HM Treasury Select Committee inquiry: Regional Imbalances in the UK Economy

A response from the West Yorkshire Combined Authority and Leeds City Region LEP

Summary:

1.1 The West Yorkshire Combined Authority and Leeds City Region Enterprise Partnership bring together local councils and businesses to build a strong, successful economy where everyone can build great businesses, careers and lives.

1.2 The Combined Authority and LEP are currently investing around £2 billion, working with our partner councils to deliver better transport and housing, regenerate our towns and cities and protect our environment, making sure that what we do meets the needs of communities and helps deliver local priorities.

1.3 Our analysis adds further weight to well-established findings:

- Despite successive Governments seeking to tackle widening inequality, the UK economy has become more spatially imbalanced, with the gap continuing to widen (see UK2070 Commission; 2019).
- Monetary and fiscal policy choices have, over the medium term and in cash terms, favoured the Greater Southeast (see Bank of England evidence to the Committee's 2017 inquiry into the effectiveness and impact of post-2008 UK monetary policy). This means together wealth and public spending have grown faster in the Greater Southeast compared to other parts of England, and especially Yorkshire and Humber (Fig 1).
- Since 2010, the Greater Southeast has continued to grow faster than the rest of the UK - and much faster than the North of England. In 2019, towns and cities in the South are still growing faster than their peers in the North, which is unsurprising given the balance of investment.
- It is noteworthy, for example, that the spatial balance of venture capital investment follows the pattern of public intervention (Fig 2), suggesting Government has targeted marginal market failure, rather than those places that have been left behind the most. In itself, that nurturing of faster growth could have been a legitimate response to the recession caused by the global financial crisis, but we believe the case is now strong to consider afresh the type of market failure Government seeks to target, and its spatial distribution.
- There is a very strong correlation between the extent to which regions benefit from fiscal and monetary choices and their productivity (Fig 3). The nature of any causal relationship is open to further study and debate.
- More recently, the North West and West Midlands have received significant increases in public investment in *'economic affairs'* (see Fig.4). Yorkshire's recent increases are the lowest in Great Britain, and this equates to <u>£815 million less spent on economic affairs</u> in the Leeds City Region than

would've been the case if investment had mirrored the trajectory in the North West and London.

1.5 We support Government's aspiration to create an economy that works for all by boosting productivity and earning power across the UK. We argue, however, the focus and scale of its strategic approach and priorities need to change in order to realise that ambition. Instead, we call for:

- The UK Government leading, in partnership with devolved governments, LEP groupings and combined authorities, a shared policy position that explicitly prioritises a more cohesive, balanced economy at least on a par with growing the overall size of the UK economy. This would be similar to *Aufbau Öst* - the commitment to a reunified and rebalanced Germany.

- A more strategic approach to public spending, based upon:
    - Recognition that monetary policy is a blunt tool, but has important spatial impacts. While the UK needs a single monetary policy, set independently by the Bank of England, its impact on wealth and industrial change needs to be factored in to fiscal decisions more clearly.
    - Fiscal policy should continue to prioritise public investment – on digital and transport infrastructure, business growth, skills and health.
    - Reorientate how HM Treasury's Green Book is applied so value for money analysis ascribe a fairer societal value to addressing the most extreme market failures, rather than favouring regions with economies that are already strong and where outputs are more viable (see Fig 5).

- Further devolution so local political and business leaders are empowered to work together and with local communities to set long-term plans, with the powers and funding to deliver. This is also vital to overcome feelings of disconnection by establishing trusted institutions, accountable to local people.

Part One: Regional imbalances

> **a) What are the most significant regional imbalances in the UK i.e. is it the imbalance between London/southeast and other regions; between towns and cities; or between urban and rural areas? How have these imbalances changed in the past decade (and potentially longer) and how are they likely to change in the future?**
>
> **b) How do imbalances present themselves in the UK, in terms of growth, wages, employment and other indicators?**

2.1 The most significant regional imbalances in the UK are between London and the Greater Southeast and other regions – particularly in the North of England.

2.2 These rebalances present themselves by:

- **Lower economic inclusion** – the employment rate in the North (73.2%) is lower than the Greater southeast (77.8%). Closing that level of gap in the Leeds City Region would mean an extra 88,600 people in employment.
- **Lower gross weekly pay for full-time workers**, which at the 20th centile is 14% lower in the North, and that gap widens to 20% at the 80th centile (both compared to the Greater southeast). This links to lower wage levels and pay policy, where 1 in 4 City Region jobs pay below the Living Wage Foundation's living wage whereas in Oxfordshire it's 1 in 6.
- **Lower skills** – with 34% of working age people in the North qualified to Level 4, compared to 45% in the Greater southeast.
- **A less productive business base** – Fig 6 shows West Yorkshire has a higher proportion of firms with mid-to-low productivity, limiting their capacity to invest and improve workers' pay and conditions. Further analysis for the City Region's local industrial strategy shows that this is a result of businesses being less productive across all sectors, rather than the sectoral mix.
- **Greater South East benefitting disproportionally from recent fiscal and monetary policy**, with a strong correlation with higher productivity.
- **Inward investment patterns skewed to stronger economies** - and those that benefit disproportionately from public decisions - raising questions about additionality and the nature of market failure/opportunity.
- The **City Region's productivity is more than 30% lower than its comparator regions** in Northern Europe (Fig 7, inc. Stockholm, Lyon and Hannover). European regions with productivity levels most similar to the City Region are Chemnitz in Eastern Germany and the southern European regions of Umbria (Italy), Attiki (Greece), Castilla La Mancha and Andalucia (Spain).

2.3 Overwhelmingly, evidence shows these disparities are projected to widen; we are not aware of any credible analysis that shows the UK's less-productive regions growing at a faster rate than more productive regions over the long-term. For example, the UK2070 Commission cites research by Prof. Philip

McCann on the ‘business as usual’ scenario which projects future jobs growth will continue to be concentrated in the South (Fig. 8).

2.4 It is also important to recognise imbalances within regions, and even within towns and cities in those regions - which are address below on para e).

c) What are the main drawbacks of having significant regional imbalances?

3.1 There are several drawbacks from significant regional imbalances, including:

- Large sections of the country will not achieve their potential, and therefore neither will the UK economy.
- Growing feelings of discontent and large parts of the country feeling ‘left behind’. This covers both lower-productive regions (who feel their full potential is not being unleashed) and high-productive regions (some of whom feel they do not see the full benefits of their activity).
- Public revenues generated by more prosperous regions are unlikely to keep pace with the needs of the whole country, as the gap in wealth continues to widen. This will result either in public finances deteriorating (as more borrowing is required to meet need) or further public spending cuts, which would be unacceptable and further exacerbate the existing imbalances.

3.2 It is worth noting, however, that there are rational reasons why this position has developed. HM Treasury objectives (see box) include driving structural reforms to increase employment and productivity across the UK, as well as placing public finances on a sustainable footing.

The Single Departmental Plan does not, however, provide any clear reflection about how the issue of regional imbalances, or distinct regional challenges and opportunities, will be addressed.

Instead, the emphasis is on spending controls to assure value for money and meet Government’s fiscal rules to achieve a balanced budget by the middle of the 2020s. In practice, therefore, use of spending prioritisation mechanisms (e.g. Green Book) are skewed towards economies that are already stronger, and therefore where more outputs can be delivered, and voices like Lord Heseltine call for reform (fig. 5).

HM Treasury - Our objectives

The department’s strategic objectives are to:

1. Place the public finances on a sustainable footing, ensuring value for money and improved outcomes in public services
2. Ensure the stability of the macro-economic environment and financial system, enabling strong, sustainable and balanced growth as we leave the EU
3. Increase employment and productivity, ensuring strong growth and competitiveness across all regions of the UK, through a comprehensive package of structural reforms, taking advantage of the opportunities provided by leaving the EU
4. Build a great Treasury, by creating a more open, inclusive and diverse department, underpinned by professionalism, skills and management excellence

3.3 The result is that the balance of public investment (as distinct from consumption spending) is in regions with stronger economies. This is compounded by those regions also enjoying the highest levels of inward investment. While we absolutely do not want to constrain the ability of more prosperous UK regions to secure inward investment, it does raise questions about the type and degree of market failure that is subject to public investment. That is to say there is a strong case for Government to consider concentrating investment in localities with the greatest structural economic disadvantage.

d) To what extent can regional imbalances explain the UK's poor productivity performance?

4.1 <u>We believe regional imbalances are both the cause and effect of the UK's poor productivity performance. Therefore, addressing them is the answer to the UK's productivity puzzle.</u>

4.2 Analysis of Bank of England and HM Treasury data by the Combined Authority shows a very strong correlation (R=0.828) between regional labour productivity and the degree to which monetary and fiscal policy has uplifted wealth and public spending in an area (fig 3). Indeed, when this analysis is restricted to England's nine regions (to negate the impact of the Barnett formula), the correlation is even stronger (R=0.932), although clearly care needs to be taken in drawing lessons about the nature of any causal relationship from the strong correlation.

e) What is the interaction between regional and income inequality? Is there greater inequality within regions or between regions?

5.1 There is a reasonably strong interaction between regional and income inequality and it is helpful to understand how this has developed over the medium-term and its implications for public spending.

5.2 In the late 1990s and 2000s, income growth in households with lower levels of income was more strongly driven by increasing welfare benefits. In the 2010s, that trend reversed as a result of austerity, widening regional imbalances. The sustainable answer, therefore, must be a private sector, wage-led answer to closing the low-income gap, combined with a more inclusive labour market.

5.3 In order to achieve that:

- Local authorities and businesses must work in partnership and across functional economic areas to identify and tackle local challenges and opportunities to boost productivity in a way so everyone contributes to, and benefits from, that growth.
- In order to do so, partners need more powers and funding.
- As a result, decisions will be taken closer to communities, who will have a stronger say, and will hold those decision-makers to account, building trust.

f) What lessons can be learnt from the success or otherwise of programs designed to promote regional economic growth so far? What are the future interventions that the UK should consider?

6.1 The success of programmes to promote regional economic growth can be interpreted in several ways:

- Short-run outputs, including new jobs or houses
- Medium-term outcomes, including higher employment rates and beginning to narrow economic imbalances across the UK.
- Longer-run societal change, including rejuvenating places with deep-seated structural economic disadvantage and stimulating hope and ambition in disconnected communities.

6.2 When considering future direction, we would urge Government to consider the findings of the Institute for Government's 'All Change' study[1], which sets out some of the challenges faced in securing an enduring strategy for regional governance, and which says that *"the current process of devolution to a city-regional tier must be given the stability it needs to develop and perform effectively".*

g) How effective have regional bodies, for example combined authorities, cities, Local Enterprise Partnerships, been in promoting strong growth across all areas of the UK?

7.1 Combined Authorities and local enterprise partnerships serve a vital purpose – bringing together public and private leaders across a functional economic area to set a long-term plan for growth.

7.2 We would argue that on short-run outputs, LEPs and Combined Authorities have performed well. However, they need more tools (e.g. greater funding and powers) and long-term institutional certainty to make a significant and measurable impact on longer-run change.

h) To what extent can devolution of funding to regional bodies promote growth and reduce regional disparities?

8.1 Our analysis indicates that a potential answer to the last four decades of economic divergence is to increase investment in regions like Yorkshire. In doing so, decision-making should be devolved to fully involve businesses and be accountable to local communities.

8.2 We would also highlight the impact of Government's Fair Funding Review for local government spending as an important manifestation of its priorities.

[1] https://www.instituteforgovernment.org.uk/sites/default/files/publications/IfG_All_change_report_FINAL.pdf

Part 2: Regional economic data and forecasts

> **i) What is the quality of regional economic data such as economic growth/ income/public spending per capita/investment levels currently available in the UK and how does its quality and coverage differ from economic data available at the national level?**

9.1 Whilst there has been improvements in the level and quality of information available at regional and sub-regional level in recent years, there remain substantial differences between national, regional and sub-regional data. Whilst regional labour market data is published alongside national data for example, there is a time lag of around 4 months to get equivalent data at a sub-regional level, and this data still lacks the depth of regional data. On economic growth and income – key measures of prosperity and vitality – most data is only available sub-nationally on an annual basis, which presents acute challenges in understanding how local economies are performing.

> **j) Which regional economic data should the Government focus on e.g. is it GDP growth, or for regions, is unemployment data and other indicators that measure well-being more relevant?**

10.1 All of this is important – particularly as a large focus for regional and sub-regional policymakers is understanding the spatial impact of changes in the economy. Whilst local output growth is important to closing the disparities in economic performance between regions and therefore crucial to measure, locally there is also more focus on understanding how people from different groups and communities can benefit from the opportunities this growth offers. In order to do this, more granular socio-demographic information is required. This is particularly true for areas with or seeking devolution deals in order to inform the development of interventions

> **k) Should regional economic data currently produced by the ONS be given a higher profile e.g. should GVA growth be routinely published in documents such as the Government's *Budget* and *Spring Statement* and the OBR's *Economic and Fiscal Outlook*?**

11.1 Given much of the domestic policy debate is focused on left behind places and regional disparities, then an overt and proactive consideration of how government policy is impacting regions and/or is forecast to do so should be very much encouraged and could help to ensure that such issues are actively considered in the policy making process.

l) The ONS produces regional statistics at different levels: regions/City regions/Combined local authorities/local authorities and sectors. How useful is it to produce statistics at all these levels?

12.1 All of these are useful and used locally. Whilst it is appreciated that producing data for a wide range of geographies is more resource intensive for ONS, the more granular the data available the better so as to understand how issues manifest themselves at a local level. For an area as large as Leeds City Region for example, the economic strengths, weaknesses and challenges are quite different between and within the area, and more local data enables us to draw out this more nuanced picture. Recently, ONS have been looking at moving to a more “bottom up” approach to producing sub-regional data, and this would have the advantage of enabling analysis at more flexible, smaller geographies. However, this needs to be balanced with a need for timely regional data to understand key economic and labour market trends.

m) What are the main gaps in regional data for users?

13.1 Regional output (GVA/GDP) data on a quarterly basis would be a substantial improvement for regional analysts and policy makers. At present, an annual GVA release means that understanding what is happening in local economies is challenging and largely reliant on survey data, which can be of varying quality and costly. Whilst labour market data is available quarterly at the sub-regional level, there is a substantial time lag – data is released approximately four months after the quarter ends, affecting policymakers’ ability to respond.

13.2 Trade data is also an area of weakness – understanding intra-regional trade would enable a more granular understanding of how regional economies function. Linked to this, an understanding of prices and inflation at regional level would inform a better understanding of the relative strength and competitiveness of UK regions. Sub-regional international trade data is also very weak which limits places’ ability to understand their key international trading relationships and, consequently, the risks and opportunities.

n) Should there be official regional economic forecasts produced for output growth and other economic indicators such as unemployment?

14.1 Locally we have the Regional Econometric Model, produced by Experian for Yorkshire & Humber for over 20 years. As such, we recognise the value that such models and forecasts can bring – the model is applied in a range of scenarios including business case development, local plans, policy impact analysis and more. Given the functionality of the model developed over the years, it is unlikely that centrally produced regional economic forecasts could replace this, but they would still have value in providing consistent forecasts that have some form of recognition or endorsement from HM Government. This would undoubtedly be valuable in informing matters such as local plans, but it is likely that private forecasters will still need to be employed to provide both depth and an understanding of how different growth scenarios as a result of local policy changes could manifest themselves.

Appendix – supporting figures and graphs

<u>Fig 1 – Annual impact of fiscal and monetary policy choices</u>
<u>(Sources: Bank of England and HM Treasury)</u>

<u>Fig 2 – Venture capital investment (£millions), 2017</u>
<u>Source: (British Venture Capital Association)</u>

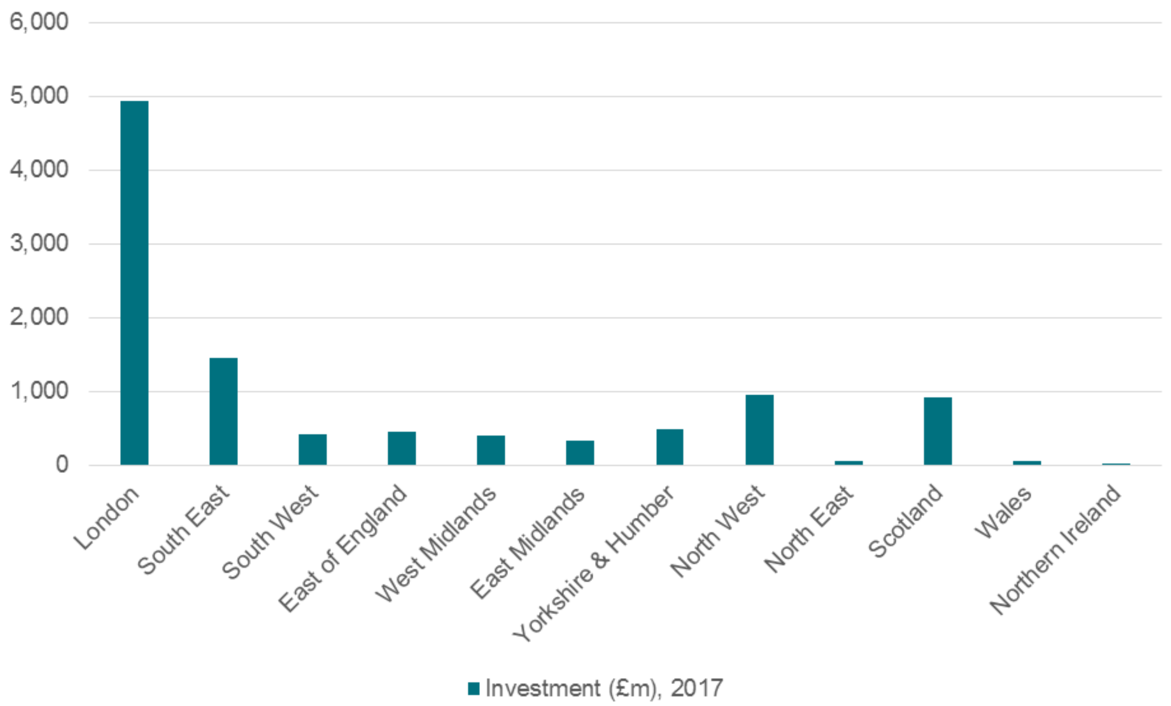

Fig 3 – Correlation between regional productivity and public investment (Source: WYCA analysis of Bank of England, HM Treasury and ONS data)

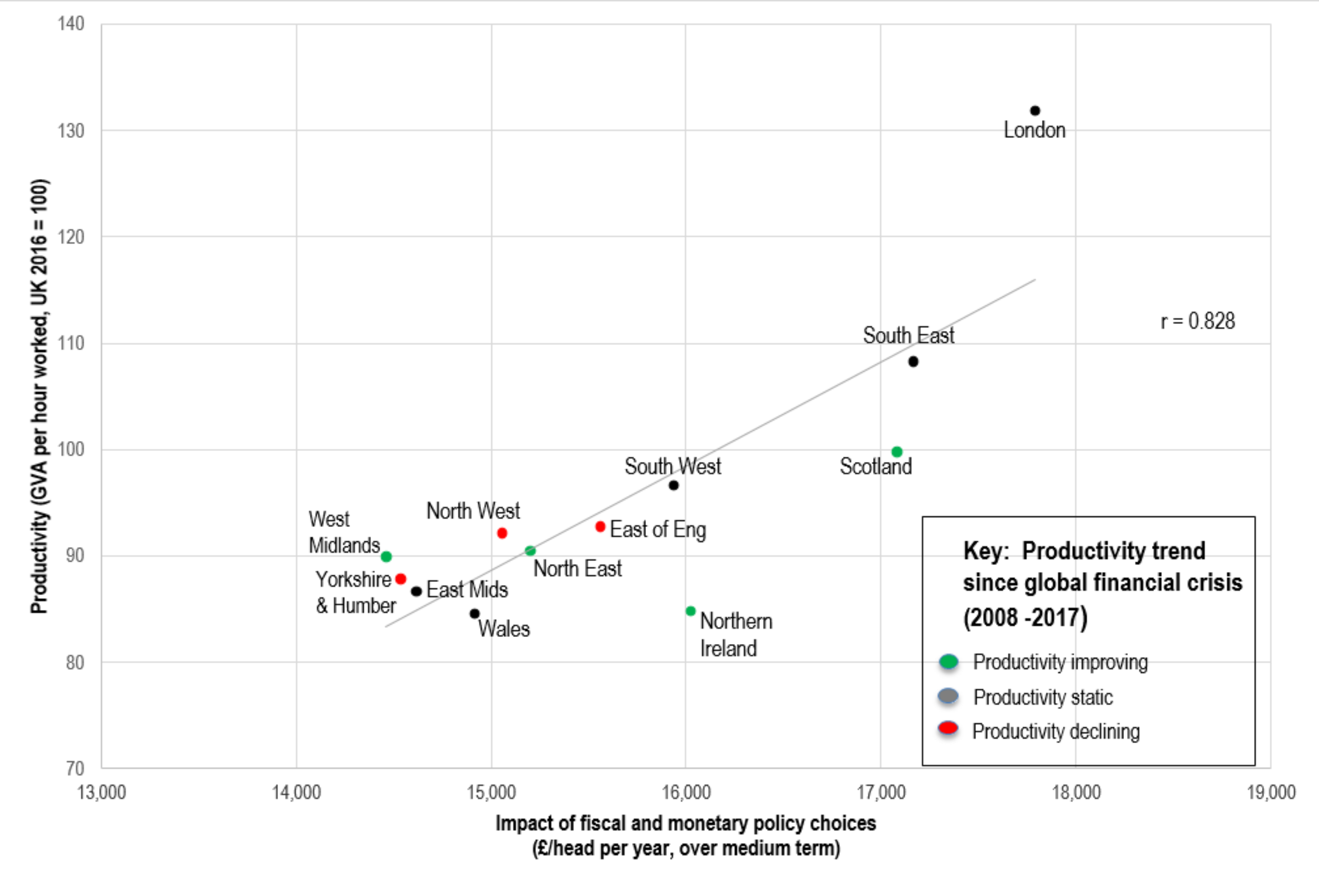

Fig 4a – Public spending on 'economic affairs' by nation/region (Source: Country and regional analysis 2018; HM Treasury)

UK region	2017/18 spending per head (£)	Change in spending/head - 2013/14 to 2017/18 (%)
South East	720	54.5%
North West	764	49.5%
London	1,300	47.4%
West Midlands	650	39.8%
South West	630	39.1%
East	683	38.0%
East Midlands	550	18.3%
Scotland	1,217	16.3%
North East	616	11.0%
Wales	846	8.7%
Yorkshire and The Humber	568	0.4%
Northern Ireland	848	-5.8%

Fig 4b – Public spending on selected 'economic affairs' by nation/region (Source: Country and regional analysis 2018; HM Treasury)

Enterprise and economic development

UK region	2017/18 spending per head (£)	Change in spending/head - 2013/14 to 2017/18 (%)
South East	203	232.8%
South West	134	116.1%
East	99	94.1%
London	161	80.9%
East Midlands	116	73.1%
Scotland	231	22.2%
Northern Ireland	202	18.8%
West Midlands	75	-3.8%
North West	86	-5.5%
Wales	162	-6.9%
North East	91	-24.2%
Yorkshire and The Humber	61	-26.5%

Transport

UK region	2017/18 spending per head (£)	Change in spending/head - 2013/14 to 2017/18 (%)
North West	528	112.0%
West Midlands	412	93.4%
East	402	68.9%
South West	290	62.9%
London	1,019	56.3%
North East	320	51.7%
South East	370	49.2%
Wales	410	23.5%
Scotland	667	22.8%
East Midlands	245	22.5%
Yorkshire and The Humber	315	11.3%
Northern Ireland	297	3.5%

Fig 5 – Proposal by Lord Heseltine

16. There is one economic judgement that must be reappraised. Orthodox Treasury thinking tests capital projects against a rate of return on investment. Such a philosophy will allocate resources to high growth areas and build on success. Therein lies the problem of the left-behind. If we are serious about rebalancing, then we have to be serious about the role of the public sector in facilitating this. There is an element of risk and an element of faith. I had no idea what the consequences would be when I created development corporations in the East End of London and on Merseyside. In rebuilding great areas of our country and restoring faith in millions of our citizens, we have to rebalance our economic priorities. The calculations cannot just be measured in crude economic terms. The Treasury, working with economists, businesses and conurbations, should devise a more balanced method for judging investment decisions in our cities. They 63 should draw on international experience. The power of competition, match funding and gearing should be harnessed to achieve the best value for money for the taxpayer.

Lord Heseltine, Empowering English Cities (2019)

Fig 6 – Distribution of businesses by labour productivity (Source: ONS)

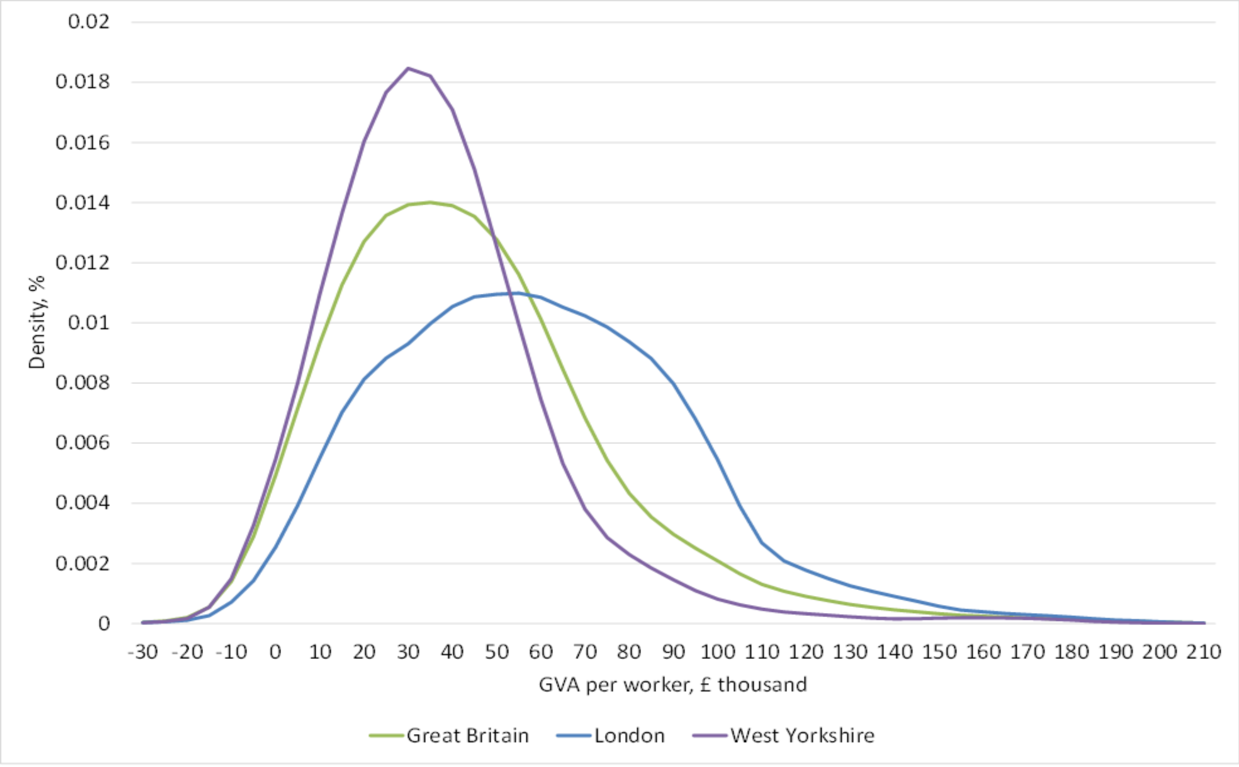

Fig 7 – Productivity across the Leeds City Region comparator European regions (Source: Eurostat; 2018)

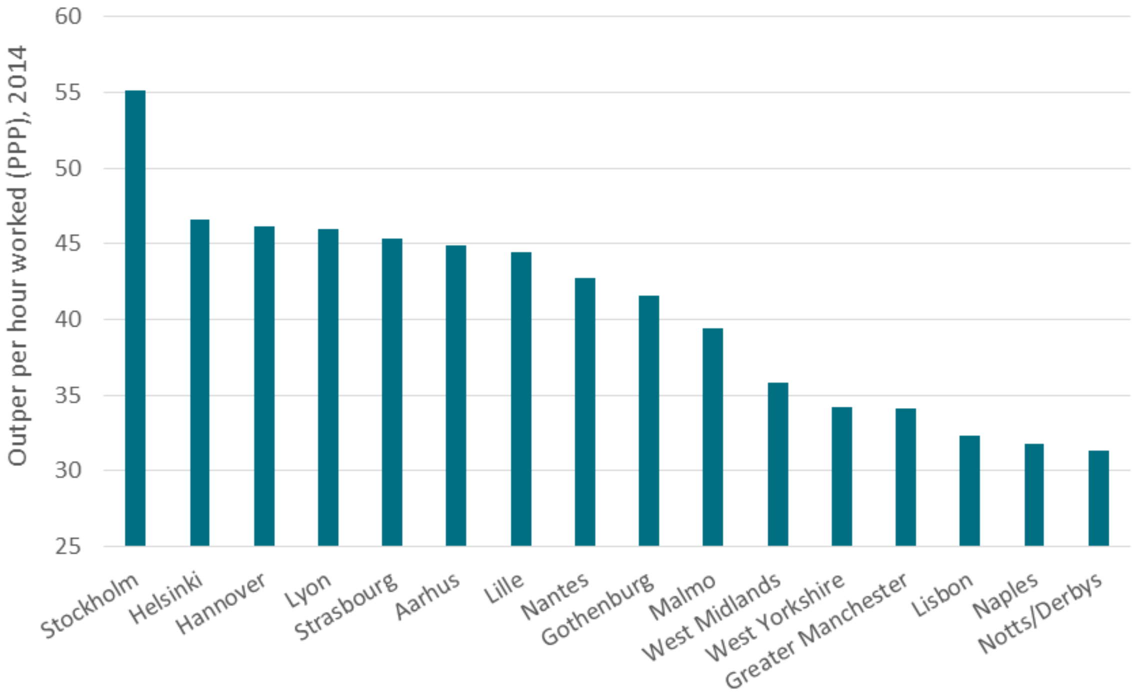

Fig 8 – 'Business as Usual' scenario impact on number of jobs by region to 2071 (millions)
(Source: Prof Philip McCann in UK2070 Commission; 2019)