



Perspectives by Ruth Lea

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As the Treasury's purse strings are tightened, London and the South East are well placed to handle the cuts

Introduction

We have already argued that the Coalition Government's plans for fiscal retrenchment are fundamentally right. Public sector borrowing on the current scale is unsustainable.¹ We will not however know where the axe is set to fall in any detail until the Spending Review for the four years FY2011 to FY2014 is announced on 20 October. And therefore we do not know which regions will be especially hard hit by the fiscal tightening.

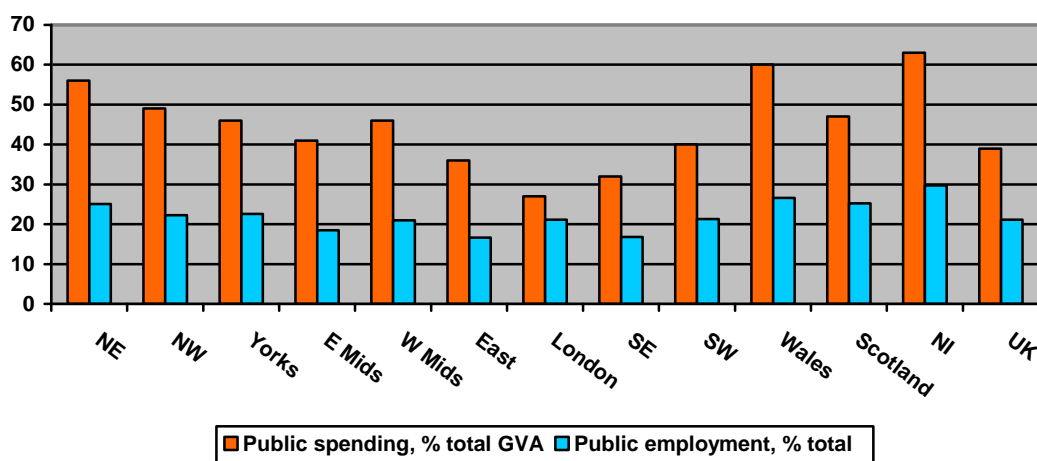
But we can, in advance, speculate which regions are relatively well placed, and which are not, to handle public spending cuts. And it is reasonable to suggest that the regions more than averagely dependent on public sector spending and employment will fare worse than those that are not.

Public sector dependency: regional breakdown

Chart 1 shows the regional breakdown for the English regions (North East, North West, Yorkshire and Humberside, East Midlands, West Midlands, East of England, London, South East and South West), Wales, Scotland and Northern Ireland (NI) for:

- The % share of regional Gross Value Added (GVA) accounted for by identified regional public spending.² Identified public spending, for example, accounts for about 40% of total UK GVA but over 55% of the North East's.
- Note that the Treasury has identified only 81% of total managed expenditure (TME) by region.³ A fifth therefore is not identifiable by region, so it may be that the figures below under-estimate the regions' dependency on public spending.^{4,5}
- The % share of the regional total employment accounted for by the public sector. In the UK as a whole, for example, 21% of employees are public sector employees, whilst in the North East the share is around 25%.
- Note that approximately 30,000 public sector employees (0.5%) cannot be assigned to a region out of a total of 6.05 million. The vast majority of employment is therefore identifiable by region.

Chart 1 Identifiable public expenditure as % share of regional GVA; public sector employment as % share of regional total employment

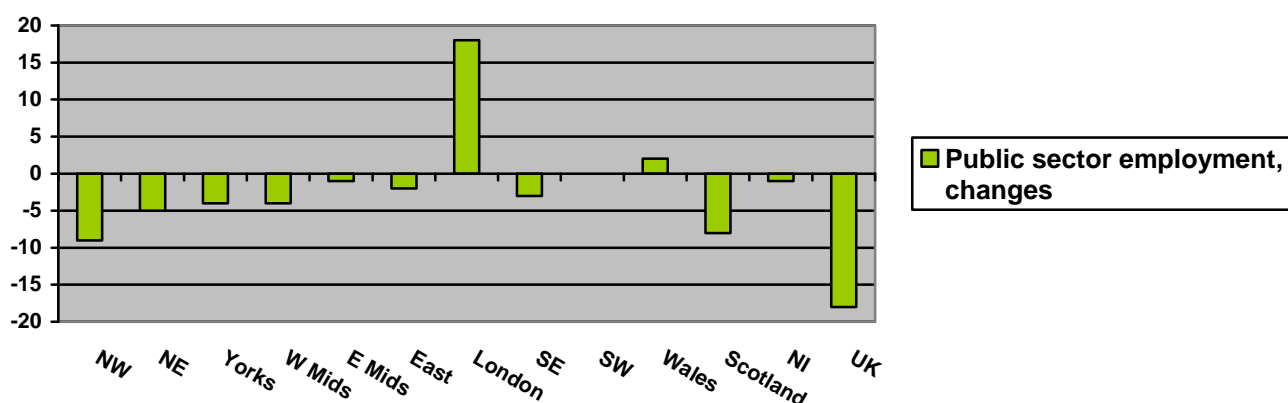


Source: House of Commons Library, Public sector employment and expenditure by region, SN/EP/5626, 8 July 2010. Note employment data are for headcount (2010Q1); spending data are on services and for FY2008 as % of calendar year 2008 GVA.

It is apparent that for both public spending and public employment there are very wide regional discrepancies. Concerning public spending, and noting again that they may be under-estimates, the published figures show that public spending as a share of regional GVA varied from 63% in Northern Ireland, 60% in Wales and 56% in the North East of England to 27% in London and 32% in the South East.

A similar regional pattern relates to employment. The public sector accounts for 30% of employment in Northern Ireland, nearly 27% in Wales and 25% in the North East, whilst it accounts for less than 17% in the East of England and the South East. London's share is bang on the national average, swollen by "Whitehall". Recent data show that public sector employment is already falling. It declined by 18,000 between 2009Q2 and 2010Q2. But within that total, London's employment rose by 18,000 whilst it fell by 9,000 in the North West and 8,000 in Scotland.

Chart 2 Regional public sector employment, changes, 2009Q2 to 2010Q2 (thousands)

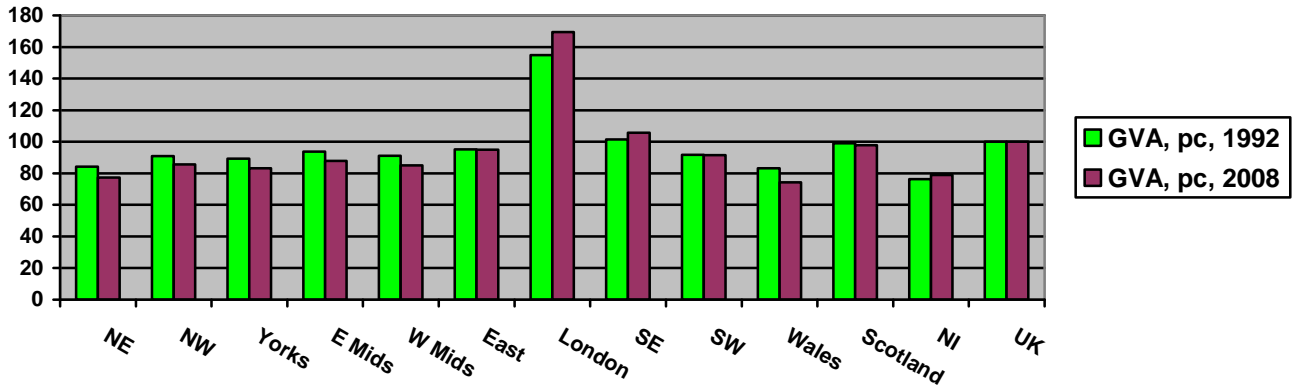


Source: ONS, "Public sector employment", 2010Q2, 15 September 2010, not seasonally adjusted data.

Regional discrepancies

Taking these data at face value suggests that some regions are much better placed to cope with public spending restrictions than others. London and its satellites (the South East and the East of England) are relatively well positioned. Other regions are not, in varying degrees. London, in particular, has other advantages over all other regions. Chart 3 below demonstrates how London's productivity performance easily outstrips other regions and how its lead has increased since the last recession.⁶ The South East has also improved its position.

Chart 3 GVA per head, workplace based, by region, 1992 and 2008 (UK=100)



Source: ONS, Regional Trends Online, 1 October 2009, and regional statistics online, www.statistics.gov.uk

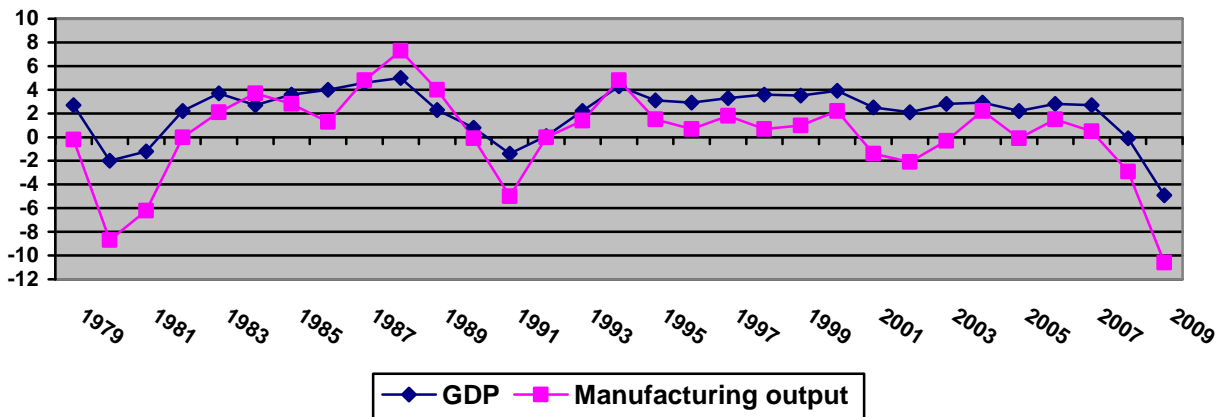
Moreover the successful “southern economies” have increased their share of total UK economic activity since the last recession. (See the pie charts in the annex.) Their success partly reflects improved productivity and partly reflects population movements. Between 1992 and 2008, London’s share has increased from 19% to 22% of total GVA whilst the shares of all the English northern regions slipped back. The economic dominance of London and its “satellites” already suggests an economy that is regionally out of balance. They account for nearly 45% of GVA.⁷ With the prospective spending cuts, the imbalances could worsen.

The industrial composition

One of the main reasons for the slippage of the “Northern regions” in the regional GVA league tables is the nature of their industrial mix, whilst London has benefited from its industrial mix – not least of all from the buoyant City.⁸ Specifically the northern regions have proportionately larger manufacturing sectors than London and the South East and manufacturing has been a noted underperformer since the early 1980s. Between 1979 and 2009, GDP rose by over 85%, manufacturing output rose by just 5%.

Chart 4 shows that manufacturing output has not merely lagged GDP growth, but it has been much more volatile. In the early 1980s, the strong pound bolstered by “petrocurrency status” and high interest rates severely undermined the international competitiveness of the manufacturing sector. Output fell by nearly 9% in 1980 and 6% in 1981 even though the falls in GDP were relatively modest. Manufacturing employment dropped from nearly 7 million in the late 1970s to 5 million by the mid 1980s. The early 1980s recession in many ways was a “manufacturing recession” and a “northern recession”, with the south escaping relatively lightly. The decline in manufacturing again exceeded that of GDP in the early 1990s, but the disparity was not as dramatic as in the early 1990s. In the recession of 2008-2009 manufacturing was again hit badly, though it is now partly recovering.

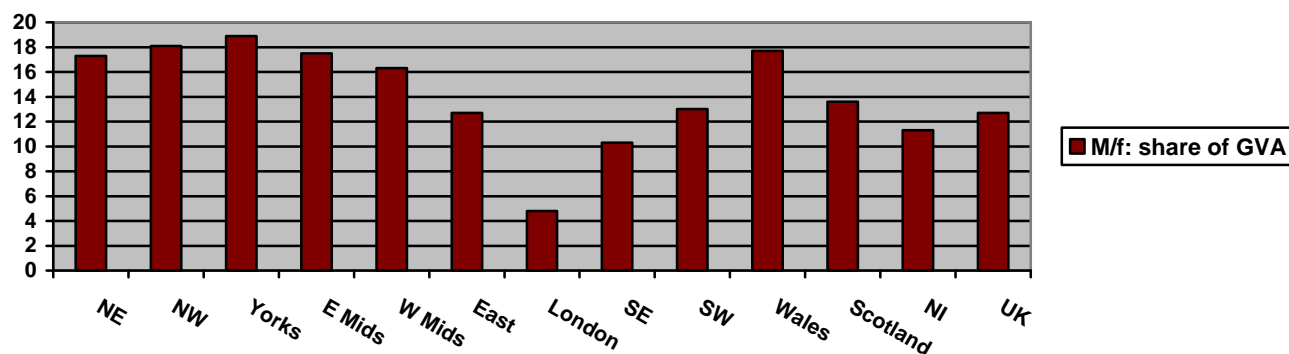
Chart 4 Manufacturing output and GDP: 1979 to 2009, annual changes (%)



Source: ONS database, the data are in constant prices.

Chart 5 shows how that even now, when manufacturing has shrunk as a share of total GDP to under 13%, some regional economies still have relatively large manufacturing sectors. The North West, the North East, Yorkshire and Humberside, the East Midlands and Wales all have sectors that account for 18-19% of their economies. By contrast London's manufacturing sector is just 5% of its regional GVA. Generalising, the sectors most at risk from the public sector cuts are those which have been more than averagely vulnerable to the vicissitudes of the traded goods sector.

Chart 5 GVA in manufacturing, as share (%) of total regional GVA



Source: ONS, Regional Trends Online.

The regional private sector challenge

As we have discussed before, the impending public sector tightening means that the private sector will have to perform very strongly, growing by 5-6% annually from FY2011 to FY2015, if the post-Budget GDP forecasts are to be achieved.⁹ In the early 2000s when GDP growth was being driven by 4-5% annual increases in public spending the private sector's contribution was paltry. It was, arguably, being "crowded out" by the burgeoning public sector. The OBR post-Budget forecast suggested that 600,000 public sector jobs would go by FY2015.^{10,11} They also projected that the private sector would create 2 million new jobs.

The \$64,000 question is where will this growth come from, especially if the City's wings are clipped by inordinately restrictive regulations and/or higher taxes? One obvious candidate is the manufacturing sector. The manufacturing sector could reverse its relative decline - especially if the OBR's post-Budget export-led growth forecast is achieved. This could help to offset the impact of the forthcoming fiscal retrenchment in the northern regions. But export-led growth cannot be guaranteed. The latest trade figures (for July) were shocking. They registered a record trade deficit.¹²

Concluding remarks

We do not know how the public spending cuts will affect the regions. But London and its satellites (the South East and the East of England) look relatively well placed to handle the forthcoming fiscal retrenchment as they are less dependent on public spending than the rest of the country and have relatively fewer people working in the public sector.¹³ Northern Ireland, Wales and the North East of England look particularly vulnerable - though Northern Ireland tends to be a special case for political reasons and may be partly ring-fenced.

But much will depend on how the private sector performs - not least of the manufacturing sector. The growth possibilities in the private sector are all too often left out of the discussion of "how the cuts will hit the economy". As the public sector retreats the private sector will have more room to flourish - just the opposite scenario from the "crowded out" early 2000s. And the Government, as it swings the axe yet mindful of the vulnerabilities of the "regions", may implement regenerative policies that strongly favour them.

References

1. Ruth Lea, "A tough, necessary Budget: a true "game-changer"", *Arbuthnot Banking Group*, 27 June 2010.
2. GVA at basic prices measures the contribution to the economy of each individual producer, industry or sector in the United Kingdom. It is equivalent to GDP at market prices minus taxes and subsidies. It is equivalent to about 90% of GDP.
3. House of Commons Library, *Public sector employment and expenditure by region*, SN/EP/5626, 8 July 2010. This estimate was for the year 2009. Public sector spending includes all spending whether direct purchases of goods and services or transfer payments, including welfare payments.
4. It should also be noted that comparisons on the basis of proportions of GVA tend to inflate the importance of the public sector to regional economies. This is because transfer payments such as social security benefits are included in public spending (the numerator), whilst they are not included in GVA (the denominator).
5. And it should also be noted that total public spending to GDP in FY2008 was 43.9% of GDP (see the *June 2010 Budget*) and GVA is about 90% of GDP, then this would suggest that total public spending in FY2008 would be about 48% of GVA.
6. ONS, Economic variations between the regions highlighted, press release, 1 October 2009
7. See chart 2 in the annex for the cumulative % share of GVA by regional economies.
8. ONS, "Regional economic indicators: a focus on regional gross value added using shift-share analysis", *Economic & Labour Market Review*, August 2010
9. Ruth Lea, "The OBR's economic forecasts are "challenging": but there'll be no "double dip"", *Arbuthnot Banking Group*, 12 July 2010.
10. OBR press release on post-Budget employment forecasts, 30 June 2010.
11. Public sector jobs are moreover, well-remunerated. The ONS, "How total reward compares in the public and private sectors", *Economic & Labour Market Review*, September 2010 concluded that total reward (pay plus pension contributions) is higher on average for full-time public sector workers than for their private sector counterparts. They added that if those with pension provision were considered on their own, the opposite was the case. But the key comparison is surely total remuneration.
12. ONS, "UK trade, July", 9 September 2010.
13. The CEBR, "Unemployment to breach 10% in half of UK regions over the next 5 years", 31 August 2010, for example, concluded that the south, east and London will escape the largest increases in unemployment. There will be larger increases in the north, west and Northern Ireland. See www.cebr.com.

Annex

Chart 1a Regional shares of total GVA, workplace based 1992

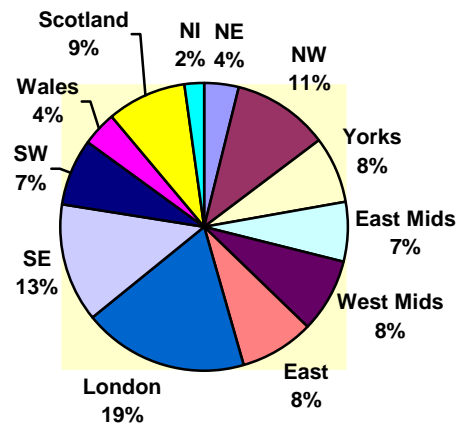
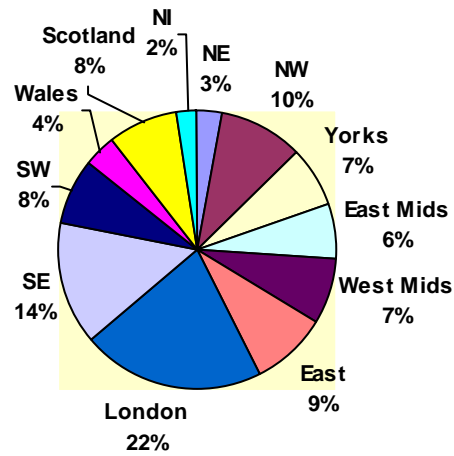
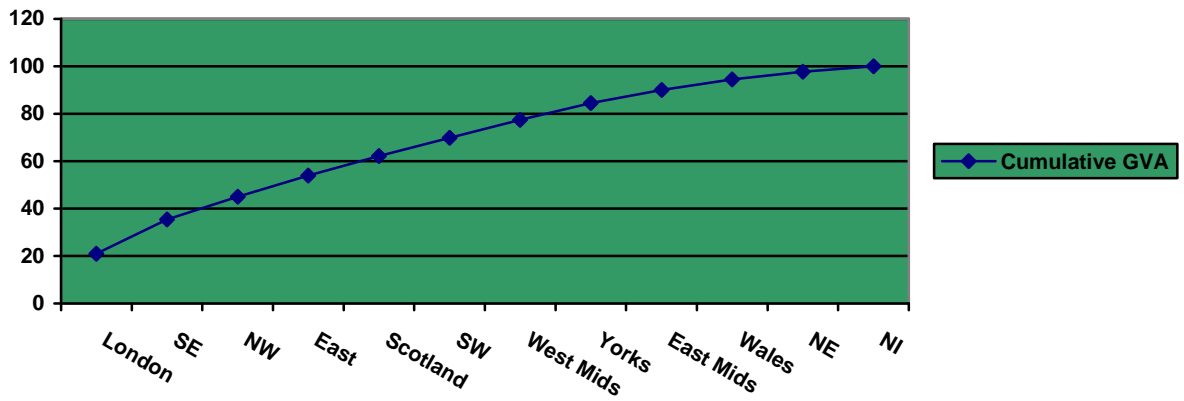


Chart 1b Regional shares of total GVA, workplace based 2008



Source: Regional Statistics Online, www.statistics.gov.uk

Chart 2 Cumulative share (%) GVA by region, 2008 data



Source: ONS, "Regional, sub-regional & local gross value added, 2009", 9 December 2009.

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