# Regional productivity, inequalities, potential causes, and institutional challenges

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# Regional productivity, inequalities, potential causes, and institutional challenges

CHAPTER NINE

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**Productivity differences in the UK have been increasing for some 35 years. For instance, London's productivity is more than one and a half times the UK average, while the regional productivity divergence in the UK is among the most extreme of all OECD countries.**

Yet it is only in recent years that awareness of these issues has come to the fore in policy debates. There is a growing realisation that England's governance is characterised by some very distinctive pathologies and problems, including an unusually centralised governance model, which might well have played a key role in constraining the economic prospects of England's second-tier cities and their hinterlands.

But other important issues include the implications of the distinct, overlapping and mostly incommensurable geographies of public service provision and local administration in many parts of England. Without a more systematic focus upon the challenge of creating geographies which align better with the jurisdictions of local and devolved government, the productivity promise associated with policy reform and devolution deals may be squandered.

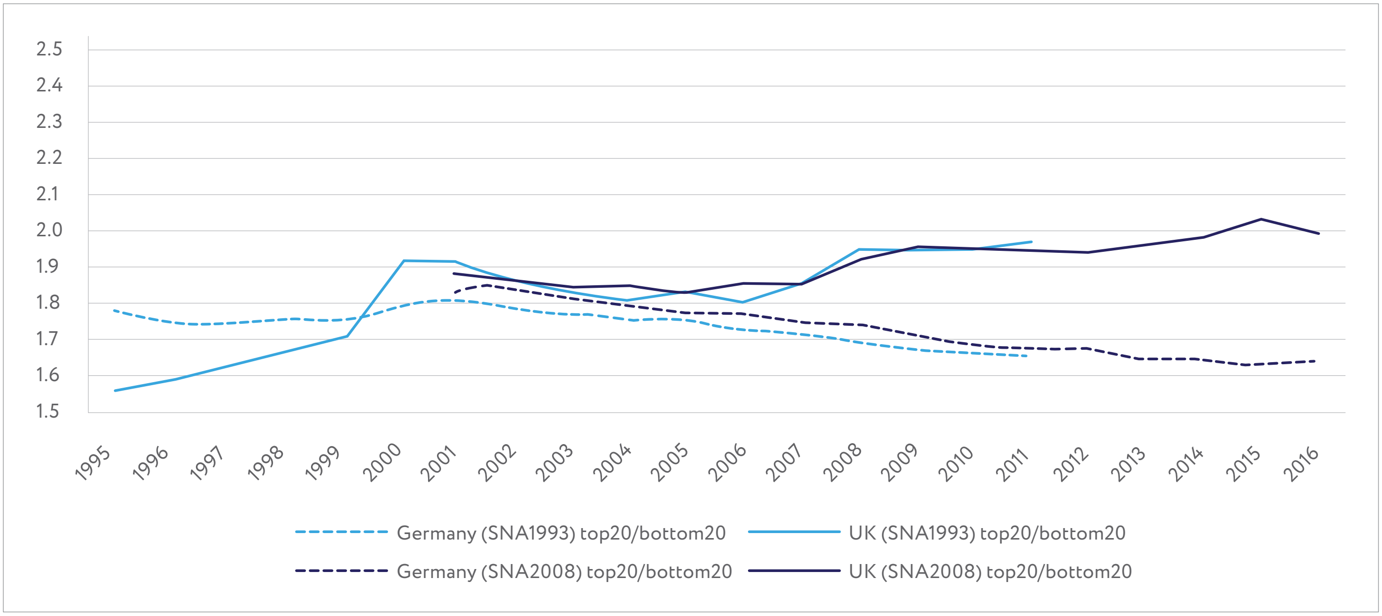
### Scale of regional inequalities

Awareness of the nature and scale of UK regional inequalities has increased significantly in recent years. Although, as we say, inter-regional productivity differences in the UK have been increasing for some 35 years, for two and a half decades there was only very limited awareness of this in most political and institutional circles.

For most of the 1980s, the productivity levels of the London economy were typically 125%-128% of the UK average, whereas from around 1988 onwards these gaps have rapidly increased, to the point where London's productivity is typically nowadays of the order of 170% of the UK average.[1] The UK was the first country in the OECD in which regional economies started to diverge rather than converge.

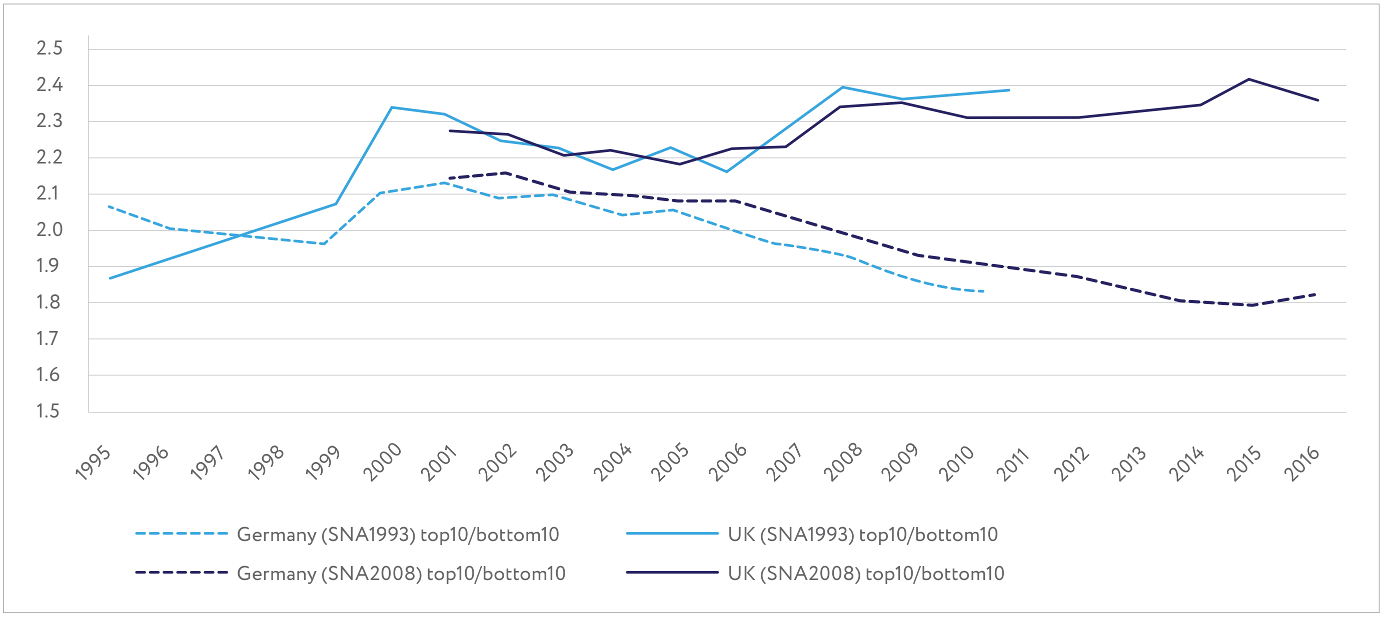
"There is a growing realisation that England's governance is characterised by some very distinctive pathologies and problems."

Figure 1: UK and Germany Inter-regional GDP Per Capita Differences: Top 20% Over Bottom 20% OECD-TL2 Regions




Source: Carrascal-Incera et al 2020

**Figure 2:** UK and Germany Interregional GDP Per Capita Differences: Top 20% Over Bottom 20% OECD-TL2 Regions




**Source:** Carrascal-Incera et al 2020

In order to get a sense of the extent of the divergence, we can compare the UK to Germany, countries with similar geographical scales, population scales, city sizes and population densities. In 1990 with reunification, in effect the economy of the former West Germany absorbed that of the former East Germany. Not surprisingly, the reunified Germany was highly imbalanced in terms of productivity, and much more so than the UK, which at that time was only starting to diverge inter-regionally. However, since then, the experiences of the two countries have been in stark contrast.

Figure 1 shows the differing UK and Germany trends in the ratios of inter-regional productivity levels, measured here as GDP per capita, between the top fifth of the population by location and the bottom fifth of the population, since the mid-1990s (showing both the 1993 and 2008 the SNA System of National Accounts). The German trend is steadily downwards whereas the UK trend is steadily upwards. In other words, at precisely the time that Germany's inter-regional productivity variations were narrowing, those in the UK were widening.

We can repeat this exercise also for ratios such as the top 10% of the population over the bottom 10% of the population, as in Figure 2. Indeed, similar exercises also carried out with other different regional productivity ratios and based on different spatial units all give largely the same picture.[2]

The reasons for these different patterns are complex, and include major national differences in terms of institutional and governance issues, as well as attitudes towards large-scale policy interventions.[3] However, these UK comparisons contrast not only with Germany. Indeed, the regional productivity divergence in the UK is amongst the most extreme of all OECD countries.[4]

# Spatial inequality and productivity

**The recent increased awareness of this unwelcome distinction re productivity divergence was in part due to the UK's 'austerity' response to the 2008 global financial crisis which led to cuts in public services, especially in weaker places. The subsequent political shocks associated with the Brexit referendum and the 2019 General Election also had profound geographic logics.[4]**

The marked geographical patterns associated with these political events engendered rapidly shifting political narratives,[5] which for the first time focused nationwide and cross-party attention on these patterns. Taken together, these events all provided domestic political reasons for the rapid increase in awareness of UK regional inequalities.

At the same time, the quality, availability and comparability of regional and local data has increased dramatically in recent years, primarily as a result of the efforts of the OECD and Eurostat. For the first time, this has allowed realistic comparisons to be made not only between UK cities and regions, but more importantly between cities and regions in the UK and in other OECD countries.

The OECD and Eurostat regional data were available some 15 years ago[6 & 7] and the metropolitan urban data 11 years ago,[8] but McCann (2016)[1] was the first researcher in the UK to use the data in a detailed, comprehensive and systematic manner.

This meant that during the pre-Brexit years debates regarding regional inequalities were largely myopic and backward-looking to UK experience, rather than to more comprehensive international comparisons, which are far more instructive in terms of UK performance. What comparisons were made by academics were primarily with respect to the USA, along with Canada and Australia, countries with economic geographies and governance systems dissimilar from the UK.[9]

These detailed comparisons from 2016 onwards have laid bare the scale of UK regional inequalities in comparison to more than three dozen other countries. Across a very broad range of more than 30 indicators at different spatial scales, in terms of all productivity-related indicators, the UK is more unequal inter-regionally than any other OECD country.[2, 4, & 10]

The political shocks the UK has experienced in recent years, including both the 2016 Brexit vote and the so-called 'red-wall' voting shifts, are in many ways a result of these vastly different inter-regional experiences.[5] They have given rise to a profound 'geography of discontent',[4] which is now also evident in other countries.[4 & 11]

In the UK, inequality regarding the fortunes of places is now the single most important distributional concern across society and all political persuasions.[12] Not only is regional productivity a national productivity problem, but the local implications of these economic realities also have profound national political implications.

In particular, the UK governance and institutional systems have been found seriously wanting in terms of their ability to respond to these asymmetric regional economic shocks.[1] Addressing these governance weaknesses has led to many of the key institutional and devolution-related reforms initiated in the 2022 Levelling Up the United Kingdom White Paper. This to some extent sought to reverse earlier 2010 reforms which had moved away from a focus on regional strategy, favouring instead ad hoc localism.[13]

"Not only is regional productivity a national productivity problem, but the local implications of these economic realities also have profound national political implications."

# Research focus

**This context discussed has significant productivity implications. There are various key features of spatial productivity and productivity growth processes about which our understanding is still very limited, and they are therefore a priority research focus at The Productivity Institute.**

First, the UK is unique amongst OECD countries in that, once London is removed, the relationships between scale and productivity in terms of economic geography found for other economies are absent for any types of places within the UK.[14] Second, the spatial diffusion of knowledge in a manner which leads to local inter-regional dissemination and local development appears to be largely stymied or stalled, again in a manner which is unlike most other OECD countries.

And third, in terms of regional issues, both the behaviour of UK capital and financial markets (see Mayer et al, 2021) as well as the policy settings[15 & 16] appear to be overwhelmingly short-termist in nature, potentially undermining these much-needed diffusion and scale-building processes typically evident in other countries. We now look at each of these in turn.

## SCALE PRODUCTIVITY RELATIONSHIPS

These are so central to how cities drive economic growth, in both OECD industrialised and many non-OECD industrialising countries, that the almost complete absence of these relationships in the UK is a major analytical as well as an empirical puzzle.

Cities in regions outside of the south of England display almost no urban scale-related productivity advantages in comparison to either small southern settlements, or even small areas in their own hinterlands.[17] Moreover, the productivity differences between UK cities[2] as well as regions[4] are also amongst the highest in the industrialised world. This all goes to suggest that the usual agglomeration processes are not evident in many UK cities. Why this is the case is, as yet, unknown.

It may be that the peculiar and unique logic of the UK land use planning system[18] plays a role in this regard by distorting the location of investments. It may also be related to the peculiarities of the UK fiscal system in inhibiting locally tailored policies. Indeed, the particular logics and operations of both the planning and fiscal systems are unique to the UK, making them the most promising lines of enquiry as to why scale-productivity relationships are barely evident.

Furthermore, there have been major changes in working practices since the COVID-19 pandemic, in that hybrid working is becoming the norm for millions of workers, thereby changing their commuting patterns and frequencies. Research suggests that (contrary to popular perceptions) large cities are likely to be the principal beneficiaries of hybrid working,[19] because reduced commuting frequencies are the most beneficial where commuting costs are the most onerous, namely into large cities.

Exactly how well the UK's land use planning and central-sub-central fiscal systems are able to adapt to the profound shifts in working practices is therefore a major research question.

"Cities in regions outside of the south of England display almost no urban scale-related productivity advantages."

"The UK is highly skewed in terms of the geography of its corporate systems, with half of FTSE100 companies having headquarters in London."

## SPATIAL DIFFUSION OF KNOWLEDGE

With the apparent lack of any systematic, widespread, and large-scale knowledge diffusion beyond the geographical core of London and wider South East, the UK economy broadly exhibits 'hub with no spokes' features.[20] Many parts of the country appear to lack any genuine involvement in knowledge, innovation and R&D-related activities.

OECD-wide evidence suggests that knowledge-intensive and highly-skilled activities tend to be heavily geographically concentrated in particular places,[21] and this is also very much true for the UK for those relating to tradeables.[22] But in the UK these concentrations of activities mostly tend to be in the same regions, rather than distributed in clusters across various different regions, as is the case in countries such as USA, Canada, Germany, Japan, France and Australia.

This points to other forces at work simply beyond the spatial decay of localised knowledge spill-overs or particular regional sectoral specialisations. Indeed, the regional productivity premium associated with being located in or around the London economy is largely independent of the sector or firm-type.[23, 24 & 25]

Positive effects of specialisation are only found in a minority of very prosperous places, and even then at only the five-digit (i.e. very specialised) sub-sectoral scales.[26] Yet, whether the inter-regional productivity problem is primarily a problem of a lack of inter-regional knowledge diffusion, or rather a lack of local and regional knowledge absorptive capacity, is still unclear.

### Knowledge

Different regions of the UK appear to have different knowledge and technological compositions[27] which may shape their absorptive capacity, but how these technological compositions relate to productivity is also typically both non-linear[28] and features more complex patterns than traditional relatedness models allow for.[29] Knowledge diffusion processes are likely to depend on both technological relationships and also institutional settings, including corporate organisation.

On this point, the UK is highly skewed in terms of the geography of its corporate systems, with half of the FTSE100 companies having headquarters in London,[30] while the greater South East accounts for two-thirds of all headquarters.[31]

Both Scotland and Wales host headquarter locations, but the regional skewness is marked in England with just 6% of FTSE100 firms and 7% of FTSE350 firms having headquarter functions north of Birmingham,[31] while none of the northern firms in the index when it was first established in 1984 remain. However, exactly how these corporate structural and functional issues relate to knowledge diffusion is not clear, and our understanding of the UK-specific issues is limited and subject of ongoing TPI research.

### Innovation

In particular, the UK institutional landscape around the promotion of knowledge and innovation-related activities may also play a role, as discussed in Chapter Four. Publicly-funded knowledge-related investments in innovation and R&D-intensive activities have also become increasingly spatially concentrated over recent decades in these same prosperous regions.

This is also the case for transport and infrastructure investments, along with heritage and cultural investments.[1] In other words, publicly-funded investments, which by their nature are intended to be productivity-enhancing, have become more spatially concentrated in the already more productive and prosperous regions over recent decades,[32] thereby reinforcing the concentration of private-sector activities.

This is even the case in situations where the cost-benefit logic does not necessarily justify such increasing concentrations.[33] Our research will therefore consider the efficacy of the knowledge diffusion processes associated with the highly centralised UK institutional set-up underpinning R&D and innovation, in the light of the lessons learned from comparison to competitor countries in the OECD.

### SHORT-TERMISM

A third issue which often arises in discussions regarding the UK productivity challenges is short-termism, a claim often made about the UK economy as an explanation for its systematically poorer levels of investment than in comparator countries, as described in Chapter Two.

The claim of short-termism implies that investment time preferences and discount rates are systematically higher in the UK than in other comparable countries. However, as yet there is limited specific evidence of business short-termism. Prior to late 2023, UK sovereign and commercial bond rates typically differed very little from other comparable countries, but it may be that such data do not fully capture the issue.

In particular, short-termism may be more relevant at a sub-national spatial scale. There is a variety of evidence that the engagement of the financial and capital markets operating out of the global financial centre of London in other regions of the UK is very limited (see Mayer et al, 2021).

However, the reasons for this remain unclear. Whether this is linked to short-termism per se, or to other risk-related factors which increase discount rates, remains an open question. There appear to be institutional and structural issues which play a role in limiting the geographical spread of investment capital, especially for start-ups and SMEs.

### Policy instability

The UK is characterised by rapid institutional churn and policy instability[15 & 16] and poor policy coordination,[34] a phenomenon which appears to have worsened in recent years. This does indeed point to short-termism in governance.

However, whether any purported short-termist behaviour in UK financial markets is caused, or exacerbated, by this institutional churn in government, is unclear. It may be that government institutional churn and policy short-termism simply increases the perceived UK investment risks, and thereby reduces the overall levels of investment, rather than affecting UK time preferences and discount rates. Yet, the links between apparent short-termism and investment levels may also be mediated via shifts in commercial risk perceptions which may be exacerbated by government churn, instability and a lack of governance coordination and policy clarity.

### Flight to safety

TPI research[35] has identified profound capital shocks associated with the 2008 global financial crisis, whereby a post-crisis 'flight to safety' partitioned UK regions into blue chip and junk bond capital pricing regimes for almost a decade after the crisis.

Moreover, the core-periphery risk-pricing partition mapped closely on to the already evident core-periphery regional productivity inequalities.[35] These fundamentally different risk-pricing regimes also led to profoundly different post-crisis growth trajectories, which exacerbated the pre-existing productivity inequalities.

Similar findings were also observed in the USA,[36] although there such partitioning favoured the already large and prosperous cities scattered across the country at the expense of smaller cities, rather than with respect to particular regions.

Importantly, the scale of core-periphery risk-pricing partitioning and dispersion in the UK is as great as the whole of the USA or the whole of the rest of Europe, an observation which suggests that the capital markets in no way consider the UK economy as an integrated whole. What appears as short-termism in capital markets may in fact reflect differences in the 'External Finance Premium'[37] applied to different parts of the UK, whereby the difference between perceived commercial risks and official discount rates widens as distance from London increases.[36]

Policy instability and poor coordination, especially as they relate to levelling up,[34] may exacerbate these regional risk pricing differences, and underpin calls for new institutions to mitigate the risk perceptions.[38] Untangling short-termism from diverging risk perceptions is an important issue about which little is currently known.

"The UK is characterised by rapid institutional churn and policy instability and poor policy coordination."

# The weakness of UK governance structures

**A key element of the potential governance and policy responses to these productivity challenges is the devolution agenda and there are disagreements in the literature on this issue.[39 & 40]**

However, some recent contributions to this wide-ranging debate point to issues and concerns that are highly germane in the context of the growing political focus on the need for a comprehensive and robust set of devolved institutions across England.[41]

Across the OECD devolved governance, per se, has no link to national growth rates, but it is associated with more spatially balanced productivity growth.[2] There is much evidence to suggest that the UK's major regional productivity inequalities are themselves intrinsically related to the UK's extreme centralisation.[1]

State or government failures as they relate to regional economic performance have received less attention in the political science literature (see Besley, 2021). However, UK weaknesses such as overcentralised government as well as constant policy and institutional churn (see Norris & Adam 2017) and [1 & 15]. are evident. Over-centralisation leaves central government with too much direct control and micromanagement, and too little knowledge of local and regional needs. This privileges short-term and large-scale intervention while undermining institutional capacity-building at lower levels of government, which in turn lack authority and decision-making powers (see Hooghe and Marks, 2021).

### Regional policy churn

One of the most egregious examples of institutional and policy churn is regional policy, which has been chopped and changed for decades.

In the 1980s the Conservative government set up Urban Development Corporations to improve land and property markets in urban areas, but this further entrenched disparities between more prosperous regions around London and parts of the South East and the Midlands and Northern England.

New Labour left intact the Thatcherite economic model of finance-powered growth in retail and service sectors but tried to tackle regional inequalities by creating Regional Development Agencies (RDAs) across nine regions of England, with a budget of approximately £2 billion a year for 12 years. This is substantially higher than the current government's funds for levelling up.

But the RDAs' focus on the 'knowledge economy' and the service sectors at the expense of industry, manufacturing and vocation and technical training failed to address growing imbalances within regions between urban areas and more suburban, rural and coastal areas.

After 2010, the coalition government scrapped RDAs in favour of local enterprise partnerships (LEPs), which have now also been abolished by the current government. What has been missing is a clear, consistent approach to which powers of central government should be devolved, alongside both resources and accountability.

### Westminster model

At the heart of UK governance lies the so-called 'Westminster Model' (e.g. Hall, 2011; Richards and Smith, 2015) and 'Northcote-Trevelyan' paradigm. Their centralisation and hoarding of power creates many problems for the regions – not least policies dictated to regions from typically uncoordinated Whitehall departmental strategies.

The UK's economic woes are linked to this high level of political instability and policy churn, which has contributed to low business confidence. This has been particularly pronounced since the 2016 EU referendum. The UK has had five Prime Ministers and seven Chancellors of the Exchequer since the vote, including three PMs and four Chancellors in 2022 alone. For big city regions with mayors, this coincides with their entire period in office as the first mayoral elections were held in 2017.

It is not only ministerial churn that characterises this current period in government. Policies and key economic institutions have been constantly changed and this has included a series of ever-changing growth strategies and the constant reconfiguration of departments associated with delivering them.

So we have seen the Conservative/LibDem coalition and its Departments for Business, Innovation and Skills (BIS), and Energy and Climate Change (DECC), to their abolition and the creation of a Department for Business, Energy and Industrial Strategy (BEIS) and a Department for International Trade (DIT). And then we have seen the establishment of a Department for Levelling Up, Housing and Communities (DLUHC), and the recent creation of the Departments for Science, Innovation and Technology (DSIT), Energy and Net Zero (DENZ), and Business and Trade (DBT).

### New policy approaches

New ministers and departments announce new policy approaches. For instance we had an Industrial Strategy under the coalition, then its abolition in 2015 and rebirth in 2017. There have been multiple growth plans since. Strategies for 'Fixing the Foundations' in 2015, an Industrial Strategy with 'five foundations' and 'four grand challenges' in 2017.

Under Prime Minister Boris Johnson there was 'Build Back Better' in 2021 (with five missions) and 'Levelling Up' in 2022 with 12. All were abandoned under Liz Truss's 'Growth Plan' in 2022 before again being replaced by current Prime Minister Rishi Sunak and Chancellor Jeremy Hunt's five pledges, four E's and a pledge for 'long-term decisions for a brighter future'.

As noted above, there have also been notable differences in approach by governments of different parties to the challenge of establishing a functioning layer of regional, or city-regional, administration. As one recent report documents, there has been an extraordinary amount of policy reversal and churn on this question in recent decades.[41]

This succession of ministers and strategies has seen a series of institutions at the national, local and sectoral levels established and abolished.

For example, barely a year after the publication of a 300-page White Paper and a detailed framework for devolution, at the Conservative Party Conference in October 2023 the Prime Minister announced a series of 'town boards' and a 'towns taskforce' to boost local economic growth in 'left behind' towns. According to Rishi Sunak, "we need to change our economic model - away from cities", but at the same time as Investment Zones are being negotiated and rolled out across English cities, because 'if Manchester succeeds, so will Bury'.

These are not only competing initiatives launched into an already crowded field, but also involve yet another set of institutions at the local level, entirely contradicting the plea for long-term stability and strong local institutions in the government's own White Paper.

"One of the most egregious examples of institutional and policy churn is regional policy, which has been chopped and changed for decades."

# Policy implications

**Demonstrating a causal relationship between decentralisation and economic improvement remains controversial,[42] but it is increasingly accepted that establishing new forms of governing authority and capacity at levels beneath the central state can generate a range of social and civic benefits.**

Some highlight, for instance, improvements in the sense of citizen efficacy,[43] and others improvements in social capital,[44] arising from such reforms. Some stress the kinds of community engagement and self-activity which these can enable.[44] As various economists – such as Andy Haldane – have suggested, these elements are often the wellsprings of economic prosperity.[46]

Equally, as one recent comparative study has demonstrated,[47] it may be that the specific features and finances of any devolved model are key factors determining whether efforts at devolution will ultimately generate economic gains. Its authors point, in particular, to the risk arising from the delegation of policy responsibilities to institutions which have 'unfunded mandates' – a very pertinent insight when a future UK government may be establishing new devolved authorities in a context of public spending stringency.

### Long term approach?

Nevertheless, in the wake of the 2022 Levelling Up White Paper published by the Johnson government, and the English devolution framework set out within it - and alongside the Labour party's shift towards greater acceptance of the metro mayoral model[48] - there is some prospect of the deep political divisions which have driven policy and institutional churn in this area abating. If this is the case, there may be a possibility of a more consistent and long-term approach to English devolution.

The Levelling Up White Paper was notable, too, for the emphasis it placed upon different kinds of social and civic benefit – expressed in the language of 'pride in place' – which may accrue from local and devolved governments partnering with Whitehall to develop growth strategies targeted to local circumstances, drawing upon local knowledge.

But while this wider vision for devolution is increasingly accepted within Westminster and Whitehall, replacing earlier scepticism, there has been insufficient consideration given to the harder question of what kinds of capability and expertise are needed to ensure different layers of government are equipped to play these prescribed roles.

### Powers of mayors

Similarly, the question of whether Mayors should be given new financial levers, for instance in the shape of hotel or airport taxes, is now being considered more seriously in political circles in relation to English devolved authorities.[49]

This is potentially an important shift given the ingrained wariness to this idea in relation to England, certainly in comparison with the powers awarded (particularly after 2015) to Scotland and Wales.[50] UK government has been highly resistant to the idea of devolving fiscal levers to authorities that do not have their own legislatures to debate and legitimate the use of such powers. But, significantly, the debate has opened up as more mayoral leaders have highlighted the opportunities missed and constraints generated by their lack of control over revenues.

In particular, there has been a growing chorus of criticism directed at the year-by-year funding settlements offered following annual negotiations with Whitehall.[51] Importantly, a new direction of travel has been signalled by the trailblazer deals agreed for the two flagship English mayoralties, West Midlands and Greater Manchester, which have been granted more flexibility in allocating their budgets to locally determined priorities.

### So where now?

While the case for devolution and arguments about its design continue, there is a growing realisation in British politics and government that England's governance in particular has some distinctive pathologies and problems, leading to greater citizen disaffection (and lower rates of political participation), than elsewhere in the UK.

These include its currently half-built tier of middle level governance, a greatly weakened and constrained layer of local government, and an unusually centralised governance model, with officials in Whitehall taking decisions about services and forms of provision across the length and breadth of England which may well have constrained the economic prospects of England's second-tier cities and their hinterlands.

Other important institutional challenges and constraints also need to be brought into focus. The potential benefits of any emerging system of devolved governance will be limited unless serious thought is given to the implications of the distinct, overlapping and mostly incommensurable geographies of public service provision and local administration in many parts of England. Without a more systematic focus upon the challenge of creating geographies which align better with the jurisdictions of local and devolved government (as is true, for instance, in London), the economic promise associated with a new generation of devolution deals may well be squandered. And without institutional reform, the UK's extreme regional productivity divergence cannot be addressed.

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These include its currently half-built tier of middle level governance, a greatly weakened and constrained layer of local government, and an unusually centralised governance model, with officials in Whitehall taking decisions about services and forms of provision across the length and breadth of England which may well have constrained the economic prospects of England's second-tier cities and their hinterlands.

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# Key takeaways

More consideration is needed into what kinds of capability and expertise are needed from increased devolution.

Without institutional reform the UK's regional productivity divergence cannot be addressed.

Productivity differences in the UK regions have been increasing for 35 years.

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