

'Brakes and Drivers' Synthesis Report

Framework for discussion

11 May 2004

Background

Low GVA

- Growth theory would suggest that market forces should result in convergence of regional GVA per capita over time
- Sustained levels of higher public spend per capita yet North East economy across a whole host of indicators lagged significantly behind the English average for a period of over 30 years
- The Cabinet Office (1999) view the lack of regional convergence by the 'lagging regions' in the medium to long-term as therefore a likely indicator of serious **market failure**
- Target for each of the 'lagging regions' is to achieve a rate of growth of Gross Value Added per head between 2003 and 2008 above that achieved by London, South East and East regions combined.

STUDY AIMS

- Explore the interrelated nature of the regional economy
- Where possible identify the nature and extent to which **market failure** has occurred
- Identify whether the regional pattern of public sector investment has helped to address structural differences
- Where possible identify 'brakes and drivers'
- Suggest how might future expenditure be skewed towards investments that have greater long term potential to increase the performance of the North East economy and in particular to begin to narrow the long-term disparities
- Identify 'key gaps' in knowledge and understanding that limit our ability to design and implement more effective long-term policies.

RESEARCH PROGRAMME

7 components:

- Population stock
- Business Stock
- Labour Market
- Finance Market
- Business Property Market
- (Product and Services Market)

Population Stock

- High and rising dependency ratio
- Low levels of educational attainment
- Historic 'brain drain'
- Low level of employee skills
- Continued net 'brain drain' – Census Data 2000-2001
 - North East does appear to be further disadvantaged through recent migration exchanges with the rest of the UK. This is especially the case in terms of **out-migration**.
 - Fully one-third (33.6%) of its out-migrant Household Reference Persons (HRPs) were in group 1 (higher managerial and professional occupations) at their destinations at the time of the 2001 Census, compared to only 24% of London's out-migrants and 29-30% for the next highest regions (NW and Y&H).

Population - Inflow

SEX AND NSSeC OF HRP	NE	NW	YH	EM	WM	EE	L	SE	SW
INFLOW FROM REST OF UK 2000-2001	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1. Higher managerial and professional occupations	19.2	21.2	18.0	20.2	22.5	22.3	28.9	25.9	20.2
1.1 Large employers and higher managerial occs	5.9	7.4	6.4	8.8	8.4	8.6	9.7	10.4	7.6
1.2 Higher professional occupations	13.3	13.8	11.6	11.4	14.1	13.8	19.2	15.5	12.6
2. Lower managerial & professional occupations	24.7	25.3	23.0	27.0	26.8	28.1	31.4	29.9	26.7
3. Intermediate occupations	8.0	7.0	6.3	7.4	6.5	8.4	9.1	8.4	7.4
4. Small employers and own account workers	3.7	4.3	3.9	5.5	5.0	5.8	4.1	5.6	6.9
5. Lower supervisory and technical occupations	6.0	5.5	4.6	6.3	5.1	5.7	3.5	5.1	5.8
6. Semiroutine occupations	8.3	7.5	6.3	7.0	6.8	6.3	4.2	5.4	7.0
7. Routine occupations	6.7	5.9	5.0	6.4	5.1	4.6	2.7	3.7	5.3
8. Never worked or long term unemployed	4.7	3.4	2.7	2.2	2.9	1.3	2.2	1.1	1.4
L14.1 Never worked	2.9	2.0	1.5	1.2	1.9	0.7	1.4	0.6	0.6
L14.2 Long term unemployed	1.8	1.4	1.2	1.0	1.1	0.6	0.8	0.5	0.8
Not classified	18.7	20.0	30.2	18.1	19.2	17.5	14.0	14.9	19.4
L15. Fulltime students	5.0	6.6	19.3	3.7	7.0	2.7	7.7	2.4	3.2
L17. Not classifiable for other reasons	13.6	13.3	10.9	14.4	12.2	14.8	6.3	12.4	16.3

Population - Outflow

SEX AND NSSeC OF HRP	NE	NW	YH	EM	WM	EE	L	SE	SW
OUTFLOW TO REST OF UK 2000-2001	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1. Higher managerial and professional occupations	33.6	29.3	29.7	25.4	25.9	28.1	23.8	26.8	25.5
1.1 Large employers and higher managerial occs	19.3	15.8	15.8	12.3	12.7	14.0	11.4	13.8	13.3
1.2 Higher professional occupations	14.3	13.5	13.9	13.1	13.2	14.1	12.4	13.0	12.2
2. Lower managerial & professional occupations	22.6	23.9	25.6	25.8	25.6	26.8	27.2	26.5	25.0
3. Intermediate occupations	5.9	6.2	6.4	7.1	6.8	7.2	8.4	7.7	7.1
4. Small employers and own account workers	3.2	4.1	3.8	4.5	4.9	4.6	7.0	5.3	4.7
5. Lower supervisory and technical occupations	4.4	4.3	4.7	5.2	4.8	4.9	5.0	5.3	5.3
6. Semiroutine occupations	5.2	5.5	6.0	6.5	6.6	5.9	5.8	5.9	6.2
7. Routine occupations	4.1	4.5	4.9	5.2	5.1	4.0	4.3	4.3	4.7
8. Never worked or long term unemployed	2.8	2.2	2.4	2.1	2.1	1.8	1.8	1.4	1.7
L14.1 Never worked	1.7	1.3	1.3	1.2	1.2	1.0	1.1	0.8	0.8
L14.2 Long term unemployed	1.1	0.9	1.0	0.9	0.9	0.8	0.8	0.7	0.9
Not classified	18.2	19.9	16.7	18.1	18.2	16.6	16.7	16.8	19.8
L15. Fulltime students	7.0	7.9	5.5	7.0	6.1	5.3	3.7	4.8	5.4
L17. Not classifiable for other reasons	11.2	12.0	11.2	11.1	12.1	11.3	13.0	12.0	14.5

Business Stock

- Traditional engineering suffered consequences of liberalisation of public procurement, privatisation and subsequent rationalisation (notably power engineering and gas-supply engineering, and defence)
- Most manufacturing sectors have declined, including those such as electronics which have been major beneficiaries of inward investment and regional selective assistance
- Small pockets of successful technology-based firms, BUT very much under-supplied with high growth high tech firms
- High levels of external ownership and control
- Small number of PLCs
- **Emphasis on production and low skill tasks rather than the high value added and strategic functions within firms**
- Weakly developed business services industry
- **Regional assistance has had little effect on the creation of long term endogenous capacity for growth in the region.**

Business Stock Explanation for - Low GVA per employee

Two possible reasons for low GVA per employee

- problem of the mix of sectors in the region, with too many low productivity sectors
- productivity in the region's sectors is lower than the national average.
- Comparing GVA/employee levels for sectors in the region and nationally, the nature of the problem is clear
 - **relatively low levels of value added across sectors which account for c.90% of employment**
 - **The problem is then made worse by a relative emphasis on declining or low growth sectors and an under-representation of high growth sectors**

Labour Market

Supply

- Lowest levels of educational attainment
- Lowest levels of qualifications of employees
- Below average investment in Education?
- Higher public sector investment in workforce training?

Demand

- Lowest level of in-migration
- Lowest level of in-migration of graduates from outside the region
- Lowest levels of demand from employers for qualifications
- Lowest wage rates
- Highest levels of unemployment, sickness and inactivity
- Low employer investment in training

Labour Market

Market Failure?

- Low levels of skills shortage vacancies
- Low level of employer perceived skills gaps
- Highest proportion of graduates working in non-graduate jobs (GLAM 99?)
- NE locked in a low demand - low supply skills equilibrium
- Raising of skills levels significantly ahead of demand could be expected to prompt further net out-migration of those most skilled and qualified.

Finance Market

- Traditional academic/policy literatures emphasise a **potential 'market failure' in the form of a supply side gap**, that potentially constrains the formation/growth of businesses in the UK (and in 'lagging regions' in particular (Macmillan Committee 1931; Bolton Committee 1971; Smallbone *et al.* 2001; Wray 2003))
- Remarkably little about **either** the supply of or demand for finance in the region
- Recent academic attention is now turning increasingly to issues of demand (see Mason and Harrison 2003)
- In the context of the NE region, there are grounds for expecting demand-side concerns to outweigh supply side considerations.

Finance Market

- Potential lack of information and uncertainty about investment opportunities. Factors which could be expected to limit the flow of information between businesses and financiers are:
 - The low ‘clustering’ of businesses in the North East (Trends?)
 - Mismatch between NE strengths and national high growth sectors?
 - Weakly developed business service industry
 - Physical distance and travel between NE and London concentrated private finance.
 - Levels of housing collateral are the lowest of the 9 English regions but again the significance of this is not adequately understood.
- but there is no evidence that there is a relative lack of information flow or that this constrains relative availability.

Business Property Market

- Investment in land and property significant component of an overall package to attract inward investment to the region from the 1960s onwards
- Investment remains a cornerstone of investment in economic development particularly by local authorities and local strategic partnerships
- In most parts of the North East private sector unable to provide business premises without some form of public support because of a **gap between cost and value**.
- Uncertain / unknown whether value gap due to **market displacement** or market failure.

Business Property Market

- Very significant public sector investment in the reclamation and servicing of derelict land and direct investment in business accommodation maintained to a remarkable degree the overall geographical distribution of employment
- Dislocation between home and work – with marked increase in travel to work distances (matching that of other regions) due to significant shifts in the distribution of service employment
- Marginally cheaper property for rent
- Over supply pockets depressing regional yields?
- Relative ‘under supply’ of premises in ‘high demand’ areas with low availability of subsidy?
- **Assumption:** evidence of latent demand = accommodation shortage = business constraint
- Evidence of businesses with a current requirement for premises
- No evidence of either business formation or growth constrained by availability of business premises

Housing Market

Low demand

- Lowest rates of household formation
- Lowest but rising rates of homes ownership
- Lowest incomes per household
- Lowest levels of borrowing per household with a mortgage

Over supply

- Supply levels crept ahead of demand
- Lowest ratio households per dwelling (marked 3.7% surplus of dwellings over households)

Consequences of market conditions

- Lowest (but eventually rising) house prices
- Lowest rents
- Lowest levels of collateral
- Lowest borrowing to income ratio (lowest level of financial pressure of home owners to raise income levels)

Housing Market

Market Failure?

- gross oversupply of housing
- Emergence of localised concentrations of difficult to let and virtually un-saleable properties
- Significant and sustained investment in housing stock in low demand areas could potentially just be **transferring the problem and in many cases at a relatively localised level?**
- (agents might be slower to pick up market signals than in other regions?)

Summary of Market Analysis

- Low demand across all markets
- BUT **NO** clear evidence of **market failure**
- Public sector emphasis on supply-side measures potentially displaced private sector investment (all markets)
- Public sector investment helped to lever in private sector investment into some locations – largely at the cost of others?
- Past interventions failed to ‘correct’ markets or narrow GVA per capita gap

Lack of Competition

The Productivity in the UK report by the Treasury - a lack of competitive pressure can impact on efficiency and prices.

Lack of local competition

- Smallest regional market bordered by areas with very low population density
- Newcastle small regional centre compared with Birmingham, Leeds and Manchester
- Lowest number and proportion of high growth businesses
- Lowest number and proportion of Knowledge Intensive Business Services.

Lack of financial pressure

- Lowest wage rates
- Cheapest rents
- Lack of personal financial pressure on owner managers
 - Lowest rates of mortgage borrowing
 - Lowest house prices

Strategies to ameliorate social consequences of industrial restructuring

- Urban policy – shifting deck chairs
- Regional policy - emphasis on cost per job
- National programmes – youth training, unemployment training, business start up, innovation
- Treasury breakdown of public spend by region?

Strategies to ameliorate social consequences of industrial restructuring

- Lion's share of net additional public sector spending per head arguably
 - Attracted waves of transient inward investment attracted on the basis of **low cost** branch plants, call centres, Civil Service?
 - Encouraged focus of indigenous businesses on comparative cost advantages?
 - Reduced 'market adjustment' through net out-migration (inward investment, national benefit structure)?
- Higher spend per capita needed to address past problems e.g. higher areas of education spend

Strategies to ameliorate social consequences of industrial restructuring

All LEA Spend	North East	England	North East – England variance
Education Welfare Service	£2.43	£1.91	£0.51
Excluded Pupils Secondary	£ 0.53	£ 0.27	£0.26
LEA factors in relation to child protection	£ 0.33	£ 0.21	£0.12
Youth Service and Connexions	£ 8.39	£ 7.45	£0.94
PRC Redundancy costs	£ 1.75	£ 1.26	£0.49
Existing early retirement costs	£ 6.24	£ 3.78	£2.46
Residual Pension Liability	£ 1.13	£ 0.88	£0.25
Strategic Management	£ 19.27	£ 16.31	£2.96

Low Cost Region

Public sector supply-side interventions in labour, business property, housing and business finance (capital subsidies) contributed to:

- Low business property rents (significant public subsidy)
- Lowest House Prices (subsidies to add to local oversupply?)
- Uncertain net finance cost (plethora of capital subsidies notably RSA,?)
- Lowest labour costs (training and recruitment subsidies)

COMFORT ZONES

- Low costs afforded businesses with a comparative advantage based on lower costs compared with competitors in England (fragile competitive strategy)
- Low cost of living notably low cost of housing - low pressure on business owners to drive increased profits and low pressure on all households to raise incomes

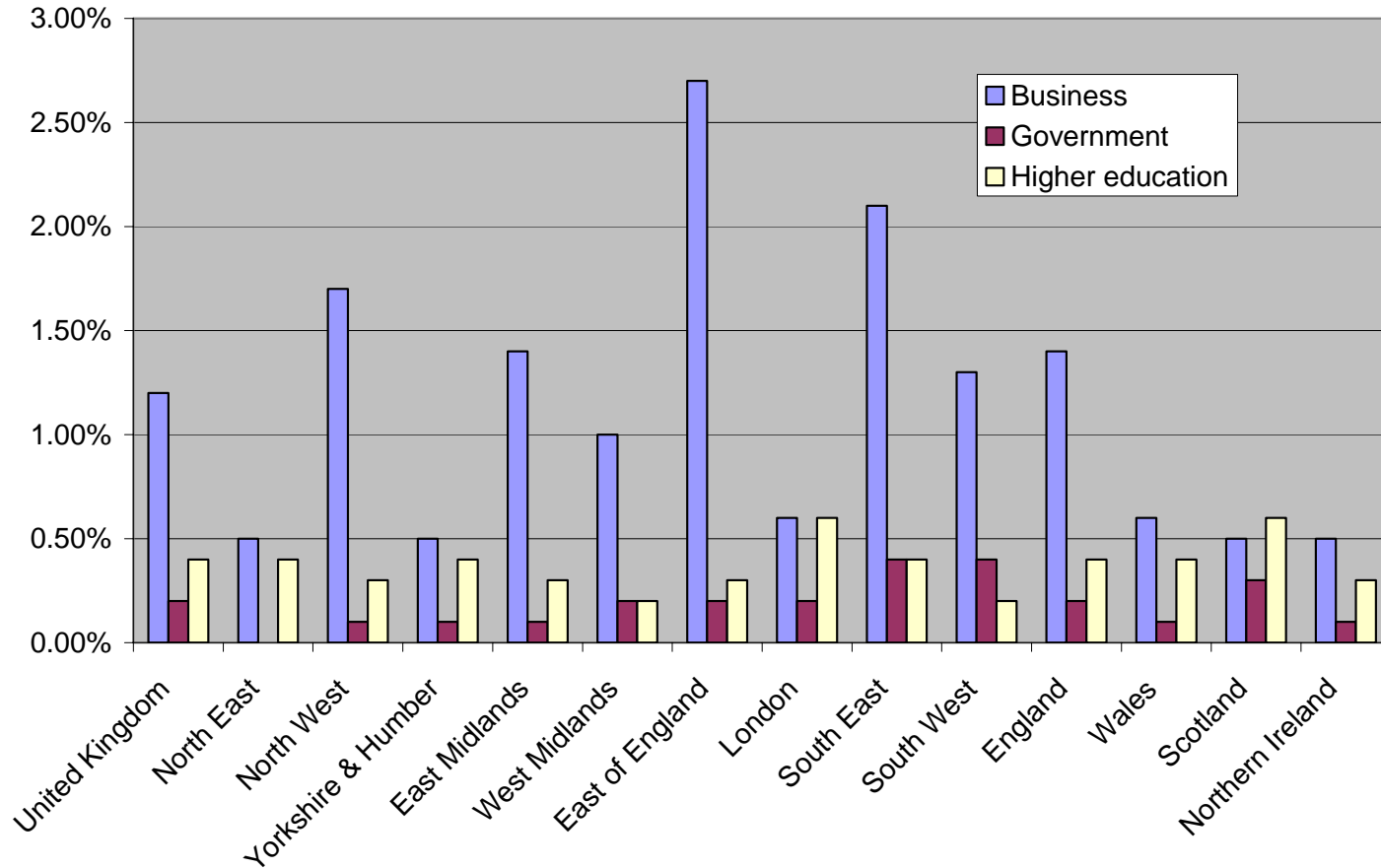
Strategies to Add Value

Massive annual deficit in public and private investment in capacity to add value?

- Non existent government research
- Low level of business R&D
- Significant under-representation of strategic level Civil Service employees in North East
- Deficit in Higher level skills investment (less indigenous graduates)

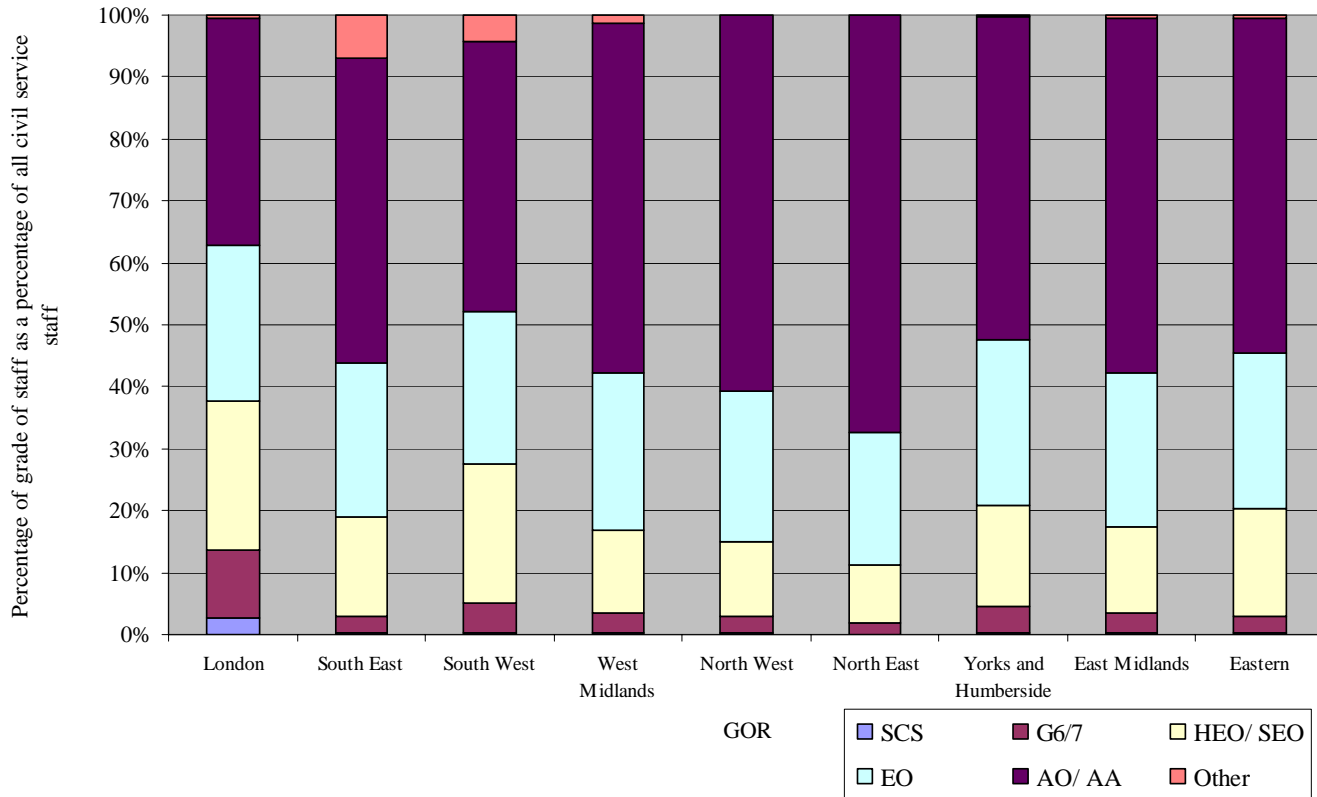
R&D Intensity

R&D by types as % of GDP



Strategic Decision Makers – Civil Service

Grade of Civil service staff by Government Office Region



Implications

- Current public spend remains focussed on ameliorating social consequences rather than adding value?
- Continued status quo of the North East 'Comfort Zone' that maintains social stability and population despite significant gap in incomes?

Strategic Shift

- To have any chance of sustained narrowing of GVA per capita gap with current population levels requires a very significant increase in investment over a prolonged period of up to 25 years to create the capacity within the region to add value
- Initial step increase in public sector net transfers to the North East leading to a gradual tailing off of dependency on net support
- The alternatives are:
 - Continued 'fire fighting' to ameliorate the social consequences of continued haemorrhaging of regional economy due to emphasis on measures to reduce cost with no narrowing of GVA gap (– annual cost £100s millions per annum)
 - Increased investment in measures to increase inter-regional labour mobility such as large scale investment in new housing in growth regions, regionally adjusted benefits system and regionally adjusted public sector pay would potentially reduce frictions in labour movement (Such measures could potentially add the diseconomies of an over congested South East, add to the regional skills divide with increased net outflow of those with scarce skills and leave behind those least able to contribute to high levels of GVA add to social polarisation and civil unrest)

Strategic Shift

- A key element of successful strategies to improve relative economic performance has been a commitment made to research and development
- Investment of around £200 - 300 million per annum on additional public R&D to put NE **on a par** with recurrent investment in top performing European Regions
- Significant investment also to secure early increase in private R&D

Strategic Shift

