

Structural Change under New Labour

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Abstract

The paper examines specific features of structural change in the UK since 1997, contrasting the decline in industrial jobs with the rise in a variety of service jobs. It examines the proximate causes of structural change, in particular whether the chronically slow growth of manufacturing output in the 1980s has persisted. The implications of this structural change are considered, particularly the effects on the balance of payments and regional employment patterns. The paper suggests that the main impact of government policies on regional employment may have been through the direct and multiplier effects of public expenditure.

96 words

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The main features of structural change in the UK – the decline of industrial jobs with a parallel rise in employment across a range of services – have been discussed for three decades or more (Singh 1977, Rowthorn and Wells 1987). This paper examines the specific features of structural change over the last nine years since the New Labour government under Tony Blair has been in power, drawing on the analysis of two earlier papers (Rowthorn (2005), Rowthorn and Coutts (2006)). The first section reviews structural trends and places them briefly in international perspective. Section 2 examines the proximate causes of structural change, in particular whether the chronically slow growth of manufacturing output, which was such a feature of UK performance in the 1980s, has persisted. Section 3 looks at the implications of this structural change, focussing on the effect on the balance of payments and regional employment patterns. Section 4 reviews briefly what government economic statements have had to say about these issues and suggests that the real impact of government policies on the regions may have been rather different from what was expected.

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I. Structural Change 1997-2005

Figure 1 presents the trends in the overall employment rate (employment/population of working age) and the employment rate in services. The difference between the two represents the proportion of the working age population employed in goods production (industry and agriculture). Since the Labour Party came to power in 1997 there has been a gentle upward trend in the overall employment rate, though in 2005 this was still fractionally below the peak rate reached in 1990. Services have grown considerably faster implying that the long-term decline of employment in goods production has continued. In fact it declined at virtually the same rate after 1997 as it did over the years of Thatcherite restructuring – 1.8% per year compared to 1.9 % over the period 1979-90 – although the fall was somewhat larger during the inter-regnum period 1990-97 when industrial decline was accelerated by the recession of the early 1990s. Indeed one noteworthy feature of structural change under New Labour is that it has occurred without a recession or even a major hiccup in the growth pattern.

Figure 2 provides a little more detail by comparing employment in tradeable goods with the three biggest service sectors (distribution; public administration, health and education³; finance and business services). The decline in goods employment shows up even more starkly in this figure since construction, omitted from tradeable goods,

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³ This sector is called "public services" in what follows to focus on its dominant characteristic; however there is an element of private sector employment included in both health and education and there is also an element of public service employment (for example refuse collection) in "other services" which is included below in the category "other private sector".

has experienced rising employment since 1997. Tradeable goods production now accounts for about one eighth of total employment and one tenth of the population of working age. Both the public services sector and distribution exceeded tradeable goods in employment terms in 1990. In 1999, under Gordon Brown's watch, employment in tradeable goods was also overtaken by employment in finance and business services. By 2005 employment in each of these three big service sectors exceeded that in tradeable goods production by a sizeable margin.

Distribution employment has stayed pretty flat since 1997, no repeat here of the rise in the late 1980s under the Lawson consumer boom. Finance and business services continued to grow strongly, though less rapidly than over the Thatcher period. After 1999, however, there was a strong expansion of employment in health and education as Gordon Brown's early squeeze on public spending was relaxed. This contrasts with the stagnation of employment in this sector during the previous decade. However this rise had a precedent in a little remarked surge in health and education employment under Margaret Thatcher in the second half of the 1980s.

Declining employment in tradeable goods has been the common experience of all OECD countries in recent decades. It is clear from Figure 3, however, that amongst the major OECD economies the decline has been sharpest in the UK. Three decades ago the UK stood out with Germany as "workshop economies" with an unusually high share of manufacturing employment. While this share has declined everywhere, the UK has now joined the pack with an average share of manufacturing employment considerably below Germany's.

The fact that the three big service sectors in the UK substantially exceed tradeable goods in terms of employment was noted above. Table 1 provides some international comparisons for employment in these sectors in 2005. In both distribution and banks & business services employment in the UK is at the high end of the spectrum, but in each case the UK share is exceeded or matched by some other countries – in distribution by the USA, France and the Netherlands, in banks & business services by France and the Netherlands. In all countries the share of employment in distribution has increased rapidly since 1997. In the case of collective and personal services (mainly public services), the UK employment share was at the low end at the start of Labour's period in government, but the gap has subsequently closed as a result of the big expansion of health and education jobs in the UK. Differences between the UK and both France and Germany are greater when employment rates rather than shares are used – reflecting lower employment overall in the latter two economies.

Table 1 Service Sectors – international comparisons

2005	UK	France	Germany	Neths	Sweden	USA
<i>% of Total Employment</i>				†		†
Distribution	26.6	26.6	23.5	25.7	21.6	27.4
Banks & Business Services	15.7	15.9	13.3	16.1	15.6	12.2
Collective & Personal Services	34.0	31.9	30.8	32.4	38.6	36.3
<i>Employment Rates (% of population of working age)</i>						
Distribution	18.8	16.8	15.4	18.6	15.6	18.8
Banks & Business Services	11.1	10.0	8.8	11.7	11.2	8.4
Collective & Personal Services	24.0	20.1	20.2	23.5	27.9	24.9

† Note: most recent data is for 2002.

Source: OECD Labour Force Statistics

2. Causes of Structural Change

Table 2 below compares the UK record under the Tories between 1979 and 1997 with performance since the Labour Party came to power in 1997. The main features to note are as follows:

- (a) Total domestic expenditure and output have both risen much faster under Labour than under the Tories.
- (b) Expenditure on manufactured goods has also grown rapidly under Labour. Despite this, aggregate manufacturing output has not grown at all, whereas in the preceding period it grew at almost 1 % a year. The combination of rising expenditure on manufactures and stagnant domestic production is reflected in an accelerating deterioration in the manufacturing trade balance (as discussed below).
- (c) As always, manufacturing productivity grew considerably faster than productivity in the economy as a whole⁴. Since output was stationary, all of this productivity growth was translated into manufacturing job shedding.

The most striking aspect of structural change under labour has been the continued decline of manufacturing against a background of rapid growth in the service sector. The shift of jobs from manufacturing to services is a feature of virtually all advanced economies and has been underway in this country for approximately four decades. However, the pace of change has accelerated under Labour and manufacturing jobs have been lost at a faster rate in parts of the country where there was already a surplus of labour. Figure 4 shows that in contrast to the UK, manufacturing output in the USA has been quite buoyant and in fact it grew there broadly in line with the output of services.

⁴ Such comparisons are of course dependent on current measures of services output growth.

Table 2

Annual percentage change

	1979-1997	1997-2005
Real Domestic expenditure		
Goods & services	2.3	3.4
Manufactures	1.7	3.4
Domestic production		
Goods & services	2.1	2.7
Manufactures	0.8	0.0
Employment		
Goods & services	0.3	1.0
Manufactures	-2.5	-3.5
Output per employed person		
Goods & services	1.9	1.7
Manufactures	3.4	3.7

Note: Domestic expenditure = C+I+G , domestic production = GDP

Source: ONS and authors' calculations

The role of trade with low wage exporters in eliminating manufacturing jobs in the industrialised countries is a contentious issue. Rowthorn and Coutts (2004, updating Rowthorn and Ramaswamy, 1999) undertook an econometric analysis of manufacturing employment across OECD countries. Their detailed results suggested trade with these countries reduced the UK manufacturing employment share by 1.3 percentage points between 1992 and 2002, about one quarter of the total decline. Assuming this effect has continued at a similar rate after 2002, it would follow that imports from low wage countries have eliminated around 300,000 manufacturing jobs under Labour. This is a net figure which takes into account the fact that some new jobs have also been created in the manufacturing sector through the export of high-tech products to the low wage economies.

3. Implications of Structural Change

This section considers whether recent structural change has been benign in the UK – simply reflecting differential sectoral growth rates of demand, productivity and international specialisation – or whether it is giving rise to significant structural “problems”. Discussion on this issue has tended to focus on two issues – the current account of the balance of payments (the ability of the UK to continue “paying its way”) and problems of labour market adjustment particularly within the old industrial regions most affected.

(i) Manufacturing and the balance of payments

The seminal paper on UK deindustrialisation by Ajit Singh (1977) concentrated on implications for the balance of payments. As Rowthorn and Wells (1987) emphasised, the UK had been unusually dependent historically on manufacturing, and the capacity of manufacturing industry to generate sufficient exports was a major preoccupation in the immediate post war decades. We noted in section 1 that there has been a very rapid growth of net imports of manufactures into the UK. How has the current account of the balance of payments overall fared?

Figure 5 shows that the current account has deteriorated after 1997 and for several years there has been a deficit fluctuating around 2% of GDP. As well as the conventional current price measure of the current account (continuous black line), the diagram also shows a constant price measure⁵. The difference between the two series shows the impact of terms of trade changes. Without an improvement in the terms of trade – fall in import prices relative to export prices - the deficit would have increased by an additional 1% of GDP⁶.

During the period in question, the trade deficit in manufactures got much larger and there was also some deterioration in the balance on “other visibles” (Figure 6). However, these losses were mostly offset by a substantial improvement in the invisibles balance. Which invisibles have come to the rescue? Figure 7 shows that much of the improvement in invisibles has been concentrated in the so-called “knowledge-based services” – finance and business services such as consulting, engineering, computer & information services, R&D etc. “Traditional” services, above all tourism, have yielded a growing deficit⁷. But just as important as success in knowledge-based services has been a rise in net investment income from rough balance in the early 1990s to a surplus of 2% of GDP now – an impressive result and quite a puzzling one since the current account has been in persistent deficit for over two decades (which in itself must increase net overseas debt, the UK having become a debtor country in the past decade), and the pound has been very strong (which should hit sterling earnings from overseas assets). Nevertheless there was a surge in UK returns on direct investment abroad, which brought net earnings on this type of

⁵ This is calculated as the current account surplus plus the difference between exports and imports of goods and services at current as compared to constant (2003) prices. Implicitly therefore no adjustment is made for a “terms of trade” for transfers. It is striking that the terms of trade for UK imports and exports of manufactures have hardly changed since 1997 – prices of both having fallen by about one sixth.

⁶ This calculation ignores the fact that there would have been some offsetting volume effects (slower real growth of net imports) but these would have been small.

⁷ We have adopted a broad definition of knowledge-based services as all services other than the traditional services – the latter being transportation, travel and government services. Education-related services should also be included in the knowledge-based group, but they do not easily fit this classification. These activities include tuition fees and purchases of goods and services of foreign students taking courses in the UK, fees and education products for students taking courses in their own countries, examination board earnings and publication of education materials including broadcast programmes. An estimate of the services earnings from education for 2001-02 based on Johnes (2004) is £8.2 billion. In the balance of payments accounts these earnings are scattered throughout various parts of visible and invisible trade, but some of it is attributed to travel services. In our classification the surplus on education-related services helps to offset the large deficit on tourism, which for 2001-02 was about £15.8 billion.

investment up from near balance in the late 1990s to a surplus of almost £45 billion in 2005⁸.

A final point on the balance of payments concerns the “other visibles” portion (Figure 6), which has wobbled along in modest deficit for about two decades. This part of the account is quite vulnerable to two influences. First, rising commodity prices tend to bring deterioration as is evident already in the data for the last couple of years. Secondly this account had previously received a massive boost when North Sea Oil came on-stream (it was in deficit to the tune of 6-10% of GDP in the first half of the 1970s). This masked the decline of the coal industry - a spectacular example of structural change in itself but one that had mainly run its course by the time New Labour came to power. However it is now North Sea Oil which is running down and by 2025 the UK will only be 25% self-sufficient in energy according to official projections. So the prospect is for a worsening energy deficit, compounding any continuing weakness of manufacturing exports.

To summarise the above discussion, a substantial deterioration in the manufacturing trade balance has had a rather muted effect on the current account for three reasons. Firstly, the overall terms of trade have moved in favour of the UK, benefiting the current account to the tune of 1% or more of GDP since 1997. Secondly, there has been a fortuitous rise in net investment income from abroad. Thirdly, the knowledge-based services have done very well, despite the overvalued exchange rate which piled such pressure on UK manufacturing exporters. However the UK does seem vulnerable to a downward fluctuation in net investment income, to deterioration in the terms of trade and to a worsening of the deficit on the energy account. It is unlikely that growing exports of knowledge-based services could be relied on to offset such developments.

(ii) Structural change and regional patterns

The decline in tradeable goods production has affected the old industrial “North” of Britain more than the more service based “South”, whilst the latter has gained more from the expansion of finance and business services. This has exacerbated a long-run shortfall of jobs in the North and contributed to a gradual shift in the balance of population as inter-regional and international migration responds to differential employment opportunities. This section reviews in more detail how the employment structure in the North and South has evolved over recent decades and whether there is evidence of a change in trend in the most recent experience.

When considering a regional economy, it is important to distinguish between goods and services that can be traded across the regional boundary and those which must be supplied locally. The terms “tradeable” and “non-tradeable” are used to denote the two

⁸ Balance of payments measurement conventions record retained earnings from foreign direct investment abroad (FDI) as an income credit, while at the same time treating the retained earnings as additional direct investment and therefore as a debit on the financial account (IMF, 1993). This procedure can raise problems of interpreting the underlying rates of return on FDI, particularly where the investments are mainly financial transactions in equity. Godley (2003) has pointed out some of the oddities of the measurement conventions. While we are not aware of evidence that the conventions result in systematic bias in the estimates of the UK net income from FDI, this is an area that requires further research, since the sustainability of the UK current account depends crucially on the strong performance of net income from investment and tradeable services.

categories. The tradeable category includes most agricultural products, fuels, minerals and manufactures, a large part of financial and business services, together with smaller parts of other sectors. Some public services, such as national administrative offices, also belong under this category, since they provide a service to the areas of the country outside of the region in question. In practice, the dividing line between the two categories is by no means clear, and the difference between tradeables and non-tradeables is a matter of degree. In this paper, we classify all agricultural products, fuels, minerals and manufactures as tradeable goods. We also use finance & business services as a proxy for tradeable services. This is not an ideal approach since this sector includes many local activities that require geographical proximity for their delivery. Conversely, there are other sectors that contain tradeable components, such as hotels and restaurants serving visitors to the region (or locals who would otherwise travel outside of the region to obtain these services). Some public services are also tradeable, such as higher education institutions which attract students (and their fees). By using finance & business services as a proxy for tradeable services, we assume that wrongly included and wrongly excluded items cancel out.

The distinction between tradeables and non-tradeables is important because it gives us some idea of the underlying economic strength of a region and its ability to autonomously generate incomes and employment of all kinds. If a region produces a very small amount of tradeable goods and services, it will be much poorer than the rest of the country and will normally be supported by large fiscal transfers from the central government.. Such transfers will reduce the gap between the region in question and the rest of the country, but they will not eliminate this gap entirely. Unless the region can generate more tradeable activities, it will remain comparatively poor, with lower than average incomes and a lower than average employment rate. In analysing the evolution of inter-regional differences, it is therefore important to identify the independent generators of wealth. It is for this purpose that we identify employment in tradeable activities as a separate category. Such employment provides a useful, albeit crude, indication of a region's underlying economic strength⁹.

The reference point in Figure 8 is the continuous thick line showing the ratio of the population of working age (shortened to population below) in the North to the population in for the South.¹⁰ The downward slope indicates a prolonged decline in the North's share of population although there are now signs that this may be coming to an end. In absolute numbers, population in the North stagnated until around the year 2000, but since then it has been rising quite strongly. However, population in the South has risen even faster, so in relative terms the Northern share has continued to fall, albeit at a much slower pace. An important element in this story is the role of migration. At one time, there was a net outward flow of people from the North and a net inflow into the South (Figure 9). This was a major factor behind the stagnation of population in the North and the growth of population in the South. Since 2000, however, the net outflow of population from the North has been reversed and like the South it is experiencing net inward migration. This is arithmetically possible because Great Britain as a whole is gaining population through immigration from abroad.

⁹ The regional role of tradeables is discussed more fully in Rowthorn (2000).

¹⁰ Here the South comprises Greater London, the South East, the South West, the East Midlands and the East, whilst the North represents the rest of England plus Wales and Scotland. Fortuitously dividing the country up in this way leaves the North and South with populations of very similar size.

The dashed line for comparative total employment in Figure 8 lies systematically below the population line, showing the persistently lower employment rate in the North. In the 1980s, employment fell faster in the North than the South, and the widening gap with the population line shows that the fall in the employment rate was larger too. The North-South divide was reasserting itself with a vengeance.

The series for tradeable goods, lying well above the population line, shows how dependent the more industrialized North had been on this sector. Such dependence made it especially vulnerable to the industrial crisis of the early 1980s; moreover, the crisis was especially severe in the North so that the proportionate fall in tradeable goods employment was much greater than in the South. Conversely, financial and business services employed far fewer people in the North, with the line representing the employment ratio between North and South far below the line for population. Thus the North gained much less from the expansion of finance and business services (which includes a sizeable tradeable element - finance, law and consulting firms mostly concentrated in London). The downward slope in the finance line throughout most of the period shows that the proportionate rate of growth of jobs in this sector was slower in the North, as well as starting from a lower base.

As noted earlier, our category “public services” consists of mainly public sector employees but it includes an increasing number of private sector providers of health and education services. Employment in public services in the North was less than the population share in the 1980s, but subsequently has grown faster there so that it had become a more important provider of jobs in the North than in the South by the mid-1990s (when the public services line crosses the population line). “Other private sector” (mainly non-tradeables like distribution and construction) has consistently employed fewer people in the North, no doubt reflecting lower incomes per head.

The North suffered less across the board in the recession of the early 1990s, and this pulled up the “other private sector” line along with the other sectors. This narrowing of the gap between North and South looked to have been a temporary hiccup as the subsequent recovery brought faster employment growth in the South, except for public services. However, from around 2000 a change in trend emerged. Employment has been growing proportionately faster in the North, and with population still growing somewhat faster in the South, the gap in employment rates has definitely narrowed. Initially the improvement was mainly in public services, but latterly these have been growing at similar rates in the two parts of the country. More recently other private sector jobs and perhaps most interestingly finance & business services have been growing proportionately faster in the North (though from a much lower base). This is really quite a striking turnaround.

A more precise appreciation of trends under Labour can be gained from Table 3 below which compares 1997-2005 with the preceding 8 year period. The employment to population ratio fell a little in both North and South between 1989 and 1997, but after 1997 the position in both regions, especially the North, improved quite markedly. During the latter period, the North lost jobs in the tradeable goods sector even faster than in the earlier period, but this was more than offset by rapid growth in other sectors, above all finance & business services and public services. As a result, total employment in the North grew by 0.7% a year faster than population of working

age, whereas in the South the two grew almost the same rate. As a result the employment gap between North and South has closed by some 3%. As compared to the previous period, the main differences were that the South was no longer drawing further ahead in terms of jobs in finance and the North was catching up in terms of other private sector where there was slightly faster growth in the North across the board - construction, distribution, transport and other services. The benefit to the North from faster growth of public services since 1997 was a continuation of the earlier trend, but none the less important for that¹¹. Taking the whole period since 1989, without the direct effect of public sector jobs the number of people in employment in the North would have grown no faster than the South. We shall return to this point in the final section.

¹¹ The importance of the expansion of public sector jobs for employment in the North, and the weakness of private sector job creation, was emphasised in an article by Chris Giles entitled "Forgotten Britain: how Labour has presided over a deepening divide" (Financial Times *March 20*, 2006). However the impression from this article was that the divide has increased under Labour, which is not true in terms of the overall employment rate as was shown above.

Table 3. North and South Employment and Population Trends 1989-2005**Average annual percentage change**

	South 1989- 1997	North 1989- 1997		South 1997- 2005	North 1997- 2005
<i>Employment</i>					
Tradeable Goods	-2.3	-2.0		-3.3	-3.6
Finance and Business Services	2.5	1.4		2.2	3.2
Other Private Sector	0.3	-0.3		1.2	1.5
Public Services	0.1	0.9		1.9	2.6
Total Employment	0.2	-0.2		1.0	1.1
Population of Working Age	0.4	-0.1		0.8	0.4

Source: Calculations from Regional Forecasting's database, by kind permission of Graham Gudgin.

The improvement in the relative position of the North over the past five years is encouraging. But the gap in employment rates is still some 5 % points – about one half of the maximum differential in the second half of the 1980s. Even quite modest differences in employment rates for the two halves of the country may translate into much bigger differences for disadvantaged groups and in smaller, but still substantial, areas. Regional differences in employment rates are very small for the highly qualified and even for those with middling qualifications. But for the least qualified, differences in the chance of being in work are still huge (Figure 10). Even prime age men were some 20% less likely to be in work in the North East than the South East in 2001; within some metropolitan areas like Merseyside the shortfall in jobs as compared to the South East was larger still (see Erdem and Glyn 2001). Hopefully, the recent improvement in employment in the North has been filtering through to these workers as well but there was a very large shortfall to make up¹².

¹² Calculations from the Labour Force Survey by Jonathan Wadsworth suggest that the gap between the employment rates of the least educated in the North and South has declined somewhat since around 2000 (personal communication).

4. Government Policies

Whilst the issues discussed above have implications for a wide range of government policies, we only have space to touch briefly on the implications of structural change discussed earlier in this paper. Accordingly this section reviews the government's relatively relaxed attitude about structural change, covering first the balance of payments and then regional employment implications. We note in the latter context a sharp contrast between the Government's supply-side rhetoric, and the very important demand-side effects of public spending in helping to reduce regional employment differences in the past few years

A typical, optimistic, Treasury statement about structural change is the following:

“changes in the structure of employment and production are a necessary part of economic development and flow not just from openness to trade but also from technological developments and changes in consumer preferences. The benefits of structural change are apparent in hindsight but often resisted as they occur.....The process of redeployment inevitably brings transitional costs, which may fall particularly heavily on those least well-equipped to cope with change – for example those with non-transferable skills. But the outcome for the economy as a whole is positive and there is a great deal governments can do to minimise transitional disruption to individuals.” (Treasury 2004 paras 2.15, 2.16)

To ease such adjustment costs, an adequate system of benefits and in particular improvements in skill provision and acquisition are emphasised.

The implications of long-term decline in the net exports of manufacturing receive no attention in the Treasury's annual budget statements; indeed the current account of the balance of payments, which used to be such a policy preoccupation a generation ago, barely rates a mention, let alone a longer term analysis. There are hints in the comments on the beneficial role of the City in contributing to net exports that there could be a gap to fill (Treasury 2005 para 1.4), but no analysis of how it has emerged or might develop.

The DTI, with specific industrial responsibility, published a Manufacturing Strategy (DTI 2002) which said that manufacturing was “crucial to our country's prosperity, now and in the future”. It noted that manufacturing employed 4 million people, accounted for 60% of exports, but that its productivity level lagged behind European rivals. Such perennial problems as investment and workforce skills were discussed but one of the “pillars” of the strategy was macroeconomic stability, a matter on which the government, and of course the Chancellor in particular, takes such pride.

The remarkable stability of economic growth over the past decade has diverted attention away from one obvious problem – the extremely high value of sterling. The series for relative unit labour costs in manufacturing – the best measure of the real exchange rate - appreciated by one half between 1993 and 2000. It reached a higher level than the peak after the monetary squeeze in the early 1980s and the present high level has been maintained for the last six years (OECD Economic Outlook June 2006 table 43). The DTI voiced a hint of reservation about this: “experience shows that changes in exchange rates by themselves don't explain the medium- to long-term

success or failure of national manufacturing sectors. Nevertheless the weakness of the euro [not the strength of sterling – authors] has been a real source of problems for many manufacturers.” (DTI 2002 p 19)

The Treasury itself discussed the strength of sterling in its 2003 document on “The Exchange Rate and Macroeconomic Adjustment” issued as part of the review of possible UK adoption of the Euro:

“Empirical analysis suggests that exchange rate movements have not been a significant source of shocks to the UK economy as a whole. Instead exchange rate changes appear to have absorbed shocks that might otherwise have had a greater impact on UK output and prices. A striking example of this is sterling’s strong appreciation after 1996, which did not result in higher unemployment or a collapse in inflation, but nonetheless restrained the net export contribution to demand and thus probably alleviated some of the inflationary pressure that might otherwise have occurred.” (para 7.4)

The Treasury did admit to “large exchange rate changes posing particular difficulties” for importers and exporters but there was no discussion of potential long-run damage to the traded goods sector. The respite given to the traded goods sector by the depreciation at the end of 1992 is obvious in Figure 6 above, together with the resumption of rapid decline of traded goods jobs as sterling appreciated under the Blair government. As noted earlier, the balance of payments has performed better than might have been expected given the high real exchange rate in recent years, but this has owed a good deal to fortuitous improvements in the terms of trade and overseas investment income and in the future the balance on energy trade is certain to decline as well. The Treasury’s implicit position that persistent current account deficits do not matter may yet turn out to have serious longer-term consequences for the UK economy.

The Treasury has also taken an optimistic view of the impact of structural change on regions. In its 2001 paper *Productivity in the UK: 3 – The Regional Dimension* it conceded that “a region’s industry mix plays some role in explaining individual regions and localities’ economic problems”, but then argued that “on the whole it does not critically constrain a region’s growth potential” (box 2.1). By 2004 the claim was bolder: “The impact on the economy of these structural shifts, due to both trade and technological change, has been strongly positive. Wages in both manufacturing and services have risen, reflecting productivity gains. Employment as a whole has risen. Those regions which depended heavily on manufacturing have maintained their share in total employment, reflecting the creation of new jobs in non-traditional sectors” (Trade and the Global Economy 2004 para 2.27). As a statement of fact this last statement is simply wrong, as the discussion in the previous section showed.

The Treasury’s approach to the regions has been to play down the systematic concentration of joblessness in some large areas of the country arguing that it is sub-regional disparities which are the problem. “Despite the strong labour market performance of recent years, within *every* region there remain localised pockets of high worklessness and deprivation (our emphasis)....Local authority districts that suffer from low employment rates do not simply lack jobs. Many are found alongside other districts with large numbers of vacancies or jobs....The Government’s goal of

full employment in every region therefore requires policies to address the barriers which prevent local people from taking local jobs” (Treasury 2002 Economic Statement para 4.38).

The policy conclusion has been to focus on supply side improvements, characterising post-war regional policy as “ambulance work getting help to high unemployment areas” and the incentives to investment in the regions in the 1960s and 1970s as inflexible, top-down and ineffective (Balls 2002 p 12).

As we saw earlier in the paper, there has been a distinct improvement in the employment situation in the North in the past five years or so. Three possible explanations suggest themselves:

- (i) Supply side improvements under the aegis of the Regional Development Agencies have slowly worked to increase the attractiveness of the North for investment;
- (ii) Prolonged economic expansion has radiated out from the South as bottlenecks and constraints were felt there;
- (iii) The government’s expansion of the public services, plus infrastructural investment, has provided a large injection of aggregate demand into the regions.

These three factors are not mutually exclusive and may all have played a role. The point to be stressed here is that an old fashioned injection of aggregate demand (factor iii) has most probably been a very important influence despite the Treasury’s disdain for such an approach. The most visible measure of public spending on jobs is provided by our series for public service employment, which has expanded especially fast in the North over the last decade and very rapidly everywhere including the North over the past five years. However, less than half of the money spent on public consumption goes on public sector wage bills, and the majority is devoted to goods and services that are bought in or contracted out to external suppliers. Public investment in the regions also creates demand for construction¹³. Thus, public consumption and investment have a much larger impact on regional employment than is reflected merely in the series for public service employment. Referring back to Table 3 above, a substantial part of the expansion of private sector employment in the North, including finance and business services, must be a spin-off from rising public expenditure. As noted in the previous section, public service employment alone accounts for virtually all of the increase in employment in the North since 1989, and for much of the growth since 1997. The point to be emphasised here is that the total amount of employment created by public spending is much greater than this direct effect, once government purchases from the private sector are included as well. If we take into account these further direct and multiplier effects, it seems plausible that the entire growth of employment in the North since 1997 is the result of public expenditure.

An analysis for the UK as a whole (Edmonds and Glyn 2005) found that all the net job creation since 2000 could be statistically attributed to the expansion of public

¹³ Note that the public services employment category includes some private sector workers provided they are employed in the first instance by the private sector (agency nurses working in the NHS).

spending. As the authors point out, such a finding should be interpreted with care, since it is always possible that some of the employment created by public spending is at the expense of other types of employment. Indeed, this is true as a matter of arithmetic in an area where there is already full employment and there is no migration across its boundaries. There is no area of the UK where these conditions hold completely. However there are parts, especially in the South, where they held sufficiently, at least until the recent rise in inward migration from the EU accession countries, to imply that jobs created by public spending have been mostly at the expense of other jobs. Conversely, there are also many areas in the country, especially in the North, but also in parts of the South such as inner London, where there is a large surplus of certain kinds of labour. To the extent that public spending creates a demand for such labour, many of the jobs created by it are likely to be additional to existing employment. This is most likely to be the case if expenditure is financed by levies on people outside of the area concerned. For example, suppose that taxes are levied disproportionately on employed people in the South and are spent disproportionately in depressed areas of the North which have a large surplus of labour. This will not only create jobs in these areas, but it will also increase the share of the North as a whole in national employment. Even a uniform increase in public spending will alter the national distribution of employment, since its employment creating effects are more likely to be offset by crowding out in the South than in the labour-surplus North.

The above argument is based on standard multiplier theory and does not take into account the incentive effects of public spending. These are slow to operate and may be positive or negative. On the positive side, public spending may finance urban renewal and make some of the old industrial areas more pleasant to live in. It may also add to the human and physical capital of the area through education and infrastructural investment. All of these are factors that may induce firms to do business there and build up the local economic base. On the negative side, the prospect of a secure public sector job paid at national rates may prop up local wages and make the area less competitive in national and international markets. Moreover, the prospect of such a job may deter talented individuals from committing themselves to the riskier private sector.

The incentive effects outlined above are potentially important, but we are not able to quantify them, although it is our view that on balance the positive effects greatly outweigh the negative ones. Others may disagree. What does seem fairly clear, however, is that the direct and multiplier effects of public spending have had a powerful and immediate impact on employment in the North and on the share of this region in the national total. It is striking that the government is so reluctant to acknowledge this effect, which has contributed in a very important way to the improvement in employment in the least prosperous regions of the country.

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Figure 1 UK Total Employment and Services 1979-2005:
as % of Population of working age

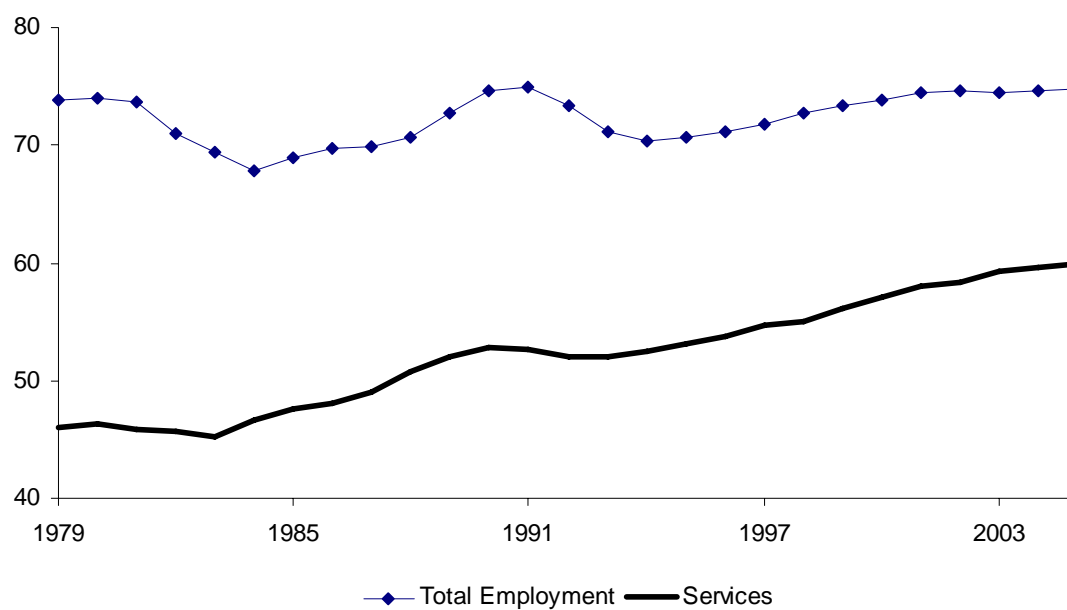
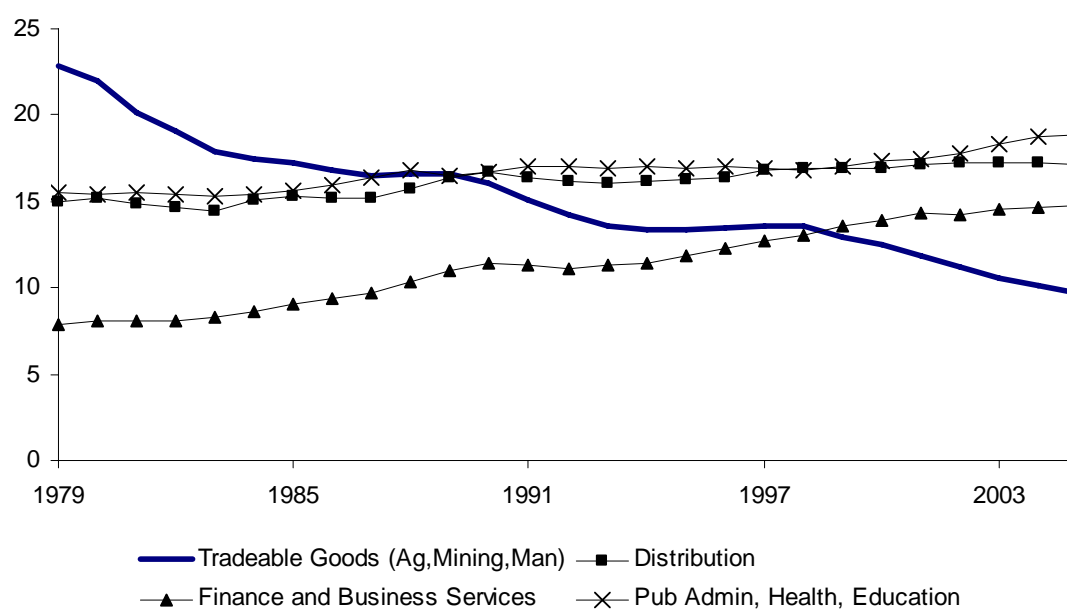


Figure 2: UK employment patterns: 1979-2005
as % of Population of working age



Source: calculated from series on ONS website

Figure 3: Share of Manufacturing Employment in Europe and North America

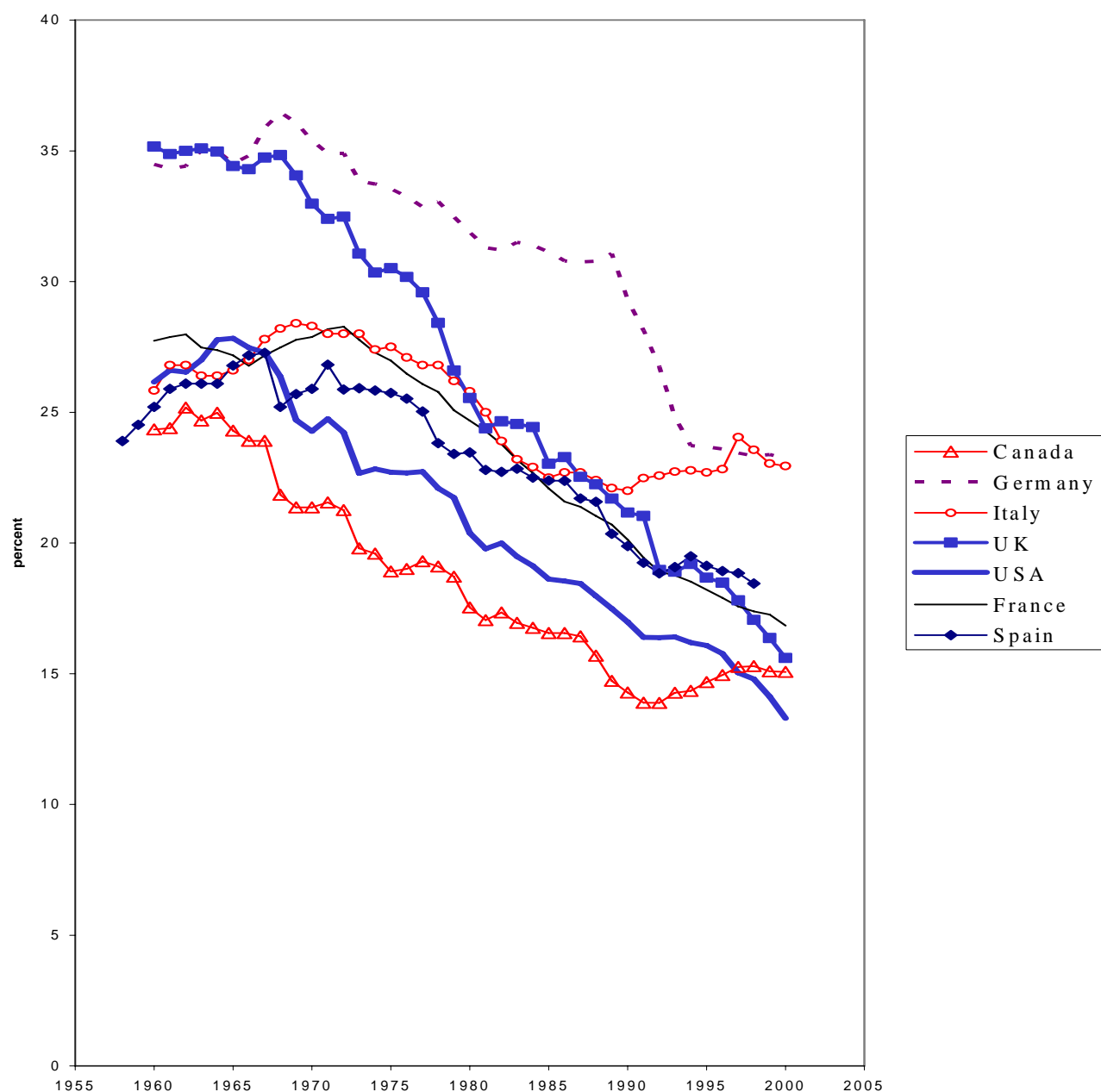


Figure 4: Manufacturing Output and Employment
logarithmic indices

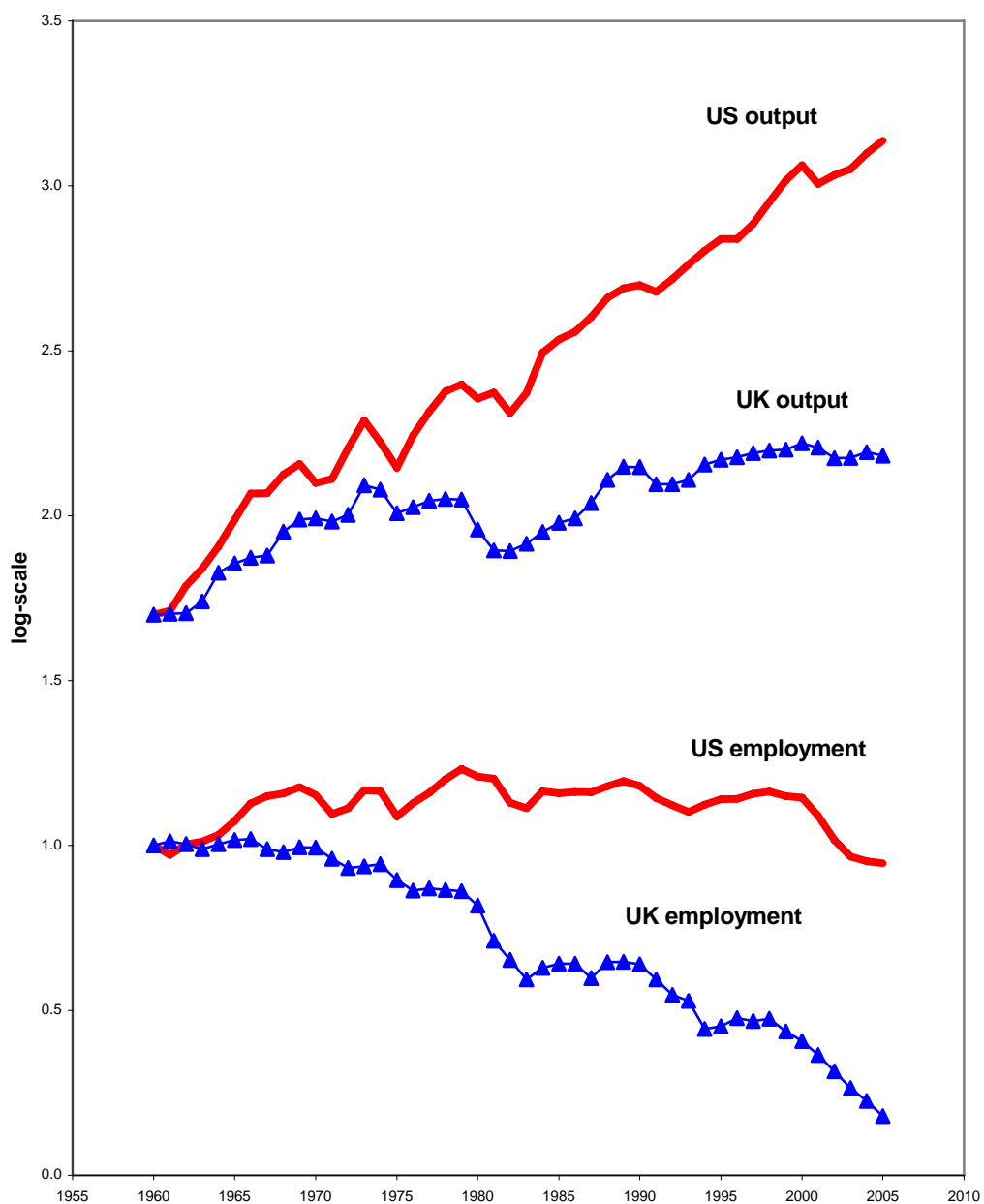
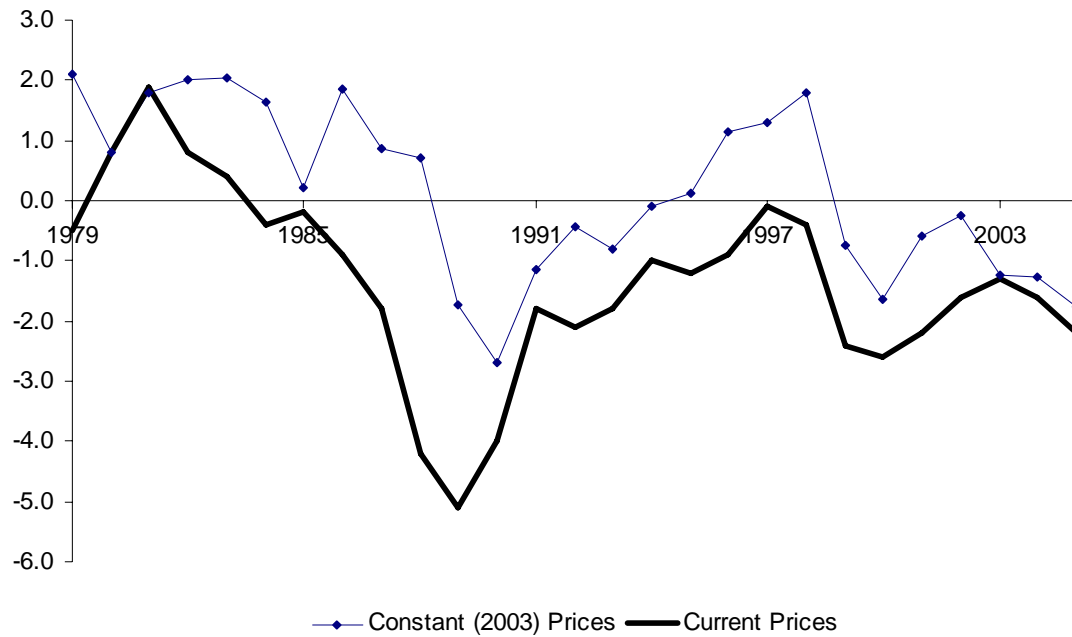


Figure 5 UK Current Account % GDP, 1979-2005



Source: UK Pink Book, database on ONS website

**Figure 6: Components of the UK Balance of Payments
1970 - 2005
current prices**

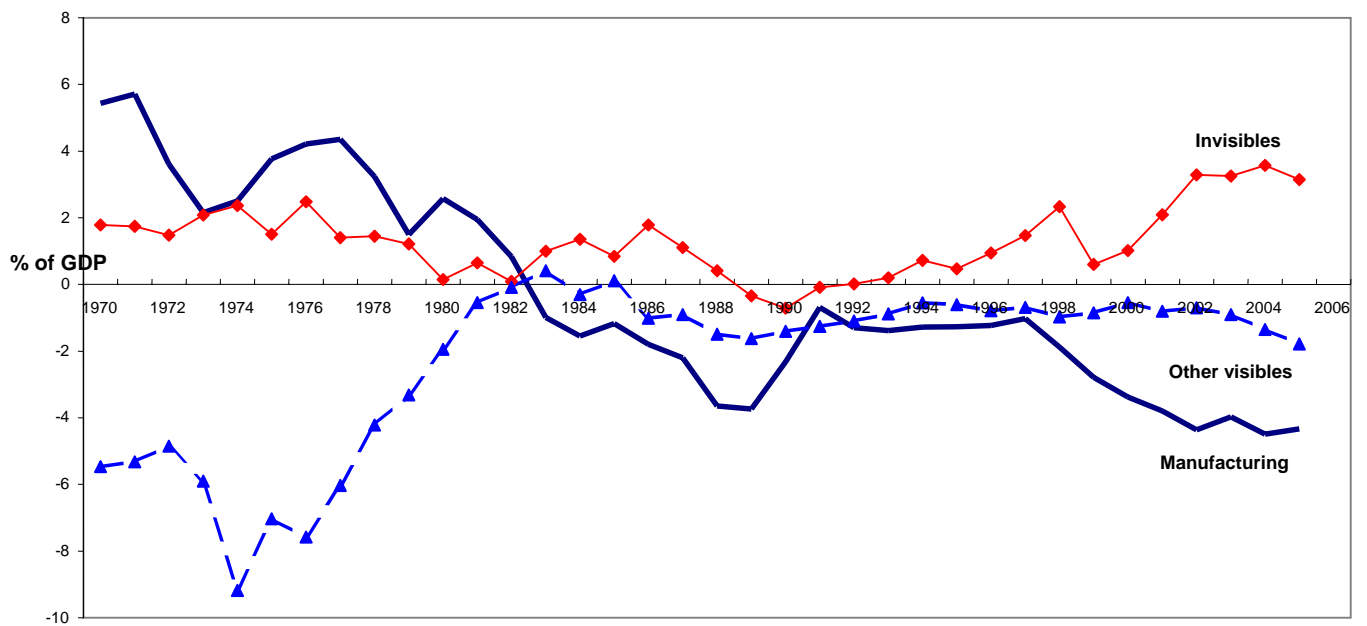


Figure 7: Invisibles component of the UK Balance of Payments
1987 - 2005
current prices

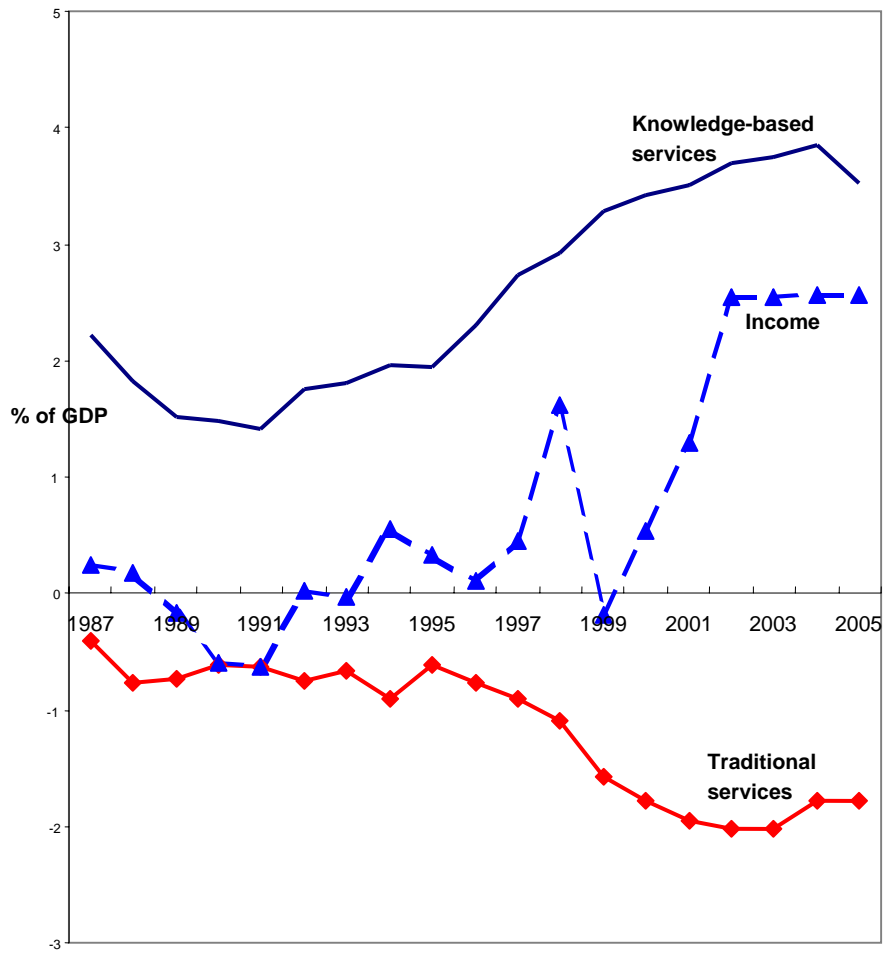
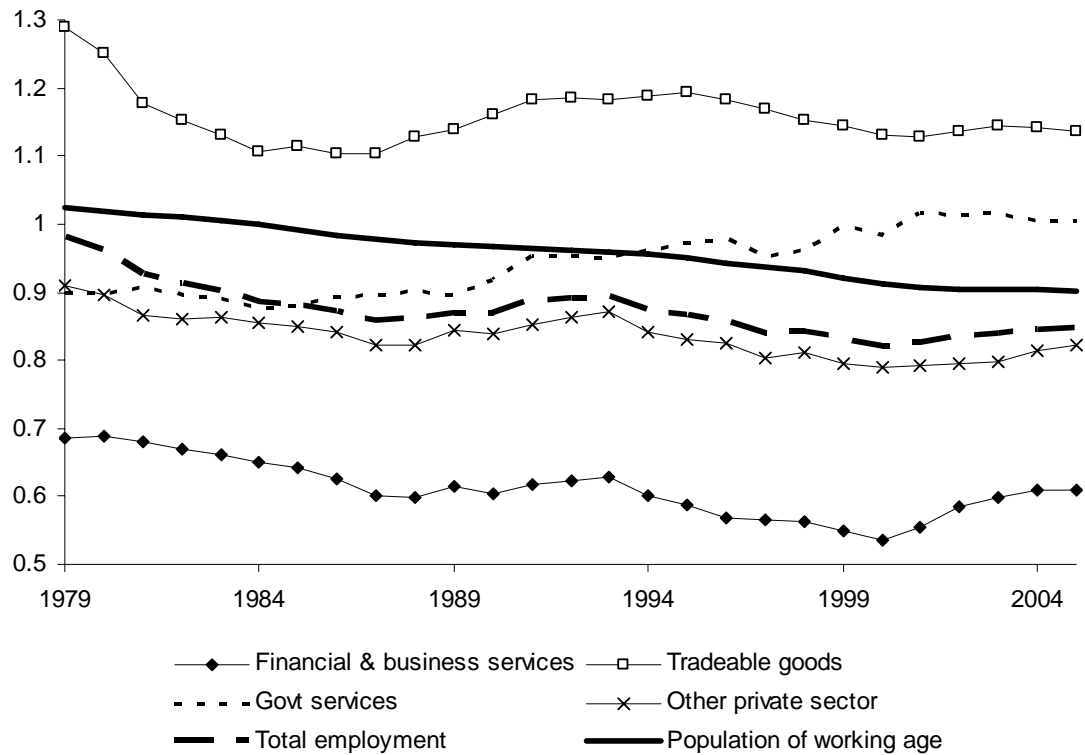


Figure 8 North/South Employment and Population 1979-2005
ratio of employment in North to employment in South



Source: elaboration of data in Regional Forecasting's database.

Figure 9: Net Migration (Working Age): 1971 - 2004
thousands

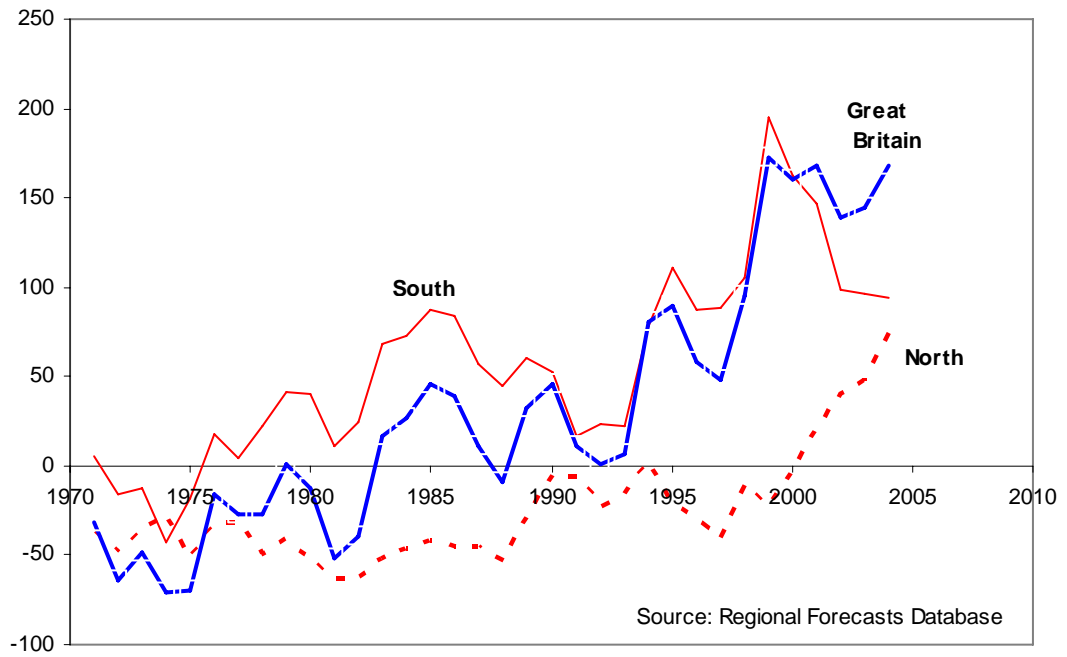
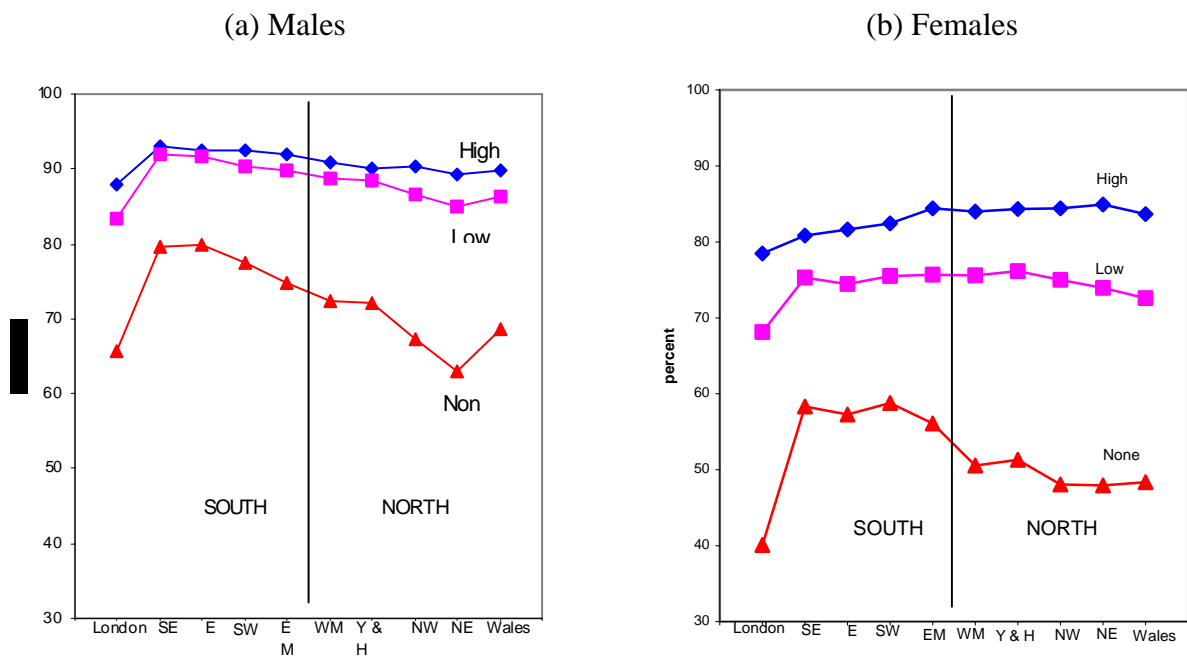


Figure 10: Employment Rates for Age 25-49 by Qualification, 2001



Source: Anne Green, University of Warwick