Musings on regional productivity

By David Hearne, researcher, Centre for Brexit Studies

In my last blog, I discussed the ramifications of a slew of recent work that has found significant differences in consumer prices between different regions of the same country. The effect appears pervasive – it's visible in the US, China, Germany, France, the UK and Italy amongst other places.

Of course, this has enormous ramifications for relative regional living standards and, it turns out, probably has relevance for inter-generational and inter-personal wealth disparities too. However, it also matters for poverty (and actions to address poverty).

The poverty line will differ in different locations. This seems obvious, but national policy rarely takes it fully into account. It takes a considerably higher dollar income to live free from poverty in California than in San Francisco.

In the developing world, this is quite profound. Since the very poor are typically concentrated in poorer regions, understanding subnational variation in prices really matters if we are committed to lifting millions out of unimaginable destitution.

More parochially, here in the UK, policy (indirectly) attempts to mitigate some of the most extreme price differences by separating the cost of housing from other benefits. Local housing allowances are precisely that: local. Nevertheless, even ignoring housing costs, consumer prices in London appear around 10% higher than in Yorkshire.

However, there are also clear implications for (regional) productivity. Consumer prices are not suitable for comparing productivity, but they do account for a significant proportion of overall GDP and therefore are likely to give an indication of what overall purchasing power parities would look like.

The results are strongly suggestive of significant price variation, with wealthier regions being significantly more costly than cheaper ones.

My own ongoing work in this area largely bears this first impression out.

The first consequence is that nominal GDP makes poorer regions look like less significant contributors to the national economy than they actually are. Take Yorkshire: it might “only” contribute 6.6% of the UK’s total GDP, but it also has a price level that is probably around 4% below the UK average. As a result, it drags the UK’s average price level down by (very approximately) 0.25%.

That might seem like a tiny amount, but it probably means Yorkshire is £5bn-£6bn bigger than we think. As can be imagined, there are small but potentially significant ramifications for decisions on the regional allocation of government spending on things like infrastructure; we systematically undervalue infrastructure in low-cost regions like Yorkshire, Wales and the North East and overvalue it in high-cost locations like London.

This implies that the economic contribution of anything like Crossrail is likely to be lower than envisioned, whilst improving rail links between Bradford and Leeds is more important. There is also a second – and important – implication of this work.

Specifically, it suggests that differences in industrial mix are bigger drivers of inter-regional productivity differentials than has hitherto been apparent in the data. This is likely to be true across the world, although my own work has focussed explicitly on the UK (which is an excellent test case simply because inter-regional disparities are so large here, at least by the standards of developed nations).

Specifically, the “correct” price level with which to assess comparative regional productivity will vary by sector. At first glance, most differences in nominal productivity between regions do not appear to be driven by the industrial mix. Differences in industrial structure explain approximately one-third of London’s productivity advantage over the UK average.

However, if prices in London are 10% above the national average, this increases to around ½. If the price level in London were 20% above the national average, differences in industrial structure would explain almost all of the capital’s comparative productivity performance.

Moreover, it would appear that London’s productivity advantage is concentrated in sectors dominated by “tradable” goods (specifically professional services, ICT and finance).

At this juncture, it’s worth mentioning that the spectrum of goods and services that fall under the “tradable” label is much broader for inter-regional trade than for international trade. Even when the UK was a member of the EU, if I needed to engage a lawyer or accountant, I could easily do so if they were in Birmingham, Bristol or Bradford. That was not true of lawyers or accountants in Berlin or Barcelona[1]. Now that the UK is no longer a member of the EU, such barriers have increased still further.

Part of this is likely to be because of government policy. Certain financial institutions need to be proximate to the Bank of England. Similarly, it’s hardly a surprise to see that high-value legal activities are located close to the highest courts in the land.

The executive, legislative and administrative functions of government are all concentrated in the same place as the financial and legal centre of the country. Quite aside from being high-value in themselves, these attract a panoply of valuable professional services. Government contracts are often lucrative, not to mention the associated political activities of many actors[2].

As long as all these remain concentrated in a single location, the UK is likely to have a spatially unbalanced economy. Nor is this situation beneficial to the average Londoner, who is faced with unaffordable housing.

Having a government in Berlin, a central bank in Frankfurt and the highest courts in Karlsruhe does not appear to have unduly harmed German productivity. New York remains a financial powerhouse, even though the US government is in Washington DC. It is no accident that Edinburgh – the seat of power in Scotland as well as the financial centre of the country – is one of the wealthiest and most productive places in the UK.

London is a fantastic city. It will remain a financial powerhouse, whether or not we concentrate the institutions of state there, although there are reasons to be wary of moving the Bank of England. It has an independently successful tech and communications sector.

However, moving the executive, legislative and administrative centres of government, as well as the legal centre of power out of the city would benefit all of us. Londoners included.

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[1] For multiple reasons, including differences in legal systems, potential language barriers and knowledge of the relevant bureaucracy. Further afield there are also questions of time zones.

[2] For better or for worse, lobbyists and political groups cluster around government and are typically well-remunerated, contributing financially to the area.