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Which kinds of firms contribute most to regional growth?

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Summary and policy recommendations

The success of firms and regions is interdependent and reciprocal…

- Firms tend to be more competitive and perform better if they are located in regions that have good infrastructure, skills, suppliers, customers and support for innovation.
- Regions grow faster and are more resilient in the face of economic shocks if they host strong, competitive and innovative firms.

But, regional growth depends more on some kinds of firms than others …

- The regional impact of any firm is related to both its size and its local embeddedness – that is the proportion of its assets and employment in the region and how much it buys and sells to other firms or customers in the region.
- Our survey of 300 businesses in the West Midlands region, covering four sectors, has shown that firms in Hospitality and the Business Professional and Financial Services (BPFS) sector are more embedded in the region, with a larger proportion of local suppliers and customers than those in Retail and Advanced Manufacturing.

Policymakers need to consider this and other evidence to improve the targeting of interventions and support to benefit firms that contribute most to local growth.

Introduction

Many City-REDI projects aim to help policymakers optimise the use of scarce public resources to promote economic growth and wellbeing locally and regionally. Some of these policies are targeted at helping improve productivity, innovation and competitiveness in local firms, because this drives regional economic growth, investment, employment and resilience.

Our regional 'Productivity and Prosperity' project focuses on identifying the barriers to improving productivity and innovation across four sectors that are key to the health of the regional economy. It has also revealed important differences in the levels of 'embeddedness' or interdependence between firms and their host regions. Some firms and sectors make more of a contribution to local and regional economies because of the structure of their local value chains.

These findings are relevant for policymakers looking to support businesses that are particularly important to the growth of the region as a whole.

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The Policy Context

Public sector policies designed to support business success and economic growth need to be developed and applied with a better understanding of how different types of firms contribute differently to growth.

Combined Authorities (CAs), Local Enterprise Partnerships in England and other enterprise agencies, local Chambers of Commerce and local authorities across the UK have limited resources to support business development and economic growth in their regions. National government subsidies and support for businesses, designed to prevent failure and safeguard jobs, to accelerate innovation and competitiveness, or to boost particular sectors or types of business, are often applied without a insufficient understanding of their impact. In particular, a lack of precision in targeting those firms and sectors which are more important to local economic growth than others.

Places Compete

Regional growth is driven by growing local firms and attracting firms, investment and skills to the region, and keeping them there. This has to be underpinned by the development of strong infrastructures, transport, housing, universities and amenities. A region needs to be attractive to both firms and people that have choices and will choose to go to the places that offer the best of these endowments. The West Midlands has been particularly strong in recent years (pre-Covid-19) at attracting skilled people and business investment people to improve productivity and growth.

The Corporate Context

Firms operate across value chains. These vary in terms of scale, scope and geography. This variation affects their performance and resilience. It also influences how much impact they have on a particular regional economy.

Firms add value to their host economies, directly via employment (which drives consumer spending) and indirectly via various multiplier effects associated with their links with others firms. But their local and regional impact varies significantly according to the spatial configuration of their activities and those of their network or value chain partners; and the degree to which their forward and backward linkages with other firms are regional, national or global.

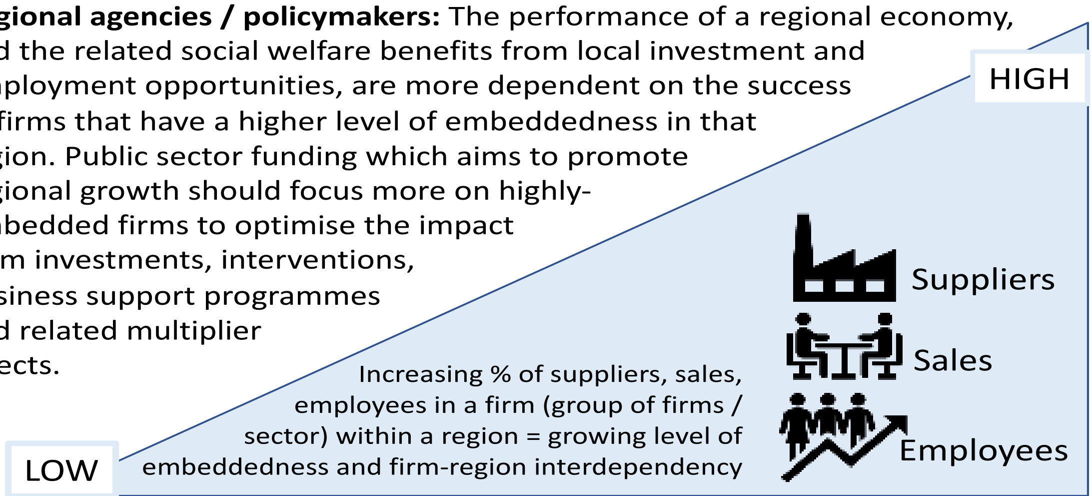
Firms Compete

Good management in larger firms, and particularly multinational firms, involves continuous restructuring to leverage the changing conditions in different locations. They sell more where markets are growing, place R&D activities where high skills and good universities are present, and put labour-intensive activities in places where cheap and/or skilled labour is available.

Their competitiveness, productivity and performance partly depend on this configuration of assets and capabilities in relation to markets. So firms compete to access the best skills, the best customers, and other place-based endowments. Small firms have few options and may be entirely dependent on one region and a specific set of larger firms or customers.

Embeddedness and Interdependency between Firms and Regions

Regional agencies / policymakers: The performance of a regional economy, and the related social welfare benefits from local investment and employment opportunities, are more dependent on the success of firms that have a higher level of embeddedness in that region. Public sector funding which aims to promote regional growth should focus more on highly-embedded firms to optimise the impact from investments, interventions, business support programmes and related multiplier effects.



Firms / Managers: Increasing % of suppliers, sales and/or employees in a region represents an increasing level of embeddedness in, and dependency on, that region. Performance is increasingly influenced by local strengths and weaknesses (skills, infrastructure, available suppliers and customers etc.) and more vulnerable to shocks which impact this region more than other regions.

Collinson and Pan, 2020

Our Research

Together with our partners at Warwick Business School (WBS) and Warwick Manufacturing Group (WMG), we are conducting a long-term study of productivity in the West Midlands region. As part of this study, City-REDI led a large-scale survey of 300 businesses in the region.

The main aim of this research is to understand why UK firms, and particularly those in regions outside London and the South-East, are less productive than their OECD counterparts. UK firms have demonstrated below average real productivity growth in both output per hour and output per worker over many years. In the West Midlands, labour productivity (output per hour) is 10.4% behind the national average (ONS, 2020). Low productivity growth in firms means weaker economic growth for the region. This policy briefing focuses on a gap in the current understanding of the varying economic impacts of firms on host regions. As described above, firms add value to their host economies, directly via employees and indirectly via various multiplier effects. Their regional impact varies significantly according to the spatial configuration of their activities and those of their network partners; and the degree to which their forward and backward linkages with other firms are regional, national or global. In the following, we introduce the four industry sectors analysed in the survey. The survey findings, on the relative embeddedness of these key sectors in the West Midlands, and policy recommendations are then presented.

Firm-Region Interdependence in the West Midlands

Key Industry Sectors in the West Midlands

Our survey of 300 firms focused on four key sectors in the region:

- Business, Professional & Financial Services (BPFS) is the largest sector, contributing over a quarter (25.4%) of the region's productivity in Gross Value Added (GVA) terms (WMCA, 2018).
- Retail contributes 14.3% (WMCA, 2018).
- Advanced Manufacturing and Engineering contributes 11% (WMCA, 2018).
- Hospitality contributes 4.1% of regional GVA but is a significant employer (the 3rd-largest in the UK) (UKHOSPITALITY, 2018).

The survey targeted a mix of sectors and firms of various sizes to compare services and manufacturing and sectors characterised by low- and high-skills. Skills are an important component of firm-level productivity, underpinning efficiency and innovation.

One study suggests that "around 40 per cent of the output gap between the West Midlands and the UK average is due to weaker performance in competition, investment, enterprise and innovation" (Magda et al., 2019). The relatively low level of skills in the region is a major factor underlying this weakness.

Access to skills, and other inputs which determine productivity, affect all firms in a region, including those in the supply chain. When a value chain, linking buyers and suppliers in a particular industry sector, is more regionally-embedded, a local shortage of skills or other input factors has a greater impact on the productivity and innovation capabilities of that industry. At the same time the performance of that industry has a greater impact on the economic performance of the region.

These firm-to-firm relationships, interdependent with the endowments of a regional economy, sit at the heart of academic studies on clusters and agglomeration economies.

Typology of regional embeddedness

Pan and Collinson, 2020

Analysing Embeddedness

Our analysis focuses on two kinds of local and regional embeddedness and interdependency: supply chain links (upstream) and customer links (downstream). In the figure above, Type 1 firms or sectors have high regional embeddedness in sales and low regional embeddedness in suppliers. A high percentage of downstream links are regional and a low percentage of upstream links are regional; they buy mainly from outside of the region and sell more to customers within the region.

Type 2 firms should be the focus of policy interventions for local growth, because a high proportion of their sales and suppliers are in the region. Improvement in their growth and employment has more significant impacts on the regional economy than improvement in other firms, via direct and indirect multiplier effects. Type 2 firms, or sectors, are also more dependent on the region than Type 1 firms. The changing availability and quality of suppliers, and the presence of customers willing to buy their products and services has a greater influence on their performance. The fate of these firms is more closely tied that of the regional economy.

Type 3 refers to the opposite of Type 1; low regional embeddedness in sales and high regional embeddedness in suppliers. These firms are also important to the regional economy, because upstream supply chain linkages drive more indirect multiplier effects than downstream customer linkages. Type 4 refers to the firms or sectors which have low regional embeddedness and relatively less direct and indirect economic impact on the region.

Research Findings:

Sector variation in regional embeddedness

The charts below summarise the main findings from our survey of 300 firms across these four sectors.

In the advanced manufacturing sector, 23.5% firms have over 50% of their sales in the region and 32.6% firms over 50% of their suppliers in the region. These percentages are relatively low compared to other sectors. BPFS, also a high knowledge-intensive sector, shows a different pattern: 52.7% firms have over 50% of their sales in the region and 58.9% firms have over 50% of their suppliers from the West Midlands.

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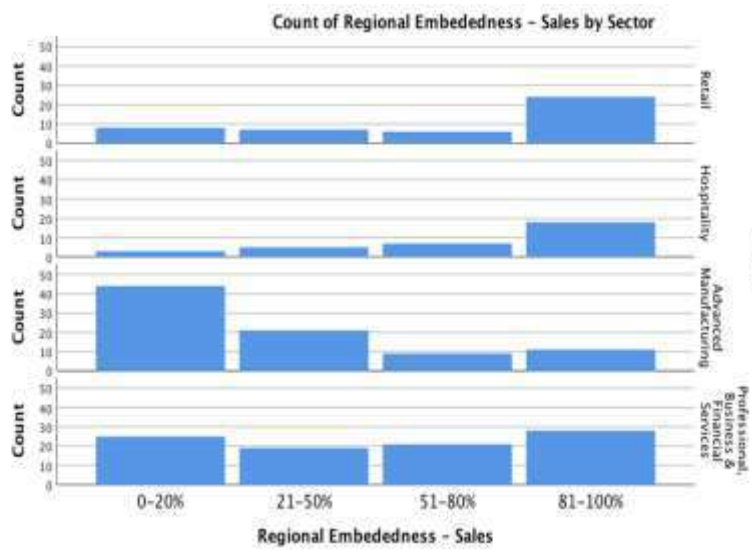
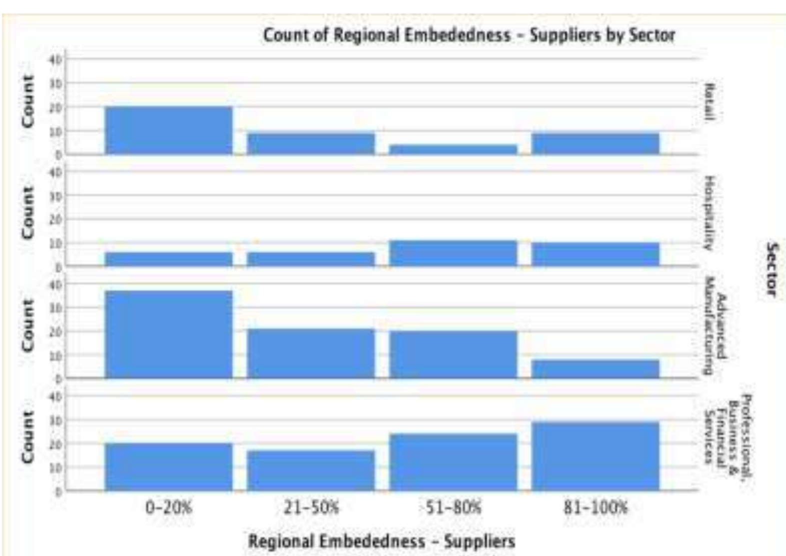
Hospitality and retail are defined here as low knowledge-intensive, high employment sectors. In hospitality 75.7% firms have over 50% of their sales in the region and 63.3% firms have over 50% of their suppliers in the region. It is highly embedded upstream and downstream.

Retail sector firms, sell more in the region than they source from the region. 66.6% firms have over 50% of their sales in the region and 30.9% firms have over 50% of their suppliers in the West Midlands.





Research Findings:

Industry sector variation in regional embeddedness

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Relative Embeddedness of Key Industry Sectors in the West Midlands

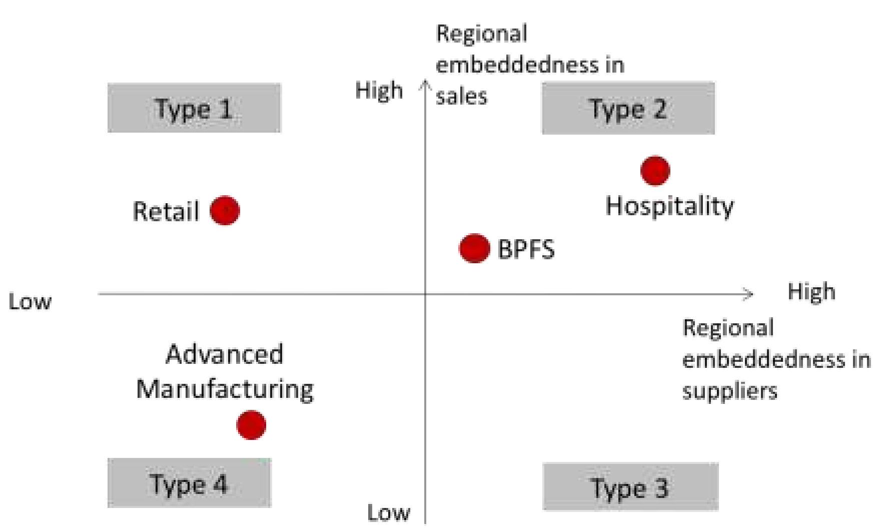
The figure below, returns to our simple four-part typology and maps the four key business sectors on to this to show the relative positioning. Hospitality and BPFS have a relatively high level of localisation in both sales and suppliers. Retailers are high in sales and the lowest of the four sectors in their use of local suppliers. Advanced manufacturing and engineering firms are low in both, and particularly low in their links with local suppliers.

This last finding questions some of the popular views of manufacturing firms and their importance to this and other regions. It is likely that some of these views are based on the presence of large firms such as JLR, which is the UK's biggest car manufacturer and heavily concentrated in the West Midlands region. Our study suggests that JLR is an outlier; the average firm in this sector is far less locally-embedded. **Given its scale, JLR remains hugely important to the regional economy, but we should not base policy interventions across the sector on the structure and impact of this one firm.**

These survey findings strongly reaffirm the importance of the BPFS sector in the West Midlands as a highly-embedded sector. Previous projects by City-REDI, led to a series of reports to regional and national policymakers on the importance of the sector. One of these, produced as part of the WMCA Productivity and Skills Commission showed how its growth and development has led to its embedded structure as a 'fully localised value chain' of high-value activities.

Because of this, its scale and its value as a high-skilled, knowledge-intensive industry, improvements in productivity and innovation in local BPFS firms are likely to have stronger local impacts than the equivalent interventions in other sectors. Its growth in the region has been driven by – and in turn, driven - the attraction and retention of higher-skilled employees to the region. This in turn drives up consumer spending and supports other services and investment in infrastructure and amenities, as part of the 'virtuous cycle of growth' regions need. These are also the kinds of growth catalysts needed for post-Covid-19 recovery and resurgence. Since the BPFS sector has many interconnections with other business sectors, its development will 'enable' firms more widely to improve productivity and innovation.

Regional embeddedness of the four sectors



Pan and Collinson, 2020

Policy Recommendations

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What should policy makers do?

- Policy makers should develop a better understanding of the businesses in their region, small and large, in terms of the degree to which they are part of local value-chain structures, supporting suppliers and customers in the region.
- Regional embeddedness, needs to be considered alongside a firm's size and sector, as criteria for support from regional agencies. This is particularly important for targeting limited resources to safeguard firms and jobs against the impacts of economic shocks like Brexit and Covid-19, as well for delivering more precise place-based growth interventions.
- More broadly, because private sector employment and investment are the primary drivers of economic growth, policymakers need to develop a better understanding about corporate structures, strategies and the kinds of incentives which align with or influence management objectives.

Sources (Further reading)

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