UK COMMISSION FOR EMPLOYMENT AND SKILLS

# Rebalancing the economy sectorally and spatially: An evidence review

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Intelligence > Investment > Impact

# Executive Summary

## Study objectives and approach

The need to '*rebalance'* the economy as the UK recovers from recession is a high priority for the coalition government. As set out in the Plan for Growth published on 23 March 2011, the government aims "to achieve strong, sustainable and balanced growth that is more evenly shared across the country and between industries" going forward. Whilst there is substantial commentary on the intent to achieve '*rebalancing'*, there remains a lack of clarity and agreement on what '*rebalancing'* means: some commentators refer to the balance between public and private employment, sectors (especially manufacturing and services) and London/the South East and elsewhere in the UK; others refer to '*rebalancing'* in the context of public spending and receipts, imports and exports, and domestic/public consumption and business investment, and, most generically of all, between economic, social and environmental outcomes. Furthermore, there appears to be limited formal articulation of the rationale for the government to intervene in the '*rebalancing'* process, how '*rebalancing'* might be achieved most effectively, and how the inherent tensions and trade-offs in addressing different elements of the '*rebalancing'* challenge should be managed.

Against this background, this study explores the issue of *'rebalancing the economy, sectorally and spatially'*, identifying where possible the role of, and implications for, skills and employment policy. The work collated and reviewed UK and international literature in order to better understand the following issues:

- the nature and scale of the *'rebalancing'* challenge in the UK, and its causes;
- the rationale for state intervention in the sectoral and spatial structure of the economy, both in the UK and abroad;
- types of interventions that have been employed by governments to influence the sectoral and geographical structure of the economy, particularly in terms of skills and employment interventions;
- what works and why in *'rebalancing'* economies sectorally and spatially;
- what might be done in the UK to create a more (re)balanced economy, and the implications for, and on, skills policy in supporting this process.

The study involved an extensive review of relevant conceptual, empirical, policy and evaluation literature from the UK and abroad, complementary case studies on '*rebalancing*' in Finland, Germany, Korea, Netherlands and Germany, and formal projections of the amenability of the UK economy to '*rebalancing*'. As part of the study, a typology of interventions was also developed to help classify the different types of actions that had been introduced to assist in economic *'rebalancing'*, reflecting the intensity of intervention by the public sector, and the extent to which resulting outcomes were tangible and/or intangible. The research took place between January and early March 2011, with subsequent analysis and reporting in late March and early April.

| | *Tangible* | *Mixed* | *Intangible* |
|---|---|---|---|
| *Setting the ground rules, direction/promoting the efficient operation of the market* | | | |
| *Building enablers/ conditions for growth* | | | |
| *Tilting the playing field/ playing the role of principal actor/agent* | | | |

The research was undertaken by SQW Ltd, in collaboration with Cambridge Econometrics Ltd (CE), the Centre for Urban and Regional Development Studies (CURDS), and the Institute for Employment Research (IER).

## Overview of findings

### Nature and scale of the '*rebalancing*' challenge

The term *'rebalancing'* has become used increasingly as a metaphor for a wide variety of changes seen to be required in the UK economy relating to its sectoral structure, shifts from public to private sector activity, differences in economic performance across spatial areas, and/or the balance between economic, social and environmental considerations. The first conclusion of the study is that, even though the term is of recent origin and has multiple interpretations, ***'rebalancing'* matters in a substantive sense.**

That said, **clarity is needed about what the term '*rebalancing*' the economy means in particular contexts**. The wide nature of the *'rebalancing'* challenge means that policy makers need to take integrating approaches to *'rebalancing'* action in their policy areas and in links with other policy areas. In the skills and employment arena, this might mean, for example, taking a holistic view of actions to address the issue of the general skills needed for trading overseas, as opposed to focusing narrowly on a specific tradeable sector.

The evidence also unambiguously shows that **there is little common agreement on the detail of what an *'optimal balance'* might be in the sectoral and spatial sense,** and there are very **few examples of direct relevance to UK's governance and planning contexts where '*sustained rebalancing'* has been realised.** It is legitimate, nevertheless, to be concerned about the need for *'rebalancing'* even though it may not be possible, or even appropriate, to paint a detailed endpoint of what balance looks like at the microeconomic level. Indeed, the endpoint itself is a moving target. For policy makers in general, this means acknowledging there is no 'silver bullet', and '*rebalancing'* objectives and actions need to be considered in process terms rather than as a well-defined endpoint.

There is a related and important definitional point here, that **microeconomic '*balance'* does not necessarily equal growth, and is not necessarily desirable in all contexts**. For example, achieving a balanced low-skills equilibrium of low value added, low skills and low wage employment, is not a desirable outcome .

Whilst there may be definitional issues about what constitutes microeconomic '*balance*', **the evidence and economic data confirm clearly that the *'rebalancing'* challenge, in all forms, is a long-standing one**. Sectoral change over the last 40 years has been driven by globalisation and resulting market and technological change, and this will continue to be the case. Western economies have shifted from manufacturing towards services and knowledge-based economies seeking to compete on content rather than price. Concerns about 'deindustrialisation' have been around for several years and, in the UK, these have been strengthened by more recent specialisation on financial services and the lack of resilience that this was seen to provide to global shocks and uncertainty. Growing spatial imbalances reflect patterns of agglomeration, and have led over many decades to some places being significantly and persistently more vulnerable to, and less capable of responding to, these sectoral shifts.

Consequently, the challenges of imbalance and *'rebalancing'* are widely experienced by the UK's competitors, and economies more generally worldwide. Decomposing GDP by its components of expenditure, the UK's broad balance is typical of several other large developed economies such as Canada, France, Italy, and further afield in New Zealand. **Therefore, whilst the UK's '*rebalancing'* challenges are significant, they are not unusual internationally.** Differences in productivity growth have also played a major role in the widening imbalances in economic performance, and skills disparities are a key factor in explaining national and regional productivity differences. Whilst the label may be new, **the issue of *'rebalancing'* is not unique to the UK, and one in which skills and employment issues in particular are key elements.** This provides a strong general argument for interventions designed to assist *'rebalancing'*.

The study has also found that **there are significant tensions and trade-offs involved in addressing the *'rebalancing'* challenge, with potential negative feedback effects between the macro and microeconomic *'rebalancing'* dimensions.** Interventions to support *'rebalancing'* on one dimension may have unintended adverse consequences for balance elsewhere. In particular, and drawing from the study's macro scenario projections, achieving macroeconomic balance at national level and shifting from the public to the private sector as a source of employment is almost certain to lead to greater spatial imbalances. These have not always been articulated fully in recent UK policy debates. The Office of Budget Responsibility's forecasts expect private sector job growth to compensate for the loss of public jobs nationally. This will go some way to rectify the public-private sector imbalance at an aggregate level. But, at the sub-national levels at which most labour, skills, and enterprise markets work, **the private sector may find it very difficult to compensate for lack of public sector job growth in areas where it has performed poorly in the past.** This potential negative feedback loop of macroeconomic action on the microeconomic context needs to be considered in the design of any '*rebalancing'* interventions.

## Rationales for intervention

There is considerable debate in the literature as to whether government can and should intervene with respect to *'rebalancing'* in a sectoral and spatial sense, which has clustered around the following issues:

- Deadweight public sector costs (expenditure that does not result in additional activity)
- The risks that such interventions are not sustainable without on-going support
- Distortive effects caused by the allocation of resources and unintended adverse effects elsewhere and/or at a later date.

These concerns are most obviously evident within a neoclassical growth framework, in which spatial and sectoral differences in productivity are expected to reduce if market forces are allowed to operate. These issues are also a concern within a theoretical framework based on more recent thinking about new economic or functional geographies, where spatial differences can be expected to persist long-term because of agglomeration economies. Over time, endogenous growth and new economic geographies theories have become more influential in economic development policy, which focus on improving the adaptive capacity, productivity and utilisation of resources in places and maximising positive externalities.

The evidence has shown that **the rationales for specific government intervention in support of *'rebalancing'* activity have generally moved towards the need to address the underutilisation of resources and improve the competitiveness of places, focusing on place-based growth rather than redistribution.**

## What works?

The evidence suggests that there are a number of factors which appear to be linked with *'rebalancing'* impact and success:

- '**Packages' of interventions that span policy areas have better chances of success than single silo actions**. For example, interventions linking housing and transport are key to enabling agglomeration benefits in urban centres. The study's projections also highlight that mixed interventions can help mitigate against the trade-offs and inherent tensions within *'rebalancing'*.
- In general terms, **interventions that go with the sectoral and cultural grain** of places and are designed to sustain growth tend to be the more successful. For example, this could be to relieve congestion in growth areas to sustain the advantages of agglomeration, which has been an important factor in the development of the UK's financial service sector.
- **Certainty and predictability going forward matters**, especially where the public sector is working with the private sector and where the market needs to have confidence in the future direction of travel if it is to invest meaningfully, as it takes time to achieve shifts in balance (especially spatial). This was, for example, a key factor in the long-run success of industrialisation initiatives in Asia. Continuous change in funding streams, qualifications, systems, governance structures, and policy disrupt the *'rebalancing'* process. Similarly, '*rebalancing*' is more successful where there is **simplicity in 'enabling' environments,** such as tax incentives and regulations.

- **Autonomy at the 'right' spatial level is key**, along with local, city regional, regional and national actors working in co-ordinated and reinforcing ways. This is especially the case in the wider European context, where the capacity and autonomy of regional institutions to develop regional spaces appears to have been a very significant factor in *'rebalancing'* effects in Sweden and the Netherlands. It seems to be the case that certain policy areas require a broader spatial perspective than the local area, because infrastructural policy issues relating to *'rebalancing'* (e.g. innovation, strategic transport, energy planning, and supply chains) tend to operate at spatial footprints that extend beyond local and sub-regional boundaries.
- **Capable and competent governance and oversight is key**. This not only provides the certainty and predictability referred to above, but the calibre of thinking and accountability for performance are important factors in driving *'rebalancing'* action forward. Linked to this, as illustrated in the international case studies, institutional context is critical in considering what works where, and how. The international evidence provided by the literature also shows that any significant role for the public sector (generally) works best in **collaboration with the private sector**.
- **Dialogue between employers, unions, workers and other organisations** builds co-operation and co-ordination in ways of working across different spatial scales, and between organisations within sectors. This can yield successful outcomes when faced with challenges of sectoral restructuring, although it takes time for trust to build.
- **Investments targeting human capital and soft infrastructures have had positive results**, although their impact varies from context to context. Skills development is a particularly effective form of investment, although it does need to be integrated with the local economic base. The existence of a varied set of institutions offering both highly qualified knowledge workers and provision for medium skilled workers also supports '*rebalancing'* interventions. Employers, as both individual organisations and within employer networks, should be part of this institutional fabric, and their products and business strategies more generally play a crucial role in shaping skills demand.

## Role of employment and skills

Skills and employment initiatives are an important part of the 'intervention mix' and very much a critical part of the long-term *'rebalancing'* process. There have been a range of skills and employment-specific interventions in the UK and abroad that have been designed to address:

- the causes of imbalance, for example to raise skills levels, as part of a broader programme to create the conditions for growth to address spatial imbalances;
- the consequences of imbalance, for example the public sector as a job-creator in areas where the private sector under-performs;
- the consequences of the sectoral '*rebalancing*' process, for example, in helping people to adapt to changing skills or occupational requirements as the sectoral structure of an economy changes.

Turning now to 'what works' in terms of employment and skills policy in '*rebalancing'* initiatives, the key messages are:

- Interventions supporting the development of the educational infrastructure and hybrid people and skills interventions have **provided some of the highest returns** of any human capital and skills interventions which have assisted in '*rebalancing'* economies sectorally and spatially in the UK and abroad.
- International evidence suggests that the **expansion of higher education**, including specific targeting of applied sciences in some regions, has provided skills of value to sector *'rebalancing'*.
- **Intermediary organisations** can play useful roles in working with employers and education and training providers to ensure employers' demand for skills are met, particularly as an economy rebalances sectorally.
- Skills development and investment in training to aid the '*rebalancing'* process needs to be **shared between employers, individuals, and government**. Multi-stakeholder approaches can help achieve better skills provision.
- **'*Flexicurity'* approaches**, emphasising lifelong learning and the skills for sustaining and progressing in work, can yield positive outcomes for individuals and can assist in the '*rebalancing'* process between sectors (including potentially the public-private sector).
- **Lifelong learning** is important in helping to deal with sectoral *'rebalancing'* and in responding to sectoral change. Information, advice, and guidance (IAG) is a crucial component of lifelong learning.

- There is international evidence on the success of **labour market policies** in helping to deal with restructuring and in responding to change, both sectorally and spatially, especially when targeted at sectors with prospects for growth. This suggests that anticipating skills change is crucial.

## Towards a future *'rebalancing'* framework'

Drawing on the evidence as a whole, the key overall conclusion is that **sectoral and spatial imbalances matter where they constrain the ability of an economy to increase and realise its growth and development potential**. This can happen in a number of ways:

- Persistent spatial imbalances will be associated with unemployed and underutilised resources that could be used more productively.
- Sectoral imbalances can restrict growth if they cause underinvestment in technological opportunity and change, and constrain its dissemination throughout the wider economy (e.g. because of fractured supply chains, wider activity that gets in the way of open innovation).
- Spatial and sectoral imbalances can make an economy, at local, city-region, regional or national levels, less resilient to the increased shocks and uncertainties that come from globalisation, be this in the form of market or technology change.

Reviewing the macro and microeconomic data, the unavoidable conclusion is that the UK has been, and is, an imbalanced economy in these three senses and that, therefore, *'rebalancing'* is an important concern for policy makers. The long-standing nature of what we now call the *'rebalancing'* challenge re-emphasises this imperative. At the same time it should also be acknowledged that in some ways '*imbalance'* is a natural state of affairs. Reducing the UK's dependence on financial services, on London and the South East and on the public sector as a source of employment and income have already been highlighted in policy as integral elements of the *'rebalancing'* process. So, too, will be increasing private sector investment in R&D and innovation, in skills development, and in overseas trade, as the Plan for Growth touches on.

**But how this *'rebalancing'* will, or should, manifest itself in the changing patterns of economic activity, and to what extent, is less easy to specify.** This is not just because of uncertainties and idiosyncrasies at the microeconomic level, but also because government's macroeconomic *'rebalancing'* policies will influence the sectoral and spatial distribution of UK activity, as will the changes taking place in the global balances of trade and investment, and the relentlessly differentiating impacts of market and technology change. Throughout this process, there is a challenging conflict between government's policy objectives and the likely outcomes of powerful market forces, especially in terms of spatial *'rebalancing'*, and a need for realism in what policy can achieve in this context, particularly in the short-term and when addressing spatial imbalance.

Despite the uncertainties about the precise shape that sectoral and spatial *'rebalancing'* can or should take, **the evidence that we have drawn from UK and international experience tells us that appropriate government microeconomic interventions can contribute to this *'rebalancing'*** and help overcome the constraints that imbalance places on growth and development. However, the evidence also suggests the need for caution about what can be achieved by these means. Overall, the evidence emphasises:

- the importance of working as far as possible with the grain of market forces to prompt the private sector to realise the full potential of *'rebalancing';*
- the care that must be taken to avoid distortive effects which displace or crowd out other sectoral or spatial economic activity, especially private sector activity;
- the need to build on existing strengths and capacities at sectoral and spatial levels, acknowledging the importance of intangible assets, including knowledge networks and assets, place and business cultures, or wider clustering effects between principal actors including those in the skills and employment arena. This might mean using 'old skills' in 'new ways' in places with sectorally relevant antecedents;
- that combinations of interventions (particularly from mainstream service providers such as local authorities) required to induce sustained changes in the behaviour and practice of people, businesses, and networks, but bearing in mind that relevant geographies are increasingly not co-terminus with administrative boundaries;
- the investments that are often required to improve access to markets, both in tangible (e.g. transport and housing) and intangible forms (e.g. supply chains and links between universities and businesses).

Referring back to the typology of *'rebalancing'* actions developed in this study, interventions that are most likely to be effective are those that fall above the line shown in the diagram below. Generally, these interventions tend not to have high unit costs in terms of public expenditure, and hence would be consistent with the current austere environment for public spending, which can be anticipated as lasting for some time.

**Defining the focus of *'rebalancing'* interventions going forward**

| | Tangible | Mixed | Intangible |
|---|---|---|---|
| **Setting the ground rules and direction / promoting the efficient operation of the market** | **1** | **2** | **3** |
| **Building enablers and conditions for growth** | **4** | **5** | **6** |
| **Tilting the playing field, playing the role of principal actor/agent** | **7** | **8** | **9** |

As well as the need for caution in implementing microeconomic *'rebalancing'* interventions, **it is important to be realistic about the extent of *'rebalancing'* that interventions might actually achieve certainly over the short term.** In particular, no matter what success is achieved in macroeconomic and sectoral *'rebalancing'*, addressing spatial imbalance is likely to prove a sustained long-term project. Significant shifts will be required to reverse imbalances in the geographical distribution of economic activity that have been caused by deep-seated historical legacies handed down from one generation to the next. Whatever the rationale, the long-term nature of such interventions will undoubtedly require the maintenance of continuity and stability in governance and management arrangements, all highlighted above as critical factors in effective *'rebalancing'*.

Executive Summaries present the key findings of the research produced by the UK Commission for Employment and Skills. More detailed analytical results are presented in Evidence Reports and all outputs are accessible on the UK Commission's website www.ukces.org.uk

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