangement. In addition to a significant increase in resources in the 2002 Spending Review, RDAs were given new responsibilities in relation to tourism and transport, and asked to work with the Learning and Skills Council (LSC) and the Small Business Service (SBS) to pilot new approaches to the delivery of skills and support for business at the regional level.

Greater London Authority

I.12 The GLA has powers to promote economic development in London, as well as powers in areas including regeneration, planning, housing and transport. Both the Mayor and the London Assembly are directly elected by and accountable to the people of London.

English Regional Assemblies

I.13 Building on the enhanced responsibilities given to the regions through the creation and strengthening of RDAs and devolution to Scotland, Wales and Northern Ireland, the Government set out its vision for prosperous and thriving English regions with accountable directly elected regional assemblies in its May 2002 White Paper, *Your Region, Your Choice*.[3] The Regional Assemblies (Preparations) Act received Royal Assent on 8 May 2003. Following a soundings exercise, the Deputy Prime Minister announced in June 2003 that that there was sufficient public support for referendums to be held in three English regions: the North East, the North West and Yorkshire and Humberside.

Government Offices

I.14 The Government Offices (GOs) in each of the English regions have seen their scope increased, with ten departments now represented in each GO. The GOs have the potential to develop into the key representatives of central government in the regions and to join up national policy and regional priorities.

Establishing a framework for EU regional policy

I.15 In March 2003, in the context of the debate on the future of the European Structural and Cohesion Funds after 2006, the Government set out for consultation its proposals for a substantial devolution of regional policy within the EU.[4] Under the proposed EU framework for devolved regional policy, Member States with the financial and institutional strength to do so would fund their regional policies domestically, allowing EU support to be focused on the less prosperous Member States, under an outcome based framework founded on Lisbon priorities and applicable to all. In the light of responses to the consultation that endorsed the broad objectives underlying the Government's approach, the EU framework approach was confirmed as the basis for the Government's negotiating position in October 2003. The Government has also had an informal round of consultations with the UK's nations and regions on proposals for reforming the state aids regime.

The Euro assessment

I.16 On 9 June 2003, the Government announced the results of the Treasury's assessment of the five economic tests for membership of the single European currency. This emphasised the importance of a high degree of flexibility in product, labour and capital markets in the UK. Flexibility at the regional level has enabled different parts of the UK to prosper with interest rates that are set with respect to national rather than local economic conditions. Within European

[3] Office of the Deputy Prime Minister, *Your Region, Your Choice*, 2002.

[4] Department of Trade and Industry, HM Treasury, Office of the Deputy Prime Minister, *A Modern Regional Policy for the United Kingdom*, 2003.

Monetary Union (EMU), interest rates would be less responsive to conditions in individual regions than is currently the case. The Government concluded that EMU membership would therefore place an even greater premium on regional flexibility for the UK, just as it does for existing members. The Chancellor's June statement set out a programme of far-reaching reforms, including measures to promote flexibility across the economy, which are right for Britain's economic interests whether or not the UK joins the single European currency. The Government reports on the progress of these reforms in Budget 2004.

Strengthening local authorities

1.17 Economic disparities at the local level are in many cases greater than at the regional level and often require solutions tailored to the specific needs of the local community. Local authorities have a key role to play in the economic development of their localities, their contribution to the success of their regions and thus the prosperity of the UK as a whole. *Productivity in the UK: 4 – the Local Dimension* set out some of the ways in which the Government has helped local authorities focus on development.[5] Budget 2004 announces a number of further steps the Government is taking to build on this.

Regional input to the Devolving Decision Making Review

1.18 While the Government has done much to devolve responsibility to institutions at the regional and local levels, further work is needed to ensure that these institutions have the flexibility and resources to meet these challenges. The RDAs, through their role as the strategic leaders of economic development in the regions, have developed a good understanding of the extent to which the current target framework, lines of accountability, number of funding streams and central guidance are restricting the ability of regional and local institutions to enhance regional economic performance. In recognition of their knowledge of regional and local economies, the RDAs were asked to identify the institutional barriers that are currently hindering effective co-ordination of policy decisions and service delivery in the regions. The RDAs' and LAs' input to the Devolving Decision Making Review has informed the institutional changes that the Government now believes are necessary to improve regional economic performance and reduce regional economic disparities.

1.19 The economic evidence presented in this report highlights the range of factors affecting economic growth in each region and locality and the interdependence of these factors in determining competitiveness. This shows the importance of an integrated approach to tackling any barriers to growth in each geographic area. Many of the representations from the regions focused on the need to ensure that the regional and local institutions can work closely together to provide a genuinely joined-up approach to improving economic performance. Applying the principles of *Devolving Decision Making: 1 – Delivering Better Public Services; Defining Targets and Performance Management*[6] to the economic challenges identified require changes to promote:

- more flexible institutions: ensuring the right institutions are in place, at the right level, with the right powers and accountability to allow them to exploit indigenous strengths and tackle particular weaknesses;
- innovative and responsive policy design: ensuring that policy design is exercised at the level where market failures in product, capital and labour markets are most effectively tackled; and
- a robust regional evidence base: policy must be firmly and demonstrably based on evidence and supported by relevant and reliable data.

[5] HM Treasury, Office of the Deputy Prime Minister, *Productivity in the UK: 4 – the Local Dimension*, 2003.

[6] HM Treasury, Cabinet Office, *Devolved Decision Making: 1 - Delivering Better Public Services; Defining Targets and Performance Management*, 2004

I.20 The Government is taking a number of further measures to deliver more effective devolution of power to regional and local levels. These are discussed in greater detail in Chapter 4 and include:

- ensuring that the target frameworks for regional and local institutions are aligned to the particular priorities and needs of their regions and localities. To achieve this, the Government will introduce a new approach to tasking the RDAs to come into effect from April 2005;
- improving policy design at the national level and ensuring that its differential regional impact is taken into account. The Government will, where appropriate, consult the RDAs and other regional and local stakeholders at an early stage on major policy developments affecting regional and local economic growth;
- announcing in Budget 2004 its intention to devolve regional and local Business Link services to the RDAs, with a framework for setting national standards and services to be developed with SBS, the RDAs and other Government departments funding business support;
- announcing in Budget 2004 its commitment to address any institutional barriers identified by the Regional Skills Partnerships to creating an effective and integrated approach to regional skills delivery, taking into account the balance with national policy; and
- improving the regional policy framework, as measuring regional differences and improvements relies on high quality regional data being available. In recognition of the scope for improving the quality of regional data, Christopher Allsopp was asked to review regional information and statistics. The review's first report was published in December 2003 and an updated report will be published shortly after Budget 2004.[7]

I.21 This document is divided into four chapters. Chapter 2 provides extensive analysis of the five drivers of regional productivity as well as regional employment, setting out the evidence base for the rest of the document. Chapter 3 describes out in detail the framework for regional policy that has been developed since 1997. It explains the Government's modern regional policy and maps out the current institutional landscape for delivery agents at the national, regional and local levels. Chapter 4 considers the RDAs' recommendations to the Devolving Decision Making Review and sets out the Government's response to the structural issues they raise. It then describes the implications for effective delivery on employment and the five drivers of productivity.

[7] Allsopp, *Review of Statistics for Economic Policymaking; First Report to the Chancellor of the Exchequer, the Governor of the Bank of England and the National Statistician*, 2003

2 The regional and local economic challenge

Introduction

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

Regional economic performance PSA target

2.2 In the 2002 Spending Review, the Government strengthened its commitment to the regional dimension of its economic policy by setting a Public Service Agreement (PSA) target to deliver sustainable improvements in economic performance in every region, and to reduce the gap in growth rates between the poorest and the richest English regions.[1] In pursuit of this target, the Government has undertaken an extensive process of evidence gathering and consultation to improve the understanding of the causes of regional economic disparities, and to provide better evidence on how key employment, skills and other policies are working.

Productivity in the UK: 3 – The Regional Dimension

2.3 The Government's analysis and approach to regional economic policy was first described in *Productivity in the UK: 3 – The Regional Dimension*, published in 2001.[2] Against this background of significant progress on the regional economic performance agenda, this chapter provides an update to the context, analysis and evidence set out in the 2001 paper, and brings this together with an examination of the underlying causes of regional employment differentials. It reaffirms the Government's commitment to the regions, and brings new evidence to bear on the causes of regional disparities in productivity, employment and growth. *Productivity in the UK: 4 – The Local Dimension*, published in 2003, developed this analysis by looking at the extent of intra-regional disparities.[3]

Improving the regional data

2.4 The Government has also taken a number of steps to improve the quality and availability of regional data to underpin the development of policy designed to promote economic growth in all regions and reduce the persistent gap in growth rates between regions. These have included:

- a wide-ranging review by Christopher Allsopp into the informational and statistical requirements needed to support the Government's key regional objectives; and
- a study led by Professor Iain McLean which examined the flow of domestic and European expenditure into the English regions.[4]

Trends in regional and local economic performance

2.5 There are considerable regional and local variations in economic performance. For the Government to achieve its central economic objective it is essential that every nation, region and locality of the UK performs to its full economic potential.

[1] HM Treasury, *2002 Spending Review, Public Service Agreements 2003-2006*, 2002.

[2] HM Treasury, Department of Trade and Industry, *Productivity in the UK: 3 – The Regional Dimension*, 2001.

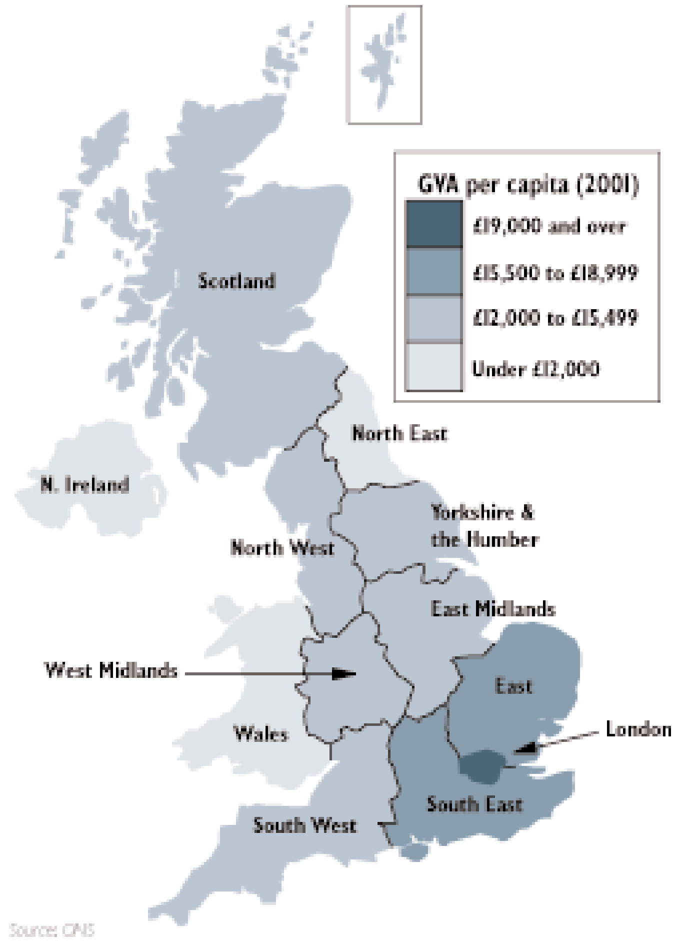
[3] HM Treasury, Office of the Deputy Prime Minister, *Productivity in the UK: 4 – The Local Dimension*, 2003.

[4] Allsopp, *Review of Statistics for Economic Policymaking; First Report to the Chancellor of the Exchequer, the Governor of the Bank of England and the National Statistician*, 2003; Nuffield College, Office of The Deputy Prime Minister. *Identifying the flow of domestic and European expenditure into the English regions*, 2003.

Regional Gross Value Added (GVA) per capita

2.6 Figure 2.1 shows that the economic output per person of the poorest nations and regions – Northern Ireland, Wales and the North East – is around 40 per cent below that of London, the most productive part of the UK.[5]

Figure 2.1: Regional GVA per capita (2001)



2.7 Even taking into account differentials in regional price levels which vary from 8 per cent above the national average in London to 8 per cent below the national average in the North East, large disparities would still remain in GVA per capita caused by differences in productivity and employment between regions, as set out in *Productivity in the UK: 3 – The Regional Dimension*.[6]

Local GVA per capita

2.8 The dispersion of GVA per capita within regions is even greater than that between regions. These intra-regional variations are much more stark in some regions than in others, although large differences in wealth exist within all regions.[7] Furthermore, regions with levels of GVA per capita above the UK average experience, in general, higher levels of absolute sub-regional dispersion. In the South East, for example, GVA per capita in Berkshire is over two and a half times that on the Isle of Wight.

[5] GVA per capita figures are residence based, which means that the incomes of commuters are allocated to where they live, rather than where they work.

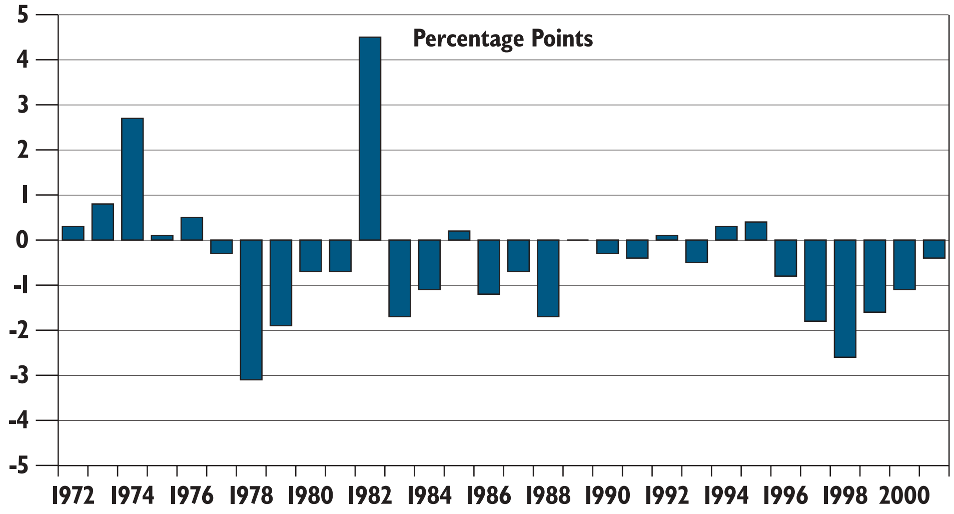
[6] HM Treasury, Department of Trade and Industry, *Productivity in the UK: 3 – The Regional Dimension*, 2001.

[7] The data is for NUTS3 areas (see Regional Trends, for further details). It should be noted that comparisons of economic performance between areas become less precise as the areas under examination become geographically smaller. In particular, while such figures may provide a useful indication of the economic capacity and industrial structure of a particular region, they do not necessarily provide a good indicator of living standards: among other things, people often do not live in the local area in which they work, especially around large cities such as London, Manchester and Bristol.

Changes in regional disparities over time

2.9 Looking at the trends in regional nominal GVA per capita over time, data for 1971-2001 show that both the size of the differentials and the relative rankings of regions have been persistent over time. These disparities are reflected in the difference in growth rates between the rest of the UK and the Greater South East, which is set out in Chart 2.1 below.[8] It shows that apart from during the period 1972-1976, the rest of the UK has generally grown more slowly that the Greater South East. However, since 1998 the gap in growth rates between the two areas has narrowed sharply. For example, growth in the Greater South East was 2.6 percentage points higher than in the rest of the UK in 1998, but by 2001 this difference had narrowed to 0.4 percentage points.

Chart 2.1: Difference (Rest of the UK – Greater South East) in GVA per capita growth rates



Source: ONS, HM Treasury. Data for 1989-2001 is based on Government Office Regions and ESA95. Earlier data for 1971-1988 is based on Standard Statistical Regions and a different accounting convention.

2.10 A large contributing factor to the narrowing of growth rates since 1998 and at other points during the 1970s and 1980s is likely to be differences in the timing of regional economic cycles. Evidence suggests that growth in the rest of the UK tends to lag behind that of the Greater South East. In particular, economic shocks tend to spill over from the Greater South East to other regions.[9] Nevertheless, even when the rest of the UK has been booming, it has rarely grown faster than the Greater South East.

2.11 While the PSA target agreed in the 2002 Spending Review was to raise the sustainable rate of growth of all English regions and to reduce the gap in growth rates between regions, *Productivity in the UK: 3 – The Regional Dimension* explained that this would clearly only be a first step in reducing disparities.[10] Ultimately, the Government has a longer-term aspiration of reducing disparities in the levels of real GVA per capita between regions.

The costs of geographical disparities

2.12 The Government's regional policy is focused on supporting growth in all regions as well as reducing the gap in growth between regions. This will help improve efficiency in some parts of the country, as well as equity in distributing economic opportunities across the UK. Regional policy is built on a platform of macroeconomic stability at the UK level, which provides conditions in which individuals, businesses and the public sector can plan and invest more effectively for the long-term.

[8] The Greater South East includes the South East, East and London Government Office regions.

[9] Chapman, *The Dynamics of Regional Unemployment in the UK, 1974-89,* 1991; Martin, *Are European Regional Policies Delivering?*, 1997.

[10] HM Treasury, Department of Trade and Industry, *Productivity in the UK: 3 – The Regional Dimension*, 2001.

Efficiency **2.13** Geographical economic inequalities can undermine economic efficiency in a number of ways. For example, increased growth in some regions may create excess demand by firms for labour and skills, leading to inflationary pressures and a volatile business cycle. Slower growth in other regions can lead to an inefficient use of resources, with firms working under capacity, and hence increased unemployment rates.

Equity **2.14** The Government is also committed to ensuring that everyone, wherever they live, is able to share in the nation's rising prosperity. However, under capacity in low-growth regions and nations can lead to fewer employment opportunities for individuals in these areas. Furthermore, increased unemployment and hence lower incomes will reinforce the lack of opportunities by reducing the demand for goods and services in the local economy.

2.15 Regional economic disparities also create unacceptable geographical variations in living standards. For example, average gross weekly nominal household incomes in London are over 60 per cent higher than those in the North East. If all lagging UK countries and regions improved their GVA per capita to at least that of the current average then, on average, each person in the UK would be over £1,100 a year better off. Even accounting for differences in prices, on average each person would still be significantly better off.

Box 2.1: Regional flexibility and European Monetary Union (EMU)

The economy continually needs to adjust to changing economic conditions affecting the competitiveness and profitability of the goods and services that it produces. Some changes will be at the local level, affecting particular regions of the country or particular industries; others will be at the national level; while others are international or global in nature.

The Treasury's assessment of the five economic tests for EMU membership set out in detail the importance of a high degree of market flexibility in the UK. Such flexibility, in labour, product and capital markets, is important irrespective of whether the UK joins the single currency or not, but would be highly important if the UK were to join.

Any decision to join the single currency would mean significant changes to the operation of macroeconomic policy in the UK. The exchange rate between sterling and the euro would be fixed irrevocably and the euro would become the national currency of the UK. Membership would also mean that the UK would lose the ability to set interest rates at the national level.

Flexibility at the regional level has enabled different parts of the UK to prosper with interest rates that are set with respect to national rather than local economic conditions. Within EMU, interest rates would be less responsive to conditions in individual regions than is currently the case. EMU membership would therefore place an even greater premium on regional flexibility for the UK, just as it does for existing members.

The UK's long-run growth and prosperity depends on every nation and region of the UK performing to its full economic potential. The characteristics and institutions that promote economic adjustment between UK regions would also equip the UK to thrive in EMU. This is why the Government wants to ensure that, in the future, regional policy in the European Union is substantially devolved, providing the flexibility for Member States to pursue the regional policies that are tailored to meet their particular needs.

EXPLAINING REGIONAL AND LOCAL ECONOMIC DIFFERENCES

2.16 The Government's first task in developing a strategy for reducing regional and local economic differentials was developing an improved understanding of the factors accounting for them. At the most fundamental level, national, regional or sub-regional differentials in GVA per capita are a function of differences in:

- productivity – the output each worker produces, which is driven by competition, enterprise, innovation, skills and investment; and
- employment rates – the proportion of the working age population who are in work, which depends on finding jobs for both the unemployed, and inactive people who want, and have the potential, to work.

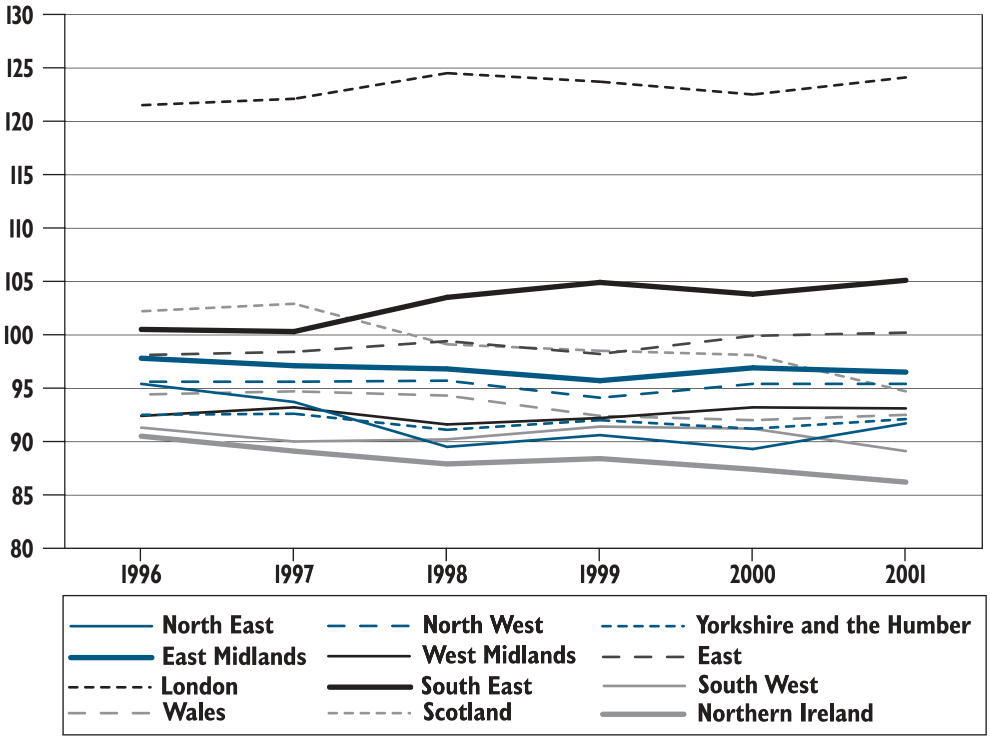
In order to understand why regional and sub-regional GVA per capita differentials persist, it is necessary to explore how these determinants vary between regions over time.

Productivity

2.17 The first determinant of growth and living standards is productivity – how effectively the economy uses the resources it has available to produce goods and services. Productivity growth underpins strong economic performance and sustained increases in living standards. Raising the productivity of every locality and region is therefore a key challenge facing the Government as it pursues its goal of a UK characterised by economic strength and social justice.

2.18 There are large and significant regional differences in productivity, measured by nominal output per filled job – see Chart 2.2 below. Over the period 1996-2001, London has continued to far outpace the rest of the UK and the gap between it and Northern Ireland, the poorest performer, has increased from around 30 percentage points in 1996 to nearly 40 percentage points in 2001. Outside London, there has also been a slight divergence: while Northern Ireland has fallen behind, the South East and East have narrowed the gap with London.

Chart 2.2: Relative regional productivity per filled job (UK=100)



Source: ONS.

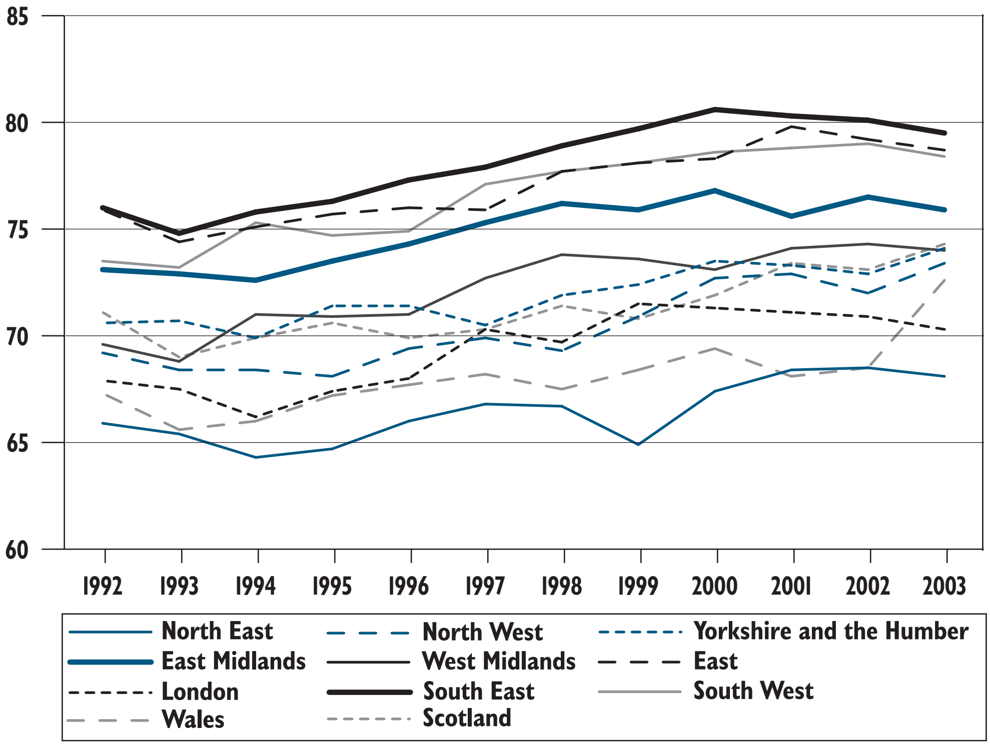
2.19 In addition, large productivity differentials exist at the sub-regional level. For example, productivity levels within the South East range from around 20 per cent below the national average in Brighton and Hove to around 10 per cent above the national average in Surrey and Portsmouth. Similarly, in the North East, where all sub-regions have productivity levels below the national average, productivity ranged from 80 per cent of average UK productivity in Sunderland and Tyneside to just under the national average in South Teeside.

2.20 The disparities in regional and sub-regional productivity levels can be explained by weaknesses in the five drivers of productivity in under-performing regions and localities – competition, enterprise, innovation, investment and skills.

Employment

2.21 The second determinant of regional and local growth is employment. Regional employment data for 1992-2003, illustrated in Chart 2.3, shows that the employment rate in every region and nation of the UK has risen since the early 1990s, although the size of regional differentials and the relative ranking of regions has proved very persistent. The North East, London and Wales have consistently had the lowest employment rates, while the South East, East and South West have had the highest.

Chart 2.3: Employment rate by region



Source:ONS.
Rates are as a proportion of the working age population.

2.22 As with productivity, the picture at a regional level to some extent masks the more diverse labour market outcomes at a sub-regional level. So while employment rates in the South East are, on average, higher than those in the North West this is by no means true for all sub-regions. For example, the employment rate in Hart in the North West was 92.3 per cent of the national average in summer 2002 while that in Thanet in the South East was just 66.9 per cent.

2.23 Reducing regional and sub-regional disparities in employment rates requires helping those people that are already actively seeking work – the unemployed – to find a job and ensuring that those inactive people with the potential to work are brought back into the labour market.

2.24 The rest of this chapter looks at the underlying factors that drive regional economic disparities and analyses the specific market failures, resource constraints and coordination problems that constrain the productivity drivers and employment in under-performing regions and localities.

PRODUCTIVITY

2.25 The Government's strategy for increasing UK productivity is based around maintaining macroeconomic stability, underpinned by comprehensive reforms to the UK's macroeconomic policy framework since 1997, and implementing microeconomic reforms to remove barriers that prevent markets from functioning efficiently.

The drivers of regional productivity

2.26 The microeconomic reform agenda seeks to address those market failures that constrain productivity and output, both nationally and at the regional and local level. The five key drivers of productivity were set out in *Productivity in the UK: The Evidence and the Government's Approach* published alongside the 2000 Pre-Budget Report.[11] They are:

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

2.27 The Government's aim is to have policies in place to remedy the market failures that impede productivity and output growth. As this chapter illustrates, many of the market failures that affect productivity and growth differ by region. Therefore the potential improvements to the underlying drivers of productivity growth may be different for different regions or localities. This means that there will be different roles for regional, national and local policy makers, enabling interventions to improve productivity to be undertaken at the level at which the market failure can most effectively be tackled.

Linkages between the drivers

2.28 At the outset, it is important to recognise the connections that exist between the five drivers of productivity. Described more fully in Box 2.2 below, the nature and extent of these linkages explains how some regions and localities have become trapped in a long-term cycle of economic under-performance. In addition to examining the specific market failures and other factors that inhibit each specific productivity driver, this chapter also highlights the impact that each driver can have on the others.

[11] HM Treasury, *Productivity in the UK: The Evidence and the Government's Approach*, 2003.

Box 2.2: The relationship between the five drivers of productivity

Productivity in the UK: The Evidence and the Government's Approach (2000) described how each of the five drivers of productivity plays a vital role in creating the conditions for businesses to flourish and for individuals to maximise their productive potential.[a] It is also important for policymakers to understand the interconnections between them.

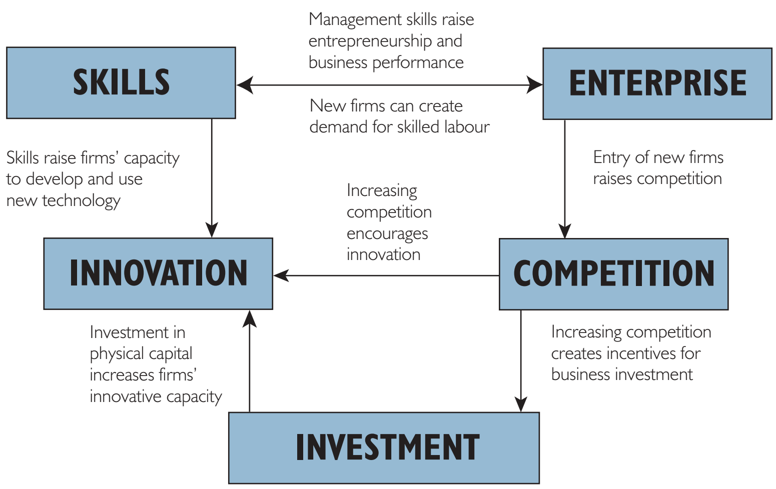
The quality of a region's skills base, for example, will influence the ability of its firms to develop, adopt and utilise innovative ideas.[b] Competition is also an effective stimulus for higher innovation, but itself depends on a thriving enterprise culture and effective investment in infrastructure networks if it is to be sustained.[c] These and other important linkages between the five drivers are illustrated in Figure 2.2 below.

The linkages between the productivity drivers have important implications for the design and delivery of regional policy in two respects.

First, it is essential that a comprehensive package of policy instruments is in place to strengthen each of the five drivers throughout the UK. Failure to do so would undermine efforts to strengthen individual drivers and overall economic performance. A region's economic underperformance could be perpetuated if, for example, policymakers failed to recognise the importance of a strong local skills base to the attraction and growth of new businesses.

Secondly, it is vital that there is a coordinated approach to the design and implementation of policies designed to raise regions' productivity and growth. There will be beneficial synergies from a coordinated effort to strengthen all of the drivers that may be holding back a particular region's growth. The nine Regional Development Agencies (RDAs) in England, and the Devolved Administrations in Scotland, Wales and Northern Ireland, have consequently been given a strategic leadership role in the economic development of their regions and nations.

Figure 2.2: Important linkages between the drivers of productivity



[a] HM Treasury, *Productivity in the UK: The Evidence and the Government's Approach,* 2000.

[b] Acemogu, Zilibotti, *Productivity Differences*, 2001.

[c] Scotchmer,Thisse, *Space and Competition: A Puzzle*, 1992; London Business School, *Global Entrepreneurship Monitor 1999 UK Executive Report,* 1999.

Competition

Why competition matters

2.29 Competition plays a central role in driving productivity growth. It puts pressure on firms to innovate, improve efficiency and better serve consumer needs in the search for competitive advantage over rivals. Competition promotes flexible product and capital markets by providing strong incentives for firms to respond quickly to changing economic and market conditions and by reallocating resources away from inefficient firms or declining sectors, to more efficient firms and growing sectors.[12] Consumers have an important role to play in driving increased competition in markets by placing pressure on companies to improve performance. This can be particularly important in local and regional markets where consumers may be more able to shop-around.

Geographical variations in competition

2.30 The level of competition in an economy may vary significantly across regions and localities. Inherent market conditions for some goods will segment markets, for example transport costs or differences in consumer tastes. Where markets are regional or local, in particular in poorer or more remote areas, they may become dominated by a few firms. In contrast, firms in more prosperous and densely populated areas are more likely to experience higher levels of competition. Not only can demand within 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.[13] Such regions may also have superior infrastructure that supports competitive markets.

Enterprise

Why enterprise matters

2.31 Entrepreneurs and their businesses also play a significant role in strengthening the other drivers of productivity by stimulating competition, creating demand for skilled labour, driving investment, and furthering innovation.[14] Successful enterprises also form part of the bedrock of local communities, contributing to economic prosperity and social cohesion. The Government has consequently devoted considerable attention to understanding the barriers to enterprise in under-performing regions and localities, as well as introducing the policy measures necessary to overcome them.

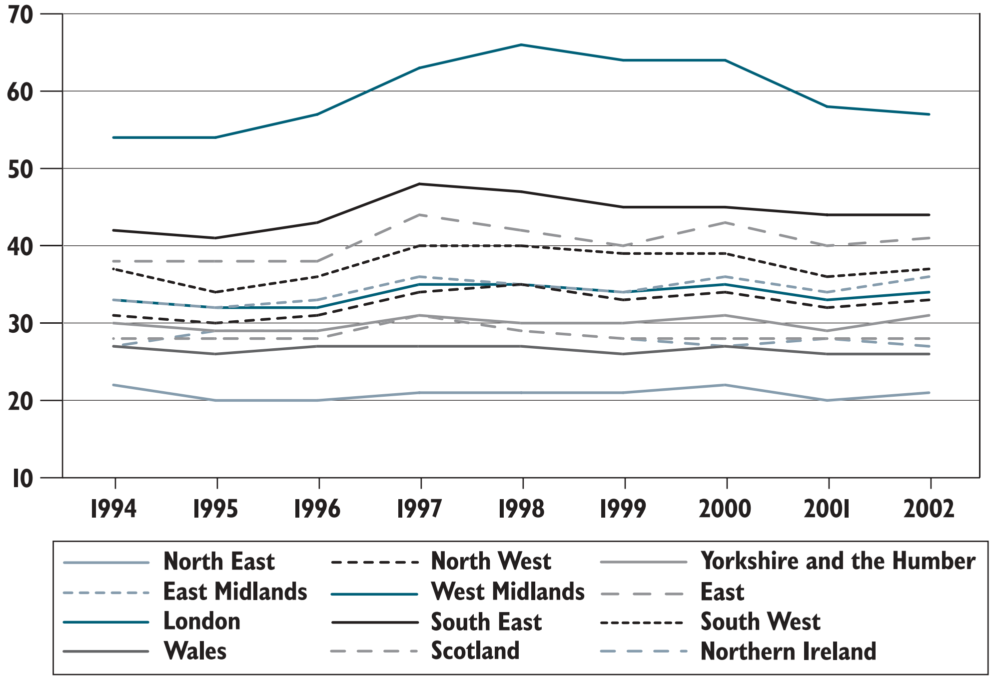
2.32 There is a large regional divide in business start-up rates across the UK that has persisted for at least the last two decades. As a proportion of their adult population, many more firms are set-up in London and the South East each year than in other regions of the UK, particularly the North East of England, Scotland and Wales. As illustrated in Chart 2.4 below, business creation rates in 2002 ranged from 21 new VAT registrations per 10,000 adult residents in the North East, to 57 per 10,000 in London. It is also evident that start-ups rates vary considerably within regions. In the North East, for example, the number of VAT registrations per 10,000 resident adults varied between 40 in Tynedale and 12 in Wansbeck.

[12] Porter, *The Comparative Advantage of Nations,* 1990; Geroski, *Innovation, Technological Opportunity and Market Structure,* 1990; Caves, Barton, *Efficiency in US Manufacturing Industries,* 1990; Blundell, Griffith, Van Reenan, *Dynamic Count Data Models of Technological Innovation,* 1995; Nickell, *Competition and Corporate Performance,* 1996.

[13] Scotchmer, Thisse, *Space and Competition: A Puzzle,* 1992; Krugman, Venables, Fujita, *The Spatial Economy,* 1999; Competition Commission, *A Report on the Supply of Groceries from Multiple Stores in the United Kingdom,* 2000.

[14] Recent research carried out on US cities has found that higher levels of entrepreneurial activity exhibit a strong positive correlation with higher long-term growth rates. See Zoltan, Armington, *Endogenous Growth and Entrepreneurial Activity in Cities,* 2003.

Chart 2.4: New VAT registrations per 10,000 resident adults



Source: Small Business Service.

Geographical variations in enterprise

2.33 The Government's 2001 paper *Productivity in the UK: 3 – The Regional Dimension* stated that, in principle, geographical variations in enterprise may be attributed to market failures and the existence of powerful incentives for firms to cluster together in areas where demand is strong and where factor inputs (capital, labour and materials) are easily accessible.[15] Since 2001, further research has deepened the Government's understanding of the causes of low enterprise in underperforming regions. These causes include:

- entrepreneurial characteristics. Individuals with certain entrepreneurial characteristics are more likely to start businesses than others, and are not uniformally distributed across the country;
- low mobility of existing firms. There are factors which discourage firms moving into regions and localities with lower wage and material costs;
- poor access to finance. Entrepreneurs in certain areas may face particular obstacles when seeking finance to set-up a business;
- low demand. Weak local demand will discourage firms from setting up in a particular area, in favour of more prosperous locations;
- low skilled labour force. A lack of skills amongst the local population will deter firms that require skilled labour from moving into an area or starting up there; and
- public sector pay. Public sector pay levels in certain localities are above those paid for equivalent work in the private sector. This inhibits the ability of ambitious enterprises to recruit new employees, and reduces individuals' incentives to become entrepreneurs.

Entrepreneurial characteristics

2.34 Entrepreneurs can be defined as those people who are self–employed or own a business. Setting up a new firm requires talent, ambition and an acceptance of risk. However, research also indicates that individuals with certain personal characteristics are more likely to set up a new business than others.[16] For instance, people with advanced qualifications are

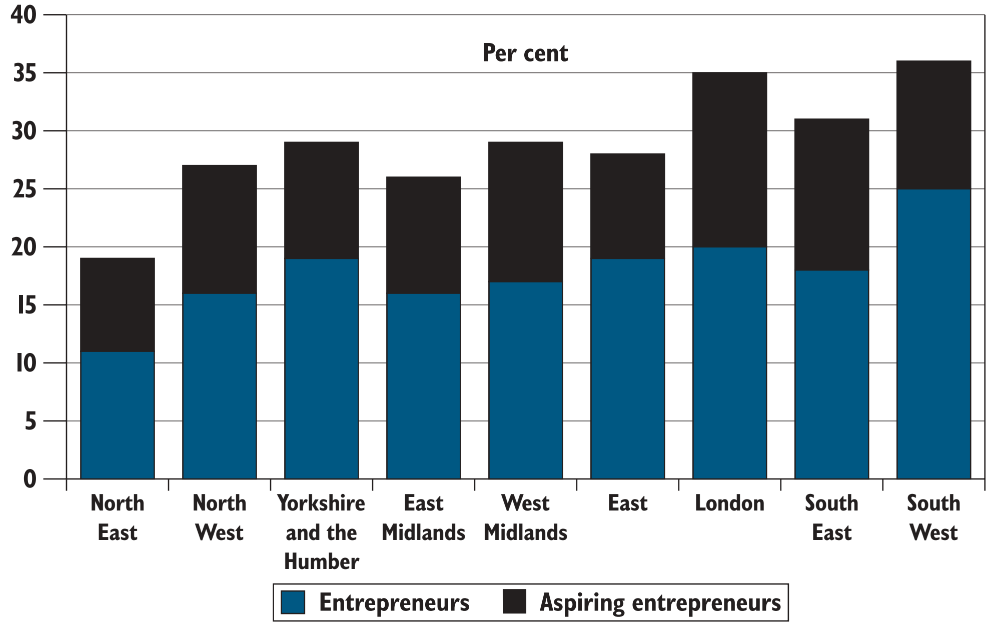
[15] HM Treasury, Department of Trade and Industry, *Productivity in the UK: 3 – The Regional Dimension*, 2001.

[16] Small Business Service, *Household Survey of Entrepreneurs*, 2001.

more likely to start their own business than the unskilled, while most self employed people tend to have previously been employed in the sector in which their firm now competes. Individuals' age, class, gender and ethnicity have also been found to influence their attitude to entrepreneurship.

2.35 As Chart 2.5 shows there are regional variations in the proportion of entrepreneurs and aspiring entrepreneurs within the working age population. A number of reasons can explain why people with these entrepreneurial attributes are more common in some areas than others. Persistently lower levels of skills in economically under-performing regions, for example, will account for some of their shortage of entrepreneurs. Similarly, the industrial mix in some regions, where business services and high value-added manufacturing sectors are less prevalent, means that only a small proportion of the resident population will have the relevant employment experience to start-up new firms in high growth sectors. It may also be the case that the traditions and culture of particular areas do not fully recognise the value of entrepreneurship.

Chart 2.5: Attitudes to entrepreneurship amongst working age population (2001)



Source: Small Business Service.

Low mobility of existing firms

2.36 In principle, the lower cost of labour and other factors of production in depressed areas, and the costs associated with congestion and pollution in high growth regions, should together lead to a movement of firms into the under-performing regions. However, a number of factors may act against this, notably the spillover of information about best-practice techniques and tacit knowledge. External benefits such as these result from the informal contacts and movements of skilled labour that occur between firms when they are clustered together. Businesses are also drawn towards the locations of their key suppliers in an effort to keep transport costs to a minimum.[17]

Poor access to finance

2.37 There is also evidence to suggest that firms in certain localities may face difficulties in accessing the finance they need to set-up and grow.[18] This can be attributed to a combination of market failures:

[17] For a fuller explanation of firm clustering, see HM Treasury, Department of Trade and Industry, *Productivity in the UK: 3 – The Regional Dimension*, 2001.

[18] Bank of England, *Finance for Small Business in Deprived Communities*, 2000.

- information problems. Lending decisions by banks and investment decisions by equity providers may require regionally and locally specific information. Enterprises in depressed areas with few local financial institutions may consequently be receiving under-investment, as creditors may lack information about lending opportunities and the risks associated with them. Similarly, enterprises may lack information about sources of finance;[19]
- transaction costs. The cost of identifying good investment opportunities in less accessible regions and localities may deter financiers from lending money to entrepreneurs in these areas, especially if weak local markets make the expected returns from these investments relatively low; and
- market power. Insufficient competition between suppliers of finance in certain localities may result in a limited supply of affordable credit for new firms.

Low demand

2.38 In addition to the whereabouts of their suppliers, firms will consider the location of their main consumers when making locational decisions. Areas of high demand for goods and services present firms with the prospect of higher earnings and, other things being equal, larger profits. This creates a tendency for firms to seek to locate in more prosperous regions and away from poorer, smaller markets in under-performing regions.

Low skilled workforce

2.39 High productivity firms will also seek locations with a skilled labour force able to develop and utilise new technology and working practices. Poor skill levels in depressed regions consequently reduce the incentive for businesses to set-up there or move there from outside. This situation can create a vicious cycle in which individual firms and workers are responding rationally to the actions of each other, but in so doing perpetuate economic under-performance. Hence, firms are deterred from setting up in low skill localities, which in turn reduces incentives for the local population to undertake education and training.

Public sector pay

2.40 As with all parts of the economy, the public sector labour market needs to be flexible so as to be able to adapt quickly to evolving circumstances. A responsive public sector labour market can make a substantial direct contribution to vigorous and balanced growth across the UK by not preventing ambitious enterprises from recruiting new employees. Also, the public sector labour force needs to be flexible and responsive to local needs and circumstances if public services are to be delivered to the standard consumers are entitled to expect.

Innovation

Why innovation matters

2.41 Innovation – the creation and successful adoption of new technologies, products and production processes – is a key driver of productivity growth, with benefits for firms, consumers and wider society. However, the UK has often been slow to recognise the commercial potential of much new research,[20] and a majority of the UK's productivity gap with the US can be attributed to differences in the level of innovation.[21] Innovative firms will

[19] Chittenden, Michaelas, Poutziouris, *Financial policy and capital structure choice in UK SMEs*, 1999.

[20] O'Mahony, *Conversion Factors in Relative Productivity Calculations: Theory and Practice*, 1996.

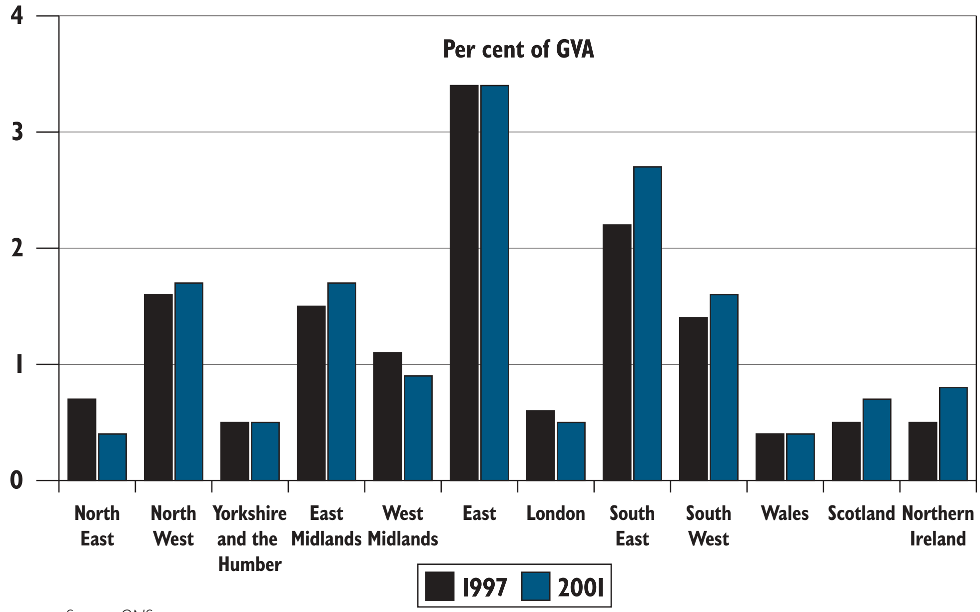
[21] Crafts, O'Mahony, *A Perspective on UK Productivity Performance*, 2000; HM Treasury, *Productivity in the UK: The Evidence and the Government's Approach*, 2000.

also generate demand for skilled labour in their vicinity, thereby supporting another of the productivity drivers. Strengthening innovation in every region and nation of the UK is therefore crucial to raising productivity and overall economic performance.

Regional variations in innovation

2.42 Expenditure on research and development (R&D) is one indicator of how much firms invest in the creation and application of new knowledge.[22] Chart 2.6, below, shows that there are substantial variations in the amount of R&D expenditure undertaken by firms in different parts of the UK. In 2001, business R&D expenditure represented 3.4 per cent of total GVA in the Eastern region, compared to only 0.4 per cent of GVA in the North East and Wales. Since 1997, business R&D expenditure as a proportion of GVA has risen or remained stable in the nine of the twelve UK regions and nations, with the fastest growth seen in Northern Ireland, Scotland and the South East.

Chart 2.6: Business expenditure on research and development

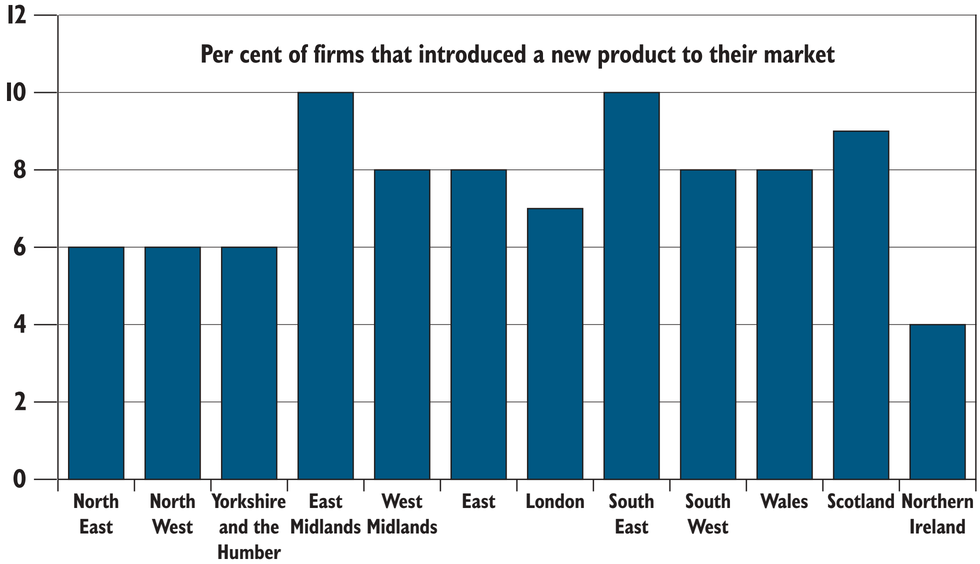


Source: ONS.

2.43 One indicator of the ability of regions to acquire and apply innovative ideas is the number of firms reporting successful product innovations. As Chart 2.7 below illustrates, a higher proportion of firms in the South East and East Midlands introduced new products to their market in 2001, compared to those based in Northern Ireland. The Patent Office, meanwhile, reports that a higher number of patents per capita are awarded to firms based in the South East than in other regions. Patents data also indicates large variations in innovative activity between different UK cities and localities.

[22] Rodriguez-Pose, *Economic Convergence and Regional Development Strategies in Spain: The Case of Galacia and Navarre*, 2001.

Chart 2.7: Product innovation by region (2001)



Source: UK Innovation Survey.

2.44 Higher Education Institutions (HEIs) are also vital to the creation and dissemination of innovative ideas. According to the Higher Education Funding Council, over a third of England's top (5 and 5* ranking) HEI research departments in science and engineering are located in London and the South East, although top-rated science and engineering departments are to be found in every region. A key challenge is to support and encourage existing centres of research excellence, and to ensure that the innovative ideas they generate can be adopted by UK firms to improve their productivity and competitiveness.

Knowledge transfer

2.45 The evidence above suggests that there are large geographical variations in the creation and adoption of new knowledge, with a higher proportion of business R&D expenditure and leading research taking place in the south of England. In theory, such geographical variations in the creation of knowledge would not be an issue if knowledge could be transferred quickly and efficiently to firms throughout the country, enabling them to apply it to their processes and products. However, in practice, as described in *Productivity in the UK: 3 – The Regional Dimension*, the dissemination of best-practice and new technologies decreases with distance, which has implications for the geographical pattern of innovation.[23]

2.46 In the 2002 Pre-Budget Report, the Government commissioned Richard Lambert to examine the links between business and universities, focusing on how business can exploit technologies and skills in the university sector. Richard Lambert published his final report on 4 December 2003.[24] The review found that, more often than not, research-active universities are to be found at the heart of successful business clusters. Oxford and Cambridge are notable examples, but many others are developing across the country. It also found that, for collaboration between SMEs and universities, proximity matters. An analysis of the UK Community Innovation Survey found that 90% of firms with a local market, which currently collaborates with a university, work with one that is less than 50 miles away. The review emphasised the importance of building links between business and universities in all regions and argued that this would have a positive impact on regional economic growth. The review recommended an enhanced role for the RDAs in facilitating business-university links in all regions of the UK.

[23] HM Treasury, Department of Trade and Industry, *Productivity in the UK: 3 – The Regional Dimension*, 2001.

[24] Lambert, *Lambert Review of Business-University Collaboration: Final Report*, 2003.

2.47 Further research since 2001 has confirmed the importance of proximity to successful innovation. Firms, especially small and medium sized enterprises (SMEs), benefit from the clustering of researchers and businesses with similar or related expertise, since this facilitates collaboration and knowledge transfer. Promoting collaboration and knowledge transfer by developing strong networks and exploiting existing regional centres of research excellence is therefore a crucial component of any strategy to increase regional innovation performance.

Skills

Why skills matter

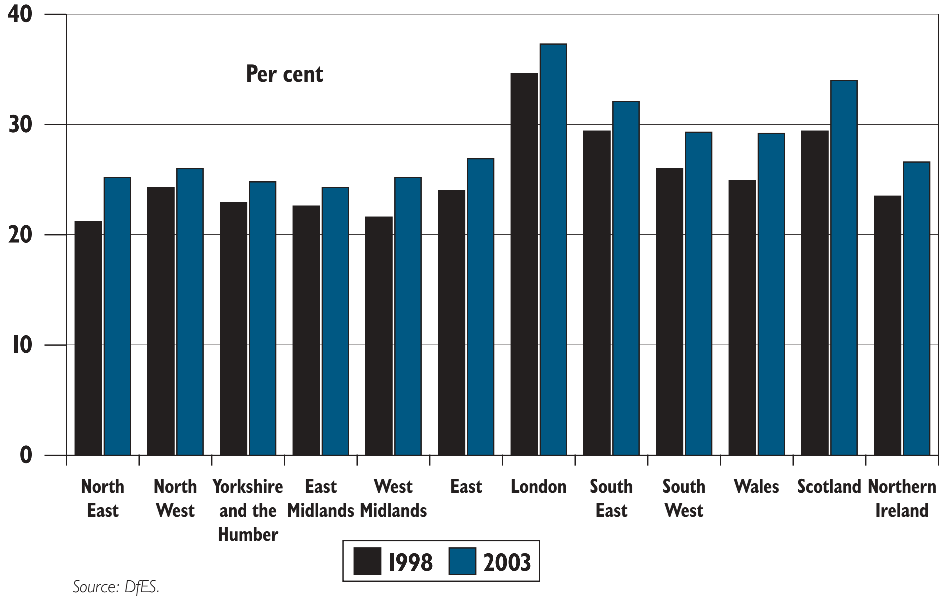
2.48 Skills are a key determinant of economic growth, since they raise individuals' productivity and flexibility.[25] In an increasingly globalised world, where UK firms are moving up the value chain, an increasing proportion of jobs in the economy require high skills.[26]

2.49 There are also strong linkages between the strength of a region's skills base and the other four drivers of productivity. High-skilled workers are essential to both introducing and operating innovative production techniques, and are more adept at taking full advantage of new capital. A strong skills base will also help attract enterprises to a locality, while skilled individuals are also more likely to set-up successful new businesses than those with few qualifications. Improving regional skills bases is therefore a crucial component of the Government's regional productivity agenda.

Geographical skills variations

2.50 There are a number of pieces of evidence that indicate regional variations in the stock of skills amongst the resident population, plus differences in the flow of highly skilled people entering the workforce. Since 1998 every region has seen an increase in the proportion of its population qualified to degree level, but London continues to contain a higher proportion of graduates than any other region. There are also significant sub-regional differences in the stock of skills. Within London, for example, the proportion of the local population with a degree or equivalent qualification ranges from under 10 per cent in Barking and Dagenham to over 50 per cent in Richmond-upon-Thames.

Chart 2.8: Percentage of economically active working-age adults qualified to at least degree level (1998–2003)



Source: DfES.

[25] Mankiw, Romer, Weil, *A Contribution to the Empirics of Economic Growth,* 1992; Benhabib, Spiegal, *The Role of Human Capital in Economic Development: Evidence from Aggregate Cross-Country Data,* 1994; Ahgion, Howitt, *Endogenous Growth Theory,* 1998; Temple, *Growth Effects of Education and Social Capital in the OECD Countries,* 2000; Bassanini, Scarpetta, *Comparative Analysis of Firm Demographics and Survival: Micro-Level Evidence for the OECD Countries,* 2001.

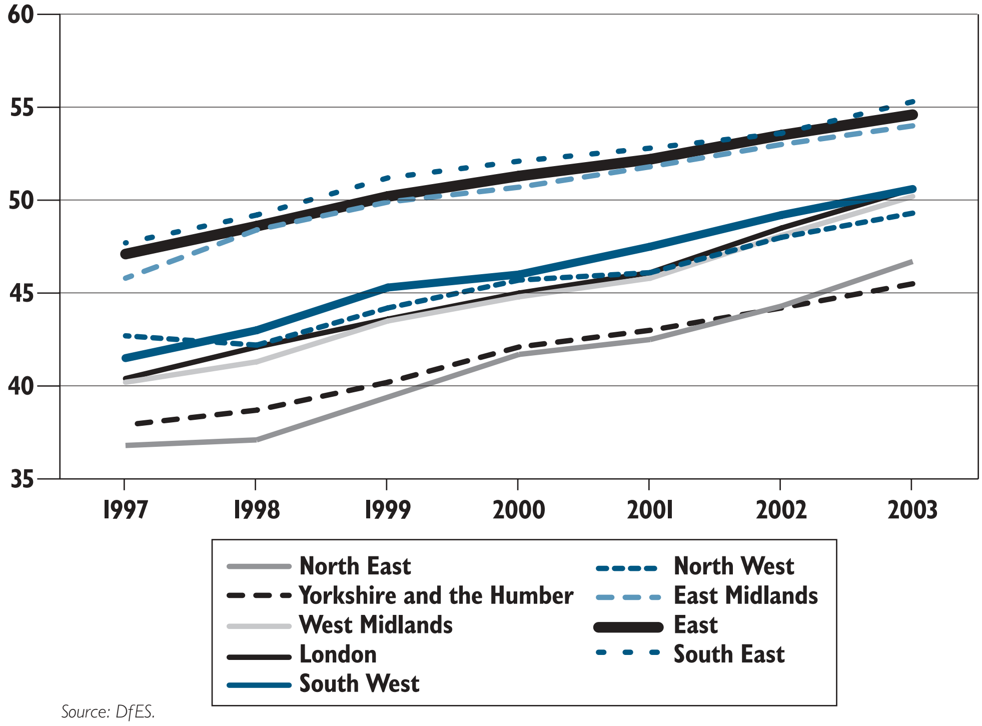
[26] Campbell, Chapman, Hutchinson, *Spatial Skill Variations: Their Extent and Implications,* 1999; Atkinson, *Building New Skills for the New Economy,* 1998.

2.51 Under-performing regions struggle to generate and retain highly mobile skilled labour from within their resident population. A smaller proportion of school leavers apply for degree or Higher National Diploma (HND) courses in northern regions than those living in the south, while economically under-performing regions also have difficulty in retaining graduates from their universities. This supports the work of Gregg *et al* (2001), which found that UK graduates are highly mobile, and will move to those parts of the country offering more highly paid jobs and wider career opportunities.[27]

Educational attainment

2.52 Educational attainment data, meanwhile, provides information on the skills possessed by individuals joining each region's labour force. The proportion of 15 year olds gaining 5 GCSEs or more at grades A* to C in 2003 varied between 55.3 per cent in the South East to 45.5 per cent in Yorkshire and the Humber. As Chart 2.9 below shows, since 1997 the proportion of pupils attaining five or more GCSEs at grades A* to C has risen in every region, with the gap between the best and worst performing regions narrowing.

Chart 2.9: Proportion of pupils achieving 5 or more GCSEs grades A*-C



Source: DfES.

2.53 Data on the flow of skills into the workforce also reveals sub-regional variations. For example, the proportion of pupils achieving 5 or more GCSEs at grades A* to C within different Local Education Authorities (LEAs) in the East Midlands varies between 62.1 per cent in Rutland and 34.3 per cent in Nottingham City. The proportion of 16 and 17 year olds in full time education also varies between English regions, ranging from nearly four out of five people in this age group living in London and the South East, down to only two-thirds of those resident in the North East.

Adult skills

2.54 Around 80 per cent of those people in today's workforce will still be there in 2010, therefore it is critical to improve adult skills if regional skills differences are to be addressed. That is why the Government has set National Learning Targets for adults as well as young people. Data for spring 2002 showed that the proportion of economically active adults qualified to National Vocational Qualification (NVQ) Level 3 or equivalent ranged between

[27] Gregg, Machin, Manning, *Mobility and Joblessness*, 2000.

44 per cent in the West Midlands to 54 per cent in London, against a target of 50 per cent for England as a whole. London is also one of only two regions yet to reach the second target of having over 28 per cent of adults qualified to NVQ level 4 or equivalent. The challenge of raising adult skills remains greater in some parts of the country than others.

2.55 These statistics reveal noticeable regional and sub-regional variations in the skills of the current workforce and the attainment of those yet to enter the labour market. Recent studies conclude that these variations in regional skill levels are a major factor in explaining variations in their productivity, and are therefore critical in determining current and future regional economic performance.[28]

Explaining geographical skills differences

2.56 The 2001 paper *Productivity in the UK: 3 – The Regional Dimension* attributed regional skills differentials to market failures and a lack of incentives for individuals to acquire skills in areas with few high-skilled job opportunities.[29] Further analysis points to three underlying factors:

- concentrations of individuals with certain characteristics. Individuals with particular characteristics, for instance relating to income or gender, face market failures and resource constraints which make them less likely to acquire skills than others, and these people tend to be concentrated in particular areas;
- place-based factors. Peer, intergenerational and neighbourhood effects may make individuals in some localities less likely to acquire skills than people with the same characteristics living elsewhere; and
- weak demand for highly skilled labour. Regions with few high productivity firms may find it difficult to attract and develop the highly skilled people necessary for future growth.

Individual characteristics

2.57 A number of studies have shown that the majority of the differences in regional education participation rates can be explained by variations in the concentration of individuals with different personal characteristics, such as class, income, gender, ethnicity and prior educational attainment.[30] These characteristics determine the difficulty individuals face in obtaining good information about the availability of, and benefits from, education and training, plus the level of resources they have available to pay for the direct and indirect costs (e.g. foregone income) of education and training. Individuals from low income backgrounds, for instance, have to overcome information problems preventing them knowing the extent of the higher earnings potential resulting from the completion of certain educational or training courses. Credit market failures can also prevent those individuals lacking physical collateral from securing any loans they require to undertake training.[31]

Placed-based factors

2.58 In addition to variations in personal characteristics, research has found that some of the differences in participation and attainment in education can be explained by various place-based factors that make people living in certain localities less likely to acquire skills than others. Such place-based factors include:

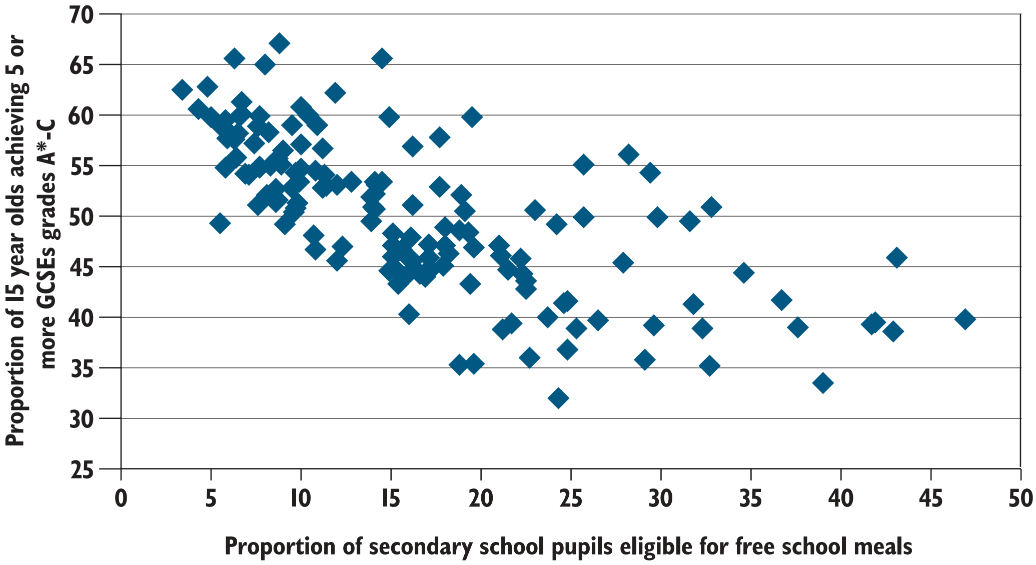
[28] Blackaby, Murphy *Industrial Characteristics and Inter-Regional Wage Differences,* 1991; Blackaby, Murphy, *Earnings, Unemployment and Britain's North-South Divide: Real or Imaginary,* 1995; Campbell, Chapman, Hutchinson, *Spatial Skill Variations: Their Extent and Implications,* 1999; Vanhoudt, Matha, Smid, *Regional Convergence in Europe: Theory and Empirical Evidence,* 2000; Duranton, Monastiriotis, *Mind the Gaps: The Evolution of Regional Inequalities in the UK, 1982-1997,* 2000.
[29] HM Treasury, Department of Trade and Industry, *Productivity in the UK: 3 – The Regional Dimension,* 2001.
[30] Andrews, Bradley, *Modelling the Transition from School and the Demand for Training in the United Kingdom,* 1997; Clark, *From 30/70 to 70/30 in 20 years: What Explains Recent Trends in Participation in Post-Compulsory Education,* 2001; Micklewright, *Choice at Sixteen,* 1989.
[31] Davies, *Public Spending,* 1998.

- family background, which exerts a significant influence on the earnings and attainment of children, with pupils from low income families particularly disadvantaged.[32] For instance, due to a lack of personal experience of further and higher education, low skilled parents with low incomes may mistakenly discourage their children from trying to attend university or college. Chart 2.10 below illustrates the correlation between family background and pupil attainment, by plotting education attainment in different local authorities against the proportion of pupils eligible for free school meals due to low parental incomes. These intergenerational effects partly account for the persistence of regional differences in educational attainment over time, since there are a higher proportion of adults with poor skills and low incomes in underperforming regions than elsewhere;

- neighbourhood characteristics, which may also determine individuals' educational attainment, by influencing their career aspirations and attitudes to study. Gibbons (2002) has estimated that variations in neighbourhood characteristics account for around 8 per cent of the differences in children's educational attainment.[33] London and the North East's comparatively low employment rates will therefore partially account for their relatively poor educational attainment levels; and

- peer group effects, which can influence individuals achievements at school by creating climates of endeavour or apathy.[34] This suggests that schools located in areas with a high concentration of disadvantaged or poorly motivated children face a disproportionately large challenge in raising each individual pupil's performance.

Chart 2.10: Eligibility for free school meals against GCSE performance, by LEA (2003)



Source: DfES.

[32] Dearden, Machin, Reed, *Intergenerational Mobility in Britain,* 1997; Blanden, Goodman, Gregg, Machin, *Changes in Intergenerational Mobilility in Britain,* 2002.

[33] Gibbons, *Neighbourhood Effect on Educational Achievement; Evidence from the Census and National Child Development Study,* 2002.

[34] Hanushek, Kain, Markham, Rivkin, *Does Peer Ability Affect Student Achievement?,* 2001.

Low demand for skills

2.59 Low demand for skilled labour provides a further explanation for relatively low levels of participation in education and training in some regions than others. Low demand may be due to an inadequate supply of high productivity firms in a region or locality, and the factors constraining enterprise in regions are explained in greater detail above. It is important to recognise here, however, that one such factor may be the perception amongst potential entrepreneurs or investors that a region has an inadequate skills base. Measures to improve skills levels should therefore also help promote enterprise in each region.

Investment

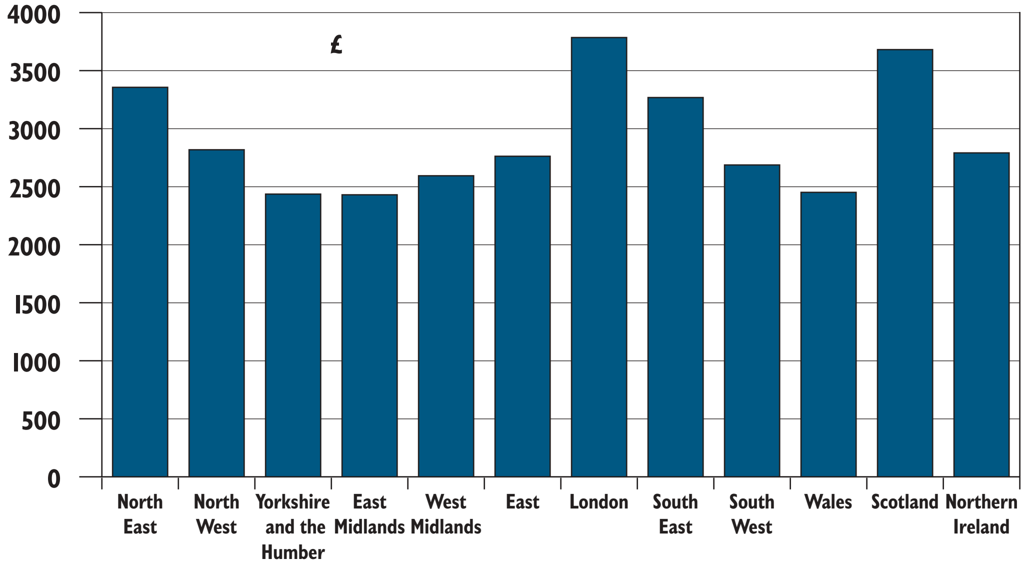
2.60 Investment in physical capital and infrastructure remains vital to raising the productivity of under-performing regions and localities. Alongside skills, physical capital is required to increase the output that any worker is able to produce. Investment in infrastructure, meanwhile, reduces the costs of communication and transport between firms, workers and customers, which is especially crucial in geographically isolated areas. The UK economy has historically experienced significant geographical variations in investment, which persist today.

2.61 Investment, whether by business or government can be undertaken to increase an area's physical capital stock, including buildings and machinery, or its infrastructure, such as transport and communications networks. Regional variations in both these types of investment are outlined below, followed by a description of the measures that the Government is pursuing to narrow them.

Physical capital

2.62 At a national level, much of the UK's productivity gap with France and Germany is due to differences in physical capital. As chart 2.11 below shows, average levels of new capital expenditure per employee since 1998 have been high in the UK's two most prosperous regions, London and the South East. High expenditure in Scotland and the North East, however, will have helped lay the foundations for future productivity growth in two of the poorer performing regions.

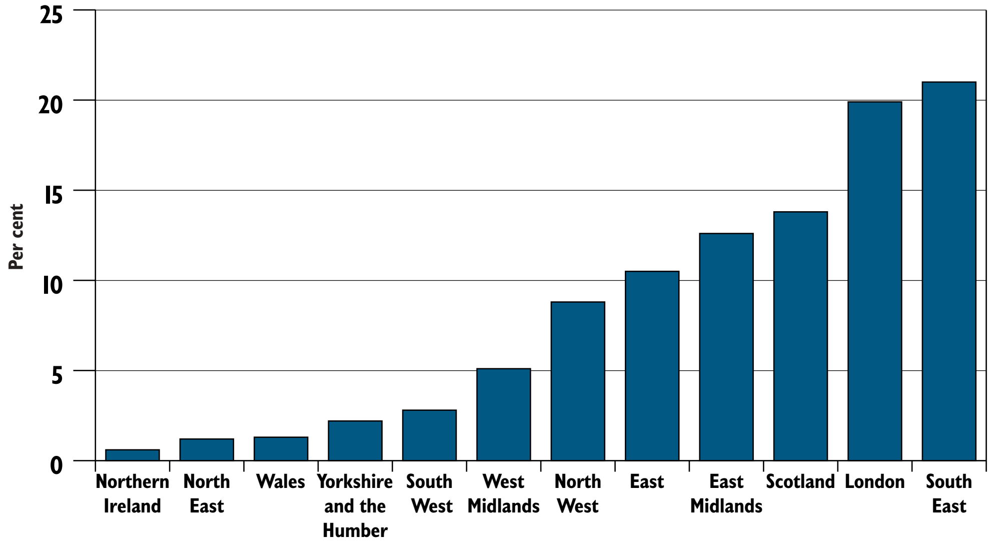
Chart 2.11: Average total net capital expenditure per employee (1998-2001)



Source: ONS, HM Treasury.

Venture capital **2.63** Venture capital is one important form of finance for new firms in many high value-added, innovative industries. Chart 2.12 below shows that venture capital spending per person is significantly higher in the South East, followed by London and Scotland, than any other region. The UK also contains around 20,000 Business Angels – private individuals who provide approximately £500 million per year to finance investments by growing businesses. Survey evidence suggests, however, that access to finance from Business Angels may be unequal across the UK. 70 per cent of Business Angels are resident in London, the South East or East Anglia, and only a slim majority regularly invest outside their own region.[35]

Chart 2.12: Distribution of early and expansion stage venture capital (2001)



Source: BVCA.

2.64 A number of studies have identified constraints on the ability of people and firms in certain localities to access finance for investment. These include a lack of information by creditors about investment opportunities, and ignorance amongst firms in geographically isolated localities about appropriate sources of finance. Low property values also constrain firms' ability to offer collateral for loans in certain areas.[36]

2.65 The historic pattern of investment can also have implications for present economic activity. Suitable housing, for example, is needed to attract and retain workers, and the size and composition of the stock of housing changes only slowly through time. Only 12 per cent of the housing stock in the North East, for example, is detached housing, whereas the figure is 24 per cent in the South East.

Infrastructure investment **2.66** Improvements in transport infrastructure have historically played a major role in enhancing economic performance. The integration and enlargement of the railway and road systems are prime examples of how improvements in infrastructure filtered through to economic growth by reducing the cost of trade and factor inputs across regions and helping to integrate national markets.[37]

[35] Investor Pulse Business Angel Attitude Survey, *A Qualitative Survey into UK Business Angel Attitudes, Preferences and Views in 2002 and 2003*, 2003.

[36] Black *et al*, *House Prices, The Supply of Collateral and the Enterprise Economy*, 1996.

[37] Fernald, *Roads to Prosperity? Assessing the Link Between Public Capital and Productivity*, 1999.

2.67 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 successful companies and intensifies competition, thereby encouraging greater efficiency and innovation. In particular, remote rural areas may face significant disadvantages that can be mitigated by improved transportation infrastructure.[38]

2.68 The main forms of physical transport infrastructure in a region are road and rail networks. Demand for infrastructure depends on a number of factors, including size of region, population density and how the population is distributed within the region. For example, large regions, particularly those with lower population densities, such as Scotland, Wales and the South West have a higher level of road and rail infrastructure per person than regions with densely populated areas, such as London. Most other regions in England have very similar density road and rail networks.

Road transport

2.69 Road transport, particularly by car, is the primary means by which people living outside London currently travel to their place of work. But access to a car does vary by region, with over a third of households in the North East without a car, compared to under 20 per cent in the South East. Improving access to work is therefore vital to raising employment in disadvantaged localities, as well as connecting people with skills to employers in need of them.

Airports

2.70 The presence of an airport with good business links is an important driver of regional productivity, since it expands market size and can facilitate foreign direct investment (FDI). Regions suffering from poor air connections may lose out from the benefits that FDI can bring, especially the introduction of new technologies and working practices to regional economies, as well as intensifying competitive pressures.[39] Domestic firms' location decisions are also influenced by the opportunity to participate in overseas markets which accessible, well-connected, airports provide.[40]

2.71 Examination of the existing passenger flows and connectivity of airports (that is, the number of direct flights to business locations, or to major international hub airports) in different regions shows that firms located in the Greater South East are in close proximity to large hub airports with an extensive global business route network (that is, Heathrow, Gatwick and Stansted). Similarly, Manchester and Birmingham airports provide a high (though smaller) number of direct flights to European and North America business locations for firms based in their locality. It is evident, however, that the South West, East Midlands and North East regions have fewer direct connections. Nevertheless, airports such as Newcastle, with direct flights to Heathrow, Gatwick, Stansted, Amsterdam-Schipol and Paris-Charles de Gaulle, do have global reach.

2.72 Developing the connectivity of existing airports in these regions may have external spillover benefits to their economies that are not considered by airports and airlines when making their route development decisions. Raising the number of direct flights from regional airports to overseas destinations or increasing their connections with the main UK hub airports could help to capture some of these positive externalities.

[38] Scotchmer, Thisse, *Space and Competition: A Puzzle*, 1992.

[39] Oulton, *Why do Foreign-Owned Firms in the UK have Higher Labour Productivity?*, 2000; Girma, Wakelin, *Are There Regional Spillovers from FDI in the UK?*, 2000.

[40] Gordon, *Industrial Districts and the Globalisation of Innovation: Regions and Networks in the New Economic Space*, 1996.

EMPLOYMENT

2.73 Increasing regional growth is not only a matter of improving the five drivers of productivity in each region. It is also determined by the number of people in work, so high employment levels in each region are important for delivering higher sustainable growth in all parts of the UK.

2.74 The Government's long-term goal is employment opportunity for all – the modern definition of full employment. It aims to ensure a higher proportion of people in work than ever before by 2010. Delivering this requires tackling unemployment in every nation, region and locality of the UK. This section explains why employment matters and explores the causes of geographical variations in employment rates.

Why employment matters

2.75 Everyone who is able to work should have the opportunity to do so. Worklessness, especially when long-term, is a constraint on the growth potential of regions and localities and entails major costs for individuals, households and society. Employment is the best means of avoiding poverty during working life and provides the best platform from which to save for security in retirement.

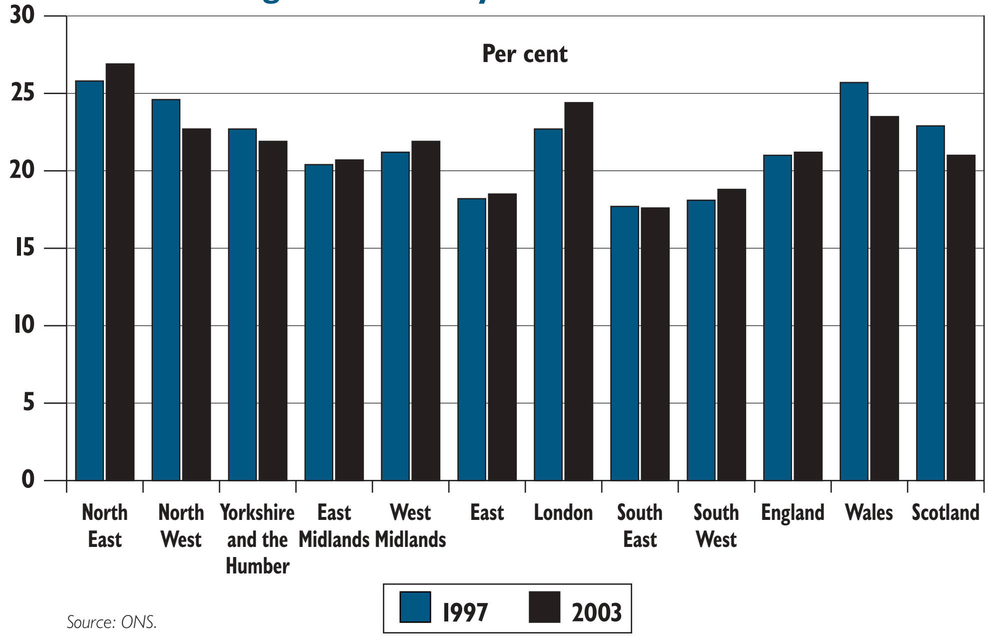
2.76 Securing a flexible, well-functioning labour market is also crucial to ensuring that economic dynamism and individual empowerment go hand in hand. A flexible labour market, in which prices and quantities adjust quickly across regions, localities and sectors, helps to promote full resource utilization and ensure that, in the event of an economic shock, the labour force is redeployed to its most efficient use. Flexibility also contributes to the security and prosperity of the labour force. The possession of skills that are transferable across localities and sectors, for example, enhances an individual's choice as to where he or she lives and works.

Geographical variation in outcomes

2.77 Historically there have been long-standing differences in national and regional employment rates. In the last few years, however, previously wide differences between regions have narrowed. The International Labour Organisation (ILO) unemployment rate is now close to its lowest point since the 1970s, while both long-term and youth long-term unemployment have fallen by more than three-quarters since 1997. Every region has experienced rising levels of employment and falling rates of unemployment and unemployment has fallen such that the differences between regional unemployment rates are now the lowest in a generation.

2.78 Looking solely at unemployment can give a misleading impression of the labour market if, for example, falling unemployment is a consequence of people being shifted into inactivity. Some regions of the UK have not shared fully in the recent strong employment performance of the UK labour market. Inactivity rates are not only high, but rising in the regions with the worst employment performances (see Chart 2.13 below).

Chart 2.13: Regional inactivity rates

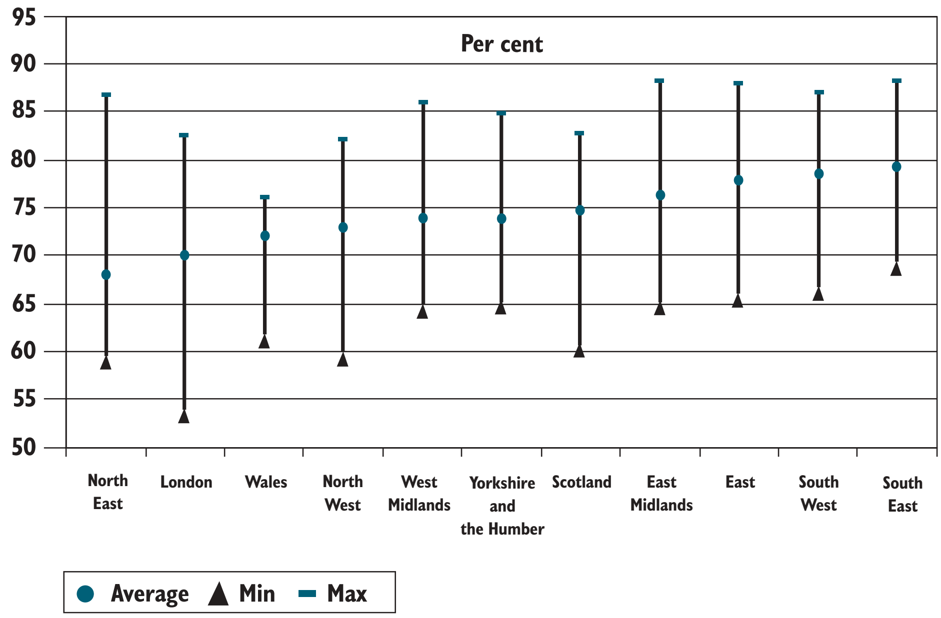


Source: ONS.

2.79 Furthermore, despite the aggregate improvement in labour market performance and the fall in inter-regional disparities, pockets of unemployment and inactivity among the working age population persist. The variation in employment rates is more marked at the local authority district level than the regional level, and even more so at the local authority ward or neighbourhood level (see chart 2.14). Recent work by the Social Exclusion Unit has shown that the neighbourhoods where there is by far the greatest concentration of people on benefits tend to be in the cities of the North West and North East, as well as areas such as the South Wales valleys. The Government has set out its analysis of the geographical patterns and causes of unemployment and inactivity more fully in *Full employment in every region*.[41]

[41] HM Treasury, Department for Work and Pensions, *Full Employment in Every Region*, 2003.

Chart 2.14: Variation in employment rates at a regional and local level



Source: Regions: Labour Force Survey, June 2003. LADs: 2001 Annual Local Area Labour Force Survey. Coverage: Great Britain
Note: Rates are as a proportion of the working age population. LADs with rates below publication threshold are not included.

Understanding geographical variations

2.80 In principle, the variations in employment rates may reflect a combination of factors, including:

- variations in the demand for labour;
- low labour mobility;
- the distribution of individuals with particular characteristics; and
- place-based factors.

The evidence suggests that the first two of these factors do not adequately account for the geographical variations in employment found within the UK. The distribution of individuals with certain characteristics and the incidence of place-based causes provide a more powerful explanation.

Demand

2.81 In theory, relatively low employment rates in certain areas could reflect low demand for labour by employers. In reality, however, differences in employment rates do not appear to be due to a lack of jobs. Most non-working adults live in cities, but every city in the UK has more jobs than it has residents in work. There are also vacancies in all regions of the country and the number of people chasing each vacancy declined sharply over the past decade.[42] Far from there being no jobs available, there are in fact jobs available in all regions.

Geographical mobility

2.82 Research generally finds that geographic mobility in the UK is a characteristic primarily of the high skill, graduate market. A number of reasons have been put forward for this, including the inflexibility of the housing market, the rise in two-earner families, the difficulties of commuting, or inefficient job matching mechanisms. Clearly, a change of

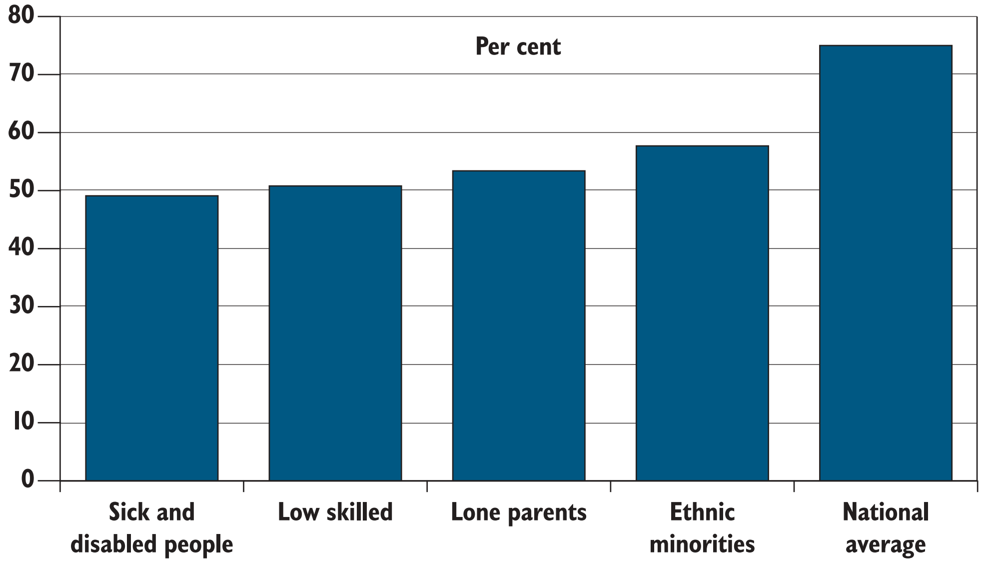
[42] HM Treasury, *The Goal of Full Employment: Employment Opportunity for all throughout Britain*, 2000.

residence, or commuting significant distances, carries some cost. However, the existence of areas of high unemployment alongside, and within easy travelling distance of, labour markets with high levels of vacancies show that travel distances are only one among a number of barriers to employment including information, aspirations and skills.

Individual characteristics

2.83 Geographical variations in employment levels can be largely attributed to the distribution of individuals who have characteristics associated with particular disadvantage in the labour market (see chart 2.15). Lone parents, disabled people, ethnic minorities and the low skilled, for example, tend to be concentrated in those regions and localities with the worst historic labour market performance. London, for example, has a high proportion of lone parents and people from ethnic minorities (see Box 2.3). Reducing unemployment and inactivity within these social groups will consequently help to narrow regional and sub-regional differences in employment.

Chart 2.15: Employment rates of disadvantaged groups (2003)



Source: DWP.

Place-based factors

2.84 In addition to the various personal characteristics that may inhibit an individual's ability to enter employment, there is also evidence to suggest that living in certain disadvantaged areas may also reduce the ease of moving into a job. Place-based factors may include postcode discrimination, poor public transport links combined with a lack of private transport, or a lack of social networks to open up job opportunities.

2.85 Targeting assistance at these disadvantaged areas is therefore also essential to widening employment opportunity in every part of the UK. Within the context of high and consistent national standards, local institutions need the flexibility to tackle the problems that are specific to their areas, delivering support in a way that will be most effective in that locality.

Box 2.3: Explaining low employment in London

Despite being the UK's most prosperous region in terms of GVA per capita, London's employment rate continues to lag significantly behind the national average. An improved understanding of the factors driving low employment, as described in the text, enables us to explain the capital's relative under-performance. Crucially, London contains a high proportion of individuals with characteristics which, at a national level, mean they are less likely to be economically active. Prominent among these groups are lone parents and people from ethnic minorities.

There are around 1.7 million lone parents in the UK, of whom almost 1 in 6 live in London. Lone parents therefore make up a higher proportion of London's population than of other regions. Nationally, the employment rate of lone parents, at 53.4 per cent in spring 2003, is significantly below the overall employment rate of 74.6 per cent, though it has risen strongly in recent years. Lone parents are also less likely to be employed if they live in London than elsewhere; London has a lone parent employment rate of 43.5 per cent.

While more lone parents in London come from ethnic minorities than elsewhere in the country, their employment rate is equal to that of their white counterparts. This contrasts with the rest of the country, where ethnic minority lone parents generally have lower employment rates than white lone parents. Research shows that differences in attitudes and characteristics also fail to explain the lower employment rates of lone parents in London.[a] Neither is the disparity the result of the characteristics (for example deprivation or employment rates) of the local areas in which lone parents live in London. The lower employment rate of lone parents in London instead reflects such factors as higher housing costs (many lone parents claim Housing Benefit) and transport problems, amongst others.

While the labour market position of people from ethnic minorities varies considerably between different groups, all ethnic minorities have higher inactivity rates than the white population. Britain's ethnic minority population is not evenly distributed across the country. Almost 29 per cent of the population of Greater London is from an ethnic minority group, compared with under 6 per cent in the rest of England.[b] Although the labour market outcomes of ethnic minority groups in London are better than some other parts of the UK, the relatively high proportion of the population from groups that, overall, do suffer labour market disadvantage contributes to London's overall low employment rate. Some ethnic groups with particularly high inactivity rates, are more likely to live in London than elsewhere in Britain.

[a] Department for Work and Pensions, *Investigating Low Labour Market Participation Among Lone Parents in London. A Review of the Methods,* 2002.

[b] Barro, Sala-I-Martin, *Convergence Across States and Regions,* 1991.

CAN REGIONS AND LOCALITIES CONVERGE?

2.86 The analysis above has identified barriers to increased productivity and employment in regions and localities. However, the policy agenda to address regional and sub-regional under-performance also needs to take into account other economic forces at work, especially those associated with agglomeration and technological progress.

Agglomeration

2.87 Agglomeration refers to the tendency for certain forms of economic activity to concentrate in particular regions or localities. Such clustering frequently occurs when there are beneficial externalities to the firms and individuals concerned. For example, this might happen when the presence of knowledge or other technological spillovers can be best captured by physical proximity. It will also occur when the economic activity or activities concerned rely on the availability of a specialist skilled workforce.

2.88 Agglomeration can be a powerful force and could act to hamper regional and sub-regional convergence. For example, the very success of a cluster may encourage other firms and individuals to relocate to it. This would increase the economic activity of the successful region further while draining labour and resources away from less successful areas. However, this conclusion is by no means inevitable. First, there is no reason why clusters should occur in any particular region or locality of the UK. Agglomeration is not a new phenomenon and experience suggests that it is geographically widespread. Second, agglomeration itself creates opposing forces. Concentrations of firms and labour in a particular area will tend to push up rents, wages and other production costs. This creates incentives for firms to relocate to lower cost parts of the UK, offsetting the benefits of being part of a cluster.

2.89 In the UK, clusters in the Greater South East tend to be in service-sector industries: for example financial services in London and information and communications technology (ICT) in the Thames Valley. In the other regions, manufacturing clusters dominate, for example metals in Yorkshire and the Humber and chemicals in the North East.

Technological progress

2.90 Moreover, technological progress and the sectoral evolution of the economy will also be important. Not all technological progress results in new activities where clustering is likely to be prevalent. For example, the information technology (IT) and financial services industries tend to be organised in a clustered way, but many other services are not generally characterised by clusters.

2.91 Technological progress creates other forces that drive convergence. For example, underdeveloped regions may be characterised by technology that is inefficient or out of date. Therefore, by definition they have much more scope to catch up by introducing the more advanced technologies found in better performing regions. It is likely to be easier for underdeveloped regions to learn from, and adopt, existing technologies than it is to push out the technological boundary themselves. However, the adoption of existing technologies is itself likely to require substantial research and development investment. As such, R&D is no less important for regions and localities catching up than for those advancing the overall technological boundaries.

2.92 Finally, technological progress may itself sometimes weaken the forces leading to agglomeration. In particular, improvements in IT and other forms of communication may allow firms to enjoy the benefits formerly obtained from close physical proximity in high cost areas even when they have relocated to lower cost areas. Such dispersal of activity will tend to encourage convergence of economic performance across regions and localities.

Regional convergence over time

2.93 Overall, these factors create complex forces acting both in favour of economic convergence and against it. Regional evidence[43] suggests a changing picture over time. On average, poorer regions grew faster than richer regions over the period 1950-1990, although this disguises two contrasting periods. From 1950 to the mid 1970s poorer regions grew significantly faster than rich regions. However, since the mid 1970s, growth in the richer regions has generally outstripped that of the poorer regions. The overall effect was an initial convergence of GVA per capita, but since the mid 1970s this has been reversed.

2.94 From a policy point of view, the implication is that regional and local economic policy needs to be pursued in an evidence-based way. In particular, it has been important for the Government to identify the market failures and other factors that are impeding the forces for convergence, and to design and adopt policy measures that redress them, including ensuring that responsibility for policy design and implementation is carried out at the most appropriate level – including devolving responsibility where the evidence justifies doing so.

[43] Barro, Sala-i-Martin, *Convergence Across States and Regions*, 1991; de la Fuente, *Convergence Across Countries and Regions: Theory and Empirics*, 2002.

Conclusions

2.95 This chapter has examined the evidence available on regional and sub-regional economic disparities, the causes of these economic differences in terms of differences in both productivity and employment, and the extent to which regions and localities can be expected to converge over time.

2.96 There has been some levelling up of the differences in the drivers of regional productivity in recent years, however significant challenges remain:

- competition – a strong enterprise culture, effective infrastructure networks and vigilant competition authorities which promote and protect competition in every region and locality, are vital to enable firms to innovate, cut costs and invest for the future;
- enterprise – in recent years regional business start-up rates have continued a historical trend that began two decades ago, by remaining higher across the Greater South East than in other regions. The challenge for Government is to continue to deepen its understanding of the causes of regional and local enterprise differentials, and the measures necessary to close them;
- innovation – business expenditure on R&D has increased as a proportion of GVA in most regions since 1997 although it remains highly uneven between regions. The challenge for Government is to remove the barriers to the dissemination of new knowledge which ensure that ambitious, dynamic firms continue to face incentives to locate close to leading innovators, thus helping to perpetuate the existing geographical pattern of economic activity;
- skills – educational attainment has risen in every region since 1997, although large regional and local differentials persist in the stock and flow of skilled labour. The Government's challenge is to continue to ensure that individuals in every region have access to high quality education and training, and are given the opportunities and incentives to raise their skill levels; and
- investment – the UK economy has historically experienced significant regional and local variations in investment, which persist today. Therefore, the challenge is to retain the right environment for firms in each region to increase their investment in physical capital and to remove the barriers to sustained investment in the UK's infrastructure.

2.97 Similarly, much progress has been made in reducing labour market disparities. Employment rates have risen in almost all regions since 1997 and the variation in regional unemployment rates has fallen to its lowest since the 1970's. However, in some regions inactivity rates are high and rising. Therefore, the challenge remains to ensure that those people who are currently inactive but want to work are given the opportunity to do so.

2.98 The rest of this paper goes on to describe the progress that has already been made in developing the institutional landscape and the design of policy. It also explains how the Government intends to respond to the call from the RDAs for further flexibilities and the removal of continuing barriers to delivery.