Devolving decision making:

3 - Meeting the regional economic challenge:

The importance of cities to regional growth

March 2006

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HM Treasury contacts

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For general enquiries about HM Treasury and its work, contact:

Correspondence and Enquiry Unit
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 4558
Fax: 020 7270 4861
E-mail: public.enquiries@hm-treasury.gov.uk

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Contents

FOREWORD – THE IMPORTANCE OF CITIES

The Government's central economic objective is to build a strong economy and fair society, where there is opportunity and security for all. An essential element of that objective is to create sustainable communities and improve the economic performance of every part of the UK, to promote a new urban renaissance, lifting growth and employment performance in our regions, building on the excellent work of Regional Development Agencies (RDAs); in our cities; and in our neighbourhoods, across the country.

As places where the majority of people live and work, cities matter to people's quality of life and life chances. English cities have made significant economic progress in recent years. Sustained economic stability and growth, combined with unprecedented public sector investment, has supported cities in competing more effectively in a rapidly changing global economy. Cities also matter because the productivity benefits they provide to knowledge-intensive businesses are important for regional and national prosperity and have an economic connectivity with other urban and rural areas. Cities provide an opportunity to narrow the economic gap between our regions and to tackle deprivation at the local and neighbourhood levels. Stronger links between cities themselves and between cities and regions will enable us to tackle economic performance within a wider strategy where cities and regions combine to promote rising prosperity and opportunity for all. In these circumstances cities should be integrated in to the wider strategic role of regional economic development.

All cities and regions must lift their economic performance, building on the foundations of macroeconomic stability, through enhanced employment and productivity growth, tackling the drivers of productivity – skills, investment, innovation, enterprise and competition. As many economic challenges cut across administrative boundaries, greater collaboration between key stakeholders such as RDAs, local authorities, government offices and regional assemblies, will reap economic rewards.

A central principle of the Government's established economic approach is therefore to devolve decision-making to the most appropriate level, finding the correct mix of decentralisation and devolution to local and regional levels. This makes it imperative for sub-national actors including regions, cities and local authorities to have clarity of purpose, strong leadership, good organisational capacity and flexibility along with the necessary policy levers. Thus sub-national economic development is achieved 'bottom-up' by agencies operating at the appropriate level within a clear but permissive national policy framework.

In recognition of these challenges this report examines the economic importance and performance of cities, and considers the role of different levels of government in supporting the enhanced economic performance of our cities. The forthcoming Local Government White Paper, the review of the Greater London Authority, the Lyons Inquiry and this year's review of sub-national economic development and regeneration will inform Government's work ahead of the 2007 Comprehensive Spending Review. This work reinforces the Government's commitment to enabling regions, cities and other local areas to enhance economic performance, which is key to delivering full employment and rising prosperity for all.

Minister of Communities and Local Government
Rt Hon David Miliband MP

Minister for Industry and the Regions
Rt Hon Alun Michael MP

Financial Secretary to the Treasury
John Healey MP

1 INTRODUCTION

THE GOVERNMENT'S APPROACH TO ECONOMIC DEVELOPMENT

1.1 The Government's central economic objective is to build a strong economy and a fair society, where there is opportunity and security for all. An essential element of that objective is to improve the economic performance of every part of the UK. Unfulfilled economic potential in every nation, region, city and locality must be released to increase the long-term growth rate of the UK.

1.2 The Government's commitment to the regional dimension of economic policy is set out in a Public Service Agreement (PSA) target to "make sustainable improvements in the economic performance of all English regions by 2008, and over the long term reduce the persistent gap in growth rates between the regions." This PSA is a shared target for HM Treasury, ODPM and DTI. The Devolved Administrations in Scotland, Wales and Northern Ireland work in partnership with the UK Government to promote economic development in their territories.

1.3 Regional policy is therefore a key element of the Government's economic and social strategy, based on devolution and decentralisation not just to the regions but further to the local level.[1] This is crucial so that local areas, led by local authorities, have the incentives and powers to deliver locally led solutions to improve prosperity in the context of Regional Economic Strategies, which are led by the Regional Development Agencies (RDAs). The regional economic performance challenge must, increasingly, be seen in the context of rapid technological change and a more closely integrated global economy, both trends which drive the imperative for more flexible and adaptive national, regional and local economies.

1.4 The increasing interdependence of the world economy means that every nation, region, and city of the UK faces more intense global competition. Flexible and innovative sub-national bodies are critical to harnessing indigenous strengths, overcoming long-term regional disparities, responding to short-term shocks, and harnessing the potential of sub-national economic growth.

1.5 Cities represent the spatial manifestation of economic activity – large, urban agglomerations in which businesses choose to locate in order to benefit from proximity to other business, positive spillovers and external economies of scale. This document sets out how successful cities can contribute to competitive regions, stimulating growth and employment, promoting excellence in surrounding areas and joining up separate business hubs to expand existing markets and create new ones. Building on *The State of the English Cities Report*,[2] this document extends the analysis and understanding of the economic role of cities and regions in lifting regional and national growth, and tackling disparities between places. It examines the drivers of, and constraints on, the economic performance of cities. It identifies the policy challenge in enabling English cities to build on recent economic growth, improve economic performance and catch up to international counterparts.

[1] See *Devolving decision making 1– Delivering better public services: refining targets and performance management*, and *Devolving decision making 2 – Meeting the regional economic challenge: increasing regional and local flexibility.*
[2] ODPM, March 2006.

I.6 This report also builds on previous Government documents that have examined the UK's productivity and growth challenge from the regional and local dimensions.[3]

Framework for regional economic policy

Macroeconomic stability and macroeconomic reform

I.7 The Government's strategy for strengthening regional economic performance has two broad strands: maintaining macroeconomic stability to help businesses and individuals plan for the future; and implementing microeconomic reforms to remove the barriers that prevent markets from functioning efficiently and flexibly. This is underpinned by the decision to make the Bank of England independent and the introduction of prudent fiscal rules to ensure sound public finances and to make fiscal policy decisions more transparent and open. It is further supported and strengthened by microeconomic reforms to address the five drivers of productivity (skills, investment, innovation, enterprise and competition), and to encourage people into work by making work pay.

Principles for regional policy

I.8 Against this background the Government's framework for regional policy has developed based on two principles:

- enabling leadership so that national, regional and local institutions can exploit indigenous strengths and tackle the particular challenges of each area; and
- providing the environment for businesses and communities to maximise their potential by tackling market failures in national, regional and local markets through targeted reforms to strengthen the key drivers of productivity, growth and employment.

I.9 There is evidence of inter- and intra-regional disparities in skills, employment levels, business start-ups, levels of research and development (R&D), business investment and availability of venture capital, as this report shows. The guiding principle in economic terms therefore is that where the market failures that underlie these disparities are primarily regional and local, the policy response should be designed and delivered regionally or locally.

Devolving decision-making

I.10 Effective policy responses to the challenges described above need to combine actions at national, regional and local levels, maximising the synergies between all geographical levels from neighbourhoods to countries. It is imperative that devolved decision-making properly encourages coordination and collaboration in order to ensure maximum impact.

I.11 Devolution of substantial powers to Scotland, Wales and Northern Ireland, in 1999, mean that Devolved Administrations have wide-ranging responsibilities in relation to public service delivery and economic development.[4] In England, RDAs were established in 1999 to act as the strategic leaders for economic development and growth in the English regions. The introduction of a single pot for the RDAs reinforced the Government's commitment to devolving decision-making to the most appropriate level. In 2000, the Government created the Greater London Authority (GLA) to which it devolved responsibility for economic development, regeneration, planning, housing and transport.

[3] *Productivity in the UK: 3 – The Regional Dimension*, HM Treasury and DTI, November 2001; and *Productivity in the UK 4: – The Local Dimension*, HM Treasury and ODPM, July 2003.

[4] Devolution is currently suspended in Northern Ireland.

Regional Development Agencies

I.12 The RDAs set out the shared growth priorities for each region and local area in Regional Economic Strategies. Many of these strategies have recently been updated to sharpen their focus on distinct regional priorities, informed by a robust evidence base. In the North of England, the three Northern RDAs have worked together with other regional and local partners to develop the Northern Way growth initiative, launched in 2004 by the Deputy Prime Minister. The RDAs recognised from the outset that their strategic priorities needed to be aligned at the sub-regional level and developed appropriate sub-regional partnership arrangements to develop these priorities. Increasingly, the RDAs and the Northern Way have recognised the particular importance of enhancing the economic performance of cities and city-regions for delivering on the Government's regional economic performance agenda.

Local Authorities

I.13 The RDAs are vital to the success of regional economic performance. However it is at the local level, through authorities prioritising economic development as one of their central objectives towards creating sustainable, thriving and cohesive communities, that changes leading to increasing prosperity in every area will be delivered. Local authorities have knowledge of factors affecting growth, such as differences in demography, history and economic and social structure between areas, and are best placed to lead and facilitate the partnerships that deliver economic growth on the ground. The Government has already taken action to enhance the economic development role of local authorities. A key challenge for the 2007 Comprehensive Spending Review will be to ensure that RDAs and local authorities work more closely together and have the right incentives and powers to have a real impact on local economic performance and growth.

The economic role of cities

I.14 The economic performance of local areas, cities, and regions is inter-related and the growth of each depends on the success of the others in reaching their full potential. Cities draw on their surrounding hinterlands, which provide additional skilled labour and affordable housing for a non-metropolitan workforce. The hinterland benefits from increased investment in infrastructure, higher employment levels and increasing prosperity. Often, the interactions between cities and their surrounding areas leads to a coming together of similar types of businesses and people in agglomerations.

I.15 Agglomerations or 'clusters' of firms and skilled workers within cities have important implications for regional economic performance. Recognition of the link between cities, agglomerations within regions and regional economic performance is illustrated in practice by the work of RDAs on regional economic strategies and City Region Development Plans. These strategies identify the comparative advantages of sub-regional areas and localities, and present different solutions for different parts of the regional economy.

I.16 Clusters of firms gain from spill-over effects from other firms' innovative activity, the existence of advanced or 'thick' local labour markets, and market benefits both in terms of overall market size and through linkages between firms up and down the supply chain. These effects can help create virtuous circles for successful areas but also risk locking in economic decline in less successful ones. Experience suggests that agglomeration is geographically widespread and that clusters within the poorer performing regions may improve their growth rates relative to the more prosperous regions.

Performance of English cities

I.17 Internationally, cities' contribution to the national economy (in terms of GDP or income) is greater than their share of the national population, and the contribution of larger urban centres is proportionately greater.[5] English cities have, in recent years, enjoyed a significant revival, reversing periods of persistent economic decline and responding positively to structural changes in regional economies, in particular a global shift towards service industries,[6] though this should be seen in the context of stronger growth in some major cities outside England, particularly in the US and some major European cities.

Ongoing challenges

I.18 The UK economy is currently experiencing its longest unbroken expansion since quarterly national account data began, with the macroeconomic framework continuing to deliver domestic stability. However, while cities are contributing to this strong macroeconomic position by leading regional growth rates, there is still substantial variation in their economic performance. Between 1995-2002, 9 cities managed cumulative growth rates 10 percentage points above the national average and 31 cities performed worse than the national average, 15 with performance 10 percentage points below the average. English cities generally, with the exception of London, are lagging behind some of their counterparts in Europe and beyond. If the economic performance of cities in England matched that of their best performing international competitors, the national GDP would be even stronger.

I.19 Despite strong overall economic performance cities also contain significant pockets of deprivation. Historically, the highest levels of deprivation have occurred in London and the metropolitan centres and large cities of the north and west, typically former industrial hubs. Despite good progress over recent years in moving people from welfare in to work, there remain pockets of persistent deprivation characterised by low employment, low skills, poor health, high crime and weak overall economic performance. Concentrations of deprivation often persist alongside, or close to, successful city centres. For example, *Employment opportunity for all: Analysing labour market trends in London*, published alongside Budget 2006, sets out the employment issues and challenges of disadvantage also faced by London.

I.20 Persistent disadvantage means deprived areas do not realise their full economic potential, reducing quality of life and access to employment and opportunity for the population. As well as failing to maximise economic potential, and sometimes making the city a less attractive business location, this risks exacerbating problems of social exclusion.

I.21 Cities face the challenge of combining economic growth with increased social cohesion – spreading the benefits of enhanced economic performance to poorer neighbourhoods and communities, within cities, and to include smaller cities and towns in increased prosperity. Devolving decision-making to the regional and local levels has helped to deliver economic strategies and interventions that reflect local and regional priorities, and ensure flexibility to respond to changing economic circumstances and short-term shocks. It is imperative that cities and regions benefit from this greater devolution, ensuring they are best placed to contribute to stronger regional growth and encouraging better collaboration and coordination across cities. Grasping the benefits of decentralisation may require greater co-operation between cities to tackle challenges, and take advantage of opportunities that cut across administrative boundaries.

[5] *Cities and national economic growth: A reappraisal*, Urban Studies, 2005.

[6] See *The State of the English Cities Report*, ODPM, March 2006.

CONCLUSIONS

I.22 This document highlights the importance of cities as drivers of growth and employment within regions, and the importance of the interaction between different strands of sub-national governance in maximising the economic potential of cities and regions.

I.23 Given the importance of cities as places where the majority of people live and work, and the strong links between city and regional economic growth in an increasingly integrated global economy, lifting the economic performance of cities is critical to improving the economic prospects of regions and to tackling disparities between regions. The following chapters explore further the reasons why cities are important in the context of a broader economic definition of cities; examines the comparative performance of English cities domestically and against European counterparts; and considers the challenges facing cities in lifting their economic performance.

2 UNDERSTANDING ENGLISH CITIES

2.1 There are many definitions of a city, meaning different things to different people, depending on the context. Considering the economic impact of cities nationally and sub-nationally requires an analytical construct that looks beyond administrative boundaries and measures the footprint and resonance of a city within a region – a concept commonly referred to as city-regions. This chapter introduces such an economic definition of cities, which is helpful for exploring the contribution cities make to regional economic performance, providing a conceptual approach to guide the analysis. This economic definition allows us to understand why there are different city types and sizes, with different industry or sector mixes, and their effect on the English economy.

An economic definition of cities

2.2 Historically, cities developed primarily because of the benefits of proximity – either to some natural resource or infrastructure, such as coal, or a port; or to a centre of administration or government.[1] This proximity reduces the transportation costs of bringing together goods, ideas and people for the purposes of exchange and production. The costs of sharing information have fallen more than costs of movement of physical goods making proximity factors more important for producers of physical goods than for service industries. This is reflected in early evidence of the effects of globilisation. While these types of proximity factors are still important for many industries, there are also benefits simply from workers and firms being located closely together.

2.3 Firstly, cities bring consumption benefits to the people that live in them. Cities provide a rich variety of goods and services, as well as social and cultural opportunities. This is reflected in the increasing phenomenon of outward commuting – in London, a quarter of a million people leave the city boundaries to travel to work each day – with people paying a cost premium to live in city centres.[2]

2.4 Secondly, and more importantly for the economic performance focus of this paper, the proximity of economic activity within cities raises the productivity of firms and workers because cities:

- provide access to large markets and to suppliers of goods and services (often referred to as forward and backward linkages);
- facilitate knowledge sharing, through the face-to-face contact of workers and entrepreneurs and from the movement of people between jobs. Firms in the same locality can also observe other firms' activities and developments, exchange ideas, and learn from and develop other firms' innovations; and
- offer large and concentrated labour markets, which provide more effective matching of vacancies and greater access to a range of skilled workers.

[1] There is evidence to suggest that cities at the centre of political power offer a distinctive economic benefit to inhabitants and investors. Survey evidence of international firms suggests an attractiveness to investing in capital cities which may be partly driven by a desire to locate where governance is perceived to be good and near where political decisions are.

[2] *Consumer City*, Glaeser, Kolko and Saiz, 2001 found that high amenity cities have seen faster population growth than low amenity cities and that US urban rents have gone up faster than urban wages. This means that some people are willing to pay a premium to live in cities over and above the higher wages they can earn from working in cities, suggesting cities must provide consumption benefits.

2.5 Identifying proximity as the economic rationale for the existence of cities leads to an economic definition of a city as an 'urban agglomeration' or the area over which the productivity of workers and firms is increased from proximity or clustering. This economic definition of cities as places for production and exchange is often referred to as city-regions and is distinct from the concept of cities as administrative units (see Box 2.1 for a summary of different definitions of cities). Indeed as many people and economic flows overlap city local authorities' boundaries, cities have an 'economic footprint' that does not typically correspond to administrative city boundaries.

Box 2.1: City concepts

There are many definitions of a city, meaning different things to different people, depending on the context. In particular, a city can be understood at more than one spatial level:

Municipal city is the city defined by the area administered by the city council. An example would be the Manchester City Council.

Metropolitan city is the city identified by the contiguous built-up area, including neighbouring towns and suburbs, and reflects the spread of development beyond its core area into its suburbs. An example would be the area of Manchester covered by the Association of Greater Manchester Authorities (10 local authorities in total). This definition of a city most closely equates to the Primary Urban Areas (PUAs) that are used as a base for analysis in the State of the Cities report.

City-region or functional economic city is the economic footprint of a city – the area over which key economic markets, such as labour markets as measured by travel to work areas, housing markets and retail markets, operate. City-Regions are the enlarged territories from which core urban areas draw people for work and services such as shopping, education, leisure and entertainment. The city-regional scale also plays a significant role for business in organising supply chains and accessing producer services.[a] An example would be the area covered by the Manchester City-Region Development Plan, which included parts of Cheshire and has a strong inter-dependent relationship with Merseyside and Leeds. This definition of a city, using the travel to work area as its proxy, is used by the State of the Cities report when it assesses the economic performance of English cities.

Throughout this paper, when the term:

- **"city" is used, it means the metropolitan city unless stated otherwise; and**
- **"city-region" is used it means the functional economic city, defined by its Travel to Work Area (TTWA) unless stated otherwise.**

[a] *A framework for city-regions*, SURF, 2006.

2.6 This wider functional economic area is an important determinant of people's quality of life and access to opportunity.[3] At the time of the 2001 census, 40 per cent of the working population crossed at least one local authority boundary during their journey to work and this percentage figure increases for higher skilled and professional workers. There are also many other ways in which people 'use' complex urban areas and the facilities distributed across them – people may live in one administrative area, work in another area, send their children to school in a third, spend a proportion of their leisure time in a fourth, use the services of a hospital in the fifth and so on.[4]

[3] For example, *Economic linkages across space*, Venables, Overman, Combes, Duranton, 2005 shows that the benefits of increasing population on productivity are greatest within 40 minutes driving time tapering off quite sharply, with no effect after 80 minutes.

[4] *A framework for city-regions*, SURF, 2006

Cities are diverse

2.7 While proximity drives cities, differences in the value of proximity to firms and industries mean that there is scope for cities of different shapes and sizes. Proximity brings costs as well as benefits – as the population increases so do the costs of congestion, labour and land.[5] These costs limit agglomeration and the point at which agglomeration benefits dip below its costs will vary between industries or sectors and within product life-cycles:

- some sectors or firms benefit from the 'urbanisation economies' of locating in large and diverse cities, while others benefit from sector specific localisation economies of being in places where lots of similar activity is taking place;[6] and
- the most complex, diversity-dependent products will originate in the largest and most diverse cities. As a product becomes more standardized (especially in manufacturing), localisation economies will become more important than urbanisation economies and production will increasingly move to medium-sized cities.

2.8 Therefore, different places of different sizes play distinctive, and complementary, roles in regional economies, and have different experiences, challenges, and opportunities. *The State of the English Cities Report* conceptualised England's urban system by developing a typology of English cities:

- London;
- six metropolitan centres (Birmingham, Leeds, Liverpool, Manchester, Newcastle, Sheffield);
- large cities with a resident population of over 275,000 in 2001;
- small cities with a population are between 125,000 and 275,000;
- large towns between 50,000 and 125, 000 population; and
- small towns below 50,000 population.

2.9 A clear focus on the potential of the city and the city-region within the economy of a region is not to overlook the economy of rural areas. Rural and urban communities are fundamentally interdependent. Indeed, the success of the rural economy depends fundamentally upon – and contributes to – the success of the urban economy. That interdependence was a theme of the Sustainable Communities Summit. The Government will continue to build the evidence base and develop our understanding of this relationship.

2.10 The urban hierarchy – between large, medium and small cities – is relatively stable over time as a consequence of the relative balance of benefits and costs of agglomeration.[7] For example, between 1913 and 1998 the broad hierarchy had continuity, albeit with shifts in

[5] *Medium sized cities*, Henderson, 1997 gives examples from the US where differences in the cost of living between small and large cities were around 60 to 100 per cent.
[6] Evidence from *Marshall's scale economics*, Henderson, 2003 for the US suggests that own industry localisation effects matter for some, but not all industries, and that these effects persist over time. For example, high-technology industries benefit from own industry clustering and the effects persist over time, while there appear to be no such benefits for the machinery industry. Similarly, recent empirical work for the Department of Transport by Graham (forthcoming) suggests that some service industries see continuing advantages as cities become more dense, with the highest return from proximity being found in business and financial services and real estate. However, manufacturing sectors tend to benefit most from medium density conurbations.
[7] *Medium sized cities*, Henderson, 1997.

economic activity from northern cities to southern cities and from coastal cities to inland cities. Within this urban hierarchy, cities – whether large, medium or small – are interdependent (see Chapter 3).

2.11 However, smaller and medium-sized cities play a vital role and can provide comparative advantage as a business location. They can offer lower costs to businesses or sectors where 'cross-industry' agglomeration is less important or where lower costs are more important than agglomeration externalities. This is reflected in the important role medium-sized cities play in generating employment and contributing to regional and national economic performance. For example, around 25 per cent of national employment is provided in cities other than London and the eight core cities, with around 34 per cent provided in their city-regions (based on the State of the Cities Report definitions). However, as smaller and medium-sized cities tends to be more specialised than larger cities, they may be more vulnerable to changing economic conditions (see Box 2.2).

Box 2.2: Diversification vs. specialisation

Economic adaptability is becoming even more important as the pace of economic change accelerates in an increasingly integrated global economy. This dynamism adds a further challenge to the economic performance of cities, as adaptability is at a premium in a rapidly changing environment. As the economic environment evolves in ways that are difficult to predict, flexibility to take advantage of new opportunities provided by the knowledge-driven economy is key.

Larger and more diverse cities, which are least dependent on a single sector, may be better placed than specialised cities to provide this flexibility. Highly specialised urban economies can face a greater risk of becoming stuck in particular structural and technological trajectories that make them very vulnerable to shifts in competition, trade and technology. However, specialised cities can also bring significant value to those industries that benefit from 'localisation economies' or clustering with firms in the same industry or business.

In an increasingly integrated global economy it is more crucial to encourage the flexibility to adapt and change. Over the long-term some English cities have seen economic restructuring in response to a decline in their 'traditional' specialism. For example:

- **Brighton, historically specialised in tourism has benefited from its proximity to London, becoming an important niche financial and creative industries satellite through the process of urban restructuring and regeneration;**
- **Bristol has developed a major national financial services and media specialism, with a strong central business district to help drive growth in the region (especially in combination with Bath and Cardiff); and**
- **Birmingham, Manchester, Liverpool and Leeds economic performance has benefited from restructuring. Leeds urban regeneration efforts have re-cast the city as a 'Business City' with a highly competitive offer to financial and advanced professional firms. In Manchester, the central city renaissance has broadened the appeal of the city for knowledge intensive and creative industries, media, technology, and broadly based business services.**

While cities are making progress, comparisons of GVA against other cities in Europe and America suggest much more room for performance improvement (see Chapter 4). In particular, English cities need to embrace the flexibility that can facilitate timelier and less painful adaptation to changing economic circumstances. Skills are a significant factor – with the pace of technological change and innovation in the global economy, the need for a skilled workforce with the flexibility to adapt to change is all the more vital.

2.12 A functional typology of medium and small cities could include:

- industrial cities (for example, Blackburn);
- heritage or tourism cities such as Blackpool and York;
- university knowledge cities (for example, Oxford and Cambridge);
- gateway cities such as Plymouth and Luton;
- cities which provide regional services such as Norwich; and
- cities that are part of large city-regions, such as Reading.

London **2.13** London is an enormous contributor to UK growth, houses a large percentage of its population and has well developed international networks (including legal and financial services), and clusters (including high-technology research). It is also the seat of central administrative and legislative power in the UK. Its unique economic, administrative and transport footprints have evolved incrementally and over the city's long existence. While London's GVA and impact as a driver of the UK's economic performance cannot be overlooked, Box 2.3 explains why London's uniqueness means it is not a model government should try to replicate elsewhere in the country.

Box 2.3 London

London is a global city that accounts for around one sixth of the UK's output and houses around 12 per cent of the population. It ranks alongside New York and Tokyo as one of the largest and most successful world financial and cultural centres. It has global connections second to none with – for example – the largest number of foreign banks of any of the world's financial centres, and five out of six of the headquarters of the largest global law firms. London's economic activity is much more focused on financial and business services and has a much smaller manufacturing sector than other parts of the UK: business and financial services together account for nearly half of London's total output and employ nearly one million people. As set out in *Financial services in London: Global opportunities and challenges*, the Government is committed to doing more to promote London as a centre for financial and business services. London also accounts for a substantial share of the total UK output of creative and leisure industries, partly relying on the fact that London receives just under half of all visitors coming to the UK.

London also faces particular challenges combining economic vibrancy with opportunity for all. For example, household incomes are more polarized in London and child poverty rates in London are the highest in the country, reaching 35 per cent in inner London, compared to 19 per cent across Great Britain. Current employment rates in London are only marginally higher than they were in 1997, the smallest increase of any region. *Employment opportunity for all: Analysing labour market trends in London*, published alongside the Budget, analyses the underlying reasons why this is the case, as a basis for future policy action.

In establishing and devolving considerable powers to a new Greater London Authority, the Government recognised the unique status of London. Its historic governance arrangements and the clear definition of the 32 London Boroughs and the corporation of London gave a strong precedence for a city-wide authority. The Government is currently considering granting further strategic and delivery responsibilities to the GLA to better match provision of public services to specific needs across the capital. .

Figure 2.1: The coincidence between administrative cities and city-regions varies

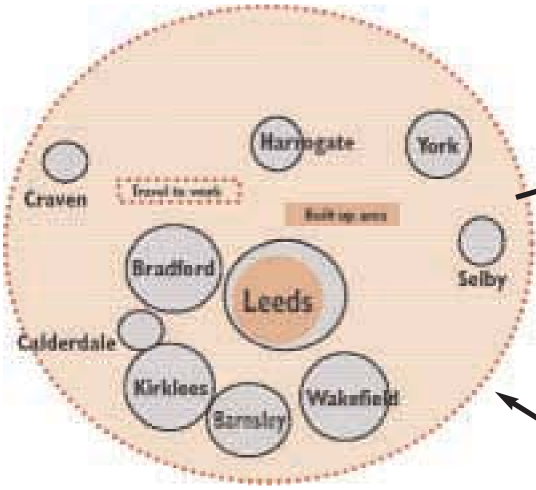
Nottingham metropolitan city

Nottingham is a classic example of under-bounding.

This means strategic decisions at the metropolitan level need to be taken across five District Councils and two County Councils

The footprint of the Nottingham economy overlaps with that of Derby and Leicester.

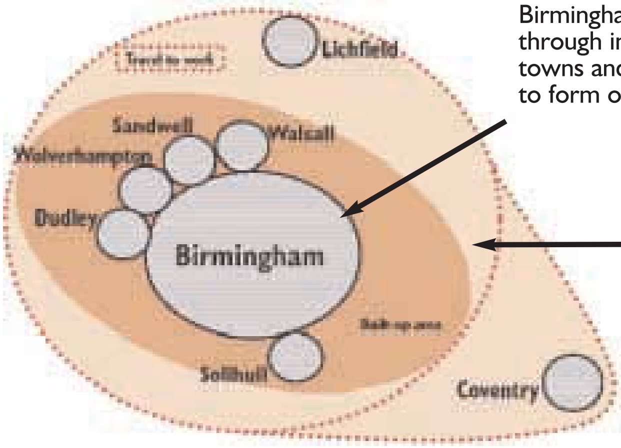
Leeds city–region



Leeds is a classic example of a well-bounded city. The City Council has a remit over the whole of the contiguous built up area of Leeds. This has advantages. For example, the Leeds Initiative has been a leading example of a strategic partnership operating across the city since the early 1990s.

Leeds has a relatively large and successful economy, with a significant economic footprint shown by its wide travel-to-work area. It is a major UK centre for finance, legal and business services. However, the long term success of the Leeds economy requires the capacity to capture the larger economic scale and the sharing of assets across the city-region.

Brimingham/West Midlands city–region



Birmingham is a classic example of where, through industrial development, existing towns and cities have grown and connected to form one large contiguous built-up area.

Birmingham has a large economic footprint illustrated by the travel-to-work area. Birmingham is also competing with the expanding London city-region and growth areas to the north (e.g. around Milton Keynes).

This is incentivising collaboration between cities in the metropolitan area and the travel-to-work area (e.g. the possible establishment of a city-regional executive board)

This is the economic city-region, based on the travel-to-work area

This is the municipal city boundary, an administrative and political definition

This is the metropolitan city, a physical definition based on the contiguous built-up area

Maximising cities' economic contribution

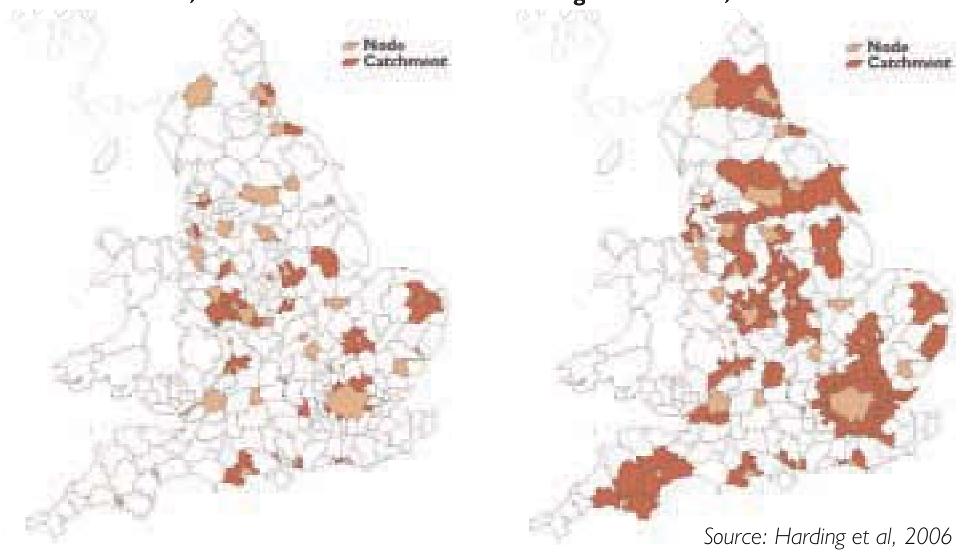
2.14 In considering how cities can maximise their contribution to regional and national economic performance, it is important to understand how, in specific cases, economic and administrative boundaries vary. As the area over which key economic markets[8] operate, the city-region is the most useful definition to use in seeking to understand the drivers of economic performance in cities and in designing policies to address constraints to city's economic performance. In particular, there is significant empirical evidence to suggest that the co-ordination of economic policies across the city-region is conducive to economic performance.[9] The challenge for each region varies, but in some cities historical spread of the city may go beyond the administrative boundaries (see Figure 2.1). For example:

- the economic footprint of Nottingham overlaps with that of Derby and Leicester, making it impossible to identify a distinct economic boundary for each of the cities; and
- some cities, such as Birmingham, have 'evolved' where two or more cities have grown up from being smaller independent settlements to form one larger metropolitan area, and where no one council has administrative control over the whole area.

2.15 The fuzziness of city-region boundaries – as illustrated in Figure 2.1 – suggests the need for flexibility in approaches to delivery of regional economic strategies through the city-region and collaboration across city-regions. In particular, the geography of city-regions varies depending on different functions or markets. For example, travel to work patterns may differ from the economic reach suggested by patterns of travel to entertainment venues or shopping centres or the geography of business supply chains. Even within one type of market, the idea of functional economic areas is not clear cut. For example, travel to work areas (TTWA) or labour catchment areas, are significantly greater for professional and managerial workers than for unskilled workers (see Figure 2.2). These types of complexities suggest that the appropriate city-region definition may vary for different types of issues or policy areas.

Figure 2.2: The coincidence between administrative cities and city-region varies

Catchments for routine and unskilled workers, 2001 | **Catchments for professional and managerial workers, 2001**



Source: Harding et al, 2006

[8] Such as labour markets, housing markets, and retail markets.

[9] See, for example, *European Urban Growth: throwing some economics light into the black box*, Cheshire and Magrini, 2005, and *Bigger, better, smarter*, IPPR, 2005.

2.16 This chapter has shown that the economic footprint of a city can far outstrip administrative boundaries and that factors such as catchment area and commuter links mean that an urban conurbation will bring a great deal of influence economically to an area outside its city borders. This reality is reflected in, for example, the Northern Way's strategic focus on city regions across the North. The challenge more widely is to ensure that regional economic strategies properly reflect both the important contribution of city regions in economic terms and the need to address possible barriers to achieving full potential. The next chapter identifies why cities matter for regional economic performance.

3 WHY CITIES MATTER

3.1 The previous chapters have described the importance of regional growth to the Government's central economic objective and have established an economic understanding of a city and city-region. The evidence in this chapter suggests that modern cities can play a key role in driving regional economic performance. Cities and city-regions:

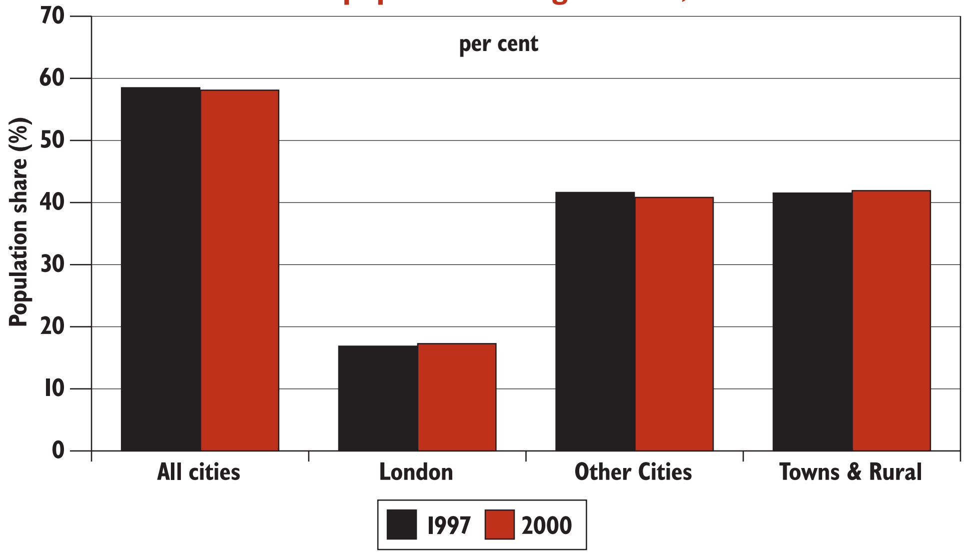
- are home to the majority of the population and to even more jobs;
- provide significant benefits to the knowledge intensive manufacturing and service industries that are important to regional and national growth in the global economy; and
- are central to driving regional and local economic growth, therefore addressing regional disparities and tackling neighbourhood deprivation.

CITIES AS HOMES AND WORKPLACES

3.2 Over the last few hundred years the clear demographic pattern has been of increasing migration into cities from surrounding areas, resulting in cities absorbing an increasing proportion of the world's economy. The picture in England and the wider UK is exceptional in the sense that large scale urbanisation occurred relatively early, but typical in the sense that the process was the dominant economic change from the seventeenth to early twentieth centuries.

3.3 The expansion in the population of English cities has not been entirely sustained, and in recent years the population of cities has not been growing as strongly as that of towns and rural areas.

Chart 3.1: Share of population living in cities, 1997–2003



Source: The State of the English Cities Report, ODPM, 2006.

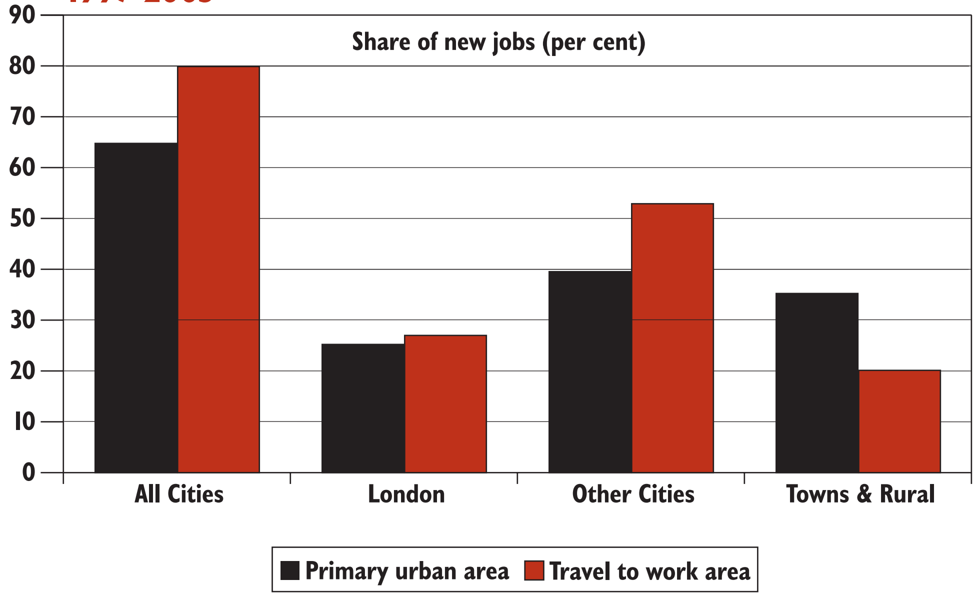
3.4 However, despite this, England remains a densely populated, highly urban population by most international standards[1] and the majority of English people (58 per cent) still lived in cities in 2003, (see Chart 3.1). Even more people live within commuting distance of cities, with 78 per cent of English people living within city-regions defined as the travel to work areas of English cities.

3.5 In addition, the share of national population growth occurring in cities has increased. Between 1997 and 2003 42 per cent of national population growth was in cities; and 58 per cent in city-regions. This represents a transformation from only 7.2 per cent of city-based national population growth over the 1980s.

3.6 Even more people work in cities than live in them and the contribution of cities to English employment growth has been strong (63 per cent of jobs were in cities in 2003, and 76 per cent were in city-regions). Cities provided almost 65 per cent of new jobs in England between 1997 and 2003, with around 40 per cent created in cities other than London. Almost 80 per cent of new jobs in this period were created in the more widely defined city-regions (the labour catchment area), with 53 per cent in city-regions other than London (see Chart 3.2).

3.7 Growth in employment has varied between different kinds of cities, with the large and smaller cities in the south and east performing best (London, Reading, Portsmouth and Bristol). However, the number of cities contributing to job growth has increased; with the rippling out of the economic recovery further west and north.

Chart 3.2: Distribution of new jobs created between 1997-2003



Source: The State of the English Cities Report, ODPM, 2006.

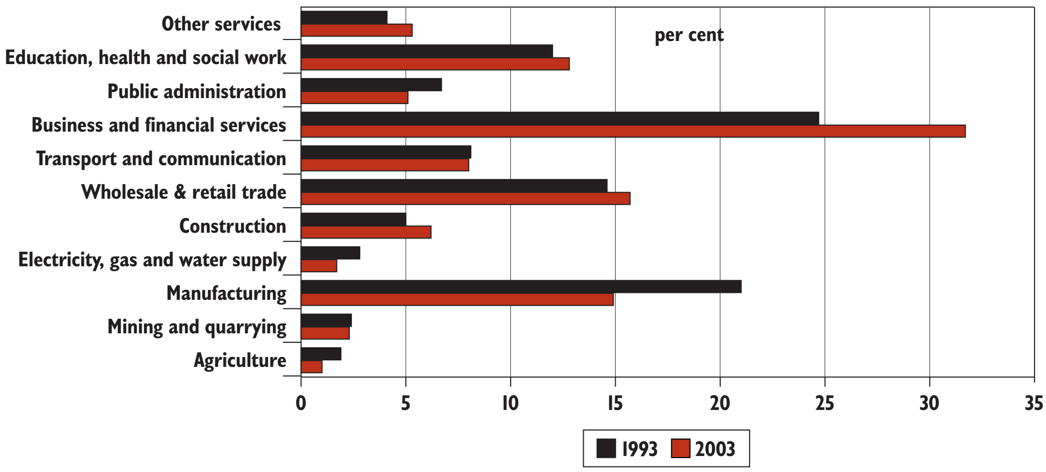
[1] The 1991 census showed that just over half the population of England and Wales were resident in the 66 large urban areas with populations of 100,000 or more.

CITIES' IMPORTANCE TO LOCAL, REGIONAL, AND NATIONAL GROWTH

3.8 The essence of why cities matter for regional and national economic performance lies in the very reason for their existence – proximity. The benefits from proximity explain why, across a wide range of countries with different economic systems and histories, cities, especially bigger cities, usually mean higher productivity and higher per capita incomes (Polese, 2005). There is significant empirical evidence of such productivity benefits, which are often referred to as agglomeration externalities.[2] Indeed while the economic performance of cities has been mixed, overall it is city-regions that have delivered the greatest increases in productivity and Gross Value Added (GVA) between 1995 and 2001.[3]

3.9 Furthermore, as globalisation increases the competition from emerging economies, England's comparative advantage is shifting towards innovative activity. This has accelerated the transition to high-value, knowledge-intensive sectors, such as business and financial services (see Chart 3.3), for which the benefits of proximity are particularly important. While the marginal cost of transmitting information across geographical space has fallen significantly, the marginal cost of transmitting knowledge, and especially tacit knowledge, still rises with distance. As knowledge can be difficult to codify, uncertain knowledge is best transmitted via face-to-face interaction and via frequent contact.[4] Therefore, the knowledge spillover benefits of clustering in cities can be large for high-value, knowledge-intensive sectors.[5] The close contact of thriving networks of related researchers and businesses will facilitate and accelerate advances in knowledge and innovation relative to the geographical dispersion of participants.[6]

Chart 3.3: Cities will grow in importance with high-value services



Source: United Kingdom Input-Output Analyses, 2005 Edition, Summary Supply and Use Tables for 1992 to 2003.

[2] For example Graham (2005) found a strong link between higher productivity and the effective density of activity, with the doubling of city size increasing average manufacturing productivity by 4 per cent and 12 per cent for service industries. Rice and Venables (2003) found that doubling density in the UK increases wages by between 3 per cent and 6 per cent. These effects decline steeply with distance – no evidence of effects between locations once travel times exceed 80 minutes.

[3] *The State of the English Cities Report*, ODPM, 2006.

[4] *Sticky information and the locus of problem solving: implications for innovation*, Von Hipple, 1994.

[5] Sensitivity of innovation and technologically advanced activities to agglomeration evidenced by: Audretsch and Feldman, 1996; Braczyk et al., 1998; Hall, 2000; Glaeser et al., 1992, 1995; and Duranton and Puga, 2002. Empirical evidence from Henderson (2003) for the US suggests that the benefits of clustering are much greater for high-technology industries.

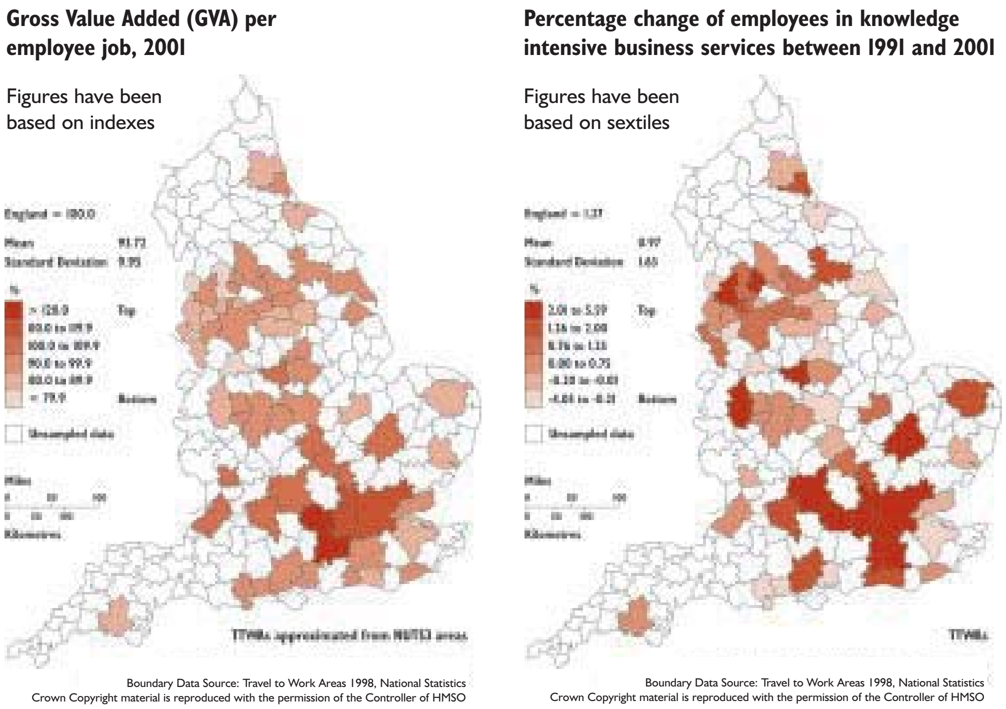
[6] Audretsch (1998) summarises a number of studies that highlight the spatial limits to knowledge spillovers and, therefore, the need for clustering to take advantage of such spillovers.

3.10 The English cities that are prospering are often those that are leading growth in knowledge intensive business and financial services (see Figure 3.1). As well as services, the proximity benefits of cities are important for a number of manufacturing businesses – notably in the case of high-technology modern manufacturers that invest heavily in knowledge, innovation and creativity, and draw on advanced skills.

3.11 Processes of agglomeration tend to lift productivity and, therefore, regional and national growth levels. As these wider productivity benefits reach further than the administrative boundaries of the central city, smaller cities and towns and rural areas within a successful city's functional economic area are also likely to share in the prosperity. For example, much of the South East and those parts of the Eastern region that are effectively part of the London labour market, benefit from their proximity to London.[7]

3.12 But not all places share in a successful city's prosperity. The higher productivity levels of successful city-regions may not just reflect the benefits of proximity but may also reflect their success at attracting high productivity sectors and the skilled people that work in them. While also increasing overall regional and national economic activity, to some extent cities are in competition with each other, and with other places, to attract economic activity. As cities are aggregations of people and industries, the extent to which other places will benefit from the success of a city will depend on the extent to which its different industries and skills are in competition with the city or complement it.

Figure 3.1: Gross Value Added (GVA) per employee



Source: The State of the English Cities Report, ODPM, March 2006

[7] *The State of the English Cities Report*, ODPM, 2006.

3.13 However, this process of competition is not a zero-sum game – Leeds' gain is not London's loss. In fact, evidence shows that inter-linkages between cities can spread the benefits of enhanced economic performance in one city to other places and is in itself critical to lifting regional and national economic growth levels by ensuring that economic activity is located in the places where the greatest value can be created. This will become increasingly important if English businesses are to thrive in more intensely competitive global markets. All cities can benefit from more competitive markets, and they will lift regional and national economic performance, if this stimulates cities to:

- provide an economic environment that nurtures productivity – thereby lifting the overall level of regional and national economic activity and potentially enabling all places to be better off;
- build on their strengths so that cities, as well as towns and rural areas, increasingly complement one another in competing within an internationally open economy for higher value activities; and
- take steps to nurture the pool of untapped economic potential by policies which actively reduce area-based deprivation.

3.14 Cities are highly dependent on each other and, while agglomeration in big conurbations can attract skilled workers from neighbouring areas, the challenge for these areas is not to construct defences to protect themselves from interaction with a powerful city-region, but to forge closer relationships with it.

Agglomeration and regional convergence

3.15 Agglomeration, or clustering – where firms in a sector or related sectors co-locate in a particular area in order to benefit from external economies of scale – can be a powerful force in creating dynamic industry clusters to drive growth, particularly in technology and knowledge-intensive areas. Agglomeration can occur at different levels, for example at the city level, as demonstrated by the financial services cluster in London, or at regional levels, such as environmental industries clusters in the south west and the south east.

3.16 As clusters develop, firms are able to derive productivity benefits from locating together; from locational advantages such as access to a pool of skilled labour, networks that facilitate knowledge transfer, and the ability to draw on specialised suppliers; and these advantages in turn attract more firms.[8] In some cases the benefits derived from these clusters can encourage firms to locate even in relatively high cost locations. And, as competition intensifies in the global economy, the benefits of agglomeration for firms in certain high-growth industries is likely to become even more important. Locational advantages can drive productivity and create a long-term lead in the successful region, while attracting labour and investment away from less successful areas. But, as a consequence, clusters could act to hamper regional convergence as the very success of a cluster may encourage other firms and individuals to relocate to it from less advantaged regions.

3.17 However, this conclusion is by no means inevitable. First, there is no reason why clusters should be focused in any particular region or locality of the UK. Experience suggests that clusters can occur in geographically diverse areas, such as the petrochemicals cluster in the north east, and clusters of creative firms in Manchester and Brighton, as well as London.

[8] See, for example: *R&D spillovers and the geography of innovation and production*, Audretsch and Feldman, 1996.

3.18 Second, agglomeration itself creates opposing forces, which over time can lead successful clusters to erode. Concentrations of firms and labour in a particular area will tend to push up rents, wages and other production costs. This creates incentives for firms to relocate to lower cost parts of the UK, offsetting the benefits of being part of a cluster. Skills shortages, and an inflexible business environment can also encourage firms to seek alternative locations.

3.19 Moreover, technological progress and the sectoral evolution of the economy will also be important. Not all technological progress results in new activities where clustering is likely to be prevalent, and many industries are not characterised by clear clusters. Moreover, technological change and the emergence of new sources of competition that lead to shifting comparative advantage can create additional challenges to which clusters have to adapt.

3.20 Technological progress creates other forces that drive convergence. For example, under-developed regions may be characterised by technology that is inefficient or out of date. Therefore, they have much more scope to catch up by introducing the more advanced technologies found in better performing regions. It is likely to be easier for under-developed regions to learn from, and adopt, existing technologies than it is to push out the technological boundary themselves. However, the adoption of existing technologies is itself likely to require substantial research and development investment. As such, R&D is no less important for regions and localities catching up than for those advancing the overall technological boundaries, though sometimes of a different nature.

3.21 Finally, technological progress may itself sometimes weaken the forces leading to agglomeration. In particular, improvements in IT and other forms of communication may allow firms to enjoy the benefits formerly obtained from close physical proximity in high cost areas even when they have relocated to lower cost areas. Such dispersal of activity could encourage convergence of economic performance across regions and localities.

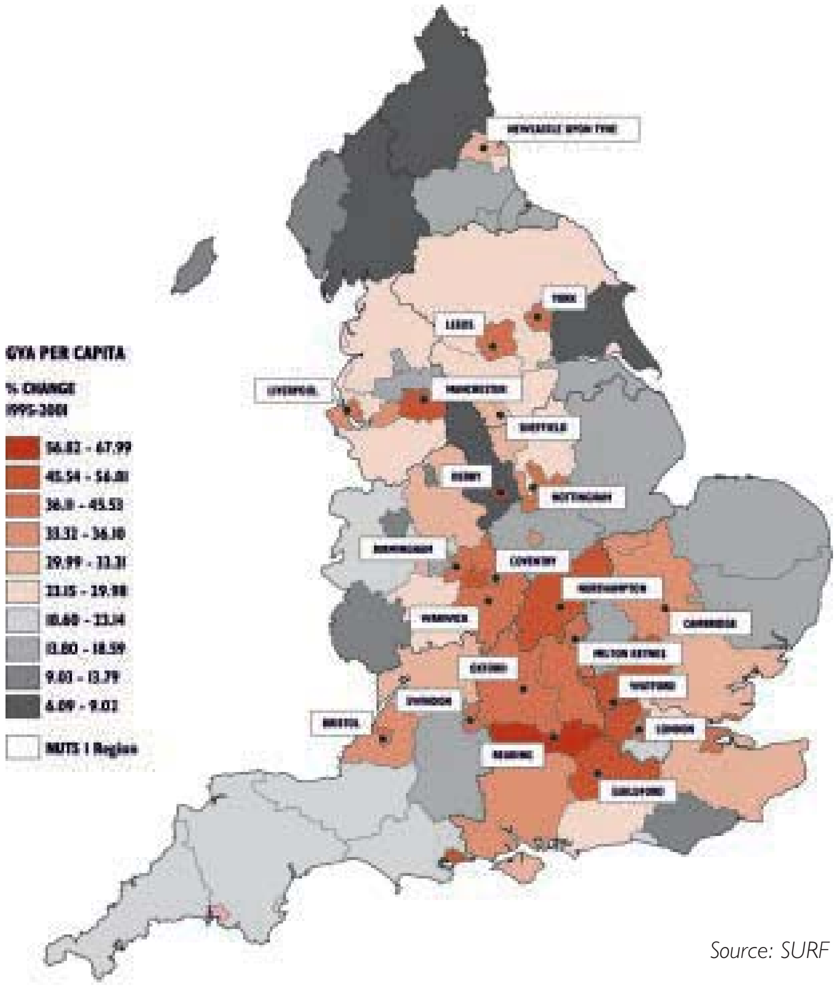
3.22 Overall, these factors create complex forces acting both in favour of economic convergence and against it. This complex inter-play suggests that development of a cluster that drives regional growth may support convergence to higher-growth regions. Sustaining and building upon the economic resurgence of city-regions will form an important part of lifting the growth rates of all regions and addressing regional disparities. Achieving regional growth targets in the slower regions will be enhanced by lifting the productivity and economic performance of the principal cities within those regions.

Cities' contribution to addressing disparities between places

3.23 Given the importance of cities as places where the majority of people live and work, lifting the performance of the weakest cities, coupled with support to the most disadvantaged groups within cities, must be important in reducing disparities between places. Cities are critical part of the equation in tackling differences in economic performance between regions, as well as the concentration of deprivation in particular neighbourhoods.

3.24 There is currently a striking regional pattern in the performance of English cities. However, while there are large variations in the economic performance of cities, city-regions have generally enjoyed the greatest gains in economic performance in the second half of the 1990s and since the turn of the century (see Figure 3.2). Lifting economic performance of cities across English regions must, therefore, be critical to tackling regional disparities.

Figure 3.2: City Gross Value Added (GVA) per capita, 1995-2001

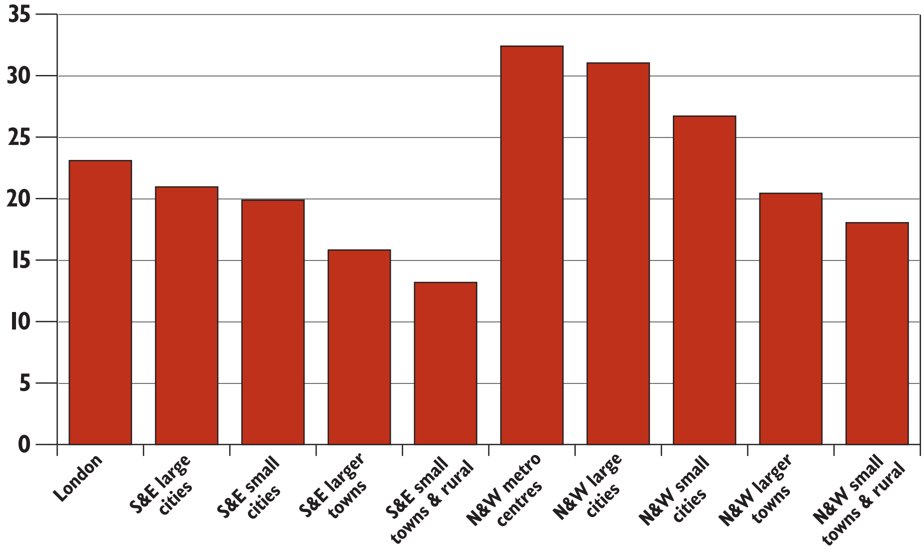


Source: SURF 2004

3.25 Disparities are even greater within regions than between them. As a consequence, the aim to narrow the gap between the most disadvantaged neighbourhoods and the rest of England remains a vital Government priority, reflected in the vision of the National Strategy for Neighbourhood Renewal that: “within 10 to 20 years, no-one should be seriously disadvantaged by where they live.” This is important for both economic and equity reasons – promoting the economic inclusion of people in deprived neighbourhoods is key to increasing employment and economic growth, and in promoting social cohesion and ensuring all can benefit from increasing national prosperity.

3.26 The Government’s Green Paper on welfare reform recognises that cities are central to meeting the Government’s aims of increasing prosperity and reducing poverty and social exclusion. Despite the post-war economic success story of cities, they still produce the greatest concentrations of deprivation in the country, greater than in most rural areas. The UK has a relatively small number of areas with an employment rate below the EU average, but nearly all of these are in major cities. Pockets of deprivation tend also to occur most frequently within cities, with some of the highest levels in London and the North and West of the country (see Chart 3.4). This suggests a correlation between weaker economic conditions in the wider city-region and deprivation within cities.

Chart 3.4: Neighbourhood deprivation[a]



Source: The State of the English Cities Report, ODPM, 2006.

[a] As measured by the Index of Multiple Deprivation – mean of super output areas.

3.27 However, the factors affecting the extent and location of neighbourhoods of serious deprivation are complex and varied. In particular, concentrated poverty and disadvantage, such as in social housing estates, often exists alongside, or close to, successful city centres. For example, London, Manchester and Leeds combine economic success with significant levels of poverty. The existence of concentrated areas of deprivation within economically successfully cities is likely to reflect the concentration of affordable housing in those neighbourhoods, with the 'sorting effect' of the housing market resulting in the most vulnerable living in poorer areas. However, once concentrated in these neighbourhoods, disadvantage may be reinforced through neighbourhood or area-based effects, such as poor schools, lack of job networks, a poor physical environment, high crime and a culture of low aspirations.[9] Therefore, understanding the factors that constrain people in disadvantaged areas from taking advantage of opportunities in the wider city-region may be an important part of tackling concentrations of deprivation.

[9] There is mixed evidence as to how importance such area or neighbourhood effects are. The Prime Minister's Strategy Unit and ODPM, 2005; cite UK and US evidence of such effects, while other studies, which control for the characteristics of individuals in the neighbourhoods find little evidence of them. See neighbourhoods, households and income dynamics: a semi-parametic investigation neighbourhoods effects, Burgess et al. 2004. The long-run consequences of living in a poor neighbourhood Oreopoulos, 2003.

4 The Economic Performance of Cities

INTRODUCTION

4.1 The Government's economic objective is to build a strong economy and a fiar society, where there is opportunity and security for all. To achieve this, the Government has put in place macro- and micro-economic reforms to improve the UK's economic performance, including independence for the Bank of England, reforms to the labour market to ensure employment opportunity for all, and a sustained agenda to drive productivity growth.

4.2 An essential objective within this is to improve the economic performance of every region of the UK, both for reasons of equity and because unfulfilled economic potential in every nation, region, city and locality must be released to increase the long-term growth rate in the UK.

Box 4.1: City success is multi-dimensional

While this report is focused on economic performance, it is recognised that economic performance and social inclusion are intertwined in ensuring cities represent sustainable communities that are able to deliver a truly high standard of living for their residents. The Government is committed not only to lifting economic performance, through employment and productivity growth, but also to creating sustainable communities by ensuring that economic growth is equitable and environmentally sustainable. There are three broad dimensions to sustainable cities:

- **Lifting economic performance** in all cities. As cities can make a significant contribution to the economic growth and prosperity of their region and the nation as a whole, it is important for all English cities to reach their economic potential
- **Reducing disparities** in economic performance between places, from the neighbourhood to the regional level. As both an economic imperative and a matter of social justice the Government believes that no place (ranging from country or region to neighbourhood) can be allowed to fall behind and that no one should be disadvantaged by where they live. Government is concerned not only about disparities in income but also the wider dimensions of social exclusion such as worklessness, and participation in the labour market, health, outcomes, crime rates, educational attainment, and housing, and incidence of homelessness.
- **Ensuring economic growth is environmentally sustainable**. The Government's commitment to 'sustainable development' is reflected in the Sustainable Development Strategy (DEFRA, 2005). The concept of urban environmental sustainability includes environmental quality and managing the environmental impact of cities, as well as 'liveability' or the quality of the built environment and the prudent use of natural resources.

These three dimensions are inter-related and, while there may sometimes be trade-offs between them, they are not mutually exclusive. For example, there are many synergies between economic performance and social inclusion. Enabling the socially excluded to reach their potential would enhance their contribution to economic performance. At the same time, robust economic performance is critical to creating the employment opportunities that provide a path out of deprivation. While many of our cities still combine economic success with concentrations of deprivation, the State of the Cities Report (2006) highlights that the chances of being income deprived in cities where per capita economic growth is less than the English average are generally higher than in those cities with more successful economies.

4.3 Previous chapters established an economic definition of cities and city-regions and described why, in the context of the objectives above, cities matter. This chapter sets out performance of cities in employment and productivity, showing that although there are large disparities between the best and worst performing cities, the recent past has seen a broad and welcome improvement in the economic performance of cites overall. The following chapter breaks down in more detail the drivers of cities' economic performance.

Economic Performance of Cities

4.4 Gross Value Added (GVA) per capita provides a measure of the value of goods and services produced in a city or city-region relative to its population, so is a good measure of the material standard of living a city-region is delivering to its residents. However in comparing economic performance between city-regions, it is also useful to consider other complementary indicators of economic performance (see Box 4.2)

Box 4.2: Comparing economic performance between city-regions

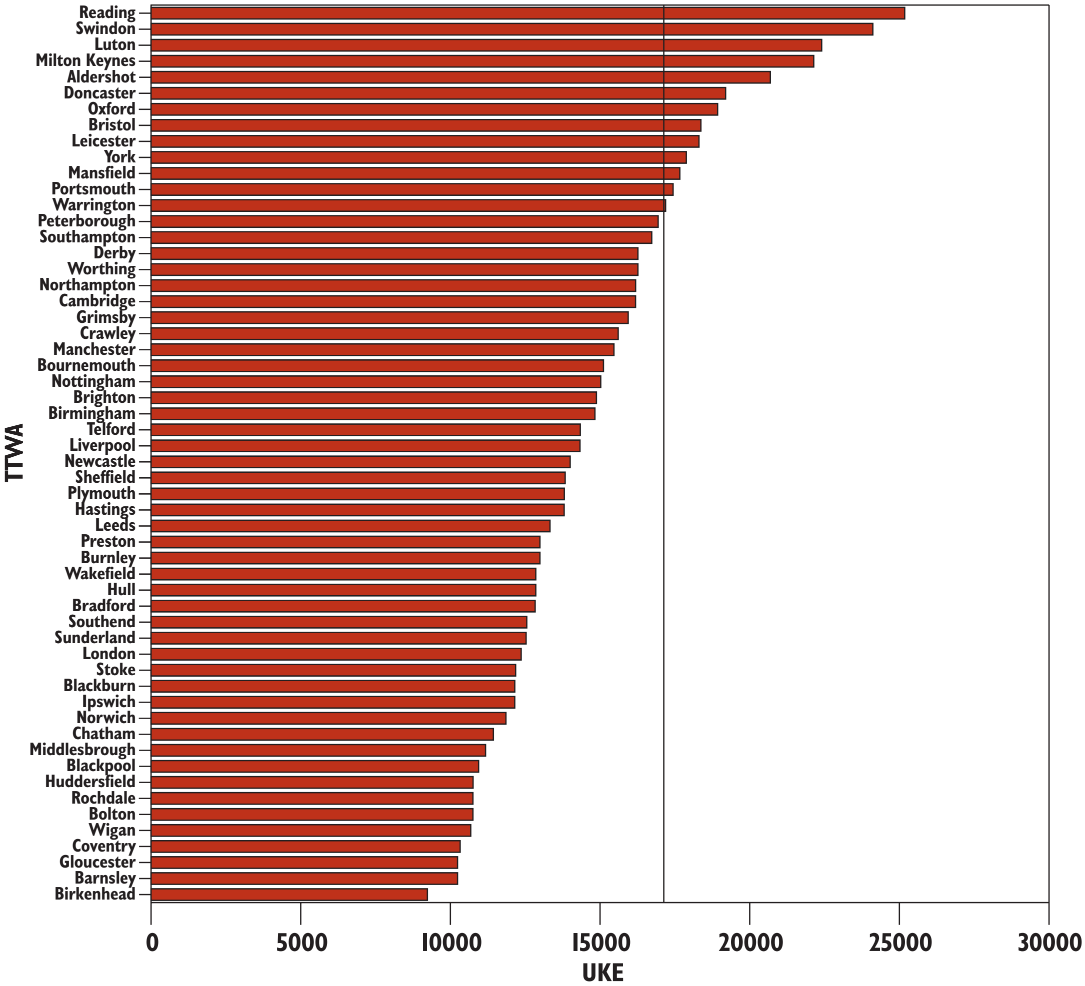
While GVA per capita is the most comprehensive measure of the economic performance of city-regions, analysis of complementary data can enhance our understanding of the drivers of differences in economic performance between cities:

- **Wages of similar workers. Some of the differences in GDP per capita between cities are driven by differences in their industrial and skill mix. Indeed these 'compositional' factors may explain a significant proportion of the differences in GDP per capita between places. For example, evidence suggests that the divergence in regional average earnings over 1982-1997 was largely explained by changes in the skill mix of cities.[a] In particular, London gained because its workforce became more educated over the period and returns to education increased nation-wide, which favoured the more educated regions, such as London.**
- **Sub-national price deflators. Differences in nominal GDP per capita may be partly driven by differences in the cost of living between places. However, while work is ongoing to develop them, robust measures of sub-national prices are not yet available.**

[a] Mind the Gaps: The Evolution of Regional Inequalities in the UK 19982-1997, Journal of Regional Science, Duranton and Monastiriotis, 2002.

4.5 There is significant variation in the material standard of living which English cities deliver to their residents, as shown in Chart 4.1. On a city-region basis, GDP per capita in 2002 was more than two and a half times greater in Reading, the highest performer, than in Birkenhead, the city-region with the lowest per capita income.

Chart 4.1: GVA per capita, in English city-regions



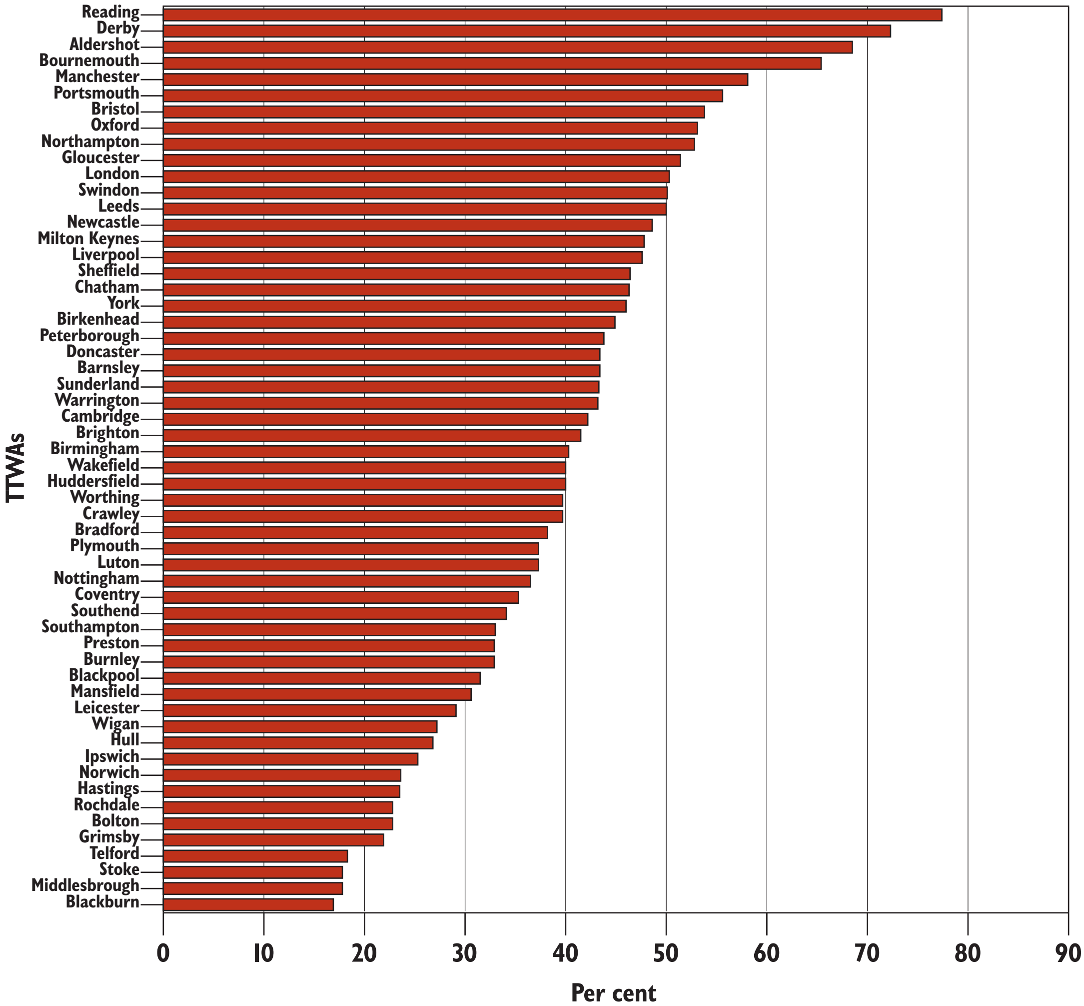
Source: The State of the English Cities Report, ODPM, 2006.

4.6 English Cities have made significant progress in lifting standards of living, improving economic performance and tackling deprivation, compared with the economic decline many experienced in the 1970s and 1980s. All English cities are performing better than they were twenty years ago, with many enjoying sustained economic growth over recent years. However, compared to some of their best performing European counterparts the performance of English cities could be stronger, although London continues to compare favourably with international cities. (See chart 4.3). London is a highly successful global city leading the growth of the greater South East. Other cities that had previously experienced serious economic problems have made strong progress in economic restructuring. For example, Bournemouth, Gloucester and Northampton have transformed their city-region economics from below to significantly above the national average between 1995 and 2002. The larger ex-industrial cities of the North, such as Leeds and Manchester, are finding new economic niches and leading Northern growth.

4.7 The growth of the knowledge economy (and services industry in particular) means that towns and cities are increasingly places of wealth creation, as well as of consumption, due chiefly to the agglomeration benefits they provide. The economic performance of England's towns and cities is based on a solid foundation and is continuing to improve. Public investment in schools, housing, hospitals and universities is modernising the fabric of our cities and reversing the population decline that has characterised them in recent years. But while at the aggregate level cities' economic performance has improved, growth and development in individual cities has been mixed.

4.8 Chart 4.2 shows that 25 cities (of the 56 analysed in the State of the City Report) grew faster than the national average between 1995-2002, including 6 of the 8 Core Cities. Nine cities managed growth rates of more than 10% above the national average. However, fifteen cities only achieved growth rates of 10 percent less or worse than the national average; and thirty one cities performed worse than the national average.[1] The best performing cities included a number in the south and east, but Bristol, Leeds, York, Manchester, Leicester and Peterborough were also growth leaders.

Chart 4.2: Economic performance in English city-regions



Source: The State of the English Cities Report, ODPM, 2006.

4.9 It needs to be recognised, however, that the comparisons of city-regions to national growth sets a very challenging benchmark for English cities given the dominance of London,[2] which is unusual by European and North American standards. That said, it is clear that making further progress in reducing disparities between regions will depend on cities outside of the South East building further on their economic potential.

[1] These data, and the employment and productivity data provided in this chapter, is drawn from *The State of the Engllish Cities Report* on the basis of travel to work areas (as an approximation of city-regions).

[2] Chart 4.2 shows the proportionate change in gross value added between 1995 and 2002. Some cities grew faster than London during this period and hence it appears eleventh in this table.

Box 4.2: International Comparisons

With the exception of London, comparisons of English cities' GDP per capita with other European cities suggest that English cities are lagging behind their European counterparts (see Figure 4.3). Comparatively larger English Cities scores relatively less well against European and North American cities. London scores well, but still faces a performance gap when compared with other very large successful cities. Smaller English Cities, such as Cambridge and Reading, score well when measured on Technology, Innovation, or Advanced Services. Of the larger cities, Manchester and Leeds have significantly improved their relative international performance recently, but have some way to go before they are leading European Cities.

What explains this performance gap?

1 The pattern of economic performance of English cities partly reflects the unusual dominance of London in the UK's urban system, with cities in the USA and Germany having a more poly-centric urban system. In addition, international comparisons tend to be based on administrative city data, rather than city-region data. Given that administrative English cities tend to have dispersed economic activities and smaller boundaries than all North American and many EU cities, there are substantial economic activities that lie outside the administrative city limits and are not captured in most international comparisons. Given that United Kingdom GDP exceeds many of our European counterparts (see Chart 4.3), it is likely that some of the difference between English and Europe cities is driven by different definitions of city boundaries.

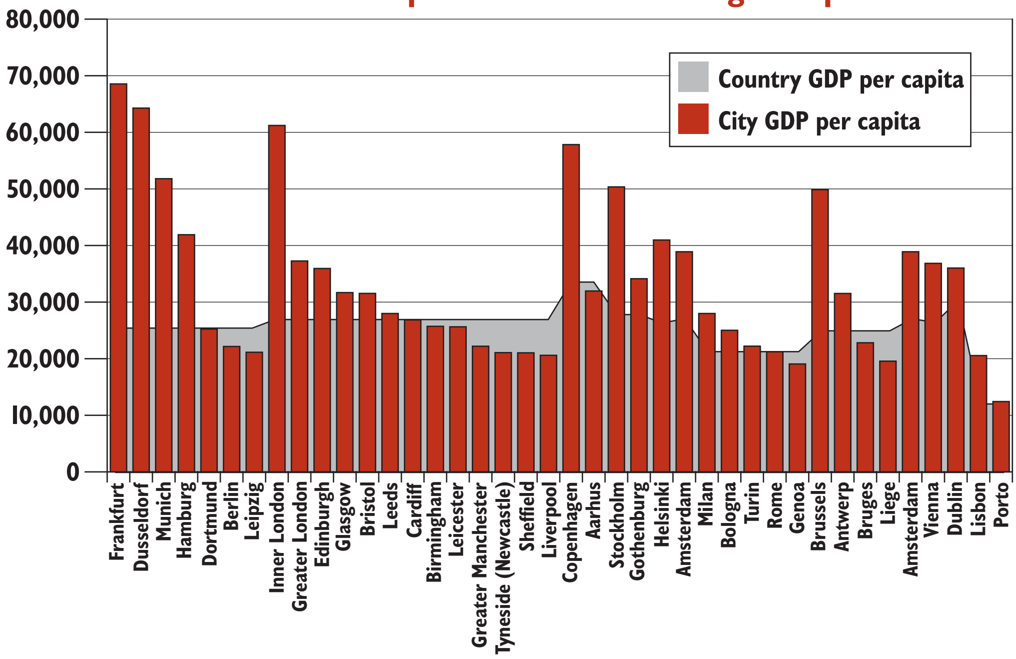
2 The 'under-bounding' of many English cities also risks sub-optimal policy interventions that tackle symptoms in a small area, rather than addressing underlying problems over the wider spatial scale which is more relevant for many economic issues. In addition, relative to most cities in EU and North America, English cities have comparatively less statutory powers, inhibiting them to an extent from fostering long term economic strategies and investment programmes. The lack of some degree of local financial autonomy, and the Executive leadership that comes with it, leaves English cities largely dependent on central Government policy making.

3. Many English cities, especially larger and smaller cities in the north and west of the country were the powerhouses of the industrial era and many became highly specialised in single sectors of industrial production. For these cities (Liverpool, Sheffield, Newcastle, for example) the transition to a knowledge led service based economy has not been easy and is still in process in many English cities. A key aspect of the transition is the re-skilling of people to increase participation in the labour market, and as well as the re-engineering of the built form of the cities to accommodate different economic activities.

4. As London is such a strong driver of UK economic performance, connectivity to London may be an important source of growth and value-added activity to other cities around the country. Good connectivity between cities in a country has the potential to support greater economic co-operation and support freight networks although the effects of connecting cities to each other can be ambiguous.

However English cities also experience significant benefits from the national framework in which they operate. National economic stability has produced increasing employment opportunities and this has translated into greatly improved employment rates in many English cities. Sound management of public finance has left English cities with low levels of debt and a prudent framework through which to borrow. National urban regeneration initiatives have been adopted and adapted by cities to further their urban renaissance.

Chart 4.3: Economic performance of leading European Cities



Source:Urban Audit, Eurostat, 2001

UNDERSTANDING THE DRIVERS OF ECONOMIC GROWTH

4.10 It is clear that there are large differences in the economic performance of cities in England, and also some differences between these cities and their international comparators. At the most fundamental level, differences in economic performance and material standards of living at all spatial levels, as measured by GDP per capita, can be explained in terms of variations in:

- employment: the number of people working, which in turn depends on demographics (the size of the working age population), labour market participation rates, and unemployment rates; and
- productivity: the output each worker produces.

4.11 Therefore, the capacity for economic growth at the city-region level, as for the nation as a whole, is ultimately driven by levels of employment and productivity. Cities will make the greatest contribution to regional and national economic performance if they focus on creating an environment that facilitates the agglomeration and consumption externalities that cities can provide. The challenges facing Core Cities in improving both their employment and productivity performance were discussed in a series of city summits in 2005 (see Box 4.3 for more details on Core Cities).

Box 4.3: Challenges highlighted by the city summits

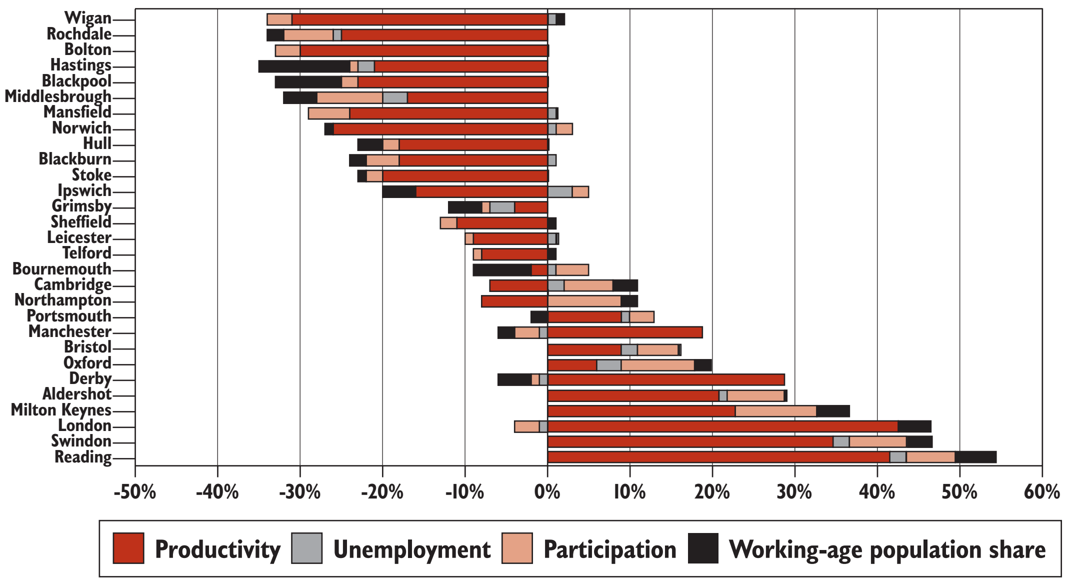
Summits were held in the eight Core Cities – Birmingham, Bristol, Leeds, Liverpool, Manchester, Newcastle, Nottingham, Sheffield – in autumn 2005 to develop a ten-year vision for each Core City. This involved developing understanding of the assets, barriers and enablers of city performance, and an exploration of what actions – at what level – could lead to improvement. The cities and their partners (including neighbouring authorities) have since submitted initial business cases to Government that set out their proposals.

In all cases, there was a strong emphasis on the need for greater and more effective partnership working at the city-region level (the level at which significant economic markets operate), as well as at the metropolitan level (the city's contiguous built up area including adjacent towns and suburbs). The proposals are informing the Government's identification of the key policy issues facing cities, and suggested ways of moving forward.

A second round of summits in smaller cities and towns are taking place between March and May 2006. Smaller urban areas also make an important contribution to the UK economy. But smaller cities and towns have different characteristics from London and the Core Cities and are therefore likely to identify some different barriers and a different set of solutions to improve their performance.

4.12 Statistical analysis of output, employment and productivity data for each English city can help separate out these factors. Chart 4.4 depicts such a statistical decomposition for selected English cities.

Chart 4.4: Composition of output, employment and productivity per capita, by city-region



Source: HM Treasury, 2006

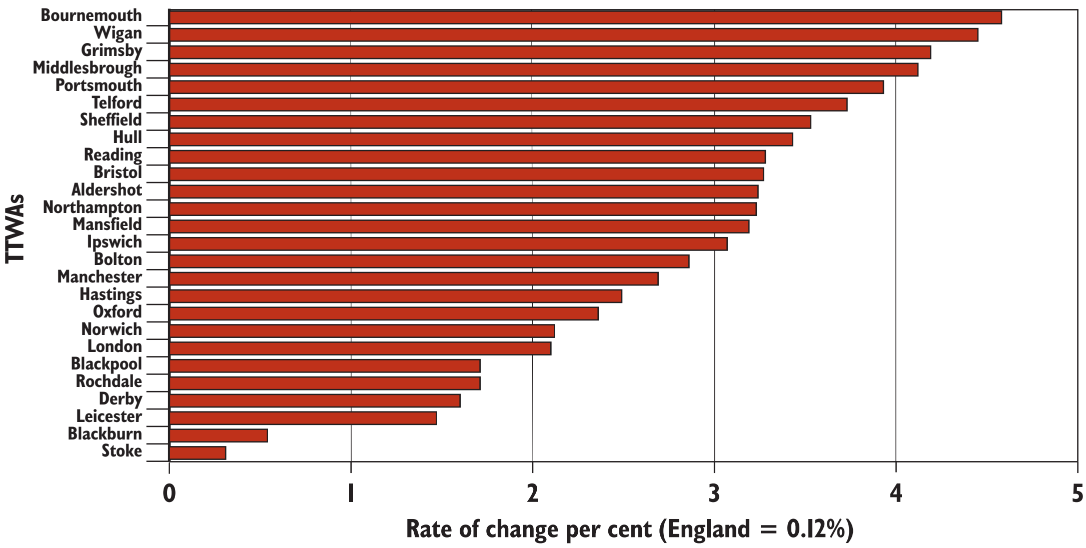
4.13 The relative performance of employment or productivity will vary across cities. The rest of this chapter will examine in greater detail these two components of differences in GVA per capita.

Employment

4.14 Employment in the UK remains close to record highs and is the second highest in the G7 after Canada, unemployment at 5.0 per cent is down from 7.2 per cent in 1997 and is around the lowest rate in 30 years. English city-regions generally have relatively healthy employment rates, with the majority enjoying an employment rate greater than or equal to the English average in 2001. However, performance is still mixed, with a 19.2 percentage point difference between the Swindon city-region, with the highest employment rate in 2001, and the Liverpool city-region that faced the lowest employment rate in 2001.

4.15 Despite this diversity in employment rates, almost all city-regions have seen an improvement in their employment rate over the last decade, with levels of employment increasing in most city-regions (measured by travel to work areas), as shown in chart 4.5. Indeed, some of the highest employment growth rates were experienced in those cities that started with the lowest employment rates at the beginning of the decade, such as Wigan, Grimsby, Middlesbrough, Sheffield and Hull. While the large and smaller cities in the South and East still tend to enjoy the highest employment rates, in recent years the job recovery has extended to the West and North.[3]

Chart 4.5: Employment performance in selected English city-regions



Source: State of the English Cities Report, ODPM, 2006

Worklessness

4.16 Whilst city-regions' unemployment rates have fallen significantly, many still have worklessness rates, which includes both the unemployed and the economically inactive, above the national average. Inactivity is often a more significant problem than unemployment with many areas experiencing significantly higher rates of inactivity than rates of unemployment.

[3] *The State of the English Cities Report,* ODPM, 2006.

4.17 There are also significant disparities in the levels of economic inactivity within city-regions. Despite progress over the last eight years, there remain persistent pockets or concentrations of unemployment and inactivity. Taking the Manchester city region as an example, inactivity rates vary from 4.8 per cent of the working age population in Macclesfield to 14.3 per cent in Manchester. Rates in London vary from less than 3 per cent in South Bucks and Elmbridge to 10.6 per cent in Hackney.[4]

4.18 Tackling this challenge will be important in addressing the significant pockets of deprivation that remain in cities. While cities can lift employment by either helping existing residents into work or attracting new workers, getting existing residents into work is important for tackling deprivation in cities. Many residents of cities are not in jobs even though they live within commuting distance of thousands of vacancies. This suggests that the problem may not be a lack of jobs but other barriers to mobility such as constraints of income, transport and/or domestic circumstances in ways which severely limit the job opportunities to which they can realistically commute, while 'neighbourhood effects' may also undermine linkages to job networks and training opportunities.[5] These types of factors mean that the disadvantaged can become 'spatially trapped'.[6] Therefore, tackling concentrations of deprivation may require local development to be complemented by policies which address the constraints to the ability of the inactive and unemployed to compete for jobs within their local economy and to take advantage of job opportunities across the functional economic area.

4.19 The Welfare Reform Green paper, in January this year, announced plans to pilot new partnerships between Jobcentre Plus, Local Authorities, Learning and Skills Councils, employers and the third sector, to deliver better co-ordinated employment and skills support for workless people in the UK's major cities. The aim of the partnerships will be to deliver a significant reduction in the number of workless people in those cities with a particular focus on incapacity benefit claimants, lone parents, older people and people from ethnic minority groups.

Productivity

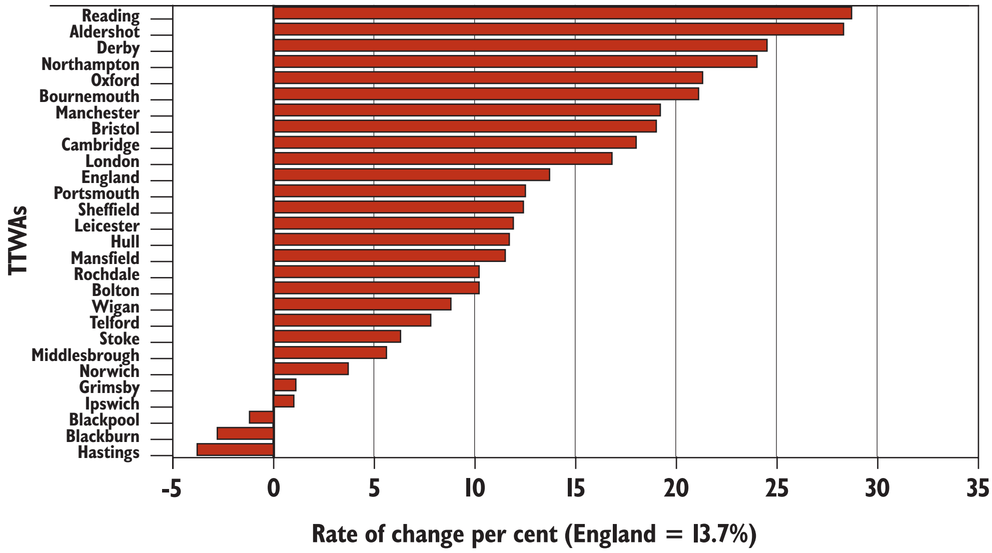
4.20 There have been significant variations in the productivity performance of English cities, as shown in Chart 4.6 below. In general the top-performing cities in terms of GVA per capita were also those who enjoyed the highest productivity growth, as measured by GVA per employee. The challenges facing cities in improving both their employment and productivity performance were discussed in a series of city summits in 2005, as well as *Productivity in the UK 6: Progress and new evidence*, published alongside Budget 2006. Differences in productivity are explored further in Chapter five.

[4] These data are sourced from the Department for Work and Pensions statistics in Incapacity Benefit and Severe Disablement Allowance as at August 2004.

[5] *Making the connections: Final report on transport and social exclusion,* Social Exclusion Unit, February 2003.

[6] In recognition of these challenges, the Government announced the Local Enterprise Growth Initiative (LEGI) in the 2005 Budget to provide around 30 successful authorities a flexible, devolved investment to support locally-developed and owned strategies that try out new or proven ways of stimulating economic activity and productivity growth through enterprise development.

Chart 4.6: Productivity performance of selected English cities, 1996-2001



Source: State of The English Cities Report, ODPM, 2006

1: GVA per employee

CONCLUSIONS

4.21 This chapter has demonstrated that English cities have made significant progress in economic performance, but that productivity and employment performance of the worst performing areas has persistently lagged behind that of the best. Addressing the gap in performance between English cities has a crucial role to play in the achievement of significant improvements in the UK's overall growth and employment rates and its overall standard of living.

4.22 Previous chapters have also shown that English cities remain less competitive in terms of productivity and economic growth than some of their international counterparts (though this chapter shows that some of this is due to differences of definition). Raising the economic performance of our cities is crucial to closing the productivity gap with other countries and in providing cities with the platform of stability and flexibility to respond to the opportunities and challenges of globalisation.

5 Understanding the Economic Performance of Cities

5.1 Chapters 2 and 3 outlined why and how cities significantly contribute to regional and national economic growth, acting as clusters (or agglomerations) of economic activity that create external economies of scale and facilitate exchange of knowledge and information. Chapter 4 then illustrated that while the economic performance of cities has improved significantly over the last decade, there still remains a degree of variation in economic performance between and within cities, and comparison with comparator international cities shows there is room for further improvement.

5.2 This chapter explains that globalisation and the rise of emerging economies raises new opportunities and challenges for the UK economy. While the UK is well positioned to capitalise on these opportunities, further progress is required in the areas of skills, science and innovation, regulation, planning and transport. To reinforce this drive for further progress, cities are key to providing the flexible business environment necessary to adequately respond to the opportunities and challenges that globalisation presents. However, to understand how cities are key to success in a globalised future also requires a good understanding of the economic history of how cities developed over time.

5.3 This chapter then explores the reasons underlying the current performance of English cities, focusing on employment and the five drivers of productivity: skills, investment, innovation, enterprise, and competition. Chapter 6 will then examine what this means for the development of the policy framework for cities.

Cities and Globalisation

5.4 As set-out in *Globalisation and the UK: Strength and opportunity to meet the economic challenge*, the advance of globalisation and the rise of emerging economies such as India and China presents new opportunities and challenges for the UK. The UK is well positioned to respond to such opportunities and challenges, but must continue with sustained action to ensure that the UK not only builds on its comparative advantage by building a knowledge-driven economy, but continues to remove barriers and tackle market failures that hold back clusters of economic activity that have developed over time – locking-in a positive path dependency in UK cities that enables them to successfully engage and compete in the global economy.

5.5 Businesses are in the front line in responding to the changing markets and new opportunities that globalisation brings – changing their strategies in a range of areas including investment, employment, training, research and development, product development, creativity and market strategy.

5.6 The role of government is to promote the conditions in which UK-based businesses can shape their market strategies, plan, invest and compete effectively in global markets, and also to make the UK as attractive a place as possible for international business. In the HM Treasury and DTI paper, *Trade and the Global economy: the role of international trade in productivity, economic reform and growth,* the Government set out the key trends shaping global markets and trade patterns and the policy challenges they present. *Long-term Global Economic Challenges and Opportunities*, identified six trends that will shape the global economy over the next decade:

- the shifting balance of global economic activity, with an increasing proportion of global output produced in rapidly emerging large economies;
- the increasing integration of global markets, as international trade and investment expand;
- the internationalisation of economic activities, with production chains becoming increasingly flexible, specialised and dispersed across continents;
- growing rewards from innovation, as the pace of technological change increases and countries move into higher-value activities;
- the importance of higher skill levels to realise the benefits that arise from global integration, enabling individuals to adapt to change and countries to move into high value-added areas; and
- increasing pressure on energy resources, other natural resources and the environment.

5.7 In responding to these key trends, the UK is starting from a strong position, with sustained macroeconomic stability, a good regulatory record by international standards, a strong science base, improvements in skills since 1997, and a solid track record on employment. In order to build on this stable platform, the Government has outlined five policy areas in which substantial further progress is needed in order to fully benefit and secure the gains from globalisation:

- raising the UK skills profile and ensuring the workforce has the skills and flexibility to take advantages of changes in technology and new opportunities, supported by appropriate training opportunities that are more responsive to changing business needs;
- improve the UK's capacity for science and innovation, through investment in the science base and improving links with business to attract and drive high value-added research and development activity;
- strive to minimise undue regulatory burdens by ensuring regulation only used where necessary, and administrative burdens of complying with regulations are as low as possible;
- ensure the planning system is flexible and responsive to changing economic needs and realities, and encourages rather than hinders the development of competitive and productive business; and
- ensure the UK's transport infrastructure supports a flexible and enterprising business sector, by reducing costs and congestion and enabling agglomeration benefits.

5.8 Cities represent the spatial manifestation of economic activity – large, urban agglomerations in which businesses choose to locate in order to benefit from proximity to other business, positive spill-overs and external economies of scale. Therefore, central to this programme of reform to respond to globalisation is ensuring that cities, as the largest agglomerations of economic activity, present a flexible and supportive environment for business. This will have a significant influence on businesses' decisions on where best to locate their activities to maximise their competitive advantage in globalised markets.

5.9 The previous chapter set out the evidence on the economic performance of English cities to date, concluding that while performance has improved markedly over the last decade, performance between and within cities remains highly variable. In addition, evidence suggests that the economic performance of English cities continues to lag behind those of key international comparator countries. Chapter 4 demonstrated that these differences could be explained by differences in headline employment and productivity performance between cities.

5.10 This chapter explores the reasons underlying both the employment and productivity performance of cities. Where data are available, this analysis is undertaken at the city-region level, using travel to work areas as a proxy for city-regions. This reflects the argument in Chapter 2 that the city-region is a more meaningful spatial level than the administrative city at which to analyse the economic performance of cities. Analysis of employment and the productivity drivers at the city-region level is more likely to capture the various dimensions of the economic challenges facing cities and to identify the implications of various policy approaches – which are discussed in Chapter 6.

The importance of Economic History

5.11 It is important, however, to not only consider the reasons affecting the variable employment and productivity performance of cities in the present, but to also examine the role of history in the development of these cities, which helps provide the necessary context for today's economic performance.

Box 5.1: The impact of economic history

While globalisation is increasing the mobility of investment and workers even between nations, both labour and capital are still much more mobile between cities (and other sub-national levels) than between nations[a]. This mobility means that cities must provide an economic environment that both attracts and retains skills workers and investment. It also means that small initial differences in productivity may compound as the flow of skilled workers and investment to successful cities further boosts their productivity and economic performance. Even places that start out with the same endowments of capital, labour and environmental resources can follow significantly different growth paths as a result of one place taking an initial lead in an industry or industries that benefit from agglomeration. This type of 'cumulative causation' means that past decisions, or accidents of history, can have important implications for the nature of subsequent economic development.

There are limits to such processes of agglomeration and in smoothly functioning markets, agglomeration will result in cities of different sizes but should not drive significant differences in incomes between places. However, markets do not always function smoothly and there are often constraints to the mobility of people. As a consequence, the interaction between agglomeration and constraints to labour mobility and other market failures may drive persistent differences in productivity and in standards of living between cities.

Therefore, the different economic histories of our cities have left them with different capacities to, and therefore challenges in, delivering high standards of living to their residents. These differences suggest that cities may need to take different approaches to lift productivity and economic performance, highlighting the need for place-specific economic development strategies[b].

However, in developing such strategies cities need to consider interventions that not only attract inward investment – both finance and labour – but also build on existing capital stocks by investing in the skills and capacities of existing residents, businesses and entrepreneurs.

[a] Growth on the periphery: Second wind for industrial regions? Fraser Allander Institute, 2003.

[b] The State of the English Cities Report, ODPM, 2006.

5.12 The following analysis in this chapter of city performance against both employment and productivity therefore needs to be understood in the context of both:

- the economic history of city development; and
- the opportunities and challenges presented by globalisation in future.

Understanding employment differences

5.13 As outlined in Chapter 4, employment growth has been robust in most UK cities in recent years. However, there still remain significant differences in employment rates between and within city-regions as the growth in employment began earlier in some cities than in others.

Transition from manufacturing to services

5.14 The trend in recent years has been a decline in manufacturing jobs offset by increasing service sector jobs. It is those cities that were the first to begin this transition that generally now show the highest employment rates. This is reflected in the high employment rates of cities and city-regions such as London and Reading. However, this transformation has also been achieved by cities outside of the south east, such as Leeds and Manchester. For example, while Leeds city-region saw a decline in manufacturing jobs of around 35 per cent between 1995 and 2003, this was more than compensated for by employment growth in services of approximately 46 per cent.[1]

Labour mobility

5.15 Differences in employment rates between cities and city-regions also reflect the limits to the mobility of people who might otherwise take advantage of job opportunities elsewhere. The unemployed and inactive sometimes face transport constraints that limit their ability to commute to jobs in a city-region, potentially reducing the effective size of the labour market. Such constraints are complex and tend to be dependent upon specific local situations. Often the cause of limited labour mobility is not constraint of transport supply but other factors of deprivation, such as limited travel horizons or ill-health, preventing use of transport opportunities. These all affect the ability of the market to 'match' workers and jobs at the local and regional level. For example, while skilled workers have a higher propensity to move and seem to operate in a regional labour market, low-skilled workers are unlikely to move between regions and generally seem to look for work in a local labour market.

Skills

5.16 Therefore, a key dimension of enabling the inactive and unemployed to take advantage of job opportunities is supporting improvements in both generic and specific skills. This is highlighted by the striking links or correlations between inactivity, unemployment and skills. For example, nearly 7 out of 10 economically inactive benefit claimants and half the unemployed do not have qualifications equivalent to Level 2, compared to the national average of just over 3 out of 10 adults.[2]

Understanding productivity differences

5.17 The Government's productivity framework identifies five drivers that comprise the engine of long-term productivity growth. Each driver has important relationships with other drivers, determining long-term productivity and the way in which the UK – and its cities – responds to the challenges of globalisation. The five drivers are as follows:

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[1] The definition of service jobs used in this example includes financial services; distribution, hotels, restaurants and other services.

[2] Data from HM Treasury, 2004.

- skills: the quantity and quality of skilled labour available in an economy is an important determinant of economic performance and productivity growth. Skills complement physical capital, and are needed to take advantage of investment in new technologies and organisational structures. Furthermore, management skills provide an important influence over how firms react to competition, new innovations and how physical investments and human capital are employed;
- investment: physical capital stocks are closely correlated with productivity performance, as they directly influence how much any given unit of labour can produce. Investments increase labour productivity by increasing the capital each worker can utilise. Skilled workers enhance investments and investments in innovation can improve production (e.g. ICT). Infrastructure investments facilitates the movement of goods and services influencing the location decisions of business;
- innovation: innovation has positive and significant effects on growth both through direct expenditure on innovation and through spillovers. Spillovers can boost productivity of all firms through emulation and raise the capacity to innovate further. Innovation is stimulated by competition but also needs the correct mix of skills and investment to exploit the full potential of innovations;
- enterprise: new enterprises compete with existing firms through new ideas and technologies, thereby increasing competition. Entrepreneurs are able to combine factors of production and new technologies forcing existing firms to adapt or exit the market. The ability of entrepreneurs to turn ideas into production is affected by the skills of the labour force, the availability of capital, and the rules and regulations that affect the competitive environment; and
- competition: competition improves productivity by creating incentives to innovate and ensures that resources are allocated to the most efficient firms. It also forces existing firms to organise work more effectively through imitations of organisational structures and technology. The threat of entry and exit of firms, with more productive firms replacing less productive firms, drives the incentive to innovate. Competition has important links to innovation, as firms compete through innovation to gain market share.

5.18 The remainder of this section discusses briefly city performance against each of these five drivers.

Skills

5.19 The quantity and quality of skilled labour available in a city-regional economy is an important determinant of economic performance and productivity growth. Skills raise labour productivity by increasing human capital, and may raise total factor productivity through innovation and other spillovers. Skilled workers often adapt faster and more effectively to change, and may be better at implementing new investments and pursuing innovation. A highly skilled workforce enables firms to update working practices and products at the rate demanded by rapidly changing global markets in which cities compete, making the economy of the city-region more flexible and productive in the long-term.[3]

[3] *The rise of the skilled city,* Glaeser, 2003 finds that while skills predict US city and metropolitan growth throughout the 20th century, their importance to both productivity and population growth has risen over the post-war period.

Globalisation and skills **5.20** Globalisation raises the need for higher skills in cities, as firms need a higher skilled workforce to compete internationally and make use of new technology and ways of working. Higher skills also allow labour to move between sectors of the economy which, given the changing industrial structure of UK cities, provides the necessary flexibility and adaptability needed by cities to respond to the opportunities and challenges presented by globalisation. For example, US manufacturing metropolitan areas with high levels of education in 1940 switched from manufacturing to other industries faster than high-manufacturing areas with less human capital.[4]

Cities and skills **5.21** The increasing importance of a knowledge-driven economy, and the role of the skilled in facilitating the flow of ideas and in enabling adoption of new technology and adaptation to change, means that cities offer benefits through sheer proximity of people and their ideas. This is a direct result of the agglomeration of economic activity in cities and the economic benefits that this can bring. Furthermore, some studies even suggest that by attracting a 'creative class' (scientists, engineers, architects, designers and other highly-skilled professions), a city could better attract inward investment and stimulate high-tech industry due to the benefits clustering brings to the effective diffusion of knowledge.

5.22 The Government's role in improving skills in the UK has historically focused on two areas, ensuring the initial education is of a high standard, and intervening to correct market failures in the wider market for skills. In the wider market for skills there are broadly accepted areas of market failure:

- externalities that occur as firms cannot capture all the benefits of investment (e.g. due to high turnover of staff);
- information problems that mean employees and employers cannot judge correctly the benefits of training; and
- credit constraints, in particular for lower paid individuals or for small firms.

5.23 The market failures identified above can help to explain why individuals and firms may under-invest in skills, particularly where starting from a low base. While data on skills are limited at the city or city-region level, the emerging data suggest there is scope for our cities to enhance productivity by raising their skill levels and that differences in skill levels are a key factor in driving differences in economic performance between cities.

Schools **5.24** Cities tend to have lower proportions of pupils who leave school with good qualifications than the UK average, as well as higher numbers who then leave learning altogether and do not find work. English cities also under-perform in the attainment of school qualifications relative to EU cities. However, there are signs of improving performance at GCSE level. For example, between 1997 and 2003, 21 per cent more students attained 5+ GCSEs in cities (i.e. NVQ Level 2 or equivalent or equivalent to 5 GCSEs at A*–C), with significant improvements across the core cities.

Further and higher education **5.25** In contrast, on average cities tend to have a relatively high proportion of university graduates[5] but there is significant variation in the number of graduates across cities. Specifically, those English cities that experienced the weakest economic performance over 1991-2001 were those functional economic areas[6] whose proportion of graduates in their workforces increased by less than the English average. Empirical evidence has shown a significant correlation between the number of university students and economic growth.[7]

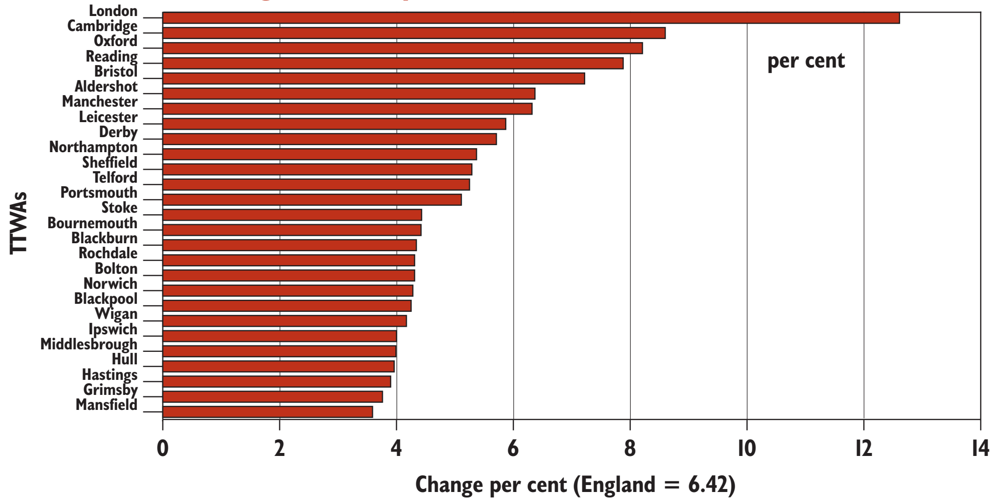
[4] *The rise of the creative class*, Florida, 2002.

[5] The fact that cities tend to have larger numbers of highly skilled workers, as well as larger numbers of lower-skilled people, partly explains spatial disparities within cities.

[6] As measured by travel to work (TTWA) areas.

[7] *European urban growth: Throwing some economics light into the black box*, Cheshire and Magrini, 2005.

Chart 5.1: Growth in proportion of working age population with degree level qualifications 1991-2001



Source: The State of the English Cities Report, ODPM, March 2006

Workforce skills **5.26** The majority of the divergence in regional average earnings over 1982-1997 was explained by differences in the education and skill levels across regions. In particular, London gained because its workforce became more educated over the period and returns to education increased nation-wide, which favoured the more educated regions, such as London. If returns to education and their distribution across UK regions remained stable over 1982-1997, regional disparities would actually have decreased.[8]

Knowledge economy **5.27** While there are clear correlations between economic performance and the number of university qualifications in cities, the productivity benefits from knowledge spillovers means that the highly-skilled will tend to be more concentrated in cities where knowledge-intensive industries cluster. It is important to recognise the need for a range of skills to support economic performance and that the skill needs of city-regions will vary depending on its industry or sector mix. The skill needs of the UK economy over the next twenty years are the subject of the Leitch Review of skills, due to report in summer 2006.

[8] *Mind the gaps: The education of regional inequalities in the UK 1982-1997*, Duranton and Monastiriotis, 2000.

Box 5.2: The Leitch Review of skills

The Government commissioned the Leitch Review to identify the UK's optimal skills mix in 2020 to maximise economic growth, productivity and social justice, and to consider the policy implications of achieving the level of change required.

The context for the Review was set out in the 2004 Pre-Budget Report document *Skills in the global economy* which describes the social and economic problems caused by the stock of adults in the UK without basic skills such as literacy and numeracy; the need for a highly skilled workforce to confront the challenges posed by global markets; and evidence of the UK's relatively poor international position in intermediate level skills

The Leitch Review of Skills will report back to Government in 2006 on what skills profile the UK should aim to achieve by 2020 in order to support productivity, economic growth as well as social objectives over the longer-term. The Review will work with a wide range of stakeholders to build an evidence base upon which the Government can set its ambitions for 2020 and will consider the implications for skills policy

The Leitch Review of Skills published its interim report Skills in the UK: The long-term challenge on 5th December 2005. Some of its key findings include:

- **the UK has a strong economy and world-leading employment levels, but its productivity trails many key comparator nations; poor skills are a key contributor to this problem as well as having wider impacts on social welfare;**
- **over the last decade, the skills profile of the working age population in the UK has improved. For example, the proportion of adults with a degree has increased from a fifth to over a quarter of the population;**
- **despite these improvements, the UK still does not have a world-class skills base:**
  - **over a third of adults in the UK do not have a basic school-leaving qualification – double the proportion of Canada and Germany;**
  - **five million people have no qualifications at all;**
  - **one in six adults do not have the literacy skills expected of an 11 year old and half do not have these levels of functional numeracy; and**
- **looking ahead to 2020, global, demographic and technological change will place an even greater premium on the UK's skills profile.**

This illustrates the importance of raising the level of skills in English cities, to not only drive the ability of cities to engage and compete in the national economy, but to drive national productivity growth.

Attracting a skilled workforce

5.28 As urban success depends on attracting and retaining skilled residents, it may be important for cities to provide quality of place or amenities and public services that attract the skilled.[9] In particular, urban population growth is linked with aesthetics and physical setting (particularly climate), good public services, such as good schools, and less crime, and low transport times, whether provided through decentralised car cities or dense walking/public transport cities – 'high amenity' cities in the US have seen faster population growth than 'low amenity' cities.[10]

[9] The relationship between skills and quality of place may actually be inter-dependent, as evidence suggests that people are attracted to places with higher levels of human capital. At the metropolitan or city-region level, people are attracted to areas with high skill levels because of the positive impact this has on their productivity and wages. At the local level people seem to be attracted to places with higher skill levels for 'consumer amenity' reasons, with people willing to pay high prices to live in 'skilled places', Glaeser and Saiz, 2003.

[10] *Consumer city*, Glaeser, Kolko, and Saiz, 2001.

5.29 Also key to attracting and retaining skilled workers is enabling a responsive housing market to provide a sufficient level and quality of affordable housing as part of sustainable communities that are supported by infrastructure and built to high environmental standards.

Investment

5.30 Investment in physical capital by both the private and public sector increases the productivity of workers and, therefore, increases the level of GDP per capita. Capital accumulation raises labour productivity through both capital intensity (labour is more productive because it has more capital to work with) and through generating knowledge (physical capital becomes more productive as labour becomes more efficient at using it, for example, investment in ICT). As well as a focus on the level of investment, a clear focus must also be on the quality of that investment. For example, capital may be a complement to innovation, where implementation might require an upgraded capital stock. As capital is a limited resource it is important to ensure that it is used efficiently and, therefore, that government provides a sound economic environment that is attractive for investment, and encourages efficient investment decision-making by the private sector.

Inward investment in cities

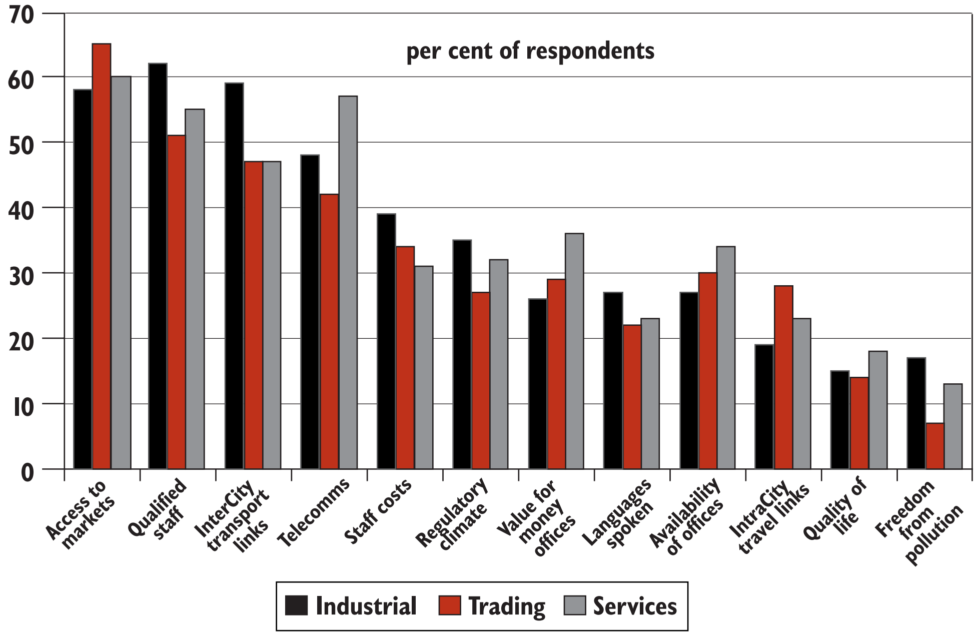
5.31 Inward investment – including foreign direct investment (FDI) – can affect the average productivity in a city-regional economy through both direct impacts on domestic and foreign firms and indirect impacts through positive spillovers (e.g. the spread of knowledge and new techniques). Such positive spillovers are more likely in agglomerations of economic activity, such as cities, where the exchange of tacit knowledge is facilitated – with new knowledge or techniques flowing from foreign firms to local firms within city-regions.

5.32 An increasingly global market provides city-regions with the potential to attract inward investment, from within the UK and internationally, but also means that the city-region's residents and businesses may also explore investment opportunities outside of the city-region. As a consequence, cities have become increasingly aware of the need to provide an economic environment that is attractive to international and British investors and businesses. It is important to recognise that investment and location decisions are likely to be made in the context of the characteristics of the geographical area over which key markets, such as labour markets and supply chains, operate rather than those within the administrative city boundaries.

5.33 The available evidence suggests English cities, with the exception of London, are not as attractive as some of their international counterparts.[11] While the importance of factors varies between industries, there are some features that appear to have general appeal. Evidence suggests that key factors are access to markets and availability of qualified staff, transportation and communication links and cost factors, particularly the cost of staff (see Chart 5.2).

[11] See the Healey and Baker (2005) international city surveys. More broadly, Parkinson et al, 2004 shows that while English core cities have improved their performance in recent years, many lag behind non-capital cities in Europe in terms of the six characteristics of economic diversity, skilled workforce, connectivity, strategic capacity to implement long-term development strategies, innovation in firms and organisation, and quality of life.

Chart 5.2: Factors affecting business location



Source: Healey and Baker (2005).
"Trading" includes the following sectors: Distribution, Wholesale, Retail.

5.34 These are all factors that impact on the rate of return of investment and will, therefore, be important not only for attracting inward investment but also for enhancing returns to existing physical (and human) capital and encouraging the expansion of existing businesses or start-up of new businesses. Capital is mobile, and city-regions need to stimulate investment by removing constraints to investing in order to maximise its rate of return, including addressing market or government failures that may distort the type of investments that are made. This will include correcting for information asymmetries that may exist by appropriately marketing the business environment in cities.

Infrastructure

5.35 Infrastructure facilitates the movement of goods and people, attracting business investment, influencing individuals' location decisions, and supporting social objectives. A well-targeted economic infrastructure within a city can encourage private investment through raising the profitability of that investment. It also facilitates labour mobility and thereby increases the returns to investment in skills, and it has benefits to consumers through lowering the cost of goods and services and increasing the variety available to them. Therefore good quality infrastructure is important in facilitating the movement of goods and services between cities, an increasingly important role in a global economy characterised by rapidly increasing trade flows.

5.36 Public sector investments in and between cities, such as transport improvements can play an important role in enhancing the return to both existing and potential private sector investment, boosting investment and overall productivity. By reducing transportation costs for firms, workers and consumers, investments in infrastructure create new growth opportunities in cities for successful companies and intensifies competition, encouraging greater efficiency and innovation.

Box 5.3: Cities and transport investment

Transport improvement may bring productivity benefits from effectively bringing firms and workers in their existing locations closer together, in terms of journey times and reduced costs for both people and freight. However, the productivity impact of transport improvements on cities can be complex, particularly in an agglomeration context:

- **transport within city-regions is critical to supporting labour market flexibility by facilitating the matching of workers to jobs. The UK is reliant on cities as the centres of service-based growth, and the dynamic role which deep labour markets play in boosting productivity. Transport can play an important role in supporting the efficiency of the labour market;**
- **better transport connections within cities may enable firms to reap agglomeration benefits, but the magnitude of the impact will depend upon whether increased proximity brings benefits to the types of firms located in the city and the extent to which firms relocate in response to the improvement. Recent evidence shows that benefits are likely to be greatest for services firms (especially business and financial) with less impact on manufacturing agglomerations;[a]**
- **furthermore, the self-reinforcing nature of agglomeration means that a marginal transport improvement in an under-performing city may not be sufficient to attract firms and workers away from cities enjoying agglomeration externalities; and**
- **links between cities may be important for supporting trade – inter-urban links are also important for freight traffic. Improving the connection of a city with other cities may induce firms to locate in 'peripheral' cities where they can take advantage of lower labour and land costs. However, constraints on how far these factor costs can fall in peripheral cities will reduce their attractiveness and the ultimate effect may be the opposite – with economic activity increasingly concentrated in the 'core'. This oft-cited "two-way road" effect may lead to inequalities widening when a city or region is opened up to trade.[b]**

The role that transport can play in supporting growth in cities is one of a number of ways that transport can support the national economy. Budget 2005 announced that the Secretary of State for Transport and the Chancellor had asked Rod Eddington to work with the Department for Transport and HM Treasury to advise on the long-term impact of transport decisions on the UK's productivity, stability and growth.

The Eddington study has focused on developing a comprehensive analysis of the links between the transport system and economic growth, within the context of the Government's objectives for sustainable development. The study is still underway, but it is already clear that transport supports the efficient functioning of the economy, playing a significant role in the operation of labour and product markets, and that it is likely to play an important role in equipping the UK economy to respond to the challenges and opportunities of globalisation.

[a] Wider economic benefits of transport improvements: Link between agglomeration and productivity, Graham, 2005.
[b] There is some empirical evidence to support this view, with Faini (1983), suggesting that policies to improve links between poor (southern) and rich (northern) Italian regions had the opposite effect to that intended, leading to a widening of disparities.

Planning and cities

5.37 The planning system and land use regulations are a key determinant of the flexibility of the business environment and firm's ability to take advantage of new opportunities by investing in cities. A central objective of the planning system is to promote sustainable economic growth and employment opportunities. A choice of sites will ensure that businesses can seek location advantage in response to various external factors, including the demands of customers; access to raw materials and suppliers; links with other businesses, particularly important for clusters and agglomeration economies such as cities; the workforce catchment area; and good transport links.

5.38 Business also requires a planning system that is value for money, speedy and transparent, in order to minimise the transaction costs associated with gaining planning permission to ensure that he investment potential of new business opportunities is realised, and to provide increased certainty for investment decisions. Delays and lack of transparency not only cause microeconomic costs to individual businesses, they can also have negative macroeconomic impacts through lost positive investment spillover effects. Planning can also have an impact on the cost to businesses that arise from the development of clusters and urban agglomerations – including cities – such as congestion, which can negatively impact on business and investment location decisions.

5.39 The Government has introduced a number of reforms to the planning system, including the introduction of Regional Spatial Strategies and Local Development Frameworks aimed at increasing the flexibility of the planning system. These reforms have started to deliver, but must be continually built upon so that the planning system in cities is flexible and responsive to the changing needs of sustainable economic development so that it attracts rather than hinders the development of competitive and productive business, and avoids inhibiting the growth of cities and economic clusters.

Box 5.4: The Barker Review of land use planning

In the context of the increased competitive climate caused by globalisation the Government is committed to further reform of land use planning, to ensure that planning delivers the development that England needs. The Chancellor and the Deputy Prime Minister therefore asked Kate Barker to conduct a review. The purpose of the review will be to consider how, in the context of globalisation, and building on the reforms already put in place in England, planning policy and procedures can better deliver economic growth and prosperity alongside other sustainable development goals.

In particular the review will assess:

- **ways of further improving the efficiency and speed of the system;**
- **ways of increasing the flexibility, transparency and predictability that enterprise requires;**
- **the relationship between planning and productivity, and how the outcomes of the planning system can better deliver its sustainable economic objectives; and**
- **the relationship between economic and other sustainable development goals in the delivery of sustainable communities.**

This assessment will contribute to the ongoing effort to ensure English cities continue to improve their economic performance and maintain and build on their attractiveness as business destinations with a flexible and competitive economic environment.

Innovation

5.40 Innovation – the successful exploitation of new ideas – is one of the main engines of long-term economic growth and structural change. Innovation can occur through investment in research and development (R&D), or through adopting new technologies from other firms or countries, or through trying different ways of working. These investments in innovation can result in new technologies, products and processes, as well as novel services and means of delivery.

5.41 The exploitation of new ideas, knowledge and creativity to create valuable goods and services is the only sustainable way for UK business to compete in the face of increased global competition from firms in lower cost economies, such as China, and is essential for gains in productivity and quality of life, this includes innovation in public services, such as healthcare, and through environmental protection.

Innovation in cities

5.42 Innovation can raise productivity in a city in three main ways:

1. direct productivity gains to the firm that has invested in innovation or R&D in terms of efficiencies in production or product improvements;

2. spillover productivity gains when a new innovation assists firms to also take advantage of other innovations; and

3. spillover productivity gains for other firms involved in trade that are able to emulate the innovation.

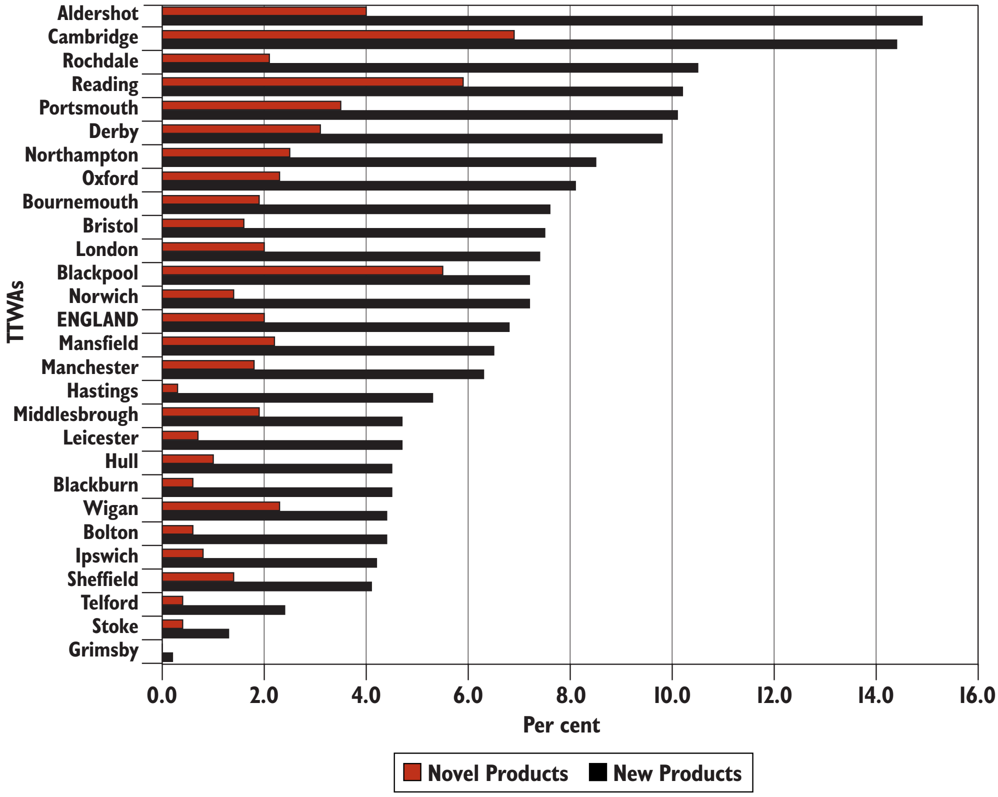
5.43 Crucially, the agglomerative characteristics of cities means that innovation spillovers in particular can be facilitated due to geographical proximity of firms. As described above this can occur though innovations building on each other and adding greater benefit over time, or though firms emulating existing innovations. Studies have found that the total or social return on innovation is significantly higher than its private return to the innovator. One example of a study suggests that this could raise the value of the innovation by 20 to 50 per cent.[12] This illustrates the role of cities – or other geographical clusters of economic activity – in realising the full economic potential of innovation.

5.44 The data available on innovation at the level of city-regions, or travel to work areas, are limited. *The State of the English Cities Report* found a correlation between economic performance and patent applications,[13] and between economic performance and the adoption of new products (see Chart 5.3 below). However, a wealth of data exists at other spatial levels that emphasise the importance of innovation in driving productivity growth which, when combined with theory and evidence on spatial agglomeration, provides a compelling account of the links between cities and innovation.

[12] *Innovation and growth: a survey of the emperical literature*, Cameron, 1998.

[13] This is drawn from patent applications to the European Patents Office. However, the sample size for these data is small at the city level and service firms are mainly excluded from the sample.

Chart 5.3: Turnover accounted for by new and novel products 2000



Source: The State of the English Cities Report, ODPM, 2006

Specialisation and Diversification

5.45 As mentioned above, spillovers from innovation benefit cities through geographical proximity and agglomeration. While some economists emphasise knowledge spillovers *within* an industry and the benefits of specialisation, others emphasise that the most important sources of knowledge spillovers are *external* to the industry in which the firm operates. In the latter case, it is the variety of industries within a city or geographical location which promotes knowledge externalities and ultimately innovative activity and economic growth. However, as Chapter 2 outlines, there is scope for both in cities as different types of industries benefit from specialisation and diversification.

Innovation networks

5.46 Empirical evidence highlights the innovation advantages to cities and regions with universities.[14] However, it is a wide range of networks which facilitate linkages between agents and firms including not only universities but also including trade associations and local business organisations, specialised consulting, market research, public relations and venture capital firms.[15] There are many ways to innovate and no single institutional structure is right" for all times and technologies.[16]

[14] Recent modelling work by Cheshire and Magrini (2005) on European functional economic areas found that the relative size of the university sector has a significant role in explaining differences in the growth of per capita incomes.

[15] *Agglomeration and the location of innovative activity,* (Audretsch, 1998) also argues that the value firms place on these networks, or the 'culture' of a city or region may contribute to differences in innovative performance across cities or regions, even holding knowledge inputs such as R&D and human capital constant. For example, Saxenian (1990) argues that a culture of greater interdependence and exchange among individuals in the Silicon Valley region has contributed to a superior innovative performance than is found around Boston's Route 128, where firms and individuals tend to be more isolated and less interdependent.

[16] For example, innovations in sectors like bio-tech and software may benefit from lots of start-ups experimenting with new techniques and business models, and to commercialise ideas from university laboratories as quickly as possible. However, in other technology-heavy sectors, such as electronics and cars, corporations with extensive business experience and a giant R&D budget may be more suitable to capture the learning-by-doing that it is needed for innovations in these industries.

Dissemination and adoption of new ideas

5.47 Cities can not only be the centres of innovation, but can be early or quick adopters of new ideas generated elsewhere or in another city. Therefore, policy needs to focus not only on the generation of new ideas, but also on tackling constraints to the dissemination of ideas. The degree to which a city innovates and/or adopts has implications for a city's skill mix – highly qualified people are necessary for driving forward innovation, and strong basic education may be more important for adoption (Aghion and Howard, 2005).

Supporting innovation in cities

5.48 To support new innovation in cities, the correct environment needs to be created that facilitates innovation, including through funding the public science base; incentivising private sector research and development (R&D) spend;[17] ensuring an attractive regulatory regime and business environment; and strengthening links between business and the public research base.[18] The Government has supported cities in developing this environment through both the *Science and Innovation Framework 2004-2014*, and through the Science Cities initiative.

[17] OECD Economic Studies: No. 33, 2001/2 OECD (2001). Increased expenditure on research and development (R&D) is correlated with a positive and persistent effect on growth. However, R&D is not the only source of new technology: in advanced, industrial economies, other activities, such as learning by doing or design are conducted in most cases on the basis of new technology coming out of R&D (e.g. changes in the organisation of business related to the use of ICT).
[18] OECD Economic Studies: No. 33, 2001/2 OECD (2001).

Box 5.5: Science Cities

In a global economy, the UK's ability to compete with emerging economic powers such as India and China will depend increasingly on harnessing the benefits of innovation, as all economies come under pressure to move up the value chain. At present, the UK can boast a strong science base, but has been less successful at realising the commercial potential of research. In particular, the UK faces a challenge in driving up comparatively low levels of business R&D investment, growing innovative new businesses, and facilitating stronger links between industry and the science base to ensure that scientific excellence translates into marketable new products and services. Science Cities can contribute to meeting these challenges by creating the right 'ecosystem' for innovation at a local/regional level.

At Budget 2005, Government defined science cities as "those with strong science-based assets – such as a major university or centre of research excellence – which have particular potential to use these assets [to] attract a critical mass of innovative businesses and become drivers of regional growth". The aim of science cities is to develop a city-based strategy to exploit centres of world-class scientific research more effectively, by developing complementary policies on knowledge transfer, business support, skills, infrastructure, communication links etc., and building a closer partnership between RDAs, city government, local businesses, and the research base. The Science Cities concept builds on the following evidence:

- **Evidence on the positive impact of investment in science and innovation on productivity and economic growth;**[a]
- **Evidence that geographical proximity ("clustering") has a positive impact on the growth of knowledge-based firms, e.g. by encouraging the co-location of firms with complementary specialisms, facilitating the flow of information and new ideas, and encouraging spin-outs and new business formation;**[b]
- **Evidence from the Lambert Review of business-university collaboration that regions and cities are particularly well placed to build stronger links between business and the local research base and encourage science-based clusters.**[c]
- **Case studies suggesting that an integrated strategy across a range of policy areas can support the growth of innovative business sectors in cities and city-regions.**[d] **For example, Science City York – an initiative which pre-dates the current national policy – estimates that 2500 knowledge-based jobs have been created through the initiative since 1998;**

Six science cities have been announced to date (Manchester, York, and Newcastle at PBR 2004; Birmingham, Nottingham and Bristol at Budget 2005). Science cities are an RDA-led policy.

The RDAs are currently working together with their partners to draw up detailed delivery plans for the six science cities, and initial ideas were presented at a national Science Cities Workshop in York in September 2005. It is too early to assess the impact of this policy as it is only beginning to enter the delivery phase, but further progress on science city strategies will be assessed at a follow-up event in Spring 2006. Government has also signalled its willingness to engage in a dialogue with the Science Cities about how the existing national policy and funding framework can best support the development of Science Cities.

[a] See for example the evidence summarised in Annex A of the Government's Science and Innovation Investment Framework 2004-2014 (HMT/DTI/DfES 2004).

[b] See for example *Productivity in the UK: 4* (HMT, 2003), and DTI Economics Paper 3 (DTI, 2003).

[c] Lambert Review of business-university collaboration: final report (HMT 2003).

[d] See for example Andy Westwood and Max Nathan, Manchester: Ideopolis? Developing a knowledge capital. The Work Foundation, 2004.

Enterprise

5.49 Entrepreneurship requires creativity, ambition, independence, and the willingness to bear the inevitable risks involved. Enterprise supports productivity growth by increasing competition in the economy and providing an important mechanism for the introduction of new technologies and innovative ways of working.

5.50 New entry created by entrepreneurs drives productivity growth by increasing competitive pressure, and raising the incentive for incumbent firms to invest, innovate and improve efficiency. Research has shown that new firms and plants entering the market account for a significant part of total productivity growth. Evidence shows that 80-90 per cent of total factor productivity growth is from entry and exit of establishments (50 per cent current and 30 per cent new).[20]

Enterprise and cities

5.51 The Government's enterprise vision is that anybody with the talent, potential and drive to succeed in business should have the opportunity and the necessary support to do so, regardless of their background or where they live.

5.52 Cities – as significant agglomerations of economic activity – are the locations in which the majority of businesses choose to locate. Benefits of infrastructure investment, innovative capacity and spillovers, skill mix, together with market demand and competition, create an environment highly conducive to entrepreneurs.

5.53 Entrepreneurs and small-business owners themselves are the most important agents in delivering this vision. The Government has an important role to play in creating a fertile business environment, addressing market failures and ensuring that, where it comes into contact with future entrepreneurs and existing businesses, it helps rather than hinders them

5.54 A central principle of the Government's economic philosophy is therefore that it is not possible to run a successful economic policy without the correct mix of decentralisation and devolution to local and regional levels. This makes it imperative for sub-national actors including regions, cities and local authorities to have clarity of purpose, strong leadership, good organisational capacity and flexibility along with the necessary policy levers. Thus economic development is achieved 'bottom-up' by agencies operating at the appropriate level within a clear but permissive national policy framework.

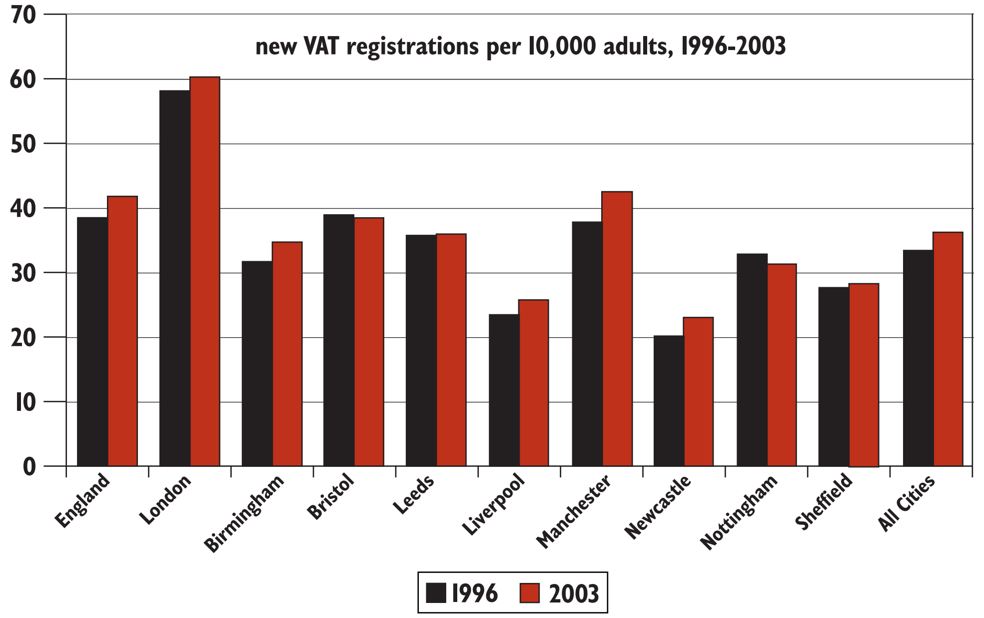
5.55 Enterprise growth within cities can contribute to wider economic development aims, from raising local productivity growth, driving employment and income growth, increasing local tax revenue, improving service provision, building strong supply chains embedded in the local economy, building social capital, improving the physical environment, and engaging the community.

City performance

5.56 However, there are significant disparities in the levels of enterprise between English cities – both in business start-up rates, levels of self-employment, and business density. Over time, differences in business creation rates contribute to a marked disparity in the total stock of businesses – for example, in 2003 there were 219 VAT registered businesses for every 10,000 residents in the North East, compared with a UK average of 378. Business start-up rates vary significantly across English cities, as can be seen from Chart 5.4.

[20] *Comparative analysis of firm demographics and survival: Micro-level evidence for the OECD countries*, OECD, 2001.

Chart 5.4: Business start-ups in cities



Source: The State of the English Cities Report, ODPM, March 2006

Enterprise and deprivation

5.57 As well as being a key driver of productivity growth, successful enterprises form part of the bedrock of local communities, contributing to economic prosperity and social cohesion. High levels of local deprivation also appear to be associated with low business formation rates. A recent Bank of England study found that "the negative relationship between deprivation and entrepreneurial activity appears to be clear-cut in the case of the 50 most deprived local authorities".[21] However enterprise is also an important tool for tackling deprivation though economic development. Cities can also benefit enterprise through access to deep labour markets and human capital and business opportunities generated through location within wider well-established regional clusters. The Government has supported cities and local areas to drive enterprise growth through the Local Enterprise Growth Initiative.

[21] *Finance for Small Businesses in Deprived Communities*, Bank of England, 2000.

Box 5.6: Local Enterprise Growth Initiative

The Local Enterprise Growth Initiative (LEGI) was announced by the Chancellor in his 2005 Budget and aims to release the economic and productivity potential of the most deprived local areas across the country through enterprise and investment thereby boosting local incomes and employment opportunities, and building sustainable communities.

The aim is supported by three national-level outcomes:

- **to increase total entrepreneurial activity among the population in deprived local areas;**
- **to support the sustainable growth and reduce the failure rate of locally-owned business in deprived areas; and**
- **to attract appropriate investment and franchising into deprived areas, making use of local labour resources.**

Local authorities were invited to submit proposals setting out how LEGI funding would be used to stimulate enterprise and transform their most deprived areas. A national advisory panel, which included two senior private sector representatives, advised the Government on the proposals submitted, with the support of the Government Offices and the RDAs.

On 23 February 2006, 15 local authorities were awarded £126 million over three years from the LEGI programme to boost the economies of some of the most deprived areas in England through enterprise development. These 15 authorities – including some cities – are as follows:

1. **Ashfield, Bolsover and Mansfield (joint bid) – £3.8 million**
2. **Barking & Dagenham – £15.5 million**
3. **Bradford – £21.4 million**
4. **Coventry – £12.6 million**
5. **Croydon – £20.3 million**
6. **Easington, Derwentside, Wear Valley & Sedgefield (joint bid) – £10.2 million**
7. **Great Yarmouth – £8.7 million**
8. **Hastings – £3.6 million**
9. **St Helens – £13.4 million**
10. **South Tyneside – £16.2 million**

LEGI has been designed to closely follow the principles of devolution and provide local institutions and communities with the authority and freedom to best determine local needs and develop targeted solutions for deprived areas.

Enterprising cities

5.58 Studies have shown that less than half the population believe they have the knowledge, skills and experience required to start-up a business and, while their attitudes towards entrepreneurs are strongly positive, many young people are unsure of their own ability to meet the challenges of starting and running a business. The Government is therefore committed to on ongoing programme of policy to build a true enterprise society that provides the right incentives to engage in enterprise, and is open to all in society irrespective of gender, ethnicity, or income.

5.59 In particular, the Government believes that efforts to build a deeper and wider entrepreneurial culture in cities must begin in schools. Therefore, following the Davies review of enterprise and the economy in education, the Government has invested a significant amount of resources into enterprise education to ensure that every child has some experience not just of work but also of business and enterprise before they leave school.

This has been further strengthened with the announcement of Enterprise Summer School Pathfinders, to ensure that young people are given the confidence and skills to apply their creativity and entrepreneurial drive to the world of work.

Better local regulation

5.60 Effective and well-focused regulation is a necessity in a modern society, helping to correct market failures, promote fairness and ensure public safety. Fairly and proportionately enforced regulation also helps to ensure that honest and decent businesses – the vast majority – are not subject to unfair competition from the unscrupulous few.

5.61 However, unnecessary or poorly implemented regulation can stifle competition, innovation and enterprise. New firm formation rates are generally lower in areas with over-burdensome regulations and administrative obstacles, and this can reduce productivity in the wider economy. The Government is therefore committed to only regulating where necessary, to minimise the administrative burdens on business where regulation is necessary, and to pursue an agenda of regulatory reform in Europe, given over half of all new regulations affecting UK businesses originate in the EU.

5.62 As well as the broader Government drive to improve regulation through the Better Regulation Action Plan, efforts are being made to improve regulation at the local level.

Box 5.7: Better regulation in cities

A key concern for business identified by the Hampton Review was lack of consistency and co-ordination in local authority regulatory services. The Government will therefore establish a Local Better Regulation Office (LBRO) with an aim to minimise burdens on business and work in partnership with local authorities and the national regulators to deliver a risk-based approach to business inspection and enforcement. The LBRO will not be a new regulator.

The LBRO will drive up standards within the wider local government performance framework. Working with national regulators, it will ensure a single co-ordinated set of priorities for local authority regulatory services covering trading standards and environmental health.

The LBRO will improve consistency and co-ordination for all businesses, particularly those that operate across local authority boundaries – as will often be the case in cities – helping to improve the business environment within local areas and ensure their continued attractiveness to business as globalisation advances.

Skills and business advice

5.63 Starting a new business is a daunting proposition for many entrepreneurs, particularly those who are doing so for the first time or have had little prior exposure to enterprise, as is often the case in less prosperous communities. Research suggests that people who take external advice when creating a business build turnover faster and are more likely to survive than those that do not. The Government is therefore committed to the support and, where appropriate, the provision of business support services and networks to ensure aspiring business men and women have access to the support they need when embarking on a new business venture.

5.64 In England, the Government established the eight RDAs and the London Development Agency to take leadership in formulating regional economic strategies, supported by the RDA Single Pot. These strategies cover economic development and regeneration, promotion of business efficiency, investment and competitiveness, promotion of employment, and enhancing of skills relevant to employment. Recently, the Government gave responsibility for Business Link, the business support service that provides free, impartial and comprehensive advice to small business, to the RDAs, and are engaged in a programme of work to streamline business support services across the country. The RDAs are also spearheading a drive – through the Northern Way – to boost enterprise across English cities in the North.

Access to finance

5.65 While the general financing situation for existing small businesses might be good (a survey by the Small Business Service found that a clear majority of 87 per cent of established small businesses reported no difficulty in raising the finance that they needed), there remain particular problems for new businesses requiring start-up funding and for the small proportion of small businesses seeking to realise high growth potential[22] – often resulting from information asymmetries. The Government is therefore committed to addressing the market failures that do exist, to ensure new and established businesses can access the finance they need to grow, create employment opportunities and drive productivity growth.

5.66 Across the English regions, Regional Venture Capital Funds have been set-up to invest a total of up to £270 million in SMEs with growth potential, backed by up to £80 million of government funding. In deprived areas, the Government invested £20 million in the Bridges Community Development Venture Fund to invest in business in the most deprived wards in England, together with the Community Investment Tax Relief, which enables community development finance institutions to raise around £35 million of new capital for onward lending to small businesses and social enterprises in disadvantaged communities.

Competition

5.67 Competition plays a central role in driving productivity growth by providing strong incentives for firms to innovate and adopt new technologies and working practices. It helps raise the performance of organisations and is crucial in the reorganisation of market structures, by reallocating resources away from inefficient firms or declining sectors, to more efficient firms and growing sectors. Empirical evidence emphasises the importance of competition to innovation,[23] particularly on firms close to the technological frontier.[24]

5.68 The UK as a whole has an supportive competition environment, with an economy open to imports and exports and flows of capital. In addition, the domestic competition regime is well-regarded internationally, with effective legislation and institutions.

Competition and globalisation

5.69 Competition and the benefits it brings can be increased through both domestic firms and foreign firms through openness to trade. Global competition increases the productivity of UK firms by allowing them to adopt foreign advances in technology and innovation, providing rewards and incentives for firms to invest in technology and innovation, and allowing the UK to focus on areas of its comparative advantage. These increases in productivity enable UK firms to compete on a global scale.

[22] *British Enterprise in transition: Growth innovation and public policy in the small and medium sized enterprise sector 1994-1999*, Cash and Hughes (eds.), 2000.

[23] Evidence based on a panel of UK manufacturing firms during the 1970s and early 80s suggests that there is a 'robust and substantial effect of...competition on productivity growth' (Nickell, 1996, p.739). Feldman and Audretsch (1999) in an analysis of the link between competition in product categories and innovation, found competition facilitated innovation.

[24] Appropiate growth policy: a unifying framework, Aghion and Howitt, 2005 – using a panel of UK manufacturing firms covering 1987 to 1993, found that the threat of entry by foreign firms (which are assumed to be close to the technological frontier) had a significant and positive effect on productivity growth in domestic incumbent plants. However, the impact is much more significant for industries closer to the technological frontier. The authors posit that this is because innovation is more likely to enable them to escape competition with new entrants, while firms far behind the frontier are not likely to be able to progress sufficiently to compete successfully with new firms.

Competition in cities

5.70 The level of competition in an economy may vary significantly across cities, regions and localities. Where goods and services are not easily traded transport costs, poor information and differences in consumer tastes will segment markets. Firms in large and densely populated cities with good access to other markets are more likely to experience high levels of competition. Not only can these markets support a greater range of competitors, but also firms and consumers are likely to have comparatively easy access to a wider variety of goods and services.

CONCLUSIONS

5.71 This chapter has shown that the economic performance of cities can be explained by both economic history that illustrates how a city has developed over time to the present day, and also by current performance against, and market failures affecting, a range of employment and productivity measures – on skills, investment, innovation, enterprise and competition. It is important to raise the economic performance of cities by tackling the market failures that hold back employment and productivity growth, raising performance in each of the areas discussed above.

5.72 This will help the Government meet its target to make sustainable improvements in the economic performance of all English regions and over the long term reduce the persistent gap in growth rates. Furthermore, it is central to the Government's programme of reform to respond to the opportunities and challenges of globalisation, by ensuring that cities – as the largest agglomerations of economic activity – present a flexible and supportive environment for business. This will have a significant influence on businesses' decisions on where best to locate their activities to maximise their competitive advantage in globalised markets.

5.73 The next chapter builds on this analysis to discuss some of the implications for policy makers.

6 A Policy Framework for the Future

6.1 The majority of English people live and work in cities, and the benefits of proximity that cities provide (particularly to knowledge-intensive sectors), mean that city regions are important drivers of regional and national economic performance. Cities also have a major role to play in reducing spatial disparities, both in terms of their roles in the regional economy, and in terms of tackling the concentrations of deprivation. Economic stability and sustainable growth, combined with unprecedented public sector investment, has supported cities in competing more effectively in a rapidly changing global economy. There has also been significant progress in creating sustainable communities in major towns and cities.

6.2 The economic rationale for the existence of cities is the consumption and productivity benefits that proximity provides. For this reason, city-regions (the wider functional economic areas of cities) are a useful spatial level at which to analyse the economic performance of cities. Despite significant progress in recent years, there are still substantial variations in economic performance between cities and between city-regions, which suggests that there is still considerable scope for them to make a bigger contribution to regional and national growth, and to tackling spatial disparities.

6.3 This report highlights that lifting the economic performance of cities depends on gains in both employment and productivity. While both employment and productivity vary across city-regions, perhaps the greatest potential gains and greatest disparities between city-regions are in productivity performance. Regional Economic Strategies need to focus on enabling cities to create an environment that facilitates employment creation and productivity, addressing the drivers of productivity – skills, investment, innovation, competition, and entrepreneurship.

6.4 The increasing interdependence of the world economy means that every nation, region, and city of the UK faces more intense global competition. Flexible and innovative sub-national bodies are critical to harnessing indigenous strengths, overcoming long-term regional disparities, responding to short-term shocks, and harnessing the potential of sub-national economic growth. The economic performance of local areas, cities, and regions is inter-related and the growth of each depends on the success of the others in reaching their full potential.

6.5 This raises a set of policy challenges which the Government will examine through a thematic review that will inform discussions in the 2007 Comprehensive Spending Review (CSR). The review will look at how to further improve the effectiveness and efficiency of existing sub-national arrangements for economic development and regeneration in order to strengthen economic growth in every region and help close the persistent gaps in performance across regions.

6.6 Within this challenge, there is a set of further questions to address in terms of the long-term economic role that cities can play, the contribution they can make and any barriers that inhibit this. This challenge is reflected in both RDAs' focus on city-regions through regional economic strategies and, in particular, pan-regional economic strategies such as the Northern Way, which seek to enhance further the economic role of cities. Box 6.1 sets out more detail on the Northern Way.

Box 6.1: Moving Forward: The Northern Way

The three northern RDAs (ONE North East, the Northwest Development Agency and Yorkshire Forward), along with other regional partners, are committed to delivering on the Northern Way Growth Strategy. The Northern Way has an ambitious vision to establish the North of England as an area of exceptional opportunity, combining a world-class economy with a superb quality of life. The Growth Strategy[a] sets out how the North will build upon its current assets – and build new assets – to deliver this vision by 2025. The Growth Strategy:

- **looks at the North as a whole to identify pan-northern investments, which will add value to that which is being undertaken in each of the individual regions;**
- **is based on how best to build on the North's strengths, clearly defining what partners can do in the North and what Government must do to realise benefits from these assets;**
- **complements the three regional economic strategies, as these define the key proposals to take forward economic development in the three regions of the North; and**
- **focuses on the North of England's eight city-regions, which are crucial to accelerating the economic growth of the North.**

The main indicators of success of the Growth Strategy will be whether implementation increases private investment across the North, increases employment and increases Gross Value Added (GVA). Key successes of the Northern Way to date include:

- **the development of a high-quality evidence-base and analytical framework for understanding the economic challenges and opportunities of the North of England;**
- **a commitment of the three northern RDAs to promote the science cities of Manchester, Newcastle and York, as part of their £100 million investment in university-business collaboration by 2010;**
- **collaboration between the eight research-intensive northern universities to increase research excellence in the North, building on existing strengths;**
- **agreement of a Northern Transport Compact as the focal point for setting pan-northern transport investment priorities;**
- **pilots to enhance the Employer Training Programme in the North of England with an entitlement to an additional Level 2 qualification in priority sectors and areas; and**
- **an extension of the Pathways to Work pilots in the North to accelerate the number of people moving from Incapacity Benefit into employment.**

[a] *Moving Forward: The Northern Way – First Growth Strategy Report,* Northern Way Steering Group, September 2004; *Moving Forward: The Northern Way – Business Plan 2005-2008*, Northern Way Steering Group, June 2005.

MEETING THE CHALLENGE – A POLICY APPROACH

Devolving decision-making

6.7 The Government believes that the best approach to meeting these challenges is to devolve decision-making to the most appropriate level. The introduction of a single pot for the RDAs reinforced the Government's commitment to devolving decision-making to the most appropriate level. Devolving decision-making enables the tailoring of public goods and services to reflect differences in preferences between places and can support an integrated approach to tackling the issues or challenges facing particular areas. The benefits of devolution or decentralisation will be greater the more preferences and circumstances differ between places.

6.8 One way to overcome spatial disparities in productivity and employment rates is to allow each region and locality the freedom, flexibility and funding to exploit their indigenous sources of growth. In particular, economic disparities at the local level are in many cases greater than at the regional level and often require solutions tailored to the specific needs of the local community. The role of local authorities in delivering local economic development strategies is important in achieving this, working in partnership with other sub-national stakeholders and with central government. The Government is strengthening the incentives and freedoms available to local authorities most recently through the Local Authority Business Growth Incentive (LABGI) scheme, the Local Enterprise Growth Initiative (LEGI) and the national roll out to all top tier authorities of Local Area Agreements (LAAs), including the new economic development block announced in the 2005 Budget.[1]

6.9 However, constraints to devolving policy-making and implementation downwards include potential losses of economics of scale, a need to avoid overlap in provision, and most importantly the need to ensure the level of government matches benefits with costs, so that it has the right incentives to balance the two in making decisions.

6.10 While cities have made significant progress, they can perform better and they are an important dimension of the Government's economic and devolution agenda. The launch of the Urban White Paper in 2000 signalled the Government's commitment to lifting the performance of cities' economies and to urban renaissance across the country. The challenges identified in the white paper and those raised in previous chapters of this report suggest a number of key issues for cities if they are to be the catalysts for improved regional and nationwide productivity and growth. They imply a need to:

- enhance the long term contribution of cities and towns to Regional Economic Strategies, with a particular focus on lifting skills and employment and enhancing connectivity between and within cities;
- encourage stronger collaboration between cities, towns and regions, reflecting their economic interdependence;
- manage city-region economic growth assets more efficiently and effectively including improved management of the physical fabric and built environment of cities and through improved links between universities and businesses; and
- achieve greater economic and social inclusion in all cities – just as the Government is committed to closing the persistent gap in economic performance between regions, so it is also committed to economic and social inclusion at the city, local and neighbourhood level.

6.11 Within the context of devolving decision-making, it is important therefore that regional economic strategies enable cities and towns to take a long-term, strategic view of that economic role and impact. While the cities that have been the most prosperous in recent years have been those leading growth in knowledge intensive business and financial services, not all cities can be successful knowledge clusters or financial service hubs. As the benefits from agglomeration differ significantly between industries or sectors there is a place for smaller and medium-sized cities to offer lower costs to sectors where 'cross-industry' agglomeration is less important.

[1] LEGI will provide around 30 successful authorities a flexible, devolved investment to support locally-developed and owned strategies that try out new or proven ways of stimulating economic activity and productivity growth through enterprise development. LAAs are a new way of working to build a more flexible and responsive relationship between central government and a locality on the priority outcomes that need to be achieved at local level. LAAs set out the priorities for a local area agreed between central government and the lead local authority and other members of the local strategic partnership. LAAs simplify some central funding and help join up public services.

6.12 Cities' strategic view needs to build on their strengths, focusing investment and addressing constraints to growth in those areas that will support their competitive advantage, developing employment, market, and growth strategies to respond to the circumstances they face. Addressing such constraints involves identifying any ways in which the market is not functioning smoothly and may be inhibiting economic performance (market failures) or creating pockets of disadvantage. Policies that focus on addressing market and governance failures will enhance productivity and contribute to regional and national economic performance, supporting complementarity rather than competition between English cities.

City-region collaboration

6.13 Economic strategies such as the Northern Way, and other inter-regional projects demonstrate the potential for greater collaboration within and across regions to deliver improvements in economic performance. These improvements can be further enhanced by strategic collaboration across administrative boundaries such as city region development plans, or that between Regional Cities East and the East of England Development Agency collaboration.

6.14 Regional Cities East (RCE) is an alliance of six cities - Colchester, Ipswich, Luton, Norwich, Peterborough and Southend – which, together with Cambridge, makes up the East of England's regional cities. They are a group of important and economically successfully medium sized cities with which the East of England Development Agency (EEDA) is working to develop a collaborative role as drivers of economic growth and sustainable development in the region. As a group, RCE aim to add £10 billion a year to the UK economy by 2021, create 140,000 new jobs, build 160,000 new homes and be recognised as a centre for creativity and innovation across Europe. They also plan to deliver a 3 per cent reduction in carbon emissions over the same period.

Wider regional performance

6.15 Cities should be integrated in to the wider strategic role of regional economic development, which join up networks and markets with surrounding areas and shaping the direction of strategic growth, supporting complementarity rather than competition between cities and regions.

6.16 Addressing constraints to economic performance within this wider strategic context require cities and regions to manage city-region assets effectively. Science Cities demonstrate the economic value that key assets such as universities and technology centres can play. Evidence in this report suggests that regional economic strategies can help focus efforts further on improved management of the physical fabric and built environment of cities, including public sector assets. Alongside wider issues such as skills and transport investments, this could help influence business location decisions.

6.17 Skills, employment and transport are key to lifting the economic performance of cities. For example, *The State of the English Cities Report* found that cities which managed to retain or attract higher numbers of graduates tended to do better economically. The report also showed that cities with good transport connections to national and international markets had higher economic performance. The core cities have put forward proposals on improving skills and transport in their business cases following from the city summits. The Government is working with those cities, RDAs and partners to see how those proposals can be taken forward.

6.18 To achieve the Government's economic and social objectives therefore, all cities must lift their economic performance through enhanced employment and productivity growth while seeking to promote economic and social inclusion. As cities are diverse and face different challenges, effective partnership and leadership at the regional and local level, with enhanced freedoms and flexibilities to address local problems, will be important. As many economic challenges cut across administrative boundaries, greater collaboration between local authorities, and with regional agencies, will reap economic rewards.

6.19 In recognition of these challenges and issues, this paper is part of a wider programme of work to inform the Government's consideration of the role of different levels of government in supporting the enhanced economic performance of our cities. Government has already undertaken a number of summits with core cities and their partners, which along with other valuable sources such as *The State of the English Cities Report*, are strengthening understanding of the challenges and opportunities facing cities. The summits with smaller cities and towns, being held between March and May 2006, will augment this understanding.

6.20 A broad work stream will feed into these deliberations including analysis of local governance and service delivery arrangements in the forthcoming ODPM Local Government White Paper, the review into extending the powers and responsibilities of the Greater London Authority and the Lyons Inquiry into the role, function and funding of local government which will report by the end of 2006. The review of sub-national economic development and regeneration will draw on evidence and findings from these and other initiatives ahead of the 2007 Comprehensive Spending Review.

6.21 Government will seek to develop a framework that will rationalise and simplify publicly funded business support provision at national, regional and local level. This responds to strong evidence, from business and elsewhere, that the business support landscape is too complex with a plethora of schemes and providers which make the system hard to use for the customer as well as affecting efficiency and effectiveness.

6.22 This agenda reflects the Government's commitment to enabling cities and regions to improve economic performance as key to delivering full employment and rising prosperity for all, within the wider context of further devolving decision-making to regional and local levels.

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