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Spatial disparities in productivity and income

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CEP Election Analysis 2024: Spatial disparities in productivity and income

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Executive summary

- The core economic objective of the next government must be to achieve higher growth. Escaping from stagnation, raising living standards and improving generation-on-generation prosperity requires productivity growth.

- Unfortunately, UK productivity growth has stalled since the financial crisis of 2007-09. It is 26% lower today than if it had followed the pre-crisis (1979-2007) trend.

- Stalled productivity growth is not the only challenge. The UK also has high and persistent spatial disparities in productivity. The best performing areas have gross value added (GVA) per worker around 50% higher than the national average. In the worst performing regions, GVA per worker is 30% lower than average.

- The UK is a world leader in complex tradeable services, such as insurance and consulting. The sector depends on high-skilled workers and the firms that employ them. Both are increasingly spatially concentrated, particularly in London and the south-east.

- Given the UK's specialisms, improving productivity requires bigger high value-added services sectors, and more cities succeeding with them. This means choosing some places to prioritise and investing heavily to achieve the scale of change required.

- High housing costs in more productive areas are bad for households, constrain growth and have implications for local and national productivity. High house prices also influence how the benefits of growth are shared across poorer and richer households.

- Instead of targeting investment at under-performing cities, government could spread money around. This will work for individual places, but not for the overall economy. Alternatively, it could invest only in London and the south-east to "build on success". While this might be good for national growth, it is politically unacceptable.

- Neither of the two main parties is grappling with these difficult trade-offs.

- Housing policy will matter – what plans do the parties have to increase housing supply significantly in the right places?

- How should we judge the extent to which the proposals from different parties will level-up the UK? Manifesto commitments on levelling-up will be less important than other commitments. The key question is what they will do on economic growth, taxation, spending and on regulation. Given what we know about spending limits, it is the spatial manifestation of the changes resulting from these policies that will matter most for spatial disparities.

Introduction

The main economic challenge facing the next government is how to escape from the stagnation the UK economy has experienced since 2008. Returning the economy to higher growth is necessary for meeting many other pressing challenges – improving living standards, repairing public services, reaching net zero and reinvesting in defence.

What to do about spatial economic disparities remains central to this challenge. An important debate revolves around the right policy instruments, funding and delivery mechanisms. But in a world of limited resources, where economic forces reward spatial concentration, the biggest dilemma facing the government is not what and how, but *where* to prioritise investment.

Should it concentrate investment in areas – like London and the south-east – that are highly productive but constrained by high house prices and congestion? Or should it concentrate on trying to transform struggling areas through investment that improves productivity and growth?

Assessing these options requires an understanding of the causes and consequences of UK spatial disparities and what, if anything, policy can do to address them.

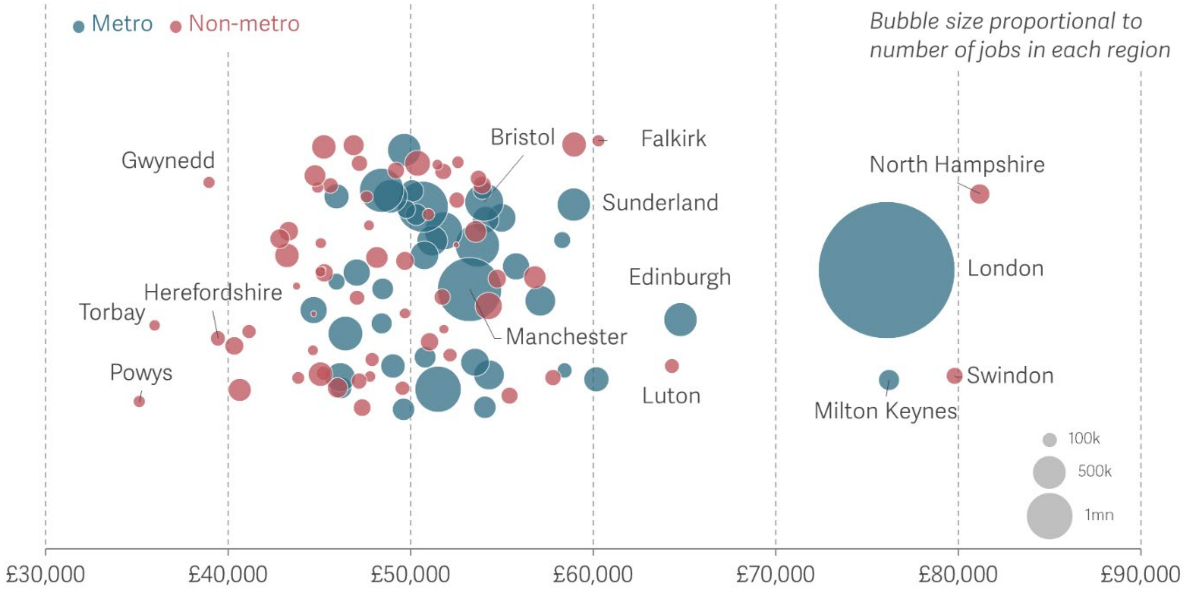
Spatial disparities in productivity are large and persistent

Escaping from stagnation, raising living standards and improving generation-on-generation prosperity requires productivity growth. Unfortunately, UK productivity growth has stalled since the global financial crisis, and it is 26% lower today than it would have been if it had followed the pre-crisis (1979-2007) trend (Valero and Van Reenen, 2024).

Stalled productivity growth is not the only challenge – as Figure 1 illustrates, the UK also has large spatial disparities in productivity. In 2019, London's GVA per job was 50% above the national average while at the other end of the scale, both Powys and Torbay were 30% less productive (Brandily et al, 2022a). These disparities are also persistent - in 2002, London's GVA per job was 40% above the national average, while Powys and Torbay were 20% less productive than the average in 2002 - and have fallen further behind since.

Figure 1: Spatial disparities in productivity in the UK

Gross value added per job, by area: UK, 2019



Notes: GVA per job in 2019, calculated as gross value added divided by number of jobs by workplace. Spatial units are a combination of OECD metro areas and NUTS3 for non-metro areas. Analysis of ONS, Subregional Productivity, July 2021. **Source:** Brandily et al., Bridging the gap: What would it take to narrow the UK's productivity disparities? Resolution Foundation and Centre for Economic Performance, June 2022. Figure 1, p.16.

These spatial disparities reflect differences in the skills of workers, the amount of business and public capital with which they work, and the technologies and management practices of the firms for which they work. These factors reinforce one another, making it difficult for policy to break the feedback loops that determine success or failure.

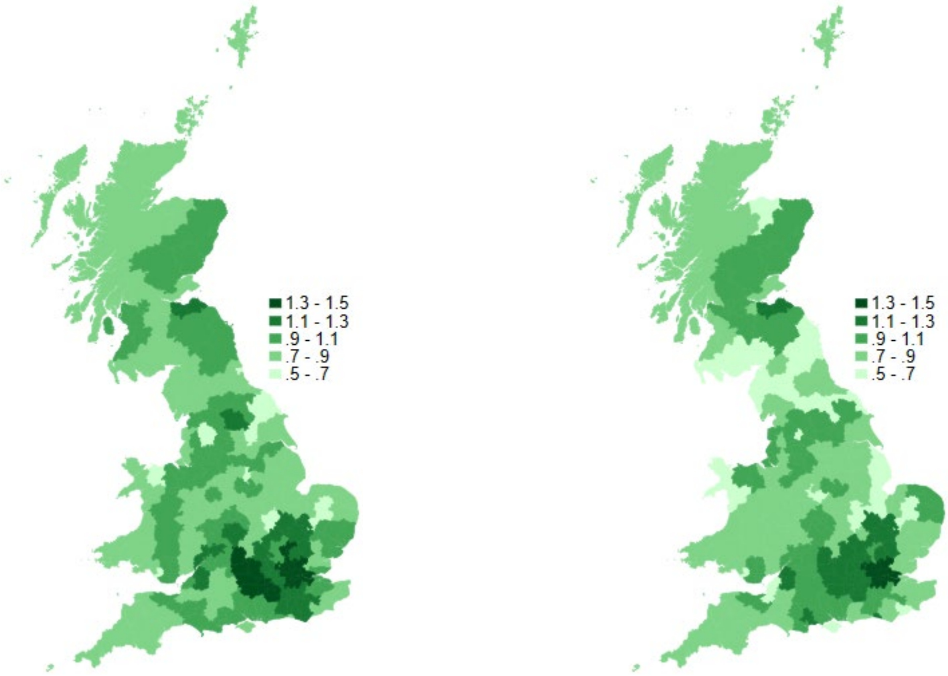
A services superpower relies on high-skilled workers and firms

The UK is a world leader in complex tradeable services like consulting, legal services, and visual effects production. We are the second-largest service exporter in the world – and these are the key activities driving productivity, growth and spatial disparities.

These tradeable services employ just under 30% of workers and represent 45% of the economy (Resolution Foundation and CEP, 2023). It is a sector that depends on high-skilled workers and the firms that employ them and as illustrated in Figure 2, these types of jobs and workers are increasingly spatially concentrated, particularly in London and the south-east.

Figure 2: High-skilled jobs have become more spatially concentrated between 1998 and 2019

(a) 1998, location quotient **(b) 2019, location quotient**



Notes: Working-age (16–64) population. Data from Annual Survey of Hours and Earnings.
Source: Overman, H.G, Xu, X. (2022), 'Spatial disparities across labour markets', IFS Deaton Review of Inequalities. Figure 16, p.27.

This is economic "agglomeration" in action – concentrations of businesses and skilled workers lead to productivity benefits, which in turn attract more high-skilled workers and business investment, further amplifying the productivity benefits. These "virtuous circles" power local economies and are responsible for high-performing cities like London, New York and San Francisco. Their mirror image occurs in poorly performing areas creating a vicious cycle as people, businesses and money leave.

The productivity advantages of London and the south-east are, in part, driven by these self-reinforcing market forces, not just a failure of successive governments to invest enough in struggling places. In countries like the UK with specialisation in high-skilled services that experience strong agglomeration economies, development is more uneven.

That uneven development is what leads to public clamour for policies like levelling up, but the market forces that underpin it mean difficult choices must be made. Many policies can support productivity by improving innovation and technology, investment, and education and skills, and this could justify spending in lots of places. But with limited public resources, concentrated funding is needed to counter strong market forces and create the virtuous circles that can truly transform places.

Levelling up

Patterns of levelling-up funding to date – including from the three main funds – illustrate the problem. The UK Shared Prosperity Fund (UKSPF) is formula funded to all areas of the country, 216 places have received levelling-up funding and 101 places Towns Fund money (National Audit Office 2023; Ward 2024).

Many of these funds are filling holes in local government budgets, so it is not surprising they are spread around. According to the Institute for Government, English councils saw a 40% real terms cut in central government grants between 2010-2020 (from £46.5bn to £28bn in 2023/24 prices) and while this trend has started to reverse, central government funding remains lower in real terms today than in 2010 (Atkins and Hoddinott 2020; Ogden and Phillips, 2024). Against this, the relatively small amounts of planned spend (£10.47bn across the three funds), and failure to grapple with the difficult issue of prioritisation suggests that this spending will not do much to ameliorate UK spatial disparities. Slow rollout – as of September 2023, just over 10% of total levelling-up funding has been spent – won't help either (House of Commons Committee of Public Accounts, 2024).

The Economy 2030 Inquiry – a joint project between CEP and the Resolution Foundation – makes the case for focusing investment on creating virtuous circles in some of the main urban centres outside London, to make the best use of limited public funds.

Given the UK's services specialisms, improving UK productivity means bigger high value-added services sectors, and a wider range of cities succeeding with them. Doing this means being honest about the implications – choosing some places to prioritise over others and investing heavily to achieve the scale of change required.

The scale of the investment means an economic strategy also faces important spatial trade-offs. First, how quickly do we want national productivity to improve relative to spatial disparities narrowing (an issue we return to below)? Second, which places to invest in most aggressively (since not all places can be prioritised simultaneously)?

The Economy 2030 Inquiry argues that England's second cities – Birmingham and Manchester – represent the best candidates. Both have populations of around 2.8 million but productivity below the national average (Birmingham is 14% below, Greater Manchester 12%). Cities this big and this far behind on productivity represent a significant drag on the overall UK economy – closing their productivity gaps with London by roughly 10 percentage points could increase total UK GVA by almost £20bn a year. Fortunately, their size and central locations in their wider regions mean they have the potential to attract high-skilled firms and workers in the tradeable services sector. But achieving this will require massive, sustained investment. For example, the Economy 2030 Inquiry analysis for Greater Manchester suggests that it will need:

- An extra 180 hectares of office space achieved by densifying and expanding the city centre, to help attract tradeable service sector firms to the most productive part of Greater Manchester.
- An additional 180,000 high-skilled workers achieved by some upskilling, but mostly through improved graduate retention or attracting graduates from elsewhere, to help increase the size of the high-skilled labour market making Greater Manchester more attractive to service sector firms.
- 126,000 new homes for them to live in – 26,000 new social housing units, costing around £2.1bn over 15 years, and 100,000 private homes requiring £350m to subsidise less commercially viable sites.
- An extra £1.5bn-£2bn to modernise public transport networks and reduce travel times to the city centre helping increase the effective size of the high-skilled labour market, making Greater Manchester more attractive to firms. This figure is on top of the £3bn of transport funding already allocated.
- An aggregate business capital increase of £30bn, to help increase productivity and attract more high-skilled workers.
- Greater devolution to the Combined Authority, possibly including fiscal devolution, to ensure it has the power it needs to coordinate and deliver these investments.

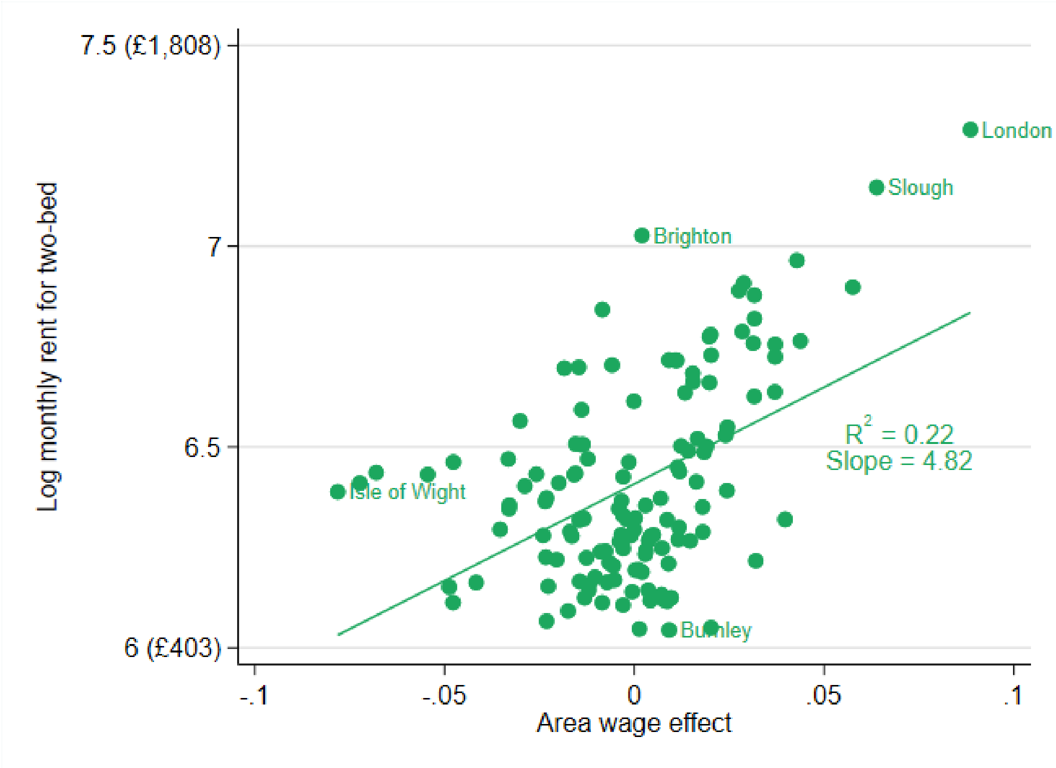
Complementary polices to increase the demand for skilled workers might include further support for Greater Manchester's universities and businesses to increase innovation and commercialisation of spin-offs.

For poorer individuals living in the area, investment will be needed to help them take advantage of new opportunities in high-skilled services and in other jobs created as the local economy grows. This might include interventions to address physical and mental health issues, improve educational outcomes, better fund further education and raise participation in higher education, increase apprenticeships and other in-work training (Layard et al, 2023; Farquharson et al, 2022). Regional transport infrastructure could help Birmingham and Greater Manchester play the same role for their wider regions as London does for the south-east.

Housing and planning

One of the big challenges of raising productivity in any area is that attracting people and business investment drives up house prices and office rents, limiting the benefits to households and acting as a brake on the virtuous circle described above. As illustrated in Figure 3, data for 2012-19 suggest that someone moving to do the same job in a different area will see rents increase 4.8% for each 1% increase in wages. These higher costs offset the gains from higher wages in some areas (Overman and Xu, 2022). In London, for example, average weekly rent for someone in the 30th percentile for weekly pay represented around 70% of that weekly pay in 2019, compared with about 43% for the England average (Hilber and Schöni, 2022).

Figure 3: **Monthly cost of living (rent for a 2-bed flat) for an area compared to nominal wage gains from moving to the same area**

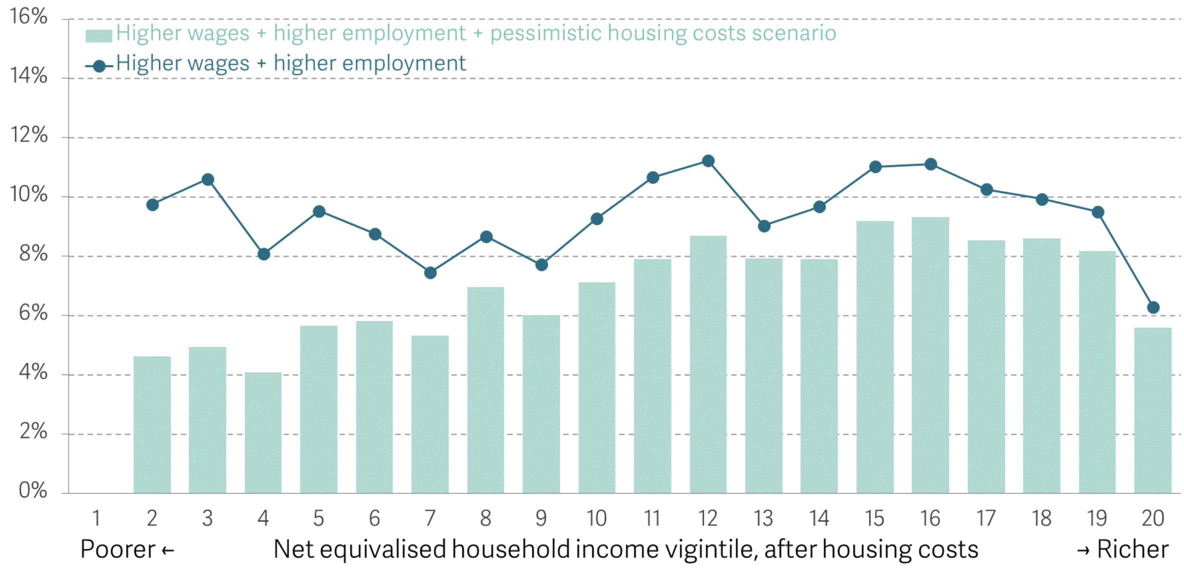


Notes: Shows average monthly rent for two-bed property in TTWA averaged over 2012–19. Rent data are available at the local authority level, and aggregated to (LA-based) TTWAs based on population size. Area effects estimated controlling for individual fixed characteristics and time-variant observed characteristics ('AKM with controls'). Data from Valuation Office Agency; Welsh Government; Scottish Government; Annual Survey of Hours and Earnings. **Source**: Overman, H.G, Xu, X (2022), 'Spatial disparities across labour markets', IFS Deaton Review of Inequalities. Figure 16, p.27.

High housing costs in more productive areas constrain growth and have implications for local and national productivity. They also determine how benefits of growth are shared across poorer and richer households.

For example, the 180,000 additional graduates needed to narrow Greater Manchester's productivity gap with London will need to live somewhere – the Economy 2030 Inquiry suggests around 126,000 additional homes will need to be built in Greater Manchester over 15 years. In a more productive city region, the inquiry estimates nominal income gains of around 10% for the poorest households, similar to those for the richest. Even in a scenario where those 126,000 additional homes can be built, increased housing costs offset some of these income gains, particularly for poorer households. But failure to deliver enough homes makes this worse, and more uneven. Figure 4 shows how that would mean the poorest households see real income gains (after housing costs) of 4% compared to nominal income gains of 10% - a difference of 6 percentage points. This contrasts to a 1 percentage point difference between nominal and real income gains for the richest households.

Figure 4: Higher housing costs from insufficient housebuilding could absorb a large part of poorer households' income gains in a more successful city region



Notes: Change in net equivalised working-age household income (after housing costs), by income vigintile (higher wages, higher employment and pessimistic housing cost scenario): Hypothetical higher-productivity Greater Manchester, 2040. Pessimistic housing costs scenario assumes city region builds half of the new homes required by a larger population. **Source**: P Brandily et al., A tale of two cities (part 2): A plausible strategy for productivity growth in Greater Manchester and beyond, Resolution Foundation, September 2023. Figure 44, p.99.

Levelling-up policies have paid lip-service to these issues – the Levelling Up fund and UKSPF fund some town centre regeneration for housing. Separately, changes to permitted development rights have made it easier to add to residential properties and convert commercial to residential use (Rankl, 2024). Offsetting these minor tweaks to supply, unfortunately, are quite significant demand side interventions including Help to Buy that have tended to increase prices in the most high-demand areas (Hilber, 2013). Small planning changes and individual regeneration programmes will not be sufficient to address the UK's housing affordability crisis and to remove a key impediment to UK productivity growth. The issues of housing and planning will be covered in a forthcoming CEP election analysis.

Difficult choices

The case for focusing large amounts of investment to turn around large, underperforming cities is that these places should be performing better, that it should be possible to create virtuous circles there, and that doing so would make a significant difference to the UK economy. The two alternatives are to spread money around or to invest it in London and the south-east to "build on success".

Spreading money around can make a large difference to individual places, but that will not scale-up to a large national impact. No one knows the right balance between London and other urban areas, but it is likely that investment in the London metro area – a highly productive area that accounts for 25% of UK employment – to increase its productivity will be needed to narrow the gap between the UK and other countries.

Investment is not the only area where we face such trade-offs. One argument for planning reform, for example, is that it means more housing in our most successful areas allowing people to move to good jobs and opportunities, rather than vice-versa.

But if we are targeting some places, then what about other cities, towns and rural areas – in short, everywhere else? In part, the answer is that growth will help to pay for the funding of better public services, investment and welfare benefits that are needed in these areas. This redistribution will increase incomes and improve the performance of public services that many people rely on.

But this isn't just a hand-out – improved infrastructure and better education and health outcomes in poorer areas should improve productivity. And higher public spending can also help support national policies that will increase productivity everywhere (Overman and Xu, 2022).

Conclusion

What to do about spatial disparities is central to debates about how we escape from stagnation and return the UK to growth. The Conservatives and Labour nod to the local dimension of economic growth in their manifestos, but neither grapple with the difficult trade-offs of where to target investment spatially.

The Conservatives promise continuation of the current levelling-up funding measures and a preference for spreading funding – extending an endowment fund for towns to cover more places, and creating more investment zones and freeports. Labour is more circumspect, promising devolution to local government, and requirements for local growth plans, together with a new national wealth fund for investing in growth, but little on whether or where spatially targeted investment might happen.

This is unsurprising – these issues are tricky for constituency-based politicians and parties seeking votes across the country. In a poll for the Centre for Cities in 2021, 48% of respondents ranked "better job opportunities in your area" as very important for what levelling-up should achieve – the highest ranking of all the priorities in the poll (Carter, 2021).

How then should we judge the extent to which the proposals from different parties will level-up the UK? Counter-intuitively, it is probably best to ignore anything they say on levelling-up policy. Housing policy will matter – is what they say significantly likely to increase housing supply in the right places?

Beyond that, the key question is what they will do on economic growth, taxation, spending and regulation, because given what we know about spending limits, it is the spatial manifestation of the changes induced by these policies that will matter most for spatial disparities.

National policies around innovation and investment are the strongest levers for raising productivity everywhere. The effects of government austerity – which reduced individual benefits and spending on public services – fell particularly hard on poorer places, exacerbating the problems generated by low incomes and economic decline (Centre for Cities, 2019). Reversing these cuts will help, if funding formulas benefit more disadvantaged areas.

The damage done has been substantial, hence the current government emphasis on levelling-up spending that partially offsets the cuts and tries to improve "pride in place" in some hard-hit places. The UKSPF, Towns Fund, and Levelling Up Fund each include money for "pride in place" related interventions, like urban and town centre regeneration, green spaces and public realm improvements, and culture. For example, according to the National Audit Office, 12% of first round, and 14% of second round Levelling Up Fund Allocations were for cultural investments, and 41% of total funding was used for town centre regeneration (NAO, 2023).

Redistribution via more progressive taxation and a more generous benefits system – where similar caveats on spending commitments apply – will also help because spatial income inequalities are partly the spatial manifestation of individual ones. Aspects of the problem are also amenable to pre-distribution – changing what happens in the labour market or wider market economy to benefit poorer households. The minimum wage and the broader good jobs agenda are good examples (so too is housing).

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