Briefing

Levelling up the economy: we can’t afford not to

The first briefing in the economic discussion series - **Shaping a recovery that reduces poverty**

As we begin to emerge from the COVID-19 pandemic, ‘levelling up’ the economy to create opportunities for everyone across the county will still be our greatest national challenge, and more important than ever. This briefing argues that levelling up needs to tackle the twin challenges of productivity and living standards.

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To tackle these challenges, the levelling-up agenda should embed four key principles:

1. Take action now to stop the levelling-up challenge becoming even harder. The next stage of economic support needs to focus on maintaining spending power and focusing job creation in our weakest economies most likely to see a rise in the unemployment rate as the furlough scheme is wound down.
2. Increase the scale of investment in basic, digital and vocational skills to match the ambitious investments in infrastructure.
3. Increase the share of planned capital investment that will be invested in local public transport systems and lever this infrastructure investment to unlock opportunities for people trapped in poverty.
4. Improve productivity in low-wage, low-productivity businesses and sectors by improving the quality of work, boosting in-work training and enhancing management practices.

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Summary

When the Chancellor, Rishi Sunak, gave his Budget speech in the House of Commons on 11 March 2020, we were already in the foothills of the COVID-19 outbreak. Despite the oncoming threat, he was keen to emphasise that this was still his ‘levelling-up’ Budget, which would set out how the Government would deliver on its promise to ‘create opportunities for everyone’ across the country.

Ambitious spending commitments followed: £600 billion over five years for ‘roads, railways, broadband and homes’; and £22 billion a year for research and development. The size of the commitments showed that levelling up our regionally unbalanced economy had become the biggest political challenge that our society faced.

Since then, our society has faced another huge challenge: the COVID-19 outbreak. But as we come out of the first stage of the health crisis and begin to see the economic impacts, levelling up the economy will still be our greatest national challenge and more important than ever.

We entered March 2020 with an economy with 14.5 million people in poverty (measured after housing costs), including 3 in 10 children, and wide disparities in the chance of being pulled into poverty across the country. Far too many people were already in poverty in an economy also with record employment rates. As we look to rebuild the economy post-COVID-19 we must work towards one that offers everyone the opportunity to get a good job and to live in a community that enables them to be free from poverty wherever they live.

This briefing makes the following key points about how to level up the post-COVID-19 economy.

Despite the huge fiscal cost of supporting our economy through COVID-19, now is not the time to be dialling down the commitment to levelling up. As our economy starts to recover, we will be looking at the highest level of national debt relative to Gross Domestic Product (GDP) for more than half a century. But with the Government currently able to borrow at historically low interest rates, we have the benefit of being able to take a long-term view on paying this debt down. In the long run, paying down debt is much easier with a fast-growing economy. As levelling up is essential to restoring productivity growth, the spending required to level up the economy will, in the long term, be good for the public purse.

The immediate levelling-up priority has to be to stop the challenge becoming any harder. Unemployment has increased fastest in areas that already had the highest unemployment rates. Many of these places have a high share of workers in hospitality and retail, and incomes may take a further hit when the furlough scheme is wound down as these are the last sectors to open-up.

Longer term, levelling up needs to tackle two challenges: the productivity challenge and the living standards challenge. While there are close relationships between these twin challenges, improving productivity will not address gaps in living standards for everyone in all places.

As well as increasing and rebalancing capital investment and research and development spending, a levelling-up strategy also needs to focus on elements of the country's productivity problem. This comes from the very factors that also drive high poverty rates: workers missing basic, digital and vocational skills; too many low-productivity, low-paid jobs; and the 'long tail' of low-productivity businesses.

To tackle these twin challenges, the levelling-up agenda should embed the following key principles:

- Take action now to stop the levelling-up challenge becoming even harder. The next stage of economic support needs to focus on maintaining spending power and focusing job creation in our weakest economies, most likely to see a rise in the unemployment rate, as the furlough scheme is wound down.
- Increase the scale of investment in basic, digital and vocational skills to match the ambitious investments in infrastructure.
- Increase the share of planned capital investment that will be invested in local public transport systems and lever this infrastructure investment to unlock opportunities for people trapped in poverty.
- Improve productivity in low-wage, low-productivity businesses and sectors by improving the quality of work, boosting in-work training and enhancing management practices.

Introduction

Before the COVID-19 crisis many low-income voters already felt disconnected from the prosperity felt in other parts of the country, voicing frustration about low-paid and insecure work, and the decline of local high streets representing a broader economic malaise in their local areas (Bevington et al, 2019).

In a briefing published alongside this report, Goodwin and Heath show that low-income voters have been central in driving recent political change. The now ‘blue wall’ seats that helped deliver the Conservative landslide victory in the December 2019 general election will again be central in the next general election, and both main political parties will need to show they have a credible plan to improve living standards.

The next section lays out the twin productivity and living standards challenges that levelling up the economy needs to address, and the subsequent section considers how the levelling-up challenges have changed post-COVID-19. The following section considers the evidence on how best to address the challenges. In these sections we also lay out the principles that levelling up needs to take on, before giving our conclusions.

The pre-COVID-19 challenges

Productivity and living standards: twin levelling-up challenges

In the past few years, a lot has been written about geographical inequalities in the UK's economy performance. Whether focusing on economic output - gross value added (GVA) - per person, productivity - economic output for every hour worked - or employment rates, the data tells a familiar story:

- The north of England, the Midlands, Wales and Northern Ireland lag far behind the south-east of England in terms of economic performance and this has been happening since the 1960s (Zymek and Jones, 2020), such that productivity in London is now 50% higher than productivity in any other region or nation of the UK (UK 2070 Commission, 2020). Among European countries, only Poland and Romania have more spatially imbalanced economies (Zymek and Jones, 2020).
- We have also heard a lot about 'left-behind' towns that have never recovered from deindustrialisation in the 1980s. Zymek and Jones (2020) found that, while the inequality in productivity between regions has shrunk very slightly since 2008, inequality within regions has grown, meaning that inequality within regions now makes up a greater share of overall inequality in productivity.
- Yet our largest cities other than Bristol and London also have lower productivity than the average for the country, which lies behind regional inequality in productivity (Martin et al, 2018).
- The UK's geographical inequalities are a major contributor to what has become known as the UK's 'productivity problem', that productivity lags behind our competitors in Europe and the United States.

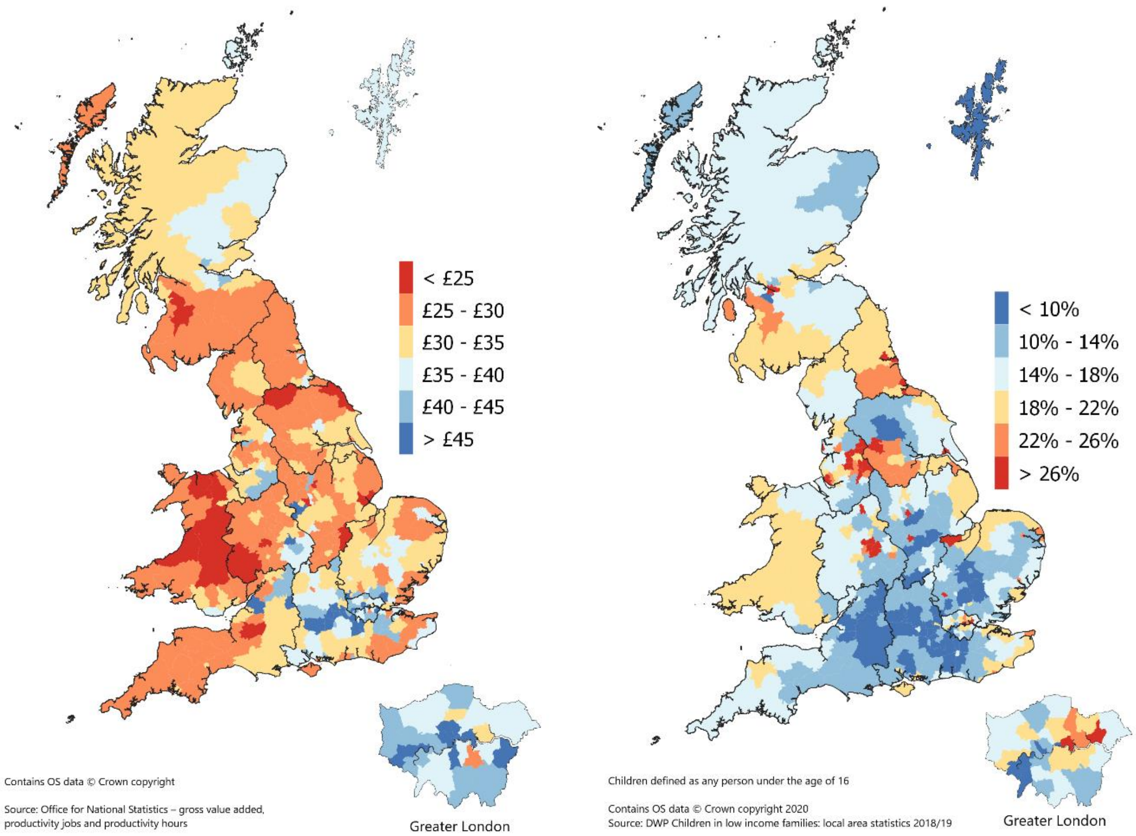
All of these geographical patterns are apparent in Figure 1(a), which shows productivity by local authority. Outside of London and the South East, the few local authorities with higher productivity than the national average relate to fairly isolated examples of highly productive industries.

Productivity and economic performance only matter to people in so far as they improve their living standards. Recent events have also drawn attention to geographical inequalities in living standards.

In this context, the living standards challenge that is most troubling is the geographical disparity of the chance of being pulled into poverty. Figure 1(b) shows child poverty rates by local authority (see Box 1 for an explanation of why we map child poverty rates rather than adult poverty rates).

Figure 1: The productivity and living standards challenges

(a) Productivity / (b) Living standards



Note: Shading is relative to the average across the whole of Great Britain. Northern Ireland is not shown due to data being unavailable.

Source: JRF calculations using ONS (2020) and DWP (2020)

There are similarities with the geographical pattern of productivity inequalities. At a regional level, the Midlands and the regions of the north of England have the highest child poverty rates as well as below-average productivity, and the South East has the lowest child poverty rate.

There are also important differences. London has a relatively high child poverty rate even measured before housing costs (and the highest child poverty rate once housing costs are taken into account). Many rural local authorities have below-average child poverty rates but also below-average productivity. Child poverty is much more prevalent in towns and cities than in rural areas. The 15 local authorities with the highest estimated child poverty rates are all towns and cities in the Midlands and the north of England.

Box 1: Measuring local poverty rates

Rates of poverty are difficult to measure at a local level because our main sources of data on household incomes have sample sizes that are too small to estimate local poverty rates. The best source of data we have on local poverty rates comes from the Department for Work and Pensions' modelled estimates of local child poverty rates.

The definition of poverty used in this briefing is when a household has an equivalised income below 60% of the median, measured before housing costs. This is different from our usual headline measure of poverty, which is measured after housing costs, thereby taking into account the necessary costs that households have to meet. We focus on before-housing-cost poverty rates because the levelling-up agenda is focused on improving people's earnings by creating better job opportunities, particularly in the weakest economies.

While the before-housing-cost measure is most relevant for the levelling-up agenda, it only gives a partial picture of the overall challenge of solving UK poverty. As well as levelling up earnings, tackling poverty also requires more people to have a decent, affordable home and a social security system that acts as an anchor to support incomes.

How closely related are the two challenges?

At a national level, productivity is the main driver of living standards over the long run. There is a strong correlation between productivity growth and wage growth over time, and stagnant productivity since the financial crisis in 2008 has been the main cause of sluggish wage growth over the past decade (Lopresto and Kara, 2018).

At a local level, there is also a fairly strong relationship between productivity in a local authority and average (median) wages of those living in that local authority (Table 1 in the Annex shows a correlation matrix for the child poverty rate, productivity and other local economic characteristics). But this relationship is weaker than at a national level partly because productivity may also affect the wages of people working in but living outside of the local authority (there is a stronger relationship between productivity and the wages of those working in the local authority). Median wages are also fairly strongly related to child poverty rates, with higher wages associated with lower poverty rates.

These effects combined, mean that there is a direct link between higher local productivity and lower child poverty rates (see Figure 2), but this effect is fairly weak. An extra £1 an hour in local productivity is associated with a 0.2% fall in the local poverty rate.

The weak correlation reflects that some local authorities, as discussed above, particularly those in rural areas, combine relatively low productivity and relatively low poverty. Similarly, relatively high poverty rates persist in some strong local economies, most notably local authorities in London. A strong economy on its own is not enough to secure high living standards for everyone in the local area.

Figure 2: Relationship between local authority productivity and child poverty rates

Source: JRF calculations using ONS (2020) and DWP (2020) and ONS local area classifications

The extent to which higher productivity feeds through to lower child poverty rates depends on other characteristics in the local economy.

Table 2 in the Annex shows the results of a series of regressions of local child poverty rates on measures of local economic conditions, showing the impact of the latter on the former once we take their interactions with each other into account.

For example, when we consider the relationship just between child poverty rates and productivity, as already noted, a £1 increase in local productivity is associated with a 0.2 percentage-point fall in the child poverty rate. But when we also take into account the effect of a £1 increase in lower-quartile pay (the pay of someone a quarter of the way up the local earnings distribution), there is no longer any additional effect of local productivity on the child poverty rate. This tells us that productivity is important for local poverty rates only through its effect on local wages.

When we include a broader set of local economic variables, we see that other local economic conditions have strong relationships with local child poverty rates. A £1 increase in local lower-quartile pay is associated with a 1.7 percentage-point fall in the child poverty rate. A higher employment rate and a larger share of the local working-age population having at least National Vocational Qualification (NVQ) Level 2 skills (equivalent to five GCSEs – General Certificates of Secondary Education – at grade C or above) also matter for the local child poverty rate.

The analysis shows that the productivity and living standards challenges that the levelling-up agenda must address are closely related. Productivity is an important driver of pay and pay is an important driver of local poverty rates. But people at risk of being pulled into poverty only see the benefits of local productivity growth when it raises wages at the lower end of the income distribution. Tackling local poverty also requires high employment rates and increasing the number of people with the basic skills that allow them to take advantage of local employment opportunities.

Before turning to how the levelling-up agenda can tackle these deep-seated productivity and living standard challenges, we next consider how the levelling-up challenges have changed since COVID-19.

What has changed?

The Budget on 11 March 2020 was given when we were in the foothills of the COVID-19 pandemic. The package of emergency fiscal stimulus measures the Chancellor, Rishi Sunak, announced then to cope with the outbreak totalled £30 billion (Sunak, 2020). Since then, society and the economy have been through and begun to emerge from the lockdown, and the total cost and measures to support incomes and the economy this financial year is now expected to total £133 billion (OBR, 2020b).

Since the March Budget, the levelling-up challenge has changed in at least three important ways:

- the public finances have taken a huge hit,
- geographical inequalities are at risk of becoming even larger,
- COVID-19 may have long- as well as short-run implications for our economic geography.

Shocked public finances

The announcements in the March Budget demonstrated a government emboldened to spend again following a decade of public spending restraint. Debt is now estimated to have topped 100%, for the first time since the early 1960s (OBR, 2020c). The focus in the past few months has been doing whatever is possible to keep businesses afloat, supporting people's incomes and keeping people attached to the labour market.

As we move out of this immediate support phase, questions will centre on how to deal with this debt and whether we can still afford the spending commitments announced in March to level up the economy. We set out below that, not only can we still afford the spending required for levelling up, but also paying down debt is much easier with a fast-growing economy. As levelling up the economy is essential to restoring productivity growth, the spending required to level up will, in the long run, be good for the public purse.

While the UK will enter the recovery phase of the crisis with high predicted levels of debt, and falling levels of GDP, the Government's cost of borrowing remains at an historic low (well below its 6% threshold outlined in the fiscal rules), and it is not struggling to meet that cost. In late May, the Government issued a bond at a negative yield for the first time.

If interest rates stay low, the Government faces no immediate threat from taking a long-term view on how to manage this new debt level. We have strong reason to believe that the cost of borrowing will stay low. Both the OBR and the Bank of England are forecasting that the bank rate will remain low over the next five years (OBR, 2020a and Bank of England, 2020b). Inflation is sitting at a four-year low at 0.5% and the central bank is under pressure to stimulate the economy and pull inflation back to the target rate of 2% (Bank of England, 2020a). Before the crisis, economists were predicting low interest rates for many years to come, and the change in circumstances gives little indication that this will change. Low rates are needed as part of the toolkit to stimulate the economy through private lending and borrowing as we move through the deepest recession in decades. As James Browne (2020) from the Tony Blair Institute writes in his recent paper on public debt following the pandemic, we don't need to run large budget surpluses to pay down our increased spending in the acute phase of the crisis when interest rates are at these historic lows.

Credit rating agency Fitch Ratings has downgraded the UK to an AA- rating (from AA), and confirmed that the outlook is negative (Fitch Ratings, 2020). This is driven by the 'weakening' of the UK's finances and a loosening fiscal stance, in combination with the expected damage to the UK economy because of COVID-19 and the uncertainty lingering over the Brexit negotiations and future European Union (EU) relationship. However, Fitch Ratings also notes that developments that could result in positive rating action include:

- improvements in the public finances, leading to a steady decline in the Government's debt to GDP ratio after the COVID-19 crisis,
- greater confidence and evidence that the UK's growth prospects and public finances will prove resilient to the consequences of COVID-19 and Brexit.

While spending cuts or tax rises could improve the deficit and debt position of the UK, they are more likely to hinder the UK's growth prospects and put the UK in a position that is similar to, or much worse than, when we entered the COVID-19 crisis. In 2018, the Office for Budget Responsibility (OBR) wrote that 'the main drag on UK growth since the EU referendum had been on non-dwellings investment' – a key driver of future productivity growth (OBR, 2018). We know that with the economic challenges associated with the response to both the coronavirus crisis and Brexit, we need to focus on better investment to grow the UK, fairly. Increasing government investments in areas that will enhance growth and wellbeing for the UK is the UK's best hope of a resilient economy that will be able to buffer future storms.

Ahead of Rishi Sunak's Budget on 11 March 2020, George Osborne's former adviser, Rupert Harrison, talked about how markets were 'crying out for government spending' (Robertson, 2020), and economists such as Joseph Stiglitz have argued the case for increasing public investments because they would increase GDP and employment now, as well as grow output for the future, and reduce the debt to GDP ratio, rather than increase it (Stiglitz, 2012). The argument of government spending to escape the low-growth trap that many advanced economies have found themselves in after the 2008 financial crisis has also been made by the Organisation for Economic Co-operation and Development (OECD), as it emphasises the need for fiscal initiatives to foster productivity in the medium to long term (OECD, 2016).

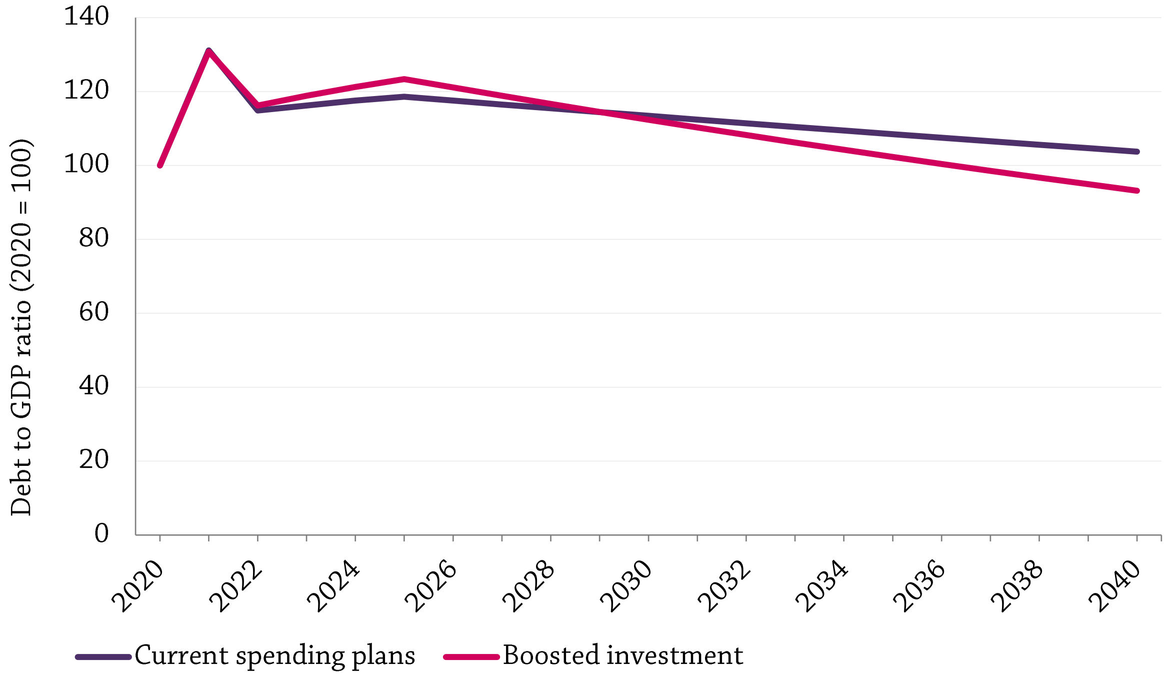
Reducing regional inequality through growth-enhancing investments is key to managing this new level of debt. As the cost of borrowing is currently low, the Government has the luxury of taking a long-term view of paying down the debt. And it will be much easier to do so if we are able to kick-start the productivity growth that was so anaemic in the past decade. A failure to level up our economy has led to an over-reliance on London and the South East to drive our national productivity growth. A focus on levelling up the economy now holds the key to reinstating productivity growth. There is therefore a strong case to maintain the pre-COVID-19 planned spending to level up the economy.

To demonstrate this point, Figure 3 provides an illustrative example of the evolution of the debt to GDP ratio in two scenarios:

- one in which we do not increase investment beyond the current forecasted deficit levels to reduce the debt in the short term, and long-run growth stabilises at the OBR's forecast growth for 2024/25;
- one in which we invest an extra 2% of GDP a year over the forecast period (years 1 to 5) and have higher long-term growth.

The model shows that increasing spending in growth-enhancing investments in the short term will improve the debt to GDP ratio over the medium and long term, despite an initial faster rise. Investing now for long-term growth is the best way to cope with our debt in the long term. Now is not the time to be cutting back on the scale of the ambition to level up our economy.

Figure 3: Illustrative scenarios for the debt to GDP ratio (2020 = 100)



Source: JRF model using analysis of OBR coronavirus scenario data (OBR, 2020b)

Box 2: Key assumptions and data used in Figure 3 for the debt to GDP illustrative examples

The illustrative examples in Figure 3 use the OBR's coronavirus reference scenario for estimated GDP and deficit figures over the forecast period, and an interest rate of 5% for each year over the next 20 years. They assume that the debt to GDP ratio starts at 1. The OBR's GDP growth estimates for Year 5 (2024/25) are 1.4%, and we have assumed this continues through the rest of the model ('current spending plans' scenario). We have also assumed that, with spending increasing by 2% of GDP each year over the forecast period, there is an additional 1% of GDP growth in the following year in our 'boosted investment' scenario, which then equates to a total of 2.4% of GDP growth a year after Year 6. The debt figure is the cumulative total of the deficit each year.

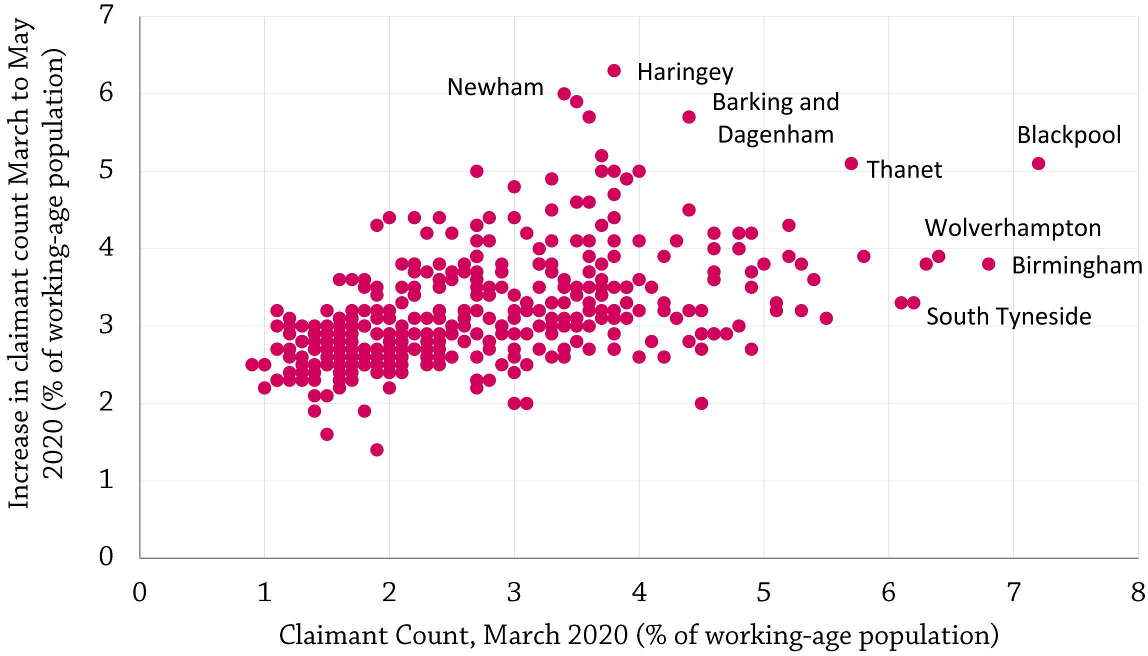
Risk of further entrenched geographical inequalities

The talk of levelling up the economy after the December 2019 general election was taking place in an economy with record employment rates. The discussion therefore focused on how more people and places could share in our national prosperity.

However, the past few months have seen record increases in the unemployment rates. The number of people claiming unemployment benefits – the 'claimant count' – rose by 1.4 million between March 2020 and May 2020 to reach 2.7 million, the fastest rise since 1947 (Institute for Employment Studies, 2020).

Nowhere has been left unaffected by the economic impacts of COVID-19. But places with the weakest economies heading into the health crisis have been hit hardest to date. Figure 4 shows that the claimant count has increased fastest where it was already highest.

Figure 4: Places with the highest pre-COVID19 unemployment rates have seen the biggest rises in unemployment rates



Source: JRF analysis of 'CC01 Regional labour market: claimant count by unitary and local authority (experimental)' (ONS, 2020)

This geographical pattern of changes in unemployment is reflective of the types of jobs available in different parts of the country. McKinsey (2020) shows that places with lower incomes have a higher share of jobs at risk of furloughs, layoffs and reductions in hours or pay. This is driven by having a higher share of jobs in at-risk sectors such as hospitality, leisure and non-food retail.

The rise in the overall unemployment rate has been accompanied by a collapse in the number of local vacancies, as businesses have cut back on hiring as they have been locked down or due to the uncertainty. People who have become unemployed recently in some parts of the country currently face a staggeringly difficult challenge in getting back to work (Wilson et al, 2020).

The immediate levelling-up priority has to be to stop the challenge becoming any harder. We have so far seen a short-term economic shock and the rise in unemployment has so far been prevented from being as bad as it could have been by the furlough scheme.

However, many places are very vulnerable to a further economic shock once the furlough scheme is wound down. The economic effects of COVID-19 have been unequal in many ways. Low-income workers have been much more likely to lose their jobs or be furloughed (Tomlinson, 2020), cutting back on spending, running down savings or turning to debt to cope with the short-term implications (Benzeval et al, 2020). Meanwhile, high-income workers are more likely to have been able to work from home and have seen forced saving as they have had to cut back on spending. These forced savings in higher-income areas could mean consumer spending picks up quickly once the lockdown is lifted (Romei, 2020), supporting a recovery.

But low-income places where people are more likely to have been struggling will miss out on this stimulus. It will take people longer to get back into work as jobs in locked-down sectors take the longest to come back. This could lead to a vicious circle of falling spending power leaving the places with the weakest economies heading into COVID-19 even further behind.

Principle 1: Take action now to stop the levelling-up challenge becoming even harder. The next stage of economic support needs to focus on maintaining spending power in our weakest economies most likely to see a rise in the unemployment rate as the furlough scheme is wound down.

The Government should consider using three types of policy to achieve this:

- Investment for job creation and infrastructure schemes should be targeted in particular on areas with the highest claimant count to vacancy ratios.
- Ensure national fiscal policy takes into account local impacts and consider whether it is possible to provide an extra stimulus to encourage spending where unemployment has risen most, such as through direct transfers to households.
- Provide extended support for businesses in these areas to help them through the prolonged local downturn.

Improving productivity to drive up living standards

As laid out in the previous section, the immediate priority must be to make sure our long-standing geographical disparities in living standards do not become worse in the next few years. Looking beyond this immediate phase, this section lays out what needs to be done to tackle these deep-seated disparities and to increase productivity and improve living standards.

There has been debate in recent years about the sources of the UK's geographical productivity differences. Pieces of evidence provide different pieces of the picture:

- The Office for National Statistics finds that regional (and city-region) productivity differences are explained almost entirely by productivity differences within industries rather than the composition of industries, other than for a few exceptions such as the contribution of oil and gas to high productivity in Aberdeen (ONS, 2018).
- Swinney (2018) argues that productivity differences across UK cities are best explained by differences in productivity within high-productivity export firms (ones that do not just provide services to the local economy) such as finance and knowledge-intensive services.
- Other evidence suggests that the 'long tail' of low productivity firms matters too. Haldane (2018) shows that the UK stands out relative to our competitors for having

many more below-average productivity firms, existing alongside a small number of highly productive businesses. The Office for National Statistics shows that the shape of the distribution of business productivity is similar across regions, but the average is higher in more productive regions (ONS, 2018). That is, the long tail that we see nationally also exists in all regions.

- The Office for National Statistics shows that there are substantial differences across regions in average productivity in all sectors of the economy, including in low-wage sectors providing local services (ONS, 2018).
- Mealy and Coyle (2019) show that within-region differences are often explained by economic complexity and specialisation. For example, the difference in productivity between central Manchester and Wigan relate to the fact that the Manchester economy has specialisations in professional, scientific and financial activities as well as some manufacturing, whereas the Wigan economy is mainly based in lower-wage manufacturing and construction.

The above pieces of evidence can all be seen as relating to *proximate* causes of geographical productivity differences, but they also imply different deeper causes that would need to be addressed to tackle them.

This briefing does not try to ascertain which of these is the most important driver of geographical productivity differences. But one thing that is clear from the above evidence is that there are multiple sources to the UK's regional economic disparities, each of these with different deeper causes and different policy levers required to address them. We will require policy action on several different fronts to tackle our geographical productivity disparities.

Our concern here is how the productivity and living standards challenges laid out in the third section of this briefing can both be tackled. This section first discusses how far the current emerging approach to levelling up the economy would tackle the living standards challenge and then suggests three policy areas that deserve a much more prominent role in the levelling-up agenda as they hold the key to improving both productivity and living standards in areas where both are currently most problematic.

The current emerging approach to levelling up the economy

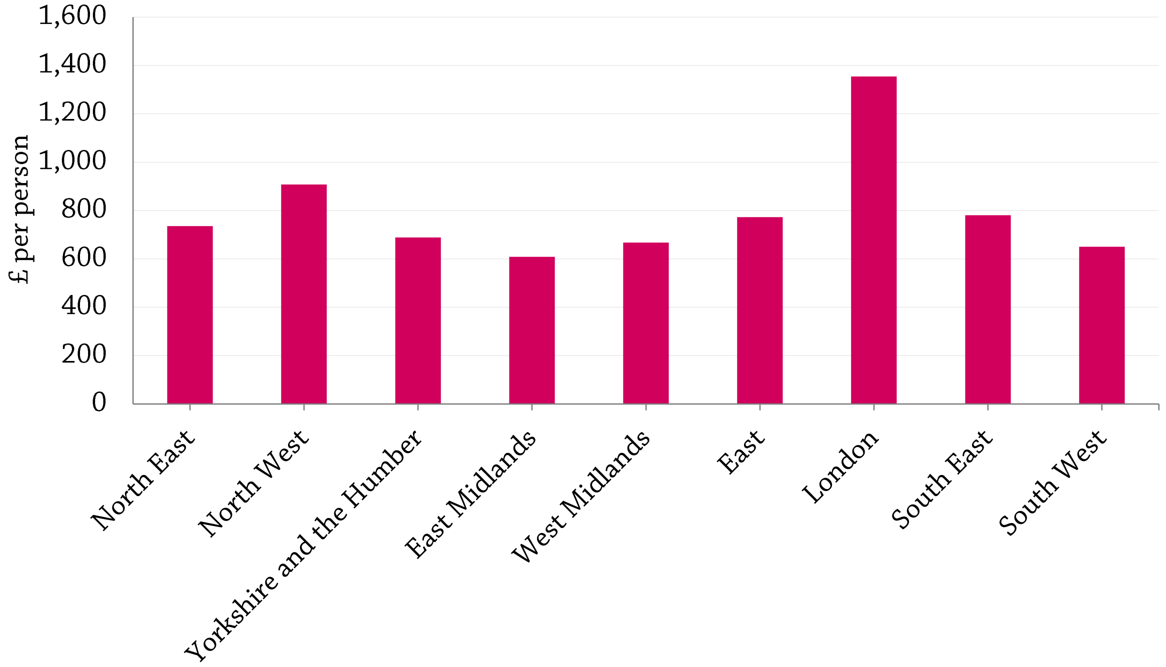
The announcements made at the March 2020 Budget focused substantial resources on levelling up capital spending – in particular transport investment – and research and development spending.

A consensus has recently developed that in recent decades the UK Government has spent too little in total on both transport investment and research and development, and what **has** been spent has been too strongly tilted towards London and the South East.

Figure 5 highlights the difference in average capital spending by region from 2014/15 to 2018/19. There is a stark contrast between regions like the East Midlands where £609 per person was spent, in comparison with more than double (£1,355) being spent per person in

London (ONS, 2019). We also know that government spending on transport by region provides a similar story. In 2018/19, less than a third of the amount spent on transport in London was spent in the East Midlands and Yorkshire and the Humber (ONS, 2019). A recent paper by Forth and Jones (2020) showed that the majority of public research and development goes to just three cities: London, Oxford and Cambridge.

Figure 5: Average capital identifiable spending by region, 2014/15 to 2018/19



Source: JRF analysis of 'Country and regional analysis 2019' (ONS, 2019)

Coyle and Sensier (2019) showed that part of the regional imbalance in capital investment comes from biases in the Treasury's 'cost–benefit analysis' model, which places more weight on consumer benefits where incomes and productivity are higher. Even so, there seems to be a large element of political decision-making, with many potential projects with high cost–benefit ratios in the Midlands and the north of England not invested in, and projects in the South East with lower ratios invested in.

There are good reasons for investing in London and the South East. Growing cities need transport investment to cope with growing demand. Research and development may be best spent where there is greater expertise. But in the context where not enough has been invested nationally, there has been too little outside of London and the South East. Given the increase in planned capital investment and research and development spending, there is now the possibility to increase spending in the Midlands and the north of England while not reducing the amount spent in London and the South East.

Investing in better infrastructure and more research and development across the country creates new opportunities for private investment in high-productivity sectors, and could contribute to bringing more high-productivity jobs into regions where they are currently lacking. These are sensible policies. Increasing and rebalancing capital investment and research and development spending were rightly a big focus in the March 2020 Budget.

Since seeing unemployment increase in the wake of COVID-19, there has also been talk of taking the opportunity now to invest in 'green' jobs, such as in renewable energy or retrofitting houses to make them more energy efficient. The location of these jobs is less driven by the factors driving knowledge-intensive jobs to locate in already productive city centres, so investing in these jobs provides an opportunity to create new, highly productive industrial jobs outside of London and the South East and contribute towards achieving the Government's target to achieve net-zero carbon emissions by 2050. Again, making such win-win investments is a sensible policy.

Will this approach be enough to tackle the living standards challenge?

The policies included in the current approach are likely to contribute to narrowing regional inequalities in productivity. But will they tackle the living standards challenge? Encouraging high-productivity industries creates jobs directly. However, at without a lot of investment in retraining, these jobs are likely to be out of reach for many currently trapped in poverty by low-paid, low-productivity work. The policies overall only create a small number of jobs directly.

It is the 'spillovers' from these industries that could be more important. In a famous paper, Moretti (2010) found a 'tech multiplier' equivalent to almost five new jobs for each additional high-technology job in a local economy. Encouraging the growth of high-technology sectors therefore might encourage many more opportunities in local service industries.

However, other research has questioned the quality of jobs created by these spillovers. Lee and Clarke (2017) also found that jobs growth in advanced industries created more jobs in local services. But they found that these new jobs tended to lower the average wage for less-skilled workers in the local economy. Lee and Rodríguez-Pose (2016) directly looked at the relationship between the growth of technology employment on local poverty rates and found 'no real impact of the presence of high-technology industries on poverty'.

This research suggests that encouraging the growth of high-value technology jobs, knowledge-intensive services and manufacturing has an important role in tackling the living standards challenge by creating job opportunities and increasing employment rates, which the analysis in the second section of this briefing showed are an important driver of local poverty rates. But, perhaps unsurprisingly, it will not be enough by itself.

To tackle the living standards challenge we also need to: either create new opportunities for people currently trapped in low-productivity, low-paid work to move into higher-productivity, better-quality jobs; or improve the productivity and pay of the jobs they are in.

We next outline three opportunities to tackle other parts of the UK's productivity problem that are also vital for tackling poverty:

- increasing people's basic, digital and vocational skills,
- investing in local transport,

- improving productivity in low-wage, low-productivity jobs.

These policies are essential as complementary policies to the above approach. They ensure that we make the most from encouraging high-productivity job growth, and make sure that it is people currently at risk of being pulled into poverty that see the benefits of this growth in jobs.

Basic, digital and vocational skills

As shown in the third section of this briefing, achieving a decent skill level can offer people security from being pulled into poverty, and at a local level a smaller share of those lacking NVQ Level 2 skills is associated with fewer children being in poverty.

Missing basic, digital and vocational skills is also an unrecognised problem that currently holds our national and regional productivity back. Our 'long tail' of low-productivity businesses is mirrored by a 'long tail' of low skills, with a quarter of adults in England lacking basic numeracy or literacy or both (Tanner et al, 2019). The Industrial Strategy Council (2019) found that the most important area where workers are under-skilled is in basic digital skills, and that 5 million workers could become acutely under-skilled in these skills by 2030, with up to two-thirds of the workforce facing some level of under-skilling.

Skills are important from an individual's perspective to allow them to progress out of low-paid work into better-quality work. Yet skills also shape the types of jobs provided in the local economy. Investing in skills is vitally important to improve local productivity. While the UK has seen labour market polarisation in recent years, countries with other skills systems have fared differently (Oesch and Piccitto, 2020). While the UK has seen a fall in the number of people in middle-skilled occupations and a rise in the number of people in low-skilled occupations in the past two decades, Germany, Spain and Sweden have seen 'skills upgrading', with more people moving from low-skilled occupations to middle-skilled ones than the opposite. Consequently, the UK now has the second-highest proportion of workers in low-skilled jobs among the countries of the OECD (CIPD, 2014). Addressing our long tail of low skills, in particular in parts of the country where it is longest, is vital to shape local economies.

Improving local skills is also vital for taking advantage of the benefits from high-productivity jobs growth, described above. While Lee and Clarke (2017) found that average wages for low-skilled workers fell following the expansion of advanced industries, in contrast the wages of middle-skilled workers rose. Offering people the chance to achieve mid-level skills would help them take advantage of this premium.

Improving skills requires looking at opportunities for adults to learn as well as at the education system. According to the Industrial Strategy Council (2019), 80% of our workforce in 2030 are already working now. The Council is the latest organisation to call for an 'urgent shift to a new norm of lifelong learning' (Industrial Strategy Council, 2019, p. 4). The Government's floated policy of an apprenticeship for every person (Parker and Moules, 2020) could be part of the answer to tackling our basic, digital and vocational skills gaps, but it will require more than this.

Yet, looking back at the spending commitments announced at the March 2020 Budget, these policy areas were barely a focus. Investment in the new flagship 'National Skills Fund' – with more details promised in the next spending review – amounted to £500 million a year. This is a tiny fraction of the £600 billion investment in roads, railways, broadband and homes promised over the next five years, and was the same amount committed to investing in potholes. There have been other new skills measures announced in the past few years – such as a National Retraining Scheme and Adult Digital Skills Entitlement – but, as the Industrial Strategy Council (2019, p. 34) has concluded 'these are unlikely to be large enough in scale to address the skills mismatch projections'.

Principle 2: Increase the scale of investment in basic, digital and vocational skills to match the ambitious investments in infrastructure.

To increase the scale of investment in basic, digital and vocational skills, the Government should be less bound by the distinction between current and capital spending allowed by the fiscal rules. Investing in skills is important for restoring long-term growth, even though it must be classed as current spending rather than capital investment.

When set, the current fiscal rules allowed for significantly more capital investment than current spending over the Government's term. We know that investing in skills and education can provide as big a return to the country as investing in physical infrastructure. However, due to different spending classifications, decisions to allocate the capital and current spending mean that these two investments are treated very differently in decision-making phases when there are different amounts of money available. As such, we recommend that the Government considers how it can incorporate investment in both skills and infrastructure into its update of fiscal rules and decision-making, rather than be bound by the current constraints on capital and current spending.

Local transport

A second issue that limits the prospects of people currently trapped in low-paid, low-productivity work is their ability to get to where better-quality jobs are. Previous JRF work has highlighted how a lack of decent public transport options can leave people disconnected from labour market opportunities (Rae et al, 2016; Crisp et al, 2018), with viable commutes restricted by the availability, reliability and cost of public transport. The work highlighted both disconnected neighbourhoods on the edge of cities but also places close to city centres yet lacking easy access.

A lack of efficient and affordable transport also holds productivity back. Looking at commute times, Forth (2019) shows that the 'effective' working population of Birmingham shrinks by 50% at peak times due to a lack of efficient public transport. A lack of local transport opportunities therefore prevents many UK cities from taking full advantage of the spillovers from high productivity jobs and cuts disconnected communities off from the benefits of being part of a larger city region. As Andy Haldane (2019), Chief Economist at the Bank of England, has said: 'This [research] helps explain why Birmingham punches below its demographic weight.' Haldane went on to conclude that raising the effective working population of UK cities would 'raise UK GDP per head by around 10% or around $4,100 (£3,100) in today's money.'

A second reason that transport matters for productivity is that recent academic work has highlighted the importance of good job matches – that is, a good fit between employer and employee – to boosting productivity. A lack of public transport options prevents many possible job matches and holds back our productivity.

As noted above, Coyle and Sensier (2019) showed that biases in the Treasury's cost–benefit analysis model and political decision-making have tilted investment spending towards London and the South East. Their paper also showed that many local transport investments – such as the Leeds Supertram with a cost–benefit ratio of 2.3 – have been evaluated with a large cost–benefit analysis ratio but are not yet funded. They argue that cost–benefit analysis is not designed to look at system-wide change, so plausibly these cost-benefit analyses underweight the benefits of public transport investments to creating effective public transport systems. These systemic benefits could be particularly great when connecting previously disconnected deprived areas with where job opportunities are.

Connecting previously disconnected areas requires giving investments in buses and bus routes as much support as new train lines and roads are. Indeed, in many places, investment in bus routes and properly integrated transport can help unlock some of the benefits of other transport investments. As with investing in skills, this requires devoting revenue spending as well as capital investment, such as for the creation of e-bus systems.

Principle 3: Increase the share of planned capital investment that will be invested in local public transport systems and lever this infrastructure investment to unlock opportunities for people trapped in poverty.

The March 2020 Budget promised £4.7 billion for a new local transport fund, which is welcome, but in comparison to the £600 billion promised for investment and the scale of the investment required, this is too small. The share of this £600 billion channelled into investment in public transport should be drastically increased.

There should be a particular emphasis in local transport investment on unlocking opportunities for people currently trapped in poverty in disconnected communities, both within and outside city regions. Providing affordable, reliable and efficient transport to these communities offers people the opportunity to access better local transport and for the local economy to realise the potential of a larger, effective working population.

Low-wage, low-productivity jobs

As described above, there is evidence that the UK's regional productivity differences stem from the 'long tail' of low-productivity businesses as well as differences in higher-productivity businesses. The long tail of low-productivity businesses that we see nationally also exists in all regions, but it is on average longer in low-productivity regions. As Swinney (2018) shows, these businesses tend to mainly provide services to the local economy, and are most prevalent in low-wage sectors such as hospitality and retail.

Many of these businesses are those that employ people trapped in in-work poverty and, as already noted, in sectors like retail, hospitality and social care. When we think about improving productivity, we often think about knowledge-intensive industries or manufacturing. But there is also a lot we can do to improve productivity in low-wage local service sectors.

Our previous research (Innes, 2018) has shown that productivity in the UK's low-wage sectors – such as hospitality, retail and leisure – lags behind our competitor economies. Similar sectors in France and Germany produce the same value-added in four days as our sectors do in five. These differences are explained by factors associated with how well businesses use the potential of their workers.

The research specifically pinpointed in-work training, information technology (IT) usage, secure contracts and management quality as particularly important drivers of productivity in these sectors. This research underlies a point made by Andy Haldane (2020): 'higher quality work, like higher pay, can serve as a spur to greater work satisfaction and motivation, thus leading to higher levels of workplace productivity.'

These sectors are also hugely important to tackling the living standards challenge. Jobs in these sectors matter directly for tackling poverty. Around a third of people in in-work poverty work (measured after housing costs) in hospitality and retail alone. These jobs also make up a larger share of jobs in parts of the country where poverty rates are higher. As Mealy and Coyle (2019) show, in many low-productivity areas these sectors make up a large share of local employment opportunities and there are fewer opportunities to progress out of them into better-paid work. Improving productivity in these sectors is also vital to making the most of the spillovers from high-productivity jobs, by ensuring the jobs created offer decent and secure incomes.

Principle 4: Improve productivity in low-wage, low-productivity businesses and sectors by improving the quality of work, boosting in-work training and enhancing management practices.

This could be done through providing business incentives to train workers, such as an in-work training tax credit (Tanner et al, 2019), investment in business support services to improve management quality, and providing better-quality jobs through more secure and stable contracts.

Box 3 reiterates these four principles and summarises how they could be met:

Box 3: Four principles to level up the post-COVID-19 economy

Principle 1: Take action now to stop the levelling-up challenge becoming even harder. The next stage of economic support needs to focus on maintaining spending power and focusing job creation in our weakest economies most likely to see a rise in the unemployment rate as the furlough scheme is wound down.
This could include targeting job creation and infrastructure schemes on areas where unemployed people have fewest job opportunities, providing extra local stimulus through direct transfers or local voucher schemes, and extending support for businesses in local areas seeing a prolonged downturn.

Principle 2: Increase the scale of investment in basic, digital and vocational skills to match the ambitious investments in infrastructure.
This requires the Government to be less bound by the distinction between current and capital spending allowed by the fiscal rules. Investing in skills is important for restoring long-term growth, even though it must be classed as current spending rather than capital investment.

Principle 3: Increase the share of planned capital investment that will be invested in local public transport systems and lever this infrastructure investment to unlock opportunities for people trapped in poverty.
Providing affordable, reliable and efficient transport to these communities offers people the opportunity to access better local transport and for the local economy to realise the potential of a larger, effective working population.

Principle 4: Improve productivity in low-wage, low-productivity businesses and sectors by improving the quality of work, boosting in-work training and enhancing management practices.
This could be done through providing business incentives to train workers, investment in business support services to improve management quality, and providing better-quality jobs through more secure and stable contracts.

Conclusion

As we begin to emerge from the COVID-19 outbreak and look to rebuild our economy, levelling up the economy so that everyone feels as though they share in our national prosperity will be the greatest economic and social challenge we face. We need to aim to build an economy that offers everyone the opportunity to get a good job and to live in a community that enables them to be free from poverty wherever they live.

Recent political change highlights the increasing role that low-income voters are playing in our national politics, and that many people across the country feel cut off from the income wealth that others are experiencing. Looking ahead to the next general election, both main political parties will need to show they have a credible plan to improve living standards.

This briefing has laid out four key principles for how to level up the economy for people currently trapped in poverty. As we begin to see the places being hit hardest by COVID-19, we need to act now to stop the levelling-up challenge being made even harder. We also need to invest now to tackle the deep-seated problems that currently hold many people and communities back.

Annex

Table 1: Correlation matrix for the child poverty rate, productivity and other local economic variables

Variables	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
(1) Child poverty rate before housing costs	1.00									
(2) Productivity (£ for every hour worked)	-0.28	1.00								
(3) Employment rate	-0.59	0.14	1.00							
(4) 25th percentile pay	-0.50	0.57	0.24	1.00						
(5) Median pay	-0.56	0.57	0.24	0.94	1.00					
(6) Share of the working-age population with less than NVQ Level 2 skills	0.65	-0.27	-0.41	-0.53	-0.55	1.00				
(7) Share of the working-age population with NVQ Level 4 skills	-0.49	0.43	0.22	0.70	0.71	-0.78	1.00			
(8) Share of jobs in manufacturing	0.21	-0.34	-0.00	-0.46	-0.45	0.35	-0.52	1.00		
(9) Share of jobs in low-wage sectors	-0.06	0.00	0.03	0.06	0.10	-0.02	0.04	-0.30	1.00	
(10) Share of jobs in knowledge-intensive business services (KIBS)	-0.36	0.64	0.14	0.65	0.69	-0.43	0.60	-0.50	-0.00	1.00

Notes: NVQ = National Vocational Qualification. The correlation coefficient captures the strength of a relationship, and ranges from -1, which is a perfect negative relationship, to +1, which is a perfect positive relationship. 0 indicates no relationship.

Source: JRF analysis using DWP (2020), ONS (2020) and local area data downloaded from NOMIS https://www.nomisweb.co.uk/

Table 2: Percentage-point change in child poverty rate associated with changes in local economic conditions

	Ordinary least squares (OLS) regression of child poverty against the following independent variables:			
	Productivity only	Productivity and pay	Productivity, pay and employment rate	Broader set of dependent variables
£1 increase in local productivity	-0.25	(Insignificant)	(Insignificant)	(Insignificant)
£1 increase in the 25th percentile pay		-3.5	-2.7	-1.7
1 percentage-point increase in the employment rate			-0.6	-0.4
1 percentage-point increase in the share of the working-age population missing NVQ Level 2 skills				-0.4
1 percentage-point increase in the share of the working-age population missing NVQ Level 4 skills				-0.1
1 percentage-point increase in the share of jobs in low-wage sectors				(Insignificant)

Notes: NVQ = National Vocational Qualification. Only effects significant at the 5% level are reported.

Source: JRF analysis using DWP (2020), ONS (2020) and local area data downloaded from NOMIS https://www.nomisweb.co.uk/

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About the Joseph Rowntree Foundation

The Joseph Rowntree Foundation is an independent social change organisation working to solve UK poverty. Through research, policy, collaboration and practical solutions, we aim to inspire action and change that will create a prosperous UK without poverty.

We are working with private, public and voluntary sectors, and people with lived experience of poverty, to build on the recommendations in our comprehensive strategy – We can solve poverty in the UK – and loosen poverty's grip on people who are struggling to get by. It contains analysis and recommendations aimed at the four UK governments.

All research published by JRF, including publications in the references, is available to download from www.jrf.org.uk

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