SUMMARY

• The strength of the United Kingdom's economy lies with London and the wider South East – while other regions appear to have been 'left behind' in terms of economic prosperity.

• The government has made rebalancing the economy a key plank of its policy agenda – particularly through its Industrial Strategy White Paper – and it is a concept which garners cross-party support in Parliament.

• International trade and inward foreign direct investment (FDI) increase the economic success of both entire nations and specific regions.

• Regions which engage relatively more in international trade, and attract relatively more FDI, can grow richer as a result – which by logical consequence can exacerbate regional inequality.

• This pointmaker examines how the UK economy is regionally imbalanced, and makes a series of recommendations as to how the government can amend its policies on trade and inward FDI in light of the UK's pending withdrawal from the European Union.

• We recommend that the government should: ensure that the UK retains preferential trading access with its current partners; seek new opportunities to increase trade elsewhere; introduce Opportunity Zones in the most deprived parts of the UK to stimulate FDI and boost local businesses; and allow for the creation of free ports to increase manufacturing industries and exports in regions outside London and the South East.
It is no secret that as the United Kingdom has steadily transitioned towards a service-based economy, its economic strength has increasingly been found in London and the wider South East. We frequently hear about ‘left behind’ areas, or entire regions, and the government has repeatedly indicated its desire to redress such regional economic imbalances.

This pointmaker assesses the role that trade and investment could play in helping to create a more regionally balanced UK economy, especially after leaving the European Union. It begins by examining regional differences in trade flows and inward investment, and explains that these have knock-on consequences for relative prosperity between regions of the UK. It then sets out several recommendations to help drive exports and attract foreign investment, particularly in regions outside London and the South East.

This pointmaker is part of a wider research project which the Centre for Policy Studies is currently undertaking on regional economic imbalances in the UK. It will inform part of the analysis for a full policy report which we will be publishing later in 2019.

**HOW TRADE AND FDI INFLUENCE REGIONAL INEQUALITY**

With the UK preparing to leave the EU, much attention has been given to its future international trade and investment policy.

Indeed, Brexit will almost inevitably signal a marked change in the current approach. For the first time in over four decades, the British government will have the chance to craft an independent trade policy, while new avenues to promote inward investment may open up.

Alongside this, the government has – largely through the efforts of the Department for International Trade – redoubled its efforts to attract more foreign direct investment (FDI) into the country.¹

Departure from the EU means the UK will have the ability to strike trade deals of its own with other sovereign nations and trading blocs, explore varying or removing tariffs on imports, and look at removing non-tariff barriers and other restrictive regulations in order to facilitate further trade and inward investment.

Certainly, this is the context in which we publish this pointmaker, and in which we seek to promote policies which ensure that the benefits of international trade and FDI in the near and long-term future are more equitably spread around the whole of the UK.

International trade can be a vitally important way of generating prosperity in an economy – something which is agreed upon by almost all contemporary economists.² For centuries, the positive-sum value of economies exporting what they are relatively good at producing, and importing that which they are not, has been understood.³,⁴,⁵
Indeed, at a national level, an abundance of evidence exists which indicates that trade openness has a positive and statistically significant impact on economic growth. Importantly, it can be shown that the relationship between international trade and economic growth is not just a correlation, but that the former explicitly causes the latter.

This is because, fundamentally, when economies are opened up to international trade, they are opened up to competition. Over time, this forces businesses to become more efficient, lest they fall by the wayside through a process of ‘creative destruction’.

Of course, international trade also allows businesses to benefit from cheaper goods and services from elsewhere, in turn helping them to produce their own wares more cost-effectively.

Crucially, this is as true for regional economies as it is for national ones. In the UK, there is strong evidence to suggest that the higher the value of goods and services a region exports, the higher productivity it sees within it. Given that productivity and worker remuneration are intimately correlated, those employed in regions with higher international trade figures can typically expect to have higher incomes.

Because there is a clear causal relationship between international trade and economic performance, it stands to reason that it can impact regional economic inequality within a national economy. This is particularly true for the UK economy, which in 2018 exported £634.1 billion of goods and services, roughly 30 per cent of gross domestic product (GDP).

Thus, while we resolutely believe that free trade delivers benefits for the UK’s economy at large, it would be foolhardy to deny its ability to exacerbate domestic regional inequality. For example, if certain regions are better able to exploit international trade opportunities than others, it is obvious that they stand a greater chance of prospering accordingly.

Turning to FDI, its relationship with beneficial economic outcomes is not as clear-cut as one might expect – certainly, it is not as apparent as the link between exports and prosperity.

In some instances, FDI can distort exchange rates, pushing up the price of the recipient nation’s currency, which lowers the competitiveness of domestic businesses. The perennial volatility of international capital flows can also mean that regions which depend heavily on FDI are all the more exposed to the risk of that investment drying up over relatively short periods of time.

However, for a developed nation like the UK – which enjoys attractive, mature and relatively stable political, legal and financial institutions – plenty of evidence exists which indicate the value of FDI to the economy. Indeed, a government report last year found that FDI has unambiguously benefited the British economy in terms of increasing rates of growth, productivity, innovation, and employment.
Most obviously, FDI can lead to business expansion by providing capital for existing or would-be firms. As a result, more productive economic activity can take place, and in all likelihood employment and wages are boosted. Furthermore, the benefits of FDI will rarely be confined to just the recipient firm – often the positive impacts will spill over to other companies in the local economy, or in the recipient firm’s supply chain.

FDI also has beneficial consequences for the recipient economy which may be less immediately apparent. For example, more than just being an inflow of money, FDI also often represents the transfer of new ideas, technologies, and ways of doing things. This might come in the form of shared expertise or technology, or through additional investment in research and development (R&D). Indeed, foreign-owned firms spend approximately five times more on R&D compared to domestic companies, and collectively account for half of all R&D spending in the UK. Innovation is crucial to increasing the long-run productive capacity of economies, and as such FDI can represent an important means of doing so.

Returning momentarily to exports, which we have already established can have beneficial consequences for economies, data on shows that foreign-owned firms are roughly six times more likely to engage in exporting – almost half do, compared to eight per cent of British-owned firms. There will be myriad reasons behind this, although knowledge of different markets, and existing ties with businesses abroad, are likely contenders.

On a similar logic to international trade, therefore, FDI can have significant consequences for regions’ relative economic standing – especially when abstracted over long periods of time. Those regions which manage to attract relatively more FDI can be expected to grow wealthier, while those which fail to do so will typically remain constant, or lapse into decline.
INTERNATIONAL TRADE ACROSS UK REGIONS

In this section, we will look at how international trade patterns differ in each region of the UK. Once having done so, we will then similarly examine patterns of FDI.

The UK is one of the most active trading economies in the world in terms of the value of goods and services it imports and exports. Over the past decades, both have steadily increased, as shown in Chart 1, above. In 2018, total trade stood at nearly £1.3 trillion, more than 60 per cent of GDP. With the country’s single largest trading partner, the USA, the UK exported £118 billion of goods and services in 2018, and imported £70 billion.

But trade does not occur equally across the whole of the UK. Some regions play host to more businesses which export, others fewer. Some regions see higher values of trade flow in and out of them, others lower. Some regions trade more in goods as a proportion of total exports, others more in services. Combined, these all add up to create variations that partly explain regions’ respective economic success.
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Chart 2, above, illustrates just how much variation there is between regions in terms of the value of goods and services they export on an annual basis. At one end, London dominates – exporting almost £155 billion of goods and services a year. At the other, Northern Ireland manages barely more than £11.6 billion. In fact, taken together, London and the South East account for 43 per cent of Britain’s exports.

In Chart 3, on page 7, one can see how many businesses in each region exported goods and services in 2017. Again, London and the South East lead the way – boasting 60,800 and 45,500 exporting businesses respectively. On this measure, Northern Ireland fares better – likely due to its relationship with the Republic of Ireland – leaving the North East with the region with the fewest exporters, with just 4,300.
Evidently, patterns of international trade are not uniform across the UK. London and the South East stand out as the two regions which engage in the most international trade, and at a magnitude much greater than that of others – both in terms of the number of exporting businesses, and the value of the goods and services they export.

Given that we know beneficial consequences flow directly from international trade, it is equally apparent that regions which export less are likely to be missing out on vital economic dividends, such as increased productivity, more job opportunities, and, ultimately, higher per capita incomes.

In sum, increasing international trade in these regions could be seen as a prudent government objective. The question, therefore, is how to achieve this outcome.

Some solutions will be linked specifically to trade policy, while others will be about simply improving business conditions within regions, and encouraging firms in relatively lower exporting regions to do more on the global stage.

We will look at potential policy changes later on in this pointmaker, having first considered how FDI in the UK differs on a regional basis.
CASE STUDY 1. INCREASING EXPORTS IN EMERGING SECTORS
From Charles Babbage and Ada Lovelace, to Alan Turing and Tim Berners-Lee, the UK has a proud heritage in computer science and information technology. Britain is a global centre of the tech industry, and tech contributes enormously to the British economy – growth rates in the tech sector are estimated to be 2.6 times that of the economy overall. Presently, the UK is at the forefront of developing the next generation of technologies – such as artificial intelligence (AI), clean tech, and cyber security systems.

Capitalising on the emergence of these still relatively nascent industries therefore represents a potentially lucrative way to grow the economy, increasing both exports and FDI. Indeed, a recent government report on AI estimated that it alone could add an additional £630 billion to the UK economy by 2035.

From the perspective of regional rebalancing, while much of the UK’s tech sector is located in London and the South East, pockets of excellence do exist elsewhere. A recent Tech Nation report found that places as diverse as Solihull, Luton, Edinburgh, Sheffield and Bristol are some of the top global destinations for clean tech investment, while Newcastle-upon-Tyne attracts similar levels of investment in AI to California’s famed San Diego. Manchester, the report found, actually outranks London on a metric which estimates the density of tech networks in a city.

The application of new technologies will likely bring productivity gains for individuals and businesses in all corners of the UK. Moreover, the incorporation of these new technologies into products such as electric and autonomous vehicles will physically take place in regions such as the West Midlands and the North East.

To its credit, the government appears to recognise the importance of these sectors, and included AI as one of its nine Industrial Strategy ‘Sector Deals’. Among other things, it pledged to increase the rate of the R&D tax credit to 12 per cent, establish a technical education system which ‘rivals the best in the world’, and boost the country’s digital infrastructure. These are all commendable policies, and should help to put the UK at the centre of the latest tech revolution.

But more could be done. In a recent CPS report looking at the UK’s tech sector, we argued for a series of reforms that would help firms at the forefront of developing and utilising new information technologies like AI.

Our recommendations included introducing a special class of visa which eligible scale-up tech firms could issue, and encouraging the government to reconsider the £30,000 minimum salary threshold proposed in its immigration white paper, due to fears that it could restrict the ability for such companies to find the talent they need to flourish – not least if freedom of movement ends when the UK leaves the EU.

Alongside improving immigration rules, we also recommended that the government explores the wider use of ‘sandbox’ regulatory frameworks for emerging industries. These provide a more sympathetic regulatory regime that allows firms to experiment and innovate their product offering.

New technologies are already transforming our lives and the economy around us, and others on the horizon will likely have similar effects. Given the potential benefits of establishing the UK as a leading nation for the tech industry – increasing economic growth, exports, and FDI – the government should implement the policies we suggested to provide the conditions tech needs to thrive.
FOREIGN DIRECT INVESTMENT ACROSS UK REGIONS

As the world’s sixth largest economy and a global centre for law and finance, it is not surprising that the UK is an attractive place for inward FDI.47

Indeed, in 2017, the stock of inward FDI increased by £149.2 billion to stand at over £1.3 trillion.48 Yet, as with international trade in goods and services, FDI into the UK is not spread equally around the country.

Chart 4, below, illustrates how London again dominates the picture in terms of overall FDI projects (2,520 between 2015 and 2018), and the new jobs they created (62,422).49,50,51

The South East ranks as the next most attractive location for FDI projects (764), which created an estimated 16,177 jobs. The West Midlands, while attracting the third-greatest number of FDI projects (490), actually saw more jobs created off the back of them (27,113) compared to the South East.

With only 95 FDI projects, Northern Ireland was the least attractive part of the UK for FDI, and saw just 4,941 new jobs created from it.

Combined, London and the South East claimed 38.7 per cent of FDI-generated new jobs, and over half of all FDI projects – 51.4 per cent.

CASE STUDY 2. SQUARING THE VIRTUOUS CIRCLE OF INWARD INVESTMENT

Since the start of the Second World War, Broughton in north Wales has been home to an airfield and a cluster of aerospace firms – all manufacturing, assembling, and modifying commercial and military grade aircraft.

Raytheon, the global technology, aerospace and defence contractor, chose Broughton as its location to pioneer its work on airborne intelligence, surveillance and reconnaissance (AISR) technology, which can gather and process data in real time. It provided FDI and know-how to develop the AISR technology, imparting specialist skills to a sizeable workforce in doing so.

Broughton now boasts leading sovereign AISR capabilities, which enhance the British military as well as those of the UK’s allies and NATO. The AISR technology also has civil applications. For example, Sentinel R1, one of two platforms currently at Broughton, was used to map flooding in the UK in 2014, and has the potential to map climate change as well.

Altogether, Raytheon provides employment for over 300 people in Broughton, who link up with other Raytheon sites across the whole of the UK. A further 250 people are employed in the supply chain, with roughly 80 local small and medium-sized enterprises benefiting from having an additional client to provide parts and services for. Through Raytheon’s apprenticeship programme, the company also offers a pathway to well-remunerated work for young people from the area.

The existence of Broughton as a success story outside London and the South East did not happen by accident. It required willingness from the government to engage with and incentivise firms to invest in the region. In this case, Ministry of Defence contracts prime a baseload level of work, on top of which aerospace firms can then garner further business, exporting to other nations. The ongoing partnership firms like Raytheon have with the Ministry of Defence is mutually beneficial, and ensures that they can deliver exactly the resources which the British military requires.

By providing such conditions to attract inward FDI, a virtuous circle of localised economic growth is set in motion – begetting higher employment, tax receipts, and yet more FDI.

REBALANCING THE ECONOMY THROUGH TRADE AND INVESTMENT POLICIES

The preceding sections illustrate just how much London and the South East dominate in terms of the UK’s trade patterns and flows of inward FDI. Much of that dominance is down to the hard-won strength and size of those regional economies. But it is obvious that existing trade and investment policies will play an important role in sculpting how successful all regions of the UK can be.

In this section, we recommend several policies which could help improve the UK’s trade and investment landscape. Most of our recommendations would help rebalance the national economy by building on the underlying assets of sectors typically based outside London and the South East (such as in the automotive, defence, and wider manufacturing sectors), and allowing them to fulfil their full potential – in terms of growth, skills-provision, and employment – as opposed to reinventing
the wheel and trying to shoehorn new industries into parts of the country to which in all likelihood they are not best suited.

As a member of the EU, the UK’s trade policy has been shaped almost entirely by rules and regulations originating from Brussels. Most evidently, the UK is part of the EU Customs Union and the EU Single Market.

In June 2016, the UK voted to leave the EU, and subsequently expected to have left by 29 March 2019, after triggering Article 50 two years prior. However, Britain currently remains an EU member state. The debate around the UK leaving the EU continues to this day, and at the time of writing it is still not clear whether or not the UK will leave the EU with a negotiated deal – or indeed what the precise terms of any such deal would be.

This has obvious consequences for what policy changes we can recommend in this pointmaker to foster economic growth across all of the UK’s regions. Therefore, many of the ideas we put forward below are changes we believe can be implemented irrespective of Brexit.

**Recommendation 1. Promote a truly open and flexible future trade policy**

Upon leaving the EU, the government should ensure as a priority that all of the UK’s existing free trade deals and preferential agreements – which it enjoys as an EU member state – are carried over.

Since the Brexit vote, the government has been negotiating with countries that have third party free trade and preferential agreements with the EU already to keep existing arrangements in place. Several arrangements have been signed and so will continue to be in effect after Britain leaves the EU – including those with Chile, Iceland and Norway, Switzerland, and Israel.

However, a number have not been signed, and are not expected to be completed before 31 October 2019 – the end of the second extension period to Article 50 agreed by the government and the EU in April. Even by the government’s own estimates, just nine of the current 39 arrangements are certain to be in place by 31 October. Twenty-five are listed as ‘engagement ongoing’, while five will not be in place – including those with Turkey, Israel and Japan, which in 2018 accounted for nearly £40 billion of trade for the UK.

As well as ensuring that UK businesses retain access to current markets, the government should seek to negotiate new preferential trade agreements with other economies. Its efforts should focus both on those economies which are presently largest, and those forecast to experience the most growth in coming years.

The government should also examine existing trade agreements it has with other nations. It is likely that many of these could be improved, particularly by removing non-tariff barriers that can be as much as - or even more of - an impediment to trade flows as ordinary tariffs.

Lastly, the government should do all it can to investigate how regulation around exporting could be improved for British businesses. It should actively engage with British firms to understand how paperwork or other administrative burdens could be reduced to facilitate extra trade.
Suffice to say, with respect to negotiating new trade deals, or improving existing ones, the government should be cognizant of how such agreements will impact different types of British firms – in terms of size and sector.

**Recommendation 2. Introduce a network of Opportunity Zones in the UK's most economically deprived areas to incentivise FDI and boost British businesses**

Opportunity Zones are not a new idea – and have received lots of attention for their recent adoption in the USA. They are government-defined areas which confer tax incentives to encourage individuals to reinvest and retain capital gains within them, via an Opportunity Zone Fund which invests in local assets over several years. As Opportunity Zones are intended to be targeted at economically-distressed areas, they can be regarded as a useful tool for economic rebalancing – as any influx of investment and business activity should help foster wealth creation.

Given the way sectors of all types tend to agglomerate in certain areas, Opportunity Zones could be a novel way of stimulating clusters of enterprise, and establishing parts of Britain as sought-after destinations for more firms to migrate to or found themselves in.

Of course, if the UK were to adopt Opportunity Zones, they would not have to replicate those in the USA exactly. Indeed, it would be prudent to iron out some of the disadvantages of the American system, such as the fact that certain poor areas are ineligible for Opportunity Zone status owing to quirks in how that status is distributed.

Indeed, British Opportunity Zones could be more radical than their American counterparts, coming to resemble economic Petri dishes where experiments can take place to see if policies have beneficial impacts. For instance, the government might wish to provide more, or higher tax breaks than those seen in the USA. They may also wish to facilitate other business friendly initiatives, such as introducing Employer’s National Insurance and PAYE holidays for new hires – as we advocated in a recent CPS report.

**Recommendation 3. Encourage exporting through government campaigns and reforms to export credit**

In 2018, the government published its Export Strategy, which set out an ambition to increase exports from 30 per cent to 35 per cent of GDP. It identified a series of problems which limit the extent to which UK businesses export, including access to capital, trade barriers, lack of knowledge around exporting, and attitude barriers – such as a firm believing it is not suited to overseas trade based on a misconception of exporting.

The Export Strategy details a number of new and existing policies to support growth in British exports. These include continuing the GREAT Britain Campaign (which aims to showcase British produce abroad), providing digital support for businesses to navigate export regulations, liaising with foreign governments to remove trade barriers, and providing financial assistance to exporters through UK Export Finance (UKEF).

This is an admirable start and the government should continue with such programmes. It should also be noted that encouraging British businesses to export and engendering further
mindset shifts around exporting should not be left solely to central government – it should also be seen as a responsibility for local authorities, metro-mayors, Local Enterprise Partnerships, and more.

Needless to say, more can and should be done to actively support exporting. A core component of the Export Strategy is UKEF, which provides concessionary finance to help exporters tap into new markets. But at the moment, certain regulations – such as limits on how much concessionary finance can go into supporting exports to one country – arguably hamper UKEF’s effectiveness.66,67

Risk aversion in lending is often sensible. If UKEF believes there is a good reason not to support a would-be recipient of credit, then it should refuse to do so. However, if businesses are being denied export finance due to arbitrary lending limits of this sort, then there is a strong case to review them and ensure that any government help is going where it will be best deployed in accordance to market forces. Indeed, though the existing rules are designed to limit risk exposure, if they lead to concessionary finance going into more risky markets because safer ones have reached their limits, quite the opposite might occur.

Moreover, the current situation may point to a more fundamental problem in need of consideration – that private banks and investors are either unwilling or unable to lend money to exporters. Therefore, the Department for International Trade should consult with the financial sector to see whether any regulations could be liberalised to help leverage more money into privately-backed export finance, especially from the challenger banks which have emerged of late.

While all parts of the UK make use of UKEF, the most recent figures show that over half of all the support it offers goes to companies in the South of England.68 From the perspective of regional inequality, this cannot be conducive for economic rebalancing. If the government is to include export finance as part of its overall strategy, it should reflect on how UKEF could do more to support businesses across the whole of the country, as opposed to those in already economically successful regions.

**Recommendation 4. Establish free ports after Brexit**

For the last few years, the CPS has led the campaign to establish ‘free ports’ in Britain. In 2016, Rishi Sunak MP published a detailed policy report with the CPS which advocated their adoption once the UK has left the EU (membership precludes their establishment).69

Free ports are areas that exist within the geographic boundary of a country but are considered outside of the country for customs purposes. This means that goods can enter and exit the free port without facing import procedures or tariffs.

A key beneficiary of free ports would likely be manufacturing industries, as they would act as a safe haven in which goods can be brought together to be assembled before being re-exported to third countries. They can also have benefits such as duty deferral and tariff inversion, which also help businesses.

Free ports exist around the world, and if Britain’s were as successful as those in the USA, the UK could expect to see over 86,000 jobs created as a result.
Importantly, the areas that would likely be designated as free ports are among the most deprived parts of the UK – meaning that those jobs would be going where they are most needed. Of the UK’s 30 largest ports, 17 are in the bottom quartile of local authorities as ranked by the Index of Multiple Deprivation.

**Recommendation 5. Government should take a holistic, supply chain-focused approach to encouraging exporting**

When thinking about international trade, it is all too easy to focus on ‘prime’ companies, which are responsible for the final export of finished goods and services. Though understandable, this approach risks overlooking the multitude of smaller companies which make up supply chains.

The automotive sector is a case in point. Though a manufacturer like Jaguar Land Rover or Nissan clearly assembles components to build a vehicle, they will not necessarily produce all of the constituent parts themselves. This is likely done by smaller, specialist companies for the sake of efficiency.

Achieving a succession of marginal gains along a supply chain – in terms of say, increased productivity – could well have a greater and more meaningful economic impact than simply helping one headline company. The government should therefore adopt a more holistic approach when seeking to assist particular sectors – appreciating the important role supply chains can play, and not focusing too much on marquee companies at the ‘end’ of an industry.

Importantly, from the perspective of economic rebalancing, focusing on supply chains could have particular impact in terms of redressing regional inequality. Lots of the sectors and supply chain companies that would benefit from a change in government approach are not located in London and the South East. For example, the plants of numerous companies in the automotive, chemicals, or defence industries are scattered around the rest of the UK.

**CONCLUSION**

This pamphlet has examined trade and investment in the UK, with a view to addressing regional economic imbalances. We began by establishing a clear causal relationship between the extent to which a region engages in international trade and its economic success. We then showed that the same was true for inward FDI.

Clearly, in an internationally open economy such as the UK’s, it stands to reason that international trade and FDI can exacerbate regional inequality. If a region is trading relatively more, or attracting relatively more FDI, it can typically expect to prosper more than other regions. Indeed, evidence suggests this is the case – as we have laid out in graphical form.

Given that addressing regional imbalances is a key priority for the current government, as well as being an issue which enjoys cross-party support, we concluded this pointmaker with a series of credible and actionable proposals.

Our proposals could encourage more exporting from the UK and attract more FDI to it, specifically in those regions outside of London and the South East which have not shared equally in the economic fortunes of the past decades.
ENDNOTES

1 Department for International Trade, “Dr Liam Fox launches global investment drive, bringing more than £30 billion to the UK”. Available from: https://bit.ly/2IlnjCW.


10 Ibid.


30 For this pointmaker we follow the Nomenclature of Territorial Units for Statistics (NUTS) definitions – a geocode standard for referencing subdivisions of countries for statistical purposes, as used by the European Union. NE = North East, NW = North West, Y&H = Yorkshire and the Humber, EM = East Midlands, WM = West Midlands, EA = East of England, LO = London, SE = South East, SW = South West, WA = Wales, SC = Scotland, NI = Northern Ireland.


33 Ibid.


36 International trade figures can differ from regional to national levels due to attribution challenges.


38 Northern Ireland Statistics and Research Agency, “Northern Ireland Broad Economy Sales and Exports Data 2011-2017”. Available from: https://bit.ly/2R2z0ij. Note, data for Great Britain and Northern Ireland are not strictly comparable due to differing methodologies in their collection, but we are confident that they are similar enough to allow for our purposes of broad illustration.


42 Ibid.


44 Ibid.


Ibid.


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