

## »» Brexit and the UK's regional divide: a cautionary example

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As it commemorates the 30th anniversary of the fall of the Berlin Wall, Germany is increasingly debating regional development and policy issues. These debates are necessary and important, not just in anniversary years. A look at the United Kingdom shows what distortions can result from selectively giving preference to particular regions and, consequently, leaving entire areas behind. In the 1990s the UK was a state with a narrower regional divide than Germany but that situation has reversed for quite some time now. Large parts of the British Isles have fallen even further behind the prosperous region of London, the capital. It was particularly the votes of the relatively weak regions of England that set the both politically and economically damaging Brexit momentum in motion in 2016. The British example is a timely reminder that regional policy is an important lever for economic and political stability. It is a continuous task that must not be neglected under any circumstances.

### Regional divide: thinking outside the national box

The 30th anniversary of the fall of the Berlin Wall has brought aspects of regional development and policy back into the spotlight of economic-policy debate. Looking at Germany as a whole, we advocate overcoming the stereotypical East-West dichotomy, as the regional divide here has long ceased to be noticeably steep by international comparison.<sup>1</sup> Such regional policy debates are necessary and important, not just in anniversary years. A look across the Channel towards the United Kingdom of Great Britain and Northern Ireland shows what distortions can result from giving selective preference to particular regions and their key sectors at the expense of leaving entire areas behind. The UK is receiving a lot of attention because of Brexit. With the very close decision to leave the European Union, regional developments and disparities can be seen to have played a significant role.

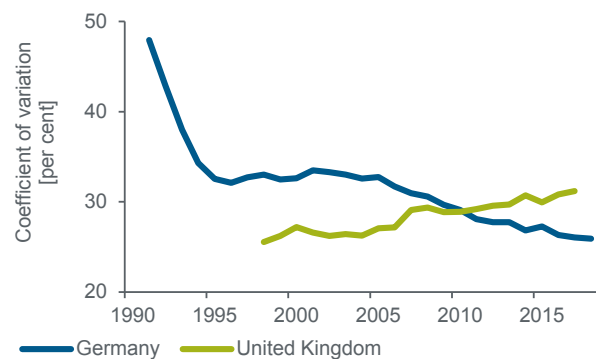
### British regions have been increasingly drifting apart economically since the 1990s

As recently as in the late 1990s, the United Kingdom was a country whose regions were much more balanced than the regions of Germany in terms of economic performance as measured by gross value added per inhabitant. Figure 1 illustrates this with the aid of the coefficient of variation, a standardised measure of dispersion. It is defined as the standard deviation of the regional figures of the observed indicator in per cent of the national average value. The smaller the coefficient of variation, the narrower the regional divide. In Germany, the internationally comparable regional level used

here is the federal states and in the United Kingdom it is the three nations of Northern Ireland, Scotland and Wales, as well as nine regions in England.<sup>2</sup>

In 1998, the first year for which British regional data on gross value added per inhabitant were available, the coefficient of variation there was just under 26%. In Germany, the average dispersion of economic performance at that time was a significantly higher 33%. Since then, the relations between the United Kingdom and Germany have not just converged but even reversed after the global financial crisis since 2010. Currently (2017, the most recent year with data for both countries), the coefficient of variation for Germany is 26%, while for the UK it is 31%.

Figure 1: Gross value added per inhabitant



Sources: Destatis, ONS (original data)

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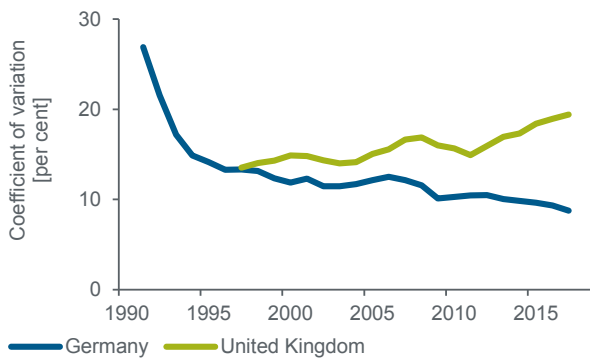
### Regional disparities in disposable income between Germany and the UK are even more striking

The differences in the two countries' regional divide are even more obvious in the disposable income of private households per inhabitant, a central measure of personal material prosperity (see Figure 2). Here, Germany and the United Kingdom were on a par already in 1997, with a coefficient of variation of around 13% each, although the German federal states at the time were considerably more disparate in terms of economic performance than the British regions. This shows that the Anglo-Saxon tax and social security system is less efficient in redistributing income than the German one. The regional gap in disposable income in the UK has become even wider to date (coefficient of variation 2017: 19%), while it has been narrowed successfully in Germany (9%). Particularly after the financial crisis, the gap to Germany widened again substantially to the detriment of the United Kingdom.

**London is the key driver of the regional divide**

The main driver behind this trend towards increasingly greater regional inequality in the United Kingdom is the growing dominance of the financial and services hub London. The upgrading of the services sector and the concentration on the region of the capital city brought with it a substantial loss of status of the producing sector<sup>3</sup> and its highly paid jobs. At present (on average for the five-year period 2014–2018) it still contributes 20% to gross value added in the UK, down from a good 26% in the second half of the 1990s (1995–1999).<sup>4</sup> By contrast, the producing sector in Germany has almost maintained its already significantly higher share. During the same period it dropped by a negligible margin from 32 to 31%.<sup>5</sup>

**Figure 2: Disposable household income per inhabitant**



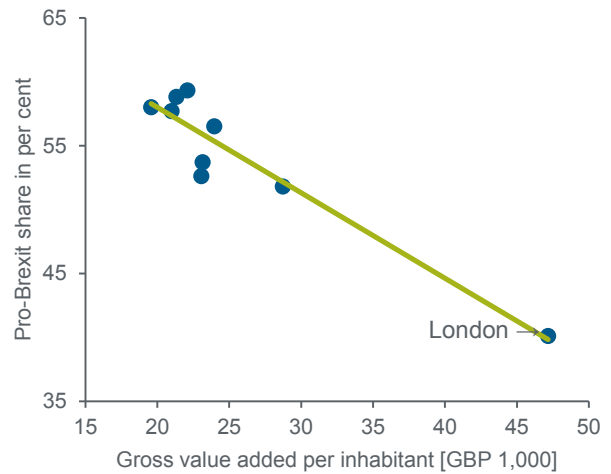
Sources: Destatis, ONS (original data) © KfW 2019

The support measures implemented in response to the global economic and financial crisis once more exacerbated the regional imbalances in the United Kingdom. As a result of those measures, the UK's public deficit surged from 2.6% in 2007 to 10.4% at its peak in 2009. Because of the systemic importance of the financial sector, the measures were necessary for the overall economy as well. But of course, they benefited London the most. At the same time, the subsequent public budget consolidation efforts, which were distributed over several years and pushed the deficit down again to 2.9% by 2016, involved cuts to social benefits, in the cultural sector and in health care. These affected the regions broadly.<sup>6</sup>

**The more disconnected the regions, the more they favour Brexit**

At the time of the Brexit referendum on 23 June 2016, the United Kingdom in any case had become an economy with conspicuous disparities in the distribution of performance and prosperity levels, particularly compared with Germany. Empirical evidence such as the in-depth analysis by Fetzer (2019) suggests that the associated problems, especially in the disconnected regions of England, were effectively projected on to the EU by the leavers.<sup>7</sup> Even if the European and international orientation of finance business in the case of London surely must have been a strong individual argument for remaining in the European Union, it is downright astonishing how steeply pro-Brexit advocacy increases with decreasing regional economic strength (see Figure 3).<sup>8</sup>

**Figure 3: England – pro-Brexit vote vs. regional economic strength**



Sources: ONS, Electoral Commission (original data) © KfW 2019

**Conclusion: Regional policy is an ongoing task that must not be neglected**

What lessons can be learned from the development of the United Kingdom's regions and from the comparison with Germany over the past three decades? Basically, there are two findings. First, we can again confirm our initial assessment that the regional divide in today's Germany can stand international comparison. We should therefore stop the rhetoric of overemphasising the remaining economic disparities between eastern and western Germany 30 years after the fall of the Wall and should instead systematically align regional policy with the needs of regions that have been left behind, regardless of where they are located. However, this is a continuous task that must not be neglected under any circumstances. The second important lesson to be learned from the warning negative example of the UK is that effective regional policy is an important lever for economic and political stability. It was particularly the regions in England that have been disconnected from the capital London which set in motion what, under all plausible assumptions, is both politically and economically damaging Brexit momentum.<sup>9</sup> It is true that the damage from a no-deal Brexit would be particularly severe. But even an orderly departure of the United Kingdom from the European Union would merely be the least-worst solution that would at best allow damage control.

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<sup>1</sup> Cf. Borger, K. (2019), **North-South, East-West – thoughts on Germany 30 years after the fall of Wall**, Focus on Economics No. 270, KfW Research.

<sup>2</sup> The methodological basis for this is the Nomenclature des Unités Territoriales Statistiques (NUTS), a hierarchical system used to identify and classify territorial units in the European Union for statistical purposes. The German federal states and the British regions mentioned correspond with the classification level NUTS-1. Comparable regional data for the United Kingdom on gross value added and disposable income of private households per inhabitant are available at NUTS-1 level only since 1997 and 1998, respectively. Regional data for Germany, on the other hand, have been available already since 1991. Data source for the United Kingdom: Office for National Statistics, Regional Accounts, Regional gross disposable household income (GDHI) reference tables (published 22 May 2019), Table 2 (GDHI per head of population at current basic prices); sowie Regional gross value added (balanced) reference tables (published 12 December 2018), Table 2 (Gross Value Added (Balanced) per head of population at current basic prices). The UK data can be retrieved from: <https://www.ons.gov.uk/economy/regionalaccounts/grossdisposablehouseholdincome/datasets/regionalgrossdisposablehouseholdincomegdhi>; and <https://www.ons.gov.uk/economy/grossvalueaddedgva/datasets/nominalregionalgrossvalueaddedbalancedperheadandincomecomponents>. Data source for Germany: Volkswirtschaftliche Gesamtrechnungen der Länder (2019), Reihe 1, Band 1 – Bruttoinlandsprodukt, Bruttowertschöpfung in den Ländern der Bundesrepublik Deutschland 1991 bis 2018, Tabellen 2.1 (Bruttowertschöpfung) und 13. (Einwohner) (*National accounts of the federal states (2019), Series 1, Volume 1 – gross domestic, gross value added in the states of the Federal Republic of Germany 1991 to 2018, Tables 2.1 (Gross value added) and 13. (Inhabitants)*), and Band 5 – Entstehung, Verteilung und Verwendung des Bruttoinlandsprodukts in den Ländern der Bundesrepublik Deutschland 1991 bis 2018, Tabelle 5.2 (Verfügbares Einkommen der privaten Haushalte) (*Volume 5 – Origin, distribution and use of gross domestic in the federal states of the Federal Republic of Germany 1991 to 2018, Table 5.2 (Disposable income of private households) (all titles unofficial courtesy translations)*). Retrievable from: <https://www.statistik-bw.de/VGRdL/tbls/?lang=de-DE>.

<sup>3</sup> The producing sector comprises the following areas of economic activity: mining and the extraction of non-metallic minerals; manufacturing; energy supply; water supply, waste disposal and similar; construction.

<sup>4</sup> Cf. Office for National Statistics, GDP output approach – low-level aggregates (published 9 August 2019), Table CP £ Millions. Retrievable from: <https://www.ons.gov.uk/economy/grossdomesticproductgdp/datasets/ukgdpowlevelaggregates>.

<sup>5</sup> Cf. Federal Statistical Office, national accounts, domestic product calculation, detailed annual results, 2018 (published on 16 September 2019), Table 2.2.1 (gross value added in current prices). Retrievable from: [https://www.destatis.de/DE/Themen/Wirtschaft/Volkswirtschaftliche-Gesamtrechnungen-Inlandsprodukt/\\_inhalt.html#sprg233858](https://www.destatis.de/DE/Themen/Wirtschaft/Volkswirtschaftliche-Gesamtrechnungen-Inlandsprodukt/_inhalt.html#sprg233858).

<sup>6</sup> Gray, M. and A. Barford, The depths of the cuts: the uneven geography of local government austerity, *Cambridge Journal of Regions, Economy and Society*, 11, 2018, pp. 541-563. Retrievable from: <https://academic.oup.com/cjres/article/11/3/541/5123936>.

<sup>7</sup> Cf. Fetzer, T., Did Austerity Cause Brexit?, CAGE Working Paper No. 328 (June 2018, revised June 2019). Retrievable from: [https://warwick.ac.uk/fac/soc/economics/research/centres/cage/manage/publications/381-2018\\_fetzer.pdf](https://warwick.ac.uk/fac/soc/economics/research/centres/cage/manage/publications/381-2018_fetzer.pdf).

<sup>8</sup> The result of London may look like an outlier here, but it is not decisive. Even without counting it, practically the same negative correlation would emerge between regional voting behaviour and regional economic strength. Cf. The Electoral Commission, Results and turnout at the EU referendum, for the data used. Retrievable from: <https://www.electoralcommission.org.uk/who-we-are-and-what-we-do/elections-and-referendums/past-elections-and-referendums/eu-referendum/results-and-turnout-eu-referendum>.

<sup>9</sup> Cf. Tetlow, G. and A. Stojanovic, Understanding the economic impact of Brexit, Institute for Government, November 2018. Retrievable from: <https://www.instituteforgovernment.org.uk/sites/default/files/Economic%20impact%20of%20Brexit%20summary.pdf>.