



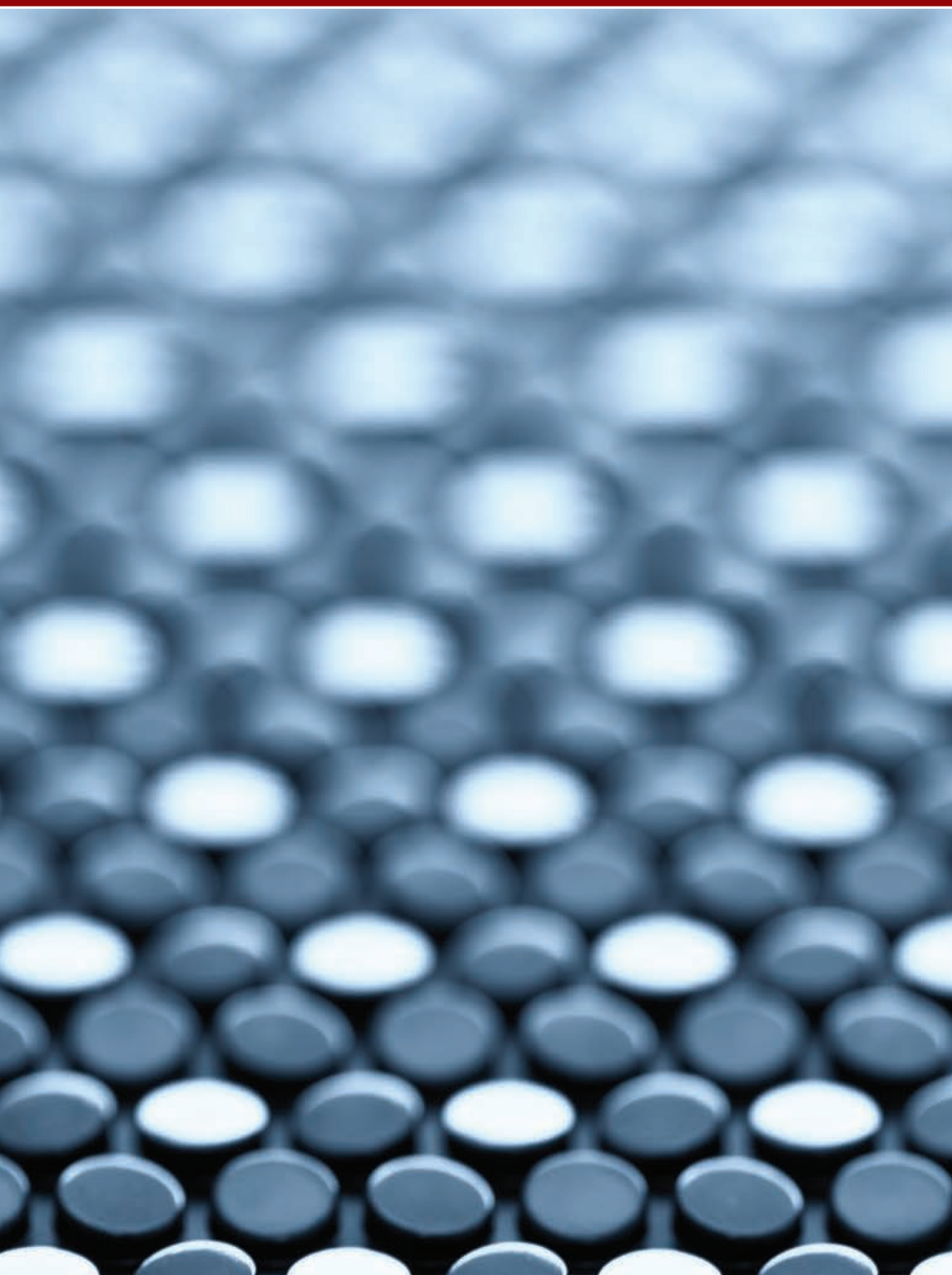
MANUFACTURING PROSPERITY

Diversifying UK economic growth

Steve Coulter

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DIVERSIFYING UK ECONOMIC GROWTH

By Steve Coulter

FIRST PUBLISHED BY

The Social Market Foundation, March 2011

11 Tufton Street, London SW1P 3QB

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EXECUTIVE SUMMARY

The financial crisis and subsequent recession have revealed stark weaknesses in a UK growth model based on financial services and debt-fuelled public and private sector expansion. Policymakers' attention is now turning to other areas of the economy that are ripe for revival.

This paper examines the scope for a revamp of industrial policy to encourage an improvement in the competitive position of UK manufacturing. Rather than simply offering a menu of suggested policy options, the paper focuses on some structural weaknesses in the economy which act as a drag on improving the performance of parts of the manufacturing sector. These weaknesses are partly institutional in origin; therefore reform should focus on deep-seated reform to the institutional foundations of the economy, provided these do not undermine the UK's existing pattern of comparative advantage.

Among the report's main arguments:

- UK manufacturing is a tale of two sectors: the country possesses a cluster of highly successful firms in high-technology, innovative market segments; but there is also a long tail of low value-added manufacturing firms that compete largely on price.
- Policy needs to be directed at improving, rather than necessarily enlarging, the UK's manufacturing base by encouraging more low-end manufacturers to upgrade their product strategies in order to compete in higher value markets.
- Industrial policy over the last two decades has tended to address the symptoms of manufacturing's problems, rather than the underlying causes of these problems, which lie in a set of institutions which foster a 'low-trust' and short-termist competitive environment.

- The UK's 'liberal market economy' relies on free-market institutions, and so policy interventions must be compatible with this. However, targeted institutional reform that closes off the 'low-road' option for many manufacturers could still be successful in improving the quality of the country's manufacturing base.

In order to address these perennial weaknesses, this report recommends a range of institutional policy reforms to improve the context in which UK manufacturing operates.

- Industrial training should be underwritten by a system of 'flexicurity' for skilled workers in which their entitlement to more generous unemployment support would reduce the risk of skills acquisition for both workers and their employers.
- The Government should set out a strategy to significantly increase the National Minimum Wage over the medium term in order to encourage firms to upgrade the skills of their workforces, boost productivity and reduce 'low-road' employers' dependence on state wage subsidies like the Working Tax Credit.
- Local Enterprise Partnerships, if they are to be effective, must be properly funded, freed from all government interference and properly equipped to coordinate intra-sectoral training, effect technology transfer and to channel 'patient' capital to firms.
- The competition and corporate governance regime should be reformed to discourage short-termism, while also allowing and encouraging firms to collaborate more on innovation and standard-setting.

Institutional reform is a central part of any successful growth strategy for the UK, and one that has received too little attention to date. The goal of reform should be to preserve the UK's global market share in high-tech industries, while capturing a larger segment of the medium-high technology markets currently dominated by Germany and Japan. This is where our industrial future lies.



INTRODUCTION

Manufacturing is centre-stage again. The last Labour government did not ignore manufacturing, but its growth model was ultimately based on high public spending paid for in large part by a booming financial sector and underpinned by a house price bubble. It went spectacularly bust. Now, as the UK emerges from the worst recession since the 1930s, the thoughts of policymakers are turning towards other activities that could power the economy back towards sustainable growth. Manufacturing industry is again being spoken of as the sector of the future – ironically, in a country that was the cradle of the industrial revolution - because it appears to offer jobs, exports and growth, but with fewer of the toxic side-effects of speculative finance.

A revitalised manufacturing sector that is at the centre of the Government's economic and industrial aspirations, rather than a tentative afterthought, could certainly provide an alternative engine for the UK economy. There is no need to mount a second industrial revolution to accomplish this, as the UK already possesses some world beating industrial firms in areas such as biotech, defence and aerospace. Moreover, the factors responsible for chronic underperformance in other sectors of manufacturing are hardly state secrets. Poor skills, low productivity and an inability to turn scientific breakthroughs into successful products top the list. Can it really be beyond the wit of policymakers to fashion enduring solutions to these?

This paper examines what may be a set of *underlying* reasons why policy has failed to get to grips with many of the problems bedevilling sections of UK manufacturing. It argues that the interventions of successive governments have tended to address the symptoms of poor performance, rather than their deep-rooted causes.

The very intractability of these flaws suggests they are ultimately located in the way the UK economy is organised, and that solutions to these must address a range of micro-economic *institutions* which shape the incentives and opportunities faced by firms, workers, financiers and regulators. These institutions structure the competitive environment in various realms, for example: how workers with the right skills are recruited and trained; how firms are financed and governed; and how innovation takes place.

Suggesting that policy should confront these issues is not to ascribe to the state an omniscient status in terms of its role in designing and constructing, as opposed to merely supporting, these institutions. Governments certainly have an important *enabling* role in the functioning of economies, and forward-thinking, innovative policymaking can play an important role in triggering change.

On the other hand, modern economies are of such complexity that government's role as the ultimate arbiter of the legal, social and institutional environment in which firms operate has to be balanced against a realisation of their strictly limited ability to affect fundamental change. Getting this balance right is one of the fundamental issues facing policymakers, but there is no obvious place where the line can be drawn.

Nevertheless, attention to the ways in which institutions help to determine the range of production strategies available to firms could improve the odds of generating policies that effectively tackle aspects of the UK's industrial underperformance. The purpose of this paper is 1) to examine the ways in which the institutions of UK capitalism impose various restraints on policymakers; and 2) to suggest strategies for reform which mesh more effectively with these constraints, rather than cutting across them, in order to address institutional strengths and weaknesses.

The rest of this introductory section provides an overview of the state of UK manufacturing industry. Section two discusses the existing policy environment. Section three examines the key micro-economic institutions affecting UK manufacturing; section four provides an evaluation of policy strategies; and section five concludes.

DO WE NEED AN INDUSTRIAL POLICY?

It is important not to overstate the case for a renaissance in industrial policy. There may be underlying reasons for the rapid 'deindustrialisation' of the UK over the last three decades which should temper hopes for a rapid increase in the size of the manufacturing sector. Moreover, the UK's location, near-universal language and cultural openness arguably provide it with a comparative advantage in service industries, particularly financial services, and a vibrant City of London is no bad thing for a modern economy to have.

Nonetheless, the financial and economic crisis has cruelly exposed a number of glaring weaknesses in the country's economic base. Now is a good time to reconsider the UK's economic and industrial model, not merely as there is a new government, but because the entire policy environment is in flux.

However, a new framework for industrial policy will have to operate within a number of unwelcome constraints:

- 1. Deficit reduction:** The Coalition Government has made it a priority to balance the structural current budget by 2015-16, implying an overall fiscal tightening of 5.9% of GDP which will mean a 25% real cut in public spending outside protected areas by the end of the Parliament. Spending on universities, vocational training, infrastructure – all things that industry requires in order to flourish – is being cut drastically to accomplish this, effectively

ruling out a return to an 'activist' industrial policy. In many respects, the Coalition Government's Spending Review in October 2010 was an exercise in setting out how to do the same as before, but with less. For example, although the infrastructure budget will be cut by £2 billion a year for four years, the remaining spending will be marshalled by a new 'bank', Infrastructure UK, to allow for a more 'strategic' approach. Labour's complex set of selective tax breaks for enterprise will likewise be replaced by a more broad-based aspiration to get the main rate of corporation tax down from 28% to 24% - the lowest rate in the G7, it is claimed - paid for by smoothing out other investment and capital allowances.¹ On skills, the coalition's approach is again not radically different to Labour's; namely, an emphasis on apprenticeships, albeit provided in a more decentralised manner and offering a more flexible system of vocational qualifications.²

2. 'Rebalancing' away from the heavy reliance on finance:

Financial services provided a quarter of all corporation tax revenues in 2007, but these collapsed following the Lehman Bros. bankruptcy to 16% in 2009/10.³ Although the banks are now recovering, the scale of the losses they can bring forward means they will face a lighter tax burden on their profits for years. Howard Davies, the former director of the Financial Services Authority, predicts that the City is certain to be more strictly regulated in future.⁴ More and better regulation, although welcome, will curb bank profits, leaving a large hole in the UK's tax base which will have to be filled from the tax revenues from other economic activities. This has inevitably led to pressure from many quarters to 'rebalance' the UK away from

1 HM Treasury, *Budget 2010*, (London: HMSO, 2010), 25.

2 Department for Business, Innovation and Skills, *Skills for sustainable growth*, (London: HMSO, 2010).

3 Duncan Mckenzie, *Economic contribution of UK financial services 2009*, (London: International Financial Services London, 2009), http://www.thecityuk.com/media/2331/Economic_Contribution_of_UK_FS_2009.pdf.

4 Howard Davies, "How can we regulate capitalism?" (Paper to conference 'New world, new capitalism', Paris, January 8-9, 2009).

financial services towards other activities. A leading candidate is manufacturing because of the UK's industrial past and the emergence of new technologies and processes available to be exploited. Again, however, financial constraints will place limits on what policy can achieve.

- 3. The environment:** Meeting United Nations (UN) targets for renewable energy and environmental protection will entail major challenges for industry. Many governments, not just the UK's, are pinning their hopes on 'the low carbon economy' to provide new sources of growth and jobs. Labour optimistically forecast that infrastructure for clean energy and other environmental goods and services would generate one million new jobs by 2030.⁵ However, there are obvious problems with speculatively banking on future sources of growth when industry is currently weak, and these claims were accordingly dismissed by the *Financial Times*.⁶ UK firms have been slow to get off the mark: in January 2010, a £1.6 billion order to build turbines for Europe's largest wind farm in the Thames Estuary went to foreign firms because no British manufacturer was up to the job.⁷ The Coalition Government has proposed setting up a 'Green Investment Bank'. This is intended to bridge the gap between the amount of investment required to put the UK economy onto a low carbon path (£450 billion, by some estimates)⁸ and the £50-£80 billion available from traditional sources of finance. Once established, it could push investment in new nuclear plants, offshore wind generation and carbon capture and storage. However, the project has already provoked

5 Department for Business, Enterprise and Regulatory Reform, *Manufacturing: new challenges, new opportunities*, (London: HMSO, 2008), <http://www.berr.gov.uk/files/file47660.pdf>.

6 Francis Bator, "Saving the real economy," *The Financial Times*, November 3, 2008.

7 The Economist, "Back to the city: Britain may get green jobs, but not the sort ministers promise," *The Economist*, January 7, 2010.

8 Ben Warren, Rajaram Jamadagni and Rob Winchester, *Capitalising the green investment bank: sowing the seeds of success*, (London: Ernst & Young, 2010), [http://www.ey.com/Publication/vwLUAssets/Capitalising_the_Green_Investment_Bank_-_Sowing_the_seeds_of_success/\\$FILE/EY_Capitalising_the_Green_Investment_Bank.pdf](http://www.ey.com/Publication/vwLUAssets/Capitalising_the_Green_Investment_Bank_-_Sowing_the_seeds_of_success/$FILE/EY_Capitalising_the_Green_Investment_Bank.pdf).

clashes between the Business, Innovation and Skills and Energy and Climate Change departments, which want it to operate as a bank and the Treasury, which is worried about the effect it will have on the national debt and wants it to be a centrally administered fund.⁹ ‘Green manufacturing’ seems certain to be an important part of the UK’s industrial future, but it is surely no panacea.

Aspirations like these, along with continued uncertainty over the Coalition’s long-term plans for manufacturing, underline how little there is available in the policy ‘locker’ to combat the challenges faced by the UK economy. The danger is that the new Government will begin, as Labour did, with the best of intentions to create the conditions necessary for industry to thrive, but will end up throwing money at the problem nearer election time if employment has not recovered.

THE STATE MANUFACTURING IS IN

The recession has led to numerous calls for manufacturing to be revived by state intervention to pick up the slack left by high finance. The calls have predictably been loudest from private sector trade unions and industrialists themselves. The Engineering Employers Federation (EEF), for example, argues that: “The UK will only achieve long-term sustainable growth through a mixed and balanced economy in which the UK’s...manufacturing base plays a greater role.”¹⁰

We have been here before. Revitalising manufacturing after the recessions of the early 1980s and 1990s was one of New Labour’s early themes. In his first big speech as Chancellor in 1997 Gordon Brown promised to: “Rebuild British economic strength with a

9 Elizabeth Rigby, “Treasury sees red at Huhne green bank,” *The Financial Times*, January 30, 2011.

10 The Engineering Employers Federation, *A manufacturing future – competitiveness and taxation in the UK*, (London: Engineering Employers Federation, 2009).

modern industrial base, high levels of investment and a culture of entrepreneurship.” Instead, boosting the City in order to bask in the glory reflected from London’s new global prestige became the priority, accompanied by a hiring boom in the public sector. At the start of the decade financial and business services, plus the public sector, represented just under 50% of employment and gross value added (GVA). Yet from 2000 to 2007 they contributed to almost 90% of GVA growth and an even higher proportion of new jobs.¹¹

The Coalition Government has also pinned its colours to the manufacturing mast. Vince Cable, the Business Secretary, has declared a new focus on skills investment to foster knowledge-based manufacturing. Yet at the same time, claiming the need for financial discipline, the Government is scrapping aid to foreign firms setting up in the UK and cancelling loans to help UK companies upgrade their technology.

Manufacturing suffered heavily along with the rest of the UK economy during the recession. Output in the sector plunged by 10.5% in 2009, compared with an overall decline in GDP of around 6% that year. The jobs impact of the recession was perhaps felt most keenly in factory employment. Between Q2 2008 and Q4 2009 UK employment fell overall by 2.9%. But it was down by 9.7% in manufacturing, compared with declines of 4.3% in finance and 8.2% in construction.¹² The manufacturing sector is estimated to have lost one million jobs over the last decade.

11 Engineering Employers Federation, *Manufacturing our future*, (London: Engineering Employers Federation, 2009), http://www.eef.org.uk/publications/reports/Manufacturing_Our_future.htm.

12 Paul Gregg and Jonathan Wadsworth, “The UK Labour Market and the 2008-09 Recession,” *National Institute Economic Review*, 212, (2010).

Table 1: Recovery building slowly: % change since the end of the recession.¹³

	GDP	Industrial Production	Exports	Employment
UK	1.8	2.4	3.1	-0.6
France	1.6	6.2	6.8	-0.9
German	2.3	9.6	7.8	-0.2
Japan	4.4	29.4	46	-0.9
US	3.5	7.5	14.9	-0.8
Eurozone	1.0	6.5	7.8	-1.1

Recovery began in earnest in early 2010, however, and was stronger than most forecasts. The EEF expects the manufacturing sector to expand by 3.5% in 2011, powered by exports. However, given the weakness of the pound against the dollar and the euro for most of the period, an export-led recovery in the sector is only to be expected and is not necessarily an indication that manufacturing is in great shape.

Moreover, the gains in production seen during 2010 reversed only about a third of the catastrophic drop seen during the recession. Manufacturing output is still almost 10% below its previous peak and similar to the levels seen 20 years ago.¹⁴ At a mere 12% of the UK economy, the sector is also now too small to power recovery across the entire UK economy in the way the Government seems to be hoping.

While manufacturers themselves remain upbeat in surveys, concerns are emerging about industry's ability to make the most of what passes for recovery, with Germany and the Far East again enjoying the lion's share of the recovering export market. The British Chambers of Commerce cautions: "The manufacturing sector must

¹³ Oxford Economics and Engineering Employers Foundation.

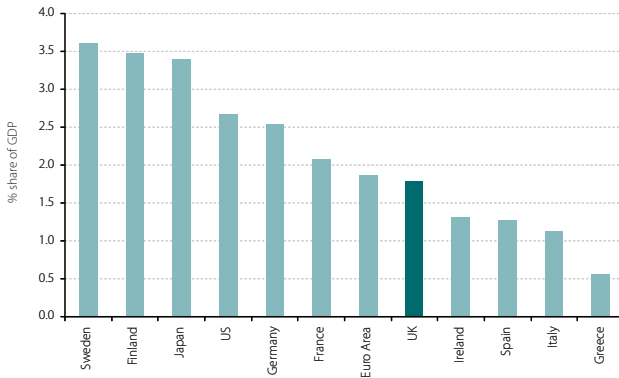
¹⁴ Capital Economics, "Industrial recovery won't save the economy", *Capital Economics: Economics Weekly*.

be nurtured, to ensure that transitory difficulties triggered by the recession do not cause permanent and irreversible damage to our manufacturing base."¹⁵

All this has to be set against the chronic problems which UK manufacturing faced even before the recession. These revolved the familiar issues of inadequacies in Research and Development (R&D), skills and productivity:

- 1. The UK's poor record on R&D:** Both UK-based businesses and the government itself continue to invest less in R&D as a percentage of GDP than other advanced economies. While the UK has one of the most productive science systems in the world, the transfer of this knowledge to industry is patchy, and R&D-intensive industries account for a lower share of UK output than in other countries.

Chart 1: Gross Domestic Expenditure on R&D (% share of GDP).¹⁶

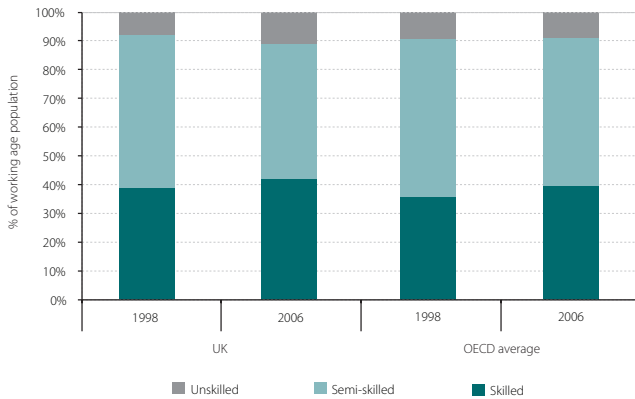


15 The British Chambers of Commerce, *Economic Forecast*, (London: British Chambers of Commerce, 2010), http://www.britishchambers.org.uk/publications_4.

16 Eurostat, "Gross domestic expenditure on R&D", <http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&language=en&pcode=tsiir020&tableSelection=1&footnotes=yes&labeling=labels&plugin=1>.

- 2. A low level of skills:** The Leitch Review for the Treasury in 2006 claimed the UK had a much higher proportion of low-skilled workers than Germany, Japan, Sweden and the Netherlands and warned that poor skills provision risked undermining the economy.¹⁷ OECD data shows that the proportion of workers in skilled occupations has been increasing – but so has the proportion in unskilled occupations (see Chart 2 below). The World Economic Forum ranks the UK 18th out of 139 countries for its higher education and training system.¹⁸ Latest data from the Labour Force Survey indicates there is still a long ‘tail’ of low skilled employment in the UK labour market, with around 1.9m jobs not requiring a qualification.¹⁹

Chart 2: The proportion of the Working Age Population in different occupations by level of skill.²⁰



- 3. Low productivity:** The UK faces a persistent productivity gap with its main competitors. Although total factor productivity (the efficiency with which capital, labour and other inputs are combined) has increased over the last 15 years, experts say this has been driven

17 HM Treasury, *Prosperity for all in the global economy*, (London: HMSO, 2006), http://www.ukces.org.uk/upload/pdf/2006-12%20LeitchReview1_2.pdf.

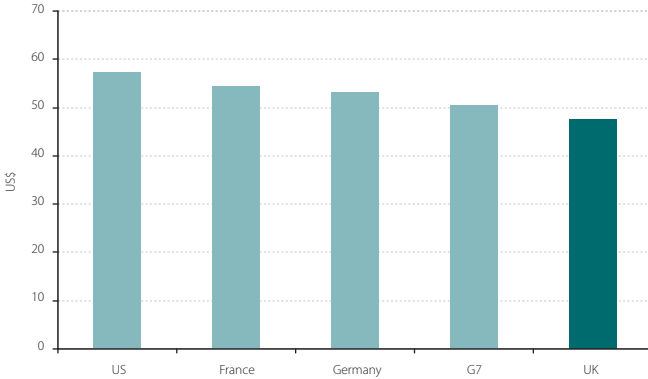
18 Klaus Schwab, *The global competitiveness report 2010-2011*, (Geneva: World Economic Forum, 2010), http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2010-11.pdf.

19 Office of National Statistics, *Labour Force Survey*, (London: HMSO, 2010).

20 Organisation for Economic Co-operation and Development (OECD), *Education at a glance*, <http://www.oecd.org/dataoecd/46/24/45925258.pdf>.

by employment growth and more use of Information Technology, rather than any underlying improvement in efficiency.²¹

Chart 3: GDP per hour worked in 2009 (US\$ at current prices and PPP).²²



Solving these problems could produce considerable dividends because manufacturing creates numerous well paid jobs. One EU-wide study claimed that each manufacturing job creates two more in related services, and that 70% of all employment was related to manufacturing.²³ Manufacturing jobs, unlike those in financial services, are spread out evenly across the country and can be an important driver of regional regeneration.

STILL GOING STRONG

Talk of the “death of manufacturing” is, however, greatly exaggerated. The long-term decline in UK manufacturing as a share of GDP – from 26% in 1978 to about 12% today – while steep, is mirrored across most advanced economies. Once the extent of ‘deindustrialisation’ is taken into account what remains of the sector actually performs quite well on measures of Gross Value Added (GVA).

21 Rafaella Sadun and Romesh Vaithilingam, *UK productivity during the Blair era*, (London: Centre for Economic Performance, 2009), http://cep.lse.ac.uk/briefings/pa_uk_productivity.pdf.

22 OECD, *Education at a glance*.

23 EU Commission, *Manufacture: A Vision for 2020*, (Brussels: EU Manufacture High Level Group, 2004), http://www.manufacture.org/documents/manufacture_vision_en%5B1%5D.pdf.

Box 1: How UK manufacturing really compares

Groups seeking to demonstrate that the UK manufacturing sector is faring poorly and needs government intervention often refer to the GVA data – GVA being basically a measure of productivity – to prove their point. The manufacturing share of total GVA in the UK economy is around 13.2%, compared with 22.46% in Germany.²⁴

However, this measure, by itself, can be misleading. We don't know if the UK performs poorly because it has an unproductive manufacturing sector or because it suffered from greater deindustrialisation than other countries. The way to find out is to weight the data according to the relative size of each country's manufacturing sector. This can be done either by comparing the amount of gross manufacturing output to total output, or by taking into account the total number of workers in the sector compared with the economy as a whole.

The first method involves dividing gross output in manufacturing by the total output in the economy. In the UK, 18.5% of total production is in manufacturing and in Germany it is 35%. Dividing GVA by the proportion of gross output share gives us a higher weighted value for the UK ($13.2 / 18.5 = .714$) than Germany ($22.46 / 35 = 0.64$). The second method compares employee share of manufacturing compared with total employees. In Germany 20.8% of German employees are employed in the manufacturing sector, compared with 12% in the UK. Weighting GVA according to employee share (a measure of the size of the sector) gives us 1.1 in the UK ($13.2 / 12$) against 1.08 ($22.46 / 20.8$) in Germany.

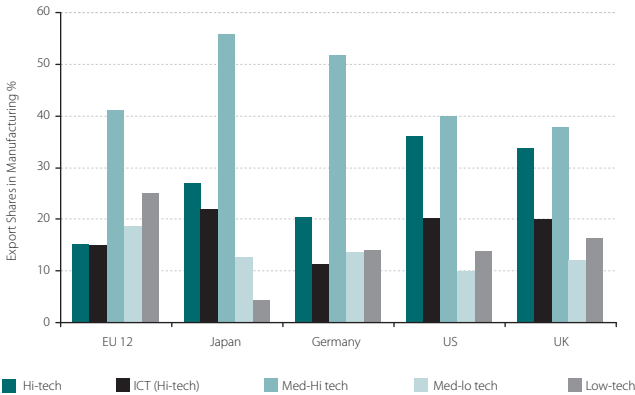
Both measures indicate that, once the size of the sector is controlled for, the UK manufacturing sector produces more value-added than Germany's – until recently the world's number one manufacturing exporter. Far from being the poor relation, UK manufacturing more than holds its own against Europe's manufacturing powerhouse, albeit on a smaller scale.

24 EU Klems database.

Moreover, ‘post-industrial Britain’ has still managed to incubate world class firms in the aerospace, defence and biotechnology sectors. *The Economist* was recently eulogising the jet engine maker Rolls Royce as an example of the kind of modern British enterprise which is blurring the boundaries between manufacturing and services in order to thrive in the ultra-competitive global aerospace market.²⁵

The big problem, as *The Economist* ruefully acknowledged, is that there simply aren’t enough Rolls Royces to make up for deficiencies elsewhere. As Fig. 5. below shows, UK manufacturing tends to be concentrated *either* in a few technologically-oriented, highly innovative sectors, *or* in flexible, low cost production. The UK’s export share of hi-tech industries is second only to the US in this sample and almost double the average of the EU 12 countries. In information and Communications Technology (ICT) equipment the UK’s lead over other European countries is less pronounced, but still apparent. These sectors make a disproportionate contribution to manufacturing’s GVA score.

Chart 4: Export shares in manufacturing, by skill intensity, 2005.²⁶



25 The Economist, “Britain’s lonely high-flier,” *The Economist*, January 8, 2009.

26 David Rae and Marte Sollie, “Globalisation and the European Union: Which countries are best placed to cope?”, (Paris: OECD Economics Department, 2008), [http://www.oecd.org/officialdocuments/displaydocumentpdf/?cote=ECO/WKP\(2007\)46&doclanguage=en](http://www.oecd.org/officialdocuments/displaydocumentpdf/?cote=ECO/WKP(2007)46&doclanguage=en).

It is revealing therefore that the UK is also over-represented in low technology industries (28% in low and medium-low tech, compared with 24% in the US and Japan's 17%). These are the market segments that are critically vulnerable to competition from low-cost developing nations and where it is most vital that firms competing at this end of the market are incentivised to upgrade their product strategies and move up the value chain.

The most realistic destination for these firms is the higher end of the medium tech segment, where the UK is currently greatly under-represented, capturing a share that is below the average for the EU 12 and far behind Germany's.

Medium technology manufacturing industries, while not necessarily cutting edge, are often based on well established technologies and require complex production processes and coordinated supplier chains to thrive. Germany has many small and medium-sized firms which enjoy access to these kinds of networks, for example in machine tools, but the UK is currently much weaker in this area.

The car industry is an example of the UK's relative weakness in medium technology sectors. Its collapse in the 1980s and 1990s has been partly offset by inward investment and it is now a substantial exporter. But it is much smaller than its German or French counterparts and makes a negative contribution to the balance of payments.

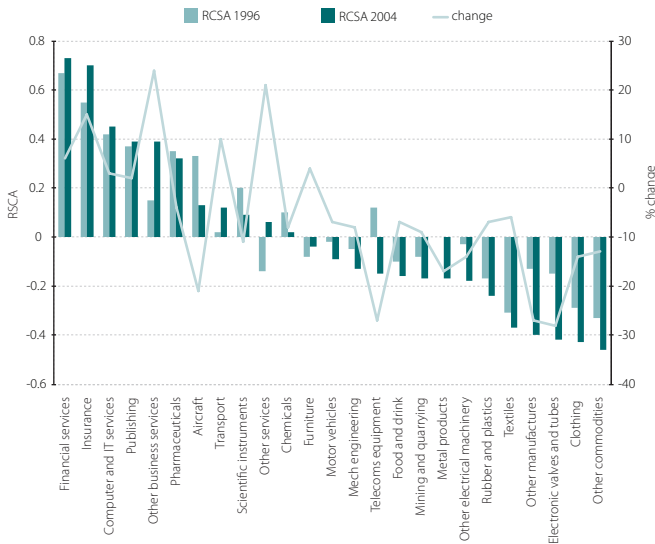
The erosion of the UK's manufacturing base is particularly evident in a weakening of the supplier chains needed to sustain high and medium-tech industries. A recent survey by the EEF found nearly a quarter of manufacturers were concerned about the lack of UK suppliers of acceptable quality.²⁷ The British-made

²⁷ Engineering Employers Federation, *The shape of British industry: growing from strong foundations*, (London: Engineering Employers Federation, 2010).

content of JCB's iconic backhoe loader has dropped from 96% in 1979 to 36% in 2009 because it can no longer source components in this country.

A good indication of the direction that UK industry has been heading is provided by other data on Revealed Symmetrical Comparative Advantage (RSCA), a technical indicator used by trade economists to analyse the degree of export specialisation in different sectors.²⁸ Chart 5 below shows the change in RSCA during the decade to 2004 in the UK. A higher RSCA index means an industry's exports are more specialised. The graph clearly indicates that the degree of specialisation in UK services industries over the period has mostly been increasing, and that of manufacturing decreasing.

Chart 5: Degree of specialisation in UK industrial sectors as measured by revealed symmetrical comparative advantage.²⁹



28 For a description of this measure see Keld Laursen, "Revealed comparative advantage and the alternatives as measures of international specialisation," (Copenhagen: Department for Industrial Economics and Strategy, Copenhagen Business School, 1998), <http://www3.druid.dk/wp/19980030.pdf>

29 OECD, UNCTAD and COMTRADE databases.

Most UK manufacturing sectors in 2004 had a negative RSCA (implying lower than average specialisation) – the exceptions being pharmaceuticals, aircraft, scientific instruments and chemicals. More recent OECD data from 2006, employing a slightly different methodology, indicates that the only UK manufacturing sectors with an above average degree of specialisation are engines and telecommunications equipment.³⁰

Although there are disadvantages to specialisation (a diverse export sector reduces exposure to demand shocks) it allows a good to be produced with a lower opportunity cost (more relatively efficiently given all the other goods that could be produced). Hence there are likely to be links between RSCA and levels of productivity and market share. Moreover, industries which are highly specialised may be less vulnerable to competition from emerging economies whose comparative advantage lies in their low labour costs.

In other words, the data shows the UK still does plenty of manufacturing. Much of it is also innovative and high-tech, boasting high levels of productivity. But, equally, much of it is of the ‘wrong’ kind: price-sensitive, not very sophisticated and stuck in a “low-wage/low skill equilibrium”.³¹ Too much of the UK’s manufacturing excellence is associated with a few world-beating firms in a limited range of sectors. The danger is that too large a proportion of the remainder is prone to competing on price rather than quality, and is therefore vulnerable to growing competition from emerging economies with very low labour costs whose firms are climbing inexorably up the value chain.

Why do many UK manufacturers still take the ‘low road’ on quality? There are a number of reasons for this: a ready supply of low-

30 Organisation for Economic Co-operation and Development, , *International trade by commodity statistics*, 2008, <http://puck.sourceoecd.org/vl=2110351/cl=13/nw=1/rpsv/ij/oechststats/16081218/v175n1/s2/p1>.

31 David Finegold and David Soskice, “The failure of training in Britain: analysis and prescription,” *Oxford Review of Economic Policy*, 4,3, (1988).

cost workers, timid management ill-prepared to make the transition to high value-added product strategies, capital constraints and skill deficiencies. The persistent skills gap is of particular concern, given all the money and effort put into resolving it, but all these issues demand urgent attention. Leftist critics also argue that increasing income inequality creates a large demand for goods and services at the bottom end of the market.

Whatever the cause, inadequacies in manufacturing industry clearly exist. Policy, however, needs to be directed at improving, rather than necessarily enlarging, the UK's manufacturing base by encouraging more low-end manufacturers to upgrade their product strategies in order to compete in higher value markets.

This, however, begs a number of questions. What are the most appropriate levers available for governments to do this? Should they intervene directly in markets, for instance by 'picking winners'? Should policy focus on tax breaks to encourage the optimal level of investment in manufacturing capabilities? What is the right mix of skills, and who should provide these?

These questions boil down to one fundamental issue, however. To what extent do manufacturing's problems lie in the organisation of the UK economy and the effect of this on firms' incentives to pursue particular product strategies?

Some economic commentators argue that the UK's 'Anglo-Saxon' model of capitalism – flexible, 'low trust' and competitive – fosters particular economic strengths, as well as weaknesses. In an era of globalisation in trade and capital movements, the institutional landscape of UK capitalism provides the country with comparative advantages in services (especially financial services) and some innovative hi-tech manufacturing sectors; but also in much flexible, low-cost production.

While the former sectors are obviously strengths to be celebrated and built upon, the latter is surely an area of concern for policymakers as it is critically vulnerable to competition from low cost producers who will always win out competitively on price alone.

But this simply begs another question. If the organisation of the UK economy sustains a particular industrial 'mix' that includes both high and low end manufacturers, is it really possible to tamper with this structure to foster more of the former and less of the latter, without altering the basis on which the UK's distinctive industrial system is constructed?

Should we, in other words, simply be prepared to take the rough with the smooth? And is it even feasible for governments to intervene strategically to try to shape these institutions without risking chaos; or should it simply get out of the way and let the invisible hand of the market determine the shape of the country's industrial structure?

To answer these questions it is necessary to examine the functioning of the country's economic institutions in more detail. But before that, it is worth briefly exploring the parameters of government intervention in industry.



CHAPTER 1: GOVERNMENT AND THE MARKET

Industrial activism has a long and varied history. It is motivated by a fear that markets, left to their own devices, may be crippled by coordination problems and information asymmetries and will produce sub-optimal outcomes. Government intervention, the argument goes, can produce socially superior outcomes that would not occur otherwise. However, while it is nowadays hard to sustain the belief that markets are always and everywhere superior, government intervention in them can also be a blunt and wasteful instrument.

There are surprisingly few econometric analyses of the recent impact of industrial policy on the performance of UK firms. One study of Regional Selective Assistance, a major business support scheme, however, concluded that it had a *negative* effect, as it helped firms with below average productivity to expand.³²

Free market economists in the eighteenth century advanced two arguments against government interference in markets, beyond the provision of basic public goods. First, that governments are excluded from the decentralised information networks that markets alone can create. Second, that governments lack the right incentives needed to distribute its largesse in the public interest.

These arguments went out of fashion in the mid twentieth century as governments intervened successfully: first to plan a war economy, and then to reconstruct the Continent after 1945. Post-war industrial policy was conducted through a set of planning mechanisms which played a co-ordinating role in solving time-inconsistency and distributional problems. Peter Hall, a Harvard political economist, argues that these addressed three interlocking problems:³³

32 Chiara Criscuolo, Ralf Martin, Henry Overman and John van Reenen, *The effect of industrial policy on corporate performance: evidence from panel data*, (London: Centre for Economic Performance, 2007), http://cep.lse.ac.uk/textonly/_new/staff/vanreenen/RSA_final.pdf.

33 Peter Hall, "The evolution of varieties of capitalism in Europe," in *Beyond Varieties of Capitalism*, ed. Bob Hancke, Martin Rhodes and Mark Thatcher, (Oxford: Oxford University Press, 2007).

1. **The wage problem:** how to ensure wages increased slowly enough to allow firms to make profits, but high enough to ensure consumer demand.
2. **The work problem:** how to secure high employment to ensure social peace.
3. **The problem of securing total factor productivity:** how can capital and labour be deployed in an efficient mix?

However, because the UK – unlike continental Europe – never developed the right labour market institutions to control wage inflation, interventionist policies went disastrously wrong in the 1970s and policymakers fell back on a more minimalist approach to industry and the economy which reinforced its free market, *laissez faire* characteristics. Under Margaret Thatcher’s Conservatives, and then New Labour, the government gave up on problems 1 and 2 and turned to an independent central bank to achieve price stability, which became the primary macro-economic goal. Problem 3 would henceforth be addressed only obliquely through occasional targeted interventions and the public provision of industry’s basic needs.

Accordingly, the Ministries of the 1950s and 1960s designed to foster French-style indicative planning (the National Economic Development Council) or German-quality technical training (the Manpower Services Commission) were phased out under the Conservatives, and New Labour showed no interest in reviving them.

However, concerns over the UK’s relative economic performance in the early 1990s led to a revival of interest in horizontal, sector-neutral policies aimed at nurturing the science base, competition and international competitiveness, rather than ‘picking winners’. It also dawned on analysts in some quarters that unfettered markets can destroy opportunities for value-creating cooperation. Governments could therefore have a role in fostering collaborative

arrangements among firms in order to tap economies of scale or promote generic research.

INDUSTRIAL POLICY UNDER BLAIR AND BROWN

New Labour entered government pledging to revive manufacturing but took a fairly narrow view of what it was possible to achieve, focusing on improving total factor productivity across the whole economy. Labour's industrial policy was set out in a Treasury document published in 2000 which identified five 'productivity drivers': investment, skills, innovation, competition and enterprise.³⁴ Although some progress has been made, the outcomes have arguably not been transformational.

1. Competition and Enterprise

The regulatory environment has an impact on firms' performance, and business groups have complained that New Labour loaded business with wealth-destroying 'red tape'.³⁵ On the other hand, OECD indicators of product market regulation show the UK continues to have one of the most competitive environments among its member countries, while the World Economic Forum puts the UK at number twelve in its competitiveness league table.³⁶

Between these two extremes the truth is more complex. New Labour's 2000 Competition Act created an independent competition authority to monitor mergers and prevent market domination by a few firms. There is plenty of evidence that competitive markets are more productive and innovative than uncompetitive ones, and the rules-based, pro-active regime overseen by the Competition Commission attacked this issue head-on by combating anti-competitive practices.

34 HM Treasury, *Productivity in the UK: The evidence and the government's approach*, (London: HMSO, 2000).

35 British Chambers of Commerce, *Red tape: The real story*, (London: British Chambers of Commerce, 2006).

36 Schwab, *The global competitiveness report*, 6.

On the other hand, the purely competitive approach ignores the tension between competition and collaboration. Because markets are frequently highly segmented, with firms interacting with a relatively small number of major competitors, factors such as trust and cooperation can play an important role in competitive success. High and medium technology firms need to be innovative as well as competitive, and an important means for firms to develop new ideas is to collaborate with others.³⁷ Emphasis on competition alone may therefore conflict with the second plank of the government's industrial agenda, considered below.

2. Investment and R&D

Basic science and technology was rightly viewed by the Government as a public good that should be provided centrally. There was further encouragement for firms to turn technology into new products and entry into new markets through tax credits for R&D, which were a key feature of Labour's technology policy.

However, some economists argue that the effectiveness of tax breaks for R&D is undermined by deadweight costs (subsidising R&D that would have been done anyway) and the distortions they produce in the market.³⁸ They may have played a role in preventing R&D activity relocating abroad by helping the UK remain tax-competitive, but there is some scepticism over whether the unfocused tax credits administered by the Treasury increased the total amount of R&D being done, which was their stated purpose. The disappointing level of R&D in industry is offset to some extent by the UK's innovative service sector, but there is no reason why both should not enjoy high levels of innovation.

Labour's latter focus was on expanding the 'knowledge

37 Michael Kitson and Jonathan Michie, *Markets, competition and innovation*, (Cambridge: ESRC Centre for Business Research, 1998).

38 Nick Bloom, Rachel Griffith and John van Reenen, "Do R&D tax credits work? Evidence from an international panel of countries 1974-94," *Journal of Public Economics*, 2002.

economy', in which the generation and exploitation of knowledge is seen as the most significant element in wealth creation.³⁹ The knowledge economy has been seen as a critical part of a future competitive strategy for the UK as the country already enjoys advantages of a strong science base and well educated population.⁴⁰ Sceptics point out that strong intellectual property rights will concentrate the benefits of the knowledge economy in a relatively small number of global players, with no guarantee that UK firms will be among these unless it tackles the problem of a lack of knowledge transfer between universities and industry.

Labour increased spending on infrastructure and enacted fiscal rules to ring-fence investment spending, which had declined sharply as a share of total government spending under the Conservatives. The World Economic Forum currently ranks the UK at number 33 out of 139 countries for the quality of its infrastructure in its global competitiveness league.⁴¹

3. Skills

The expansion of education under Labour – particularly the massive increase in the supply of university graduates - has undoubtedly increased the UK's skills level. In some respects this focus on skills has led to improvements in productivity, which the government was not slow in trumpeting.

However, distinguishing between *real GDP per person* (which reflects changes in demography and labour force participation) and *real GDP per hour worked* (which directly measures the productivity of individual workers) casts a shadow over the government's claims

39 Department of Trade and Industry, *Our competitive future: Building the knowledge driven economy*, (London: HMSO, 1998).

40 Ian Brinkley, *Manufacturing and the knowledge economy*, (London: The Work Foundation, 2009), http://www.theworkfoundation.com/assets/docs/publications/212_Manufacturing%20and%20the%20Knowledge%20Economy.pdf.

41 Schwab, *The Global Competitiveness Report*

to have decisively narrowed the productivity gap (see Chart 3). The UK has failed to close the gap with the US in real GDP per hour worked.⁴²

Manufacturing accounts for around 20% of this productivity gap, according to the OECD,⁴³ and it is perhaps telling that the Labour Government's later emphasis was on selective improvements to capital inputs, especially information technology.

Critics argue that New Labour's approach to vocational technical training was half-hearted, with a limited role for the state that nevertheless still crowded out private sector initiatives; minimal funding; and reliance on existing institutional arrangements which are clearly inadequate.⁴⁴ Despite reforms to the benefit system many low skilled workers remain stuck in low wage traps, reducing their incentives to invest in further education and training because of the high rate of benefit withdrawal as incomes rise.⁴⁵

The combination of central government box ticking and low aspirations arguably resulted in an under-provision of the kinds of skills firms need to upgrade their product strategies. Manufacturers' organisations have, accordingly, called for a focus on increasing the *quality* of skills apprenticeships, rather than merely their quantity. Between 2000 and 2008, the number of apprenticeships increased by almost 20%. However, most of this growth has occurred in the category of Level 2 Apprenticeships (based on NVQ2), while the number of internationally competitive Advanced Apprenticeships (NVQ3) has fallen.⁴⁶

42 Office for National Statistics, *International Comparisons of Productivity*. (London: HMSO, 2005).

43 Organisation for Economic Co-operation and Development, "Economic Survey of the United Kingdom," (Brussels: OECD, 2007), <http://www.oecd.org/dataoecd/49/34/39384976.pdf>.

44 Stewart Wood, "Education and training: Tensions at the heart of the British third way," in *New labour: a progressive future?* ed. Stewart White (Basingstoke: Palgrave MacMillan, 2001).

45 OECD, *Economic survey of the United Kingdom*.

46 Institution of Mechanical Engineers, "UK skills apprenticeships: education policy statement," <http://www.imeche.org/knowledge/policy/education/policy/apprenticeships>.

At the other end of the scale, falling wage premiums for graduates⁴⁷ indicate that the focus on expanding the number of workers with flexible, transferable skills as a solution to the skills gap has met with limited success. The number of science, technology and engineering students at university rose under Labour, but half of them did not go into industry.

Taken together, these developments suggest that the problem is one of skills utilisation (firms not using the skills available) as much as under-provision of skills. Skills under-utilisation may affect up to 45% of the workforce, compared with only 10% affected by a skills gap.⁴⁸ The causal link between greater investment in skills and improvements in productivity is therefore probably more complex than appreciated. Skills policies should sit within a complex dynamic of a broader strategy for economic development.

COALITION INDUSTRIAL POLICY SO FAR

There are encouraging signs that the Coalition Government is taking these problems seriously. Before the election David Cameron, the Conservative leader, commissioned a report on manufacturing and engineering by the inventor and industrialist, James Dyson. Dyson warned that the UK barely makes an impact on world trade in the medium technology bracket compared with Germany and Japan, even though most of the recommendations in his report concerned high-tech manufacturing.⁴⁹

On the other hand, Vince Cable, the Liberal Democrat Secretary of State at the business department, appears to have ruled

47 Ian Walker and Yu Zhu, "The college wage premium and the expansion of higher education in the UK," *Scandinavian Journal of Economics*, 110 (2008), 695-709. OECD data from the middle of the decade also show the UK has a higher than average proportion of graduates working at a low skill level.

48 Jonathan Wright, Ian Brinkley and Naomi Clayton, *Employability and skills in the UK: Redefining the debate*, (London: The Work Foundation, 2010).

49 James Dyson, "Ingenious Britain: Making the UK the leading high-tech exporter in Europe," http://www.russellgroup.ac.uk/uploads/Dyson-report-Ingenious_Britain1.pdf.

out industrial activism: “We shouldn’t try to micromanage the economy at the level of individual companies or so-called national champions, trying to supersede the judgment of markets.”⁵⁰

The Coalition nevertheless recognises the importance of revitalising the private sector, and especially manufacturing industry – not least because the deep cuts in public spending mandated by the spending review are predicated on the non-state sector flourishing to take up the slack.

George Osborne’s Treasury has set out some early industrial priorities. These include: consolidating existing strengths in advanced manufacturing to drive export growth; supporting new industries, particularly green ones; improving performance in large domestic sectors; and repositioning government as a more ‘intelligent’ customer. Policy levers nominated for the achievement of these goals are sensible, if a little familiar. They centre on beefing up the UK’s already stringent competition regime and an ever lower corporate tax rate.⁵¹

Also apparent is a concern with boosting high-value manufacturing.⁵² The focus on high-end manufacturing is understandable, given the need to foster rapid expansion in areas of industry where the UK already enjoys a track record of success. However, it also risks diverting attention from the need for more deep-rooted reform in other areas where conditions incentivise firms to compete on price rather than quality. Ultimately, the difference between Labour’s industrial policy and the Coalition’s is one of emphasis.

50 Speech to Cass Business School, June 3, 2010.

51 HM Treasury, *The Path to Strong, Sustainable and Balanced Growth*, (London; HMSO, 2010).

52 Department for Business, Innovation and Skills, *Growth review framework for advanced manufacturing*, (London: HMSO, 2010).

CHAPTER 2. FUTURE POLICY OPTIONS: GETTING THE INSTITUTIONS RIGHT

If the recent policy focus on incentivising industry to do more R&D and employ more apprentices has not produced the step change in performance that is sought, what are the principles underlying a successful alternative to this that policymakers should be considering? The reluctance to intervene directly in the market is understandable, given previous policy failures, but policy has often merely tended towards 'second-guessing' the market instead.

On the other hand, the deep-rooted institutional reforms that some are proposing means moving into uncharted territory. Before analysing what an institutional approach to industrial reform might look like, it is worthwhile examining the likely constraints. These revolve around the idea that the UK represents a particular economic 'model' that is difficult to change.

ECONOMIC MODELS AND POLICY OPTIONS

Economists have noticed for some time that national economies are organised in different ways. This is likely to have important implications for their industrial structures, labour markets and welfare states. Moreover, these differences seem to be enduring, in spite of expectations that globalisation would cause all advanced industrial nations to converge.

Two economic 'models' are conventionally recognised: the free-market 'Anglo-Saxon' type; and 'Rhenish' capitalism, its more 'managed' antagonist.⁵³ The former group include the English-speaking countries, centring on the UK and US; the latter includes Germany and most European continental countries, but also Japan. Various definitions are offered, focusing mainly on cultural and

53 Michel Albert, *Capitalisme contre Capitalisme*, (Paris: Seuil, 1991).

ideological cleavages: 'neo-liberalism' versus a more egalitarian and 'consensual' approach to economics and social justice.

Table 2: 'Anglo-Saxon' versus 'Rhenish' Capitalism.

	'Rhenish' Capitalism	'Anglo-Saxon' Capitalism
Ideology	'Stakeholder'	'Neo-liberal'
The State	Enabling	Minimal
Industry/ Economy	Managed	Free markets
How egalitarian?	Low levels of income inequality	High levels of inequality

Neither model is necessarily superior to the other in terms of economic performance, and both have enjoyed their time in the sun. In the 1970s, policymakers in the UK and US looked enviously at Germany and Japan as firms like Sony and Volkswagen conquered their domestic markets. Following structural reforms by Margaret Thatcher and Ronald Reagan, which liberated the productive potential of the Anglo-Saxon economies (according to their supporters) or crushed the trade unions in order to drive down wages (say critics), these overtook their Rhenish capitalist rivals, enjoying lower unemployment and higher growth through much of the 1990s.

The credit crunch and recession of 2008-09 was blamed on free markets and an approach to deregulation that bordered on reckless, but its impact was indiscriminate and the jury is still out on which model will thrive in its aftermath. Will it be the flexible, nimble Anglo-Saxons, or the 'fairer', more cohesive continental societies?

Economic models are, of course, ultimately generalisations. Whether or not they are useful in an analytical sense, they have often been embraced by politicians and economic commentators

as suggesting important reasons for economic success or failure and offering policy suggestions. However, we should be cautious about approaching industrial policy with the idea of ‘borrowing’ features from other models, even if they seem to be more successful and appealing.

In the 1990s, for instance, there was a brief enthusiasm for adopting a ‘stakeholder’ model along the lines of Germany’s social market economy.⁵⁴ Germany represented an attractive model of economic adjustment, at the heart of which was the upgrading of a broad range of industrial sectors to focus on higher quality, specialised goods targeted towards premium domestic and world markets.

The essence of stakeholding was an admiration for the long-termist, collaborative character of ‘Modell Deutschland’, which was seen to deliver political and social as well as economic benefits. The newly-crowned Labour Party leader, Tony Blair, gave a speech in Singapore in 1995 praising stakeholding, but dropped the idea like a hot potato when trade union leaders began climbing on the stakeholder bandwagon.

Modell Deutschland was also not without its critics, who draw attention to the chronic weakness of its service sector, ‘insider-outsider’ labour market with low female participation and Germany’s inability to generate hi-tech industrial clusters.

What the debate about stakeholding achieved, however, was to focus attention on the economic *institutions* which structure behaviour in the market and shape national economies from the ground up. Institutions are rules, customs or organisations which shape incentives. Examples include the Bank of England’s interest rate setting mechanism, the body of company law which

54 The core text of this movement was Will Hutton’s surprise bestseller, *The State we’re In*, (London:Vintage, 1996).

dictates how firms can behave, or how terms and conditions for workers are negotiated with their managers. Institutions tend to be 'embedded' in society, reflecting in many ways the characteristics of that society.

They are therefore difficult, though certainly not impossible, to alter. The argument of this paper is that fixing the institutions which encourage so many UK manufacturing firms to pursue low value-added product strategies could play a large part in transforming the country's manufacturing base.

As already argued, these problems revolve around the familiar issues of low productivity, inadequate skills and a paucity of R&D. These issues have been raised in countless DTI, BERR and BISS White Papers, but never resolved. Why is this? One reason for the meagre returns from recent government policy may be that it tries to tackle the symptoms of the problems facing manufacturing industry (firms or individuals not investing enough in training, say), rather than the underlying causes of these problems (a lack of incentives for them to do this). As institutions shape incentives, these problems are therefore partly institutional in origin, a point which is increasingly being recognised in policy circles.

For example, in a 2003 study prepared for the DTI that was implicitly critical of government policy, Harvard economists Michael Porter and Christian Ketel cautioned that, in assisting firms in upgrading their product strategies, "Lower taxes, less regulation and an even smaller role for the government are no longer the most critical elements of UK competitiveness.' Achieving higher prosperity needed: '...the development and strengthening of new types of institutions".⁵⁵

55 Michael Porter and Christian Ketels, "UK competitiveness: moving to the next stage," Department for Business, Innovation and Skills, (London: HMSO, 2003), <http://www.bis.gov.uk/files/file14771.pdf>.

What is needed, therefore, is a policy approach that addresses the entire set of incentives faced by market actors – firms, financiers and workers – as well as the institutions which structure these incentives. The next section looks more closely at the institutional features of economies which help to determine their orientation and performance.

EXPLAINING THE DIVERSITY OF CAPITALISM: AN 'INSTITUTIONAL' APPROACH

If most of the gains from the current approach to industrial policy have already been banked then what should the new focus be? Many commentators urge a renewed focus on institution-building; not with a view to recreating the lumbering macro-institutions of the 1960s and '70s, but improving the micro-level institutions needed to help businesses themselves overcome the 'prisoner's dilemma' whereby many firms are reluctant to move upmarket because of uncertainty over whether this is commercially sustainable.

This could be a fruitful approach because it offers a way out of the cul de sac of trying to 'bribe' manufacturers to do more R&D through tax credits, or the central provision of apprenticeships that business does not necessarily want or need.

So what does an 'institutional' approach to policy have to offer? One way of looking at the varying structures and performances of the national economic models is to examine how economic activity is *coordinated* through the institutions specific to these economies. These institutions help to overcome market failures that are specific to these models.

A leading approach, drawing on insights from new institutionalist economics and game theory, is to focus on how economic institutions shape firms' incentives to pursue particular product strategies – high, medium or low value-added. As these institutions vary between countries, they produce different

'varieties' of capitalism.⁵⁶ But what kinds of institutions are we talking about? There are four significant areas:

1. **Labour markets:** How do firms manage their workforce?
2. **Vocational educational and training:** How do firms secure a workforce with suitable skills?
3. **Corporate finance/governance:** How is access to finance regulated, and how are firms managed?
4. **Inter-firm relations:** How are relations with suppliers and customers regulated, and how do firms innovate?

These institutions are interlocking and complementary to each other – i.e. the whole is greater than the sum of its parts. The way institutions operate dictates interactions between firms and other economic actors (workers, regulators, financiers) and confers an *institutional comparative advantage* on particular industrial sectors. Successful economies will tend to specialise in the areas where they enjoy a comparative advantage.

Two distinctive models of capitalism emerge from this approach which correspond to the Anglo-Saxon/Rhenish categories described above, but for different reasons. They are dubbed 'liberal' and 'coordinated' market economies respectively. In the former, economic activity is coordinated primarily through markets and the price mechanism. In the latter, a range of non-market institutions are also in operation. They are explored in more detail below.

THE INSTITUTIONS OF COORDINATED MARKET ECONOMIES

In the *Varieties of Capitalism* literature, Germany -along with many Continental European economies - is dubbed a 'coordinated market economy', as its economic institutions foster collaboration among firms which underpin an industrial system known as 'Diversified

⁵⁶ Peter Hall and David Soskice. *Varieties of capitalism: the institutional foundations of comparative advantage*, (Oxford: Oxford University Press, 2001).

Quality Production.⁵⁷ This is a company strategy which combines standardised forms of industrial practices with non-market goods created collectively by groups of firms. This strategy encourages the long-term outlook which has underpinned Modell Deutschland's exporting prowess. It has the following institutional characteristics:

Labour markets: Many firms in coordinated market economies employ production strategies that rely on a skilled labour force which is given substantial autonomy in order to generate continuous improvements in production processes. Because this system entrusts firms' workforces with so much autonomy they are vulnerable to strikes and require very good relations between management and workforce. This is achieved by giving workers seats on company boards and setting wages through industrial-level bargaining with powerful, centralised trade unions.

Training: Technical and vocational training is taken very seriously in coordinated market economies. Manufacturing firms require workers with a high degree of technical skills that are usually specific to the sector or firm they work in. These are secured through a network of industry-wide employer associations and trade unions supervising a publicly-subsidised training system. A 'compensatory' welfare state, providing generous wage and employment protection, underwrites this skill formation as it reassures workers undergoing lengthy and costly vocational training that they will not be forced to take the first job that is offered to them.

Finance and governance: One of the most widely-admired features of coordinated market economies is the ready provision of 'patient' capital necessary to fund long-term industrial restructuring and liberate firms from the tyranny of stock market short-termism. In Germany, for instance, funding is provided instead through a system

57 Wolfgang Streeck, "Productive constraints: On the institutional preconditions of diversified quality production," in *Social Institutions and Economic Performance*, ed. Wolfgang Streeck, (London: Sage, 1992).

of 'hausbanks'. These forge close links with firms and may enjoy inside information about their operation, enabling the hausbank to take a more measured approach to evaluating the return on its investment. Internal corporate governance is characterised by worker representation and consensus decision-making, impeding radical restructuring of the firm which is therefore likely to take place in a less contested manner.

Inter-firm relations: Since many firms in the manufacturing sectors of coordinated market economies depend on long-term labour contracts to retain skilled workers they cannot rely on the easy movement of technical staff to affect technology transfer in the way that firms in the US and UK can do. Instead, they cultivate close inter-firm networks to disseminate technology and best-practice. This fosters a much greater degree of inter-firm collaboration than would be possible under a competition regime which prioritises highly competitive markets. Innovation carried out by firms in coordinated market economies tends to be incremental, marked by small but continuous improvements to existing product lines and processes. For instance, the German electronics industry collaborated extensively to introduce 'just in time' techniques in the 1980s. Firms in Japan operate in a more competitive environment than those in Germany, but are still able to collaborate with other members of their *keiretsu*, or 'family' of firms.

Taken together, these institutions encourage firms to invest in specific and co-specific assets (i.e. assets which cannot easily be switched between purposes). The effect they have on firms' product strategies is to benefit those active in fields characterised by incremental innovation, with an accompanying need for close links with supplier networks. Accordingly, German firms excel in the production of semi-customised goods in mature technologies. These include many medium-technology sectors such as mechanical engineering, transport, consumer durables and machine tools. They have less of a presence in fast-moving high-



tech sectors requiring the swift redeployment of financial, human and technical resources in response to changing market conditions.

THE INSTITUTIONS OF LIBERAL-MARKET ECONOMIES

Liberal market economies, such as the UK, on the other hand, do things very differently, with different consequences for the range of product strategies available to them.

Labour markets: Senior management in a liberal market economy typically enjoys unilateral control over the firm and generally feels under no obligation to include workers or their trade union representatives in decision-making. Private sector unions are generally much less powerful and there is no inter-sectoral coordination of wage bargaining. The market flexibility this produces makes it much easier for firms to switch assets between sectors to take advantage of new commercial opportunities, but less able to pursue the kinds of long-term collaborative relationships which firms in coordinated market economies are able to do.

Training: The education and training system in liberal market economies generally complements this market fluidity by producing workers with flexible, transferable skills achieved through a general education at school or university. Vocational and technical training, the poor relation in the UK education system, is handled by educational institutions, often responding to instructions from the government, rather than by industry itself. The liberal-market welfare state provides a 'safety net' only, offering no protection against skill redundancy, so workers are more likely to invest in general, transferable skills not specific to an industry or sector.

Finance and governance: Corporate finance in liberal market economies is provided by well developed equity markets operating on publicly available information. There is also a strong venture capital industry and the competition authorities take a relaxed

view of hostile takeovers. Managers therefore pay a lot of attention to maintaining their firms' share price and current profitability, encouraging a more short-termist outlook.

Inter-firm relationships: These are governed by standard market relationships and formal contracting. Technology transfer is achieved by hiring workers with the requisite knowledge from other firms, which the UK's flexible labour markets facilitate, or through licensing products. Research consortia and inter-firm collaboration are less in evidence and collective standard-setting is much more difficult than in coordinated market economies. The more innovative firms pursue 'radical' innovation, which is especially important in fast-developing technology sectors which call for rapid product development, as in biotechnology and software development. But it is also in evidence in the provision of complex, system-based products such as telecommunications and their service sector equivalents, such as financial services.

Table 3: Liberal and coordinated market economies: the key institutions

	'Liberal-market economies': The UK and USA.	'Co-ordinated market economies': Germany, Benelux; Japan.
Labour markets:	Flexible; few restrictions on hire and fire; weak private sector unions.	Collaboration between workers and management and workers; powerful, centralised trade unions; restrictions on hire and fire.
Education and vocational training:	Geared towards producing flexible, transferable skills; 'safety net' welfare state.	Training is firm-centred and coordinated by industry associations; produces good level of technical, industry-specific, skills
Corporate governance and finance:	'Shareholder' model of equity finance; well developed venture capital markets; acceptance of hostile takeovers; management autonomy.	'Stakeholder' model of governance; 'hausbanks' foster long-term relationships; ltd venture capital industry; hostile takeovers frowned upon.
Inter-firm coordination:	Highly-competitive markets; technology transfer by poaching staff; 'radical' innovation.	Firms collaborate on innovation and standard-setting; incremental innovation produces continuous improvements in established technologies.

The institutional complementarities in liberal market economies favour firms competing in **either** of two market sectors:

1. Highly innovative, hi-technology sectors.
2. Price-sensitive, low value added goods.

On the other hand, firms competing in liberal market economies will face institutional obstacles to choosing product strategies built on long-term relationships and incremental innovation. They will be less successful in these industries because they lack the institutions required to: provide and manage a well qualified work force equipped with industry specific skills; access 'patient' capital necessary for long-term restructuring; or collaborate with other firms in the same industry on product development and standard setting. They are therefore less likely to specialise in industries such as machine tools, white goods and cars, as these require an institutional environment based on coordination.

Against this analysis it may reasonably be objected that the institutional complementarities of the UK economy have not prevented firms like Rolls Royce and GKN from enjoying considerable success through production processes which arguably depend on incremental innovation and extensive collaboration – the institutions of coordinated market economies, in other words. On the other hand it should be born in mind that GKN, although British owned and headquartered, employs only 5,500 of its 38,200 employees in the UK. Rolls Royce's business model arguably hinges on deploying service sector skills alongside its undoubted engineering excellence. Ultimately, the presence of some very successful UK firms in sectors employing engineering processes requiring collaboration and incremental innovation does not alter the argument for wider institutional reform.

CHAPTER 3: THE IMPLICATIONS FOR POLICY

To briefly recap, many UK manufacturing firms choose to compete on price rather than quality because the UK's micro-economic institutions provide them with certain competitive advantages in doing this. They also hinder them from upgrading to higher-value product strategies. Of course, these institutions also nurture very successful firms competing in radically innovative, high technology sectors at the higher end of the market - but these firms are not the problem. The issue for policymakers is, therefore, whether institutional reform can take place which removes barriers preventing firms from moving up the value chain at the bottom end, while not undermining those institutions which also foster competitive success at the top.

The analysis above suggests that reform should be subject to the following constraints:

1. Policies will be effective only if they are incentive-compatible: in other words, if they are complementary to the coordinating capacities of the entire economy.

In liberal market economies, where economic activity is mainly coordinated through markets, better economic performance will be achieved by policies that rely mainly on market mechanisms. This is not to say that targeted interventions to correct market failures, where these exist, will be doomed to failure. But it probably does place limits on the extent to which non-market coordinating institutions can be created to do this, and so policymakers will be forced to work largely with, rather than against, the grain of the existing institutional form of UK capitalism.

2. Policy must take account of institutional complementarity. Economic institutions are an interlocking web of codes,

customs and rules. For this reason it is likely to be very difficult to simply transplant one national model of capitalism from one country to another.

‘Borrowing’ German-style institutions for training, labour relations etc. is not practical, as the German social market economy (ditto the Japanese, Dutch and Scandinavian ones) is a complex system of mutually reinforcing and interdependent features. Adopting just one or two of these features - its industrial vocational training system, say, or ‘co-determination’ between workers and managers on company boards - would not work because they might be incompatible with other aspects of the UK economy which continue to tend towards competitive, unfettered markets. Therefore the UK needs to develop and modify its own unique institutions to foster more inter-firm collaboration.

3. Policy must take a highly coordinated approach. In view of 1 and 2 above, any attempt to reform the institutions of the UK labour market, corporate governance, financial system, welfare state and training arrangements would need to address all these areas simultaneously. Politically, such a bottom-up reorientation of industrial policy would require a broad-based coalition of employers, trade unions, financiers and policymakers behind it to succeed. Such coalitions have not proven particularly durable in the past.

These three sets of constraints might appear to doom to failure any major attempt at institutional reform. After all, if the UK is a largely free-market economy, and not unsuccessful, then what scope is there for any form of policy intervention aimed at fostering more collaboration?

However, there may be room for a less ambitious program focussing initially on selective interventions to correct the most

glaring failings. Will Hutton, the executive vice-chair of The Work Foundation, has suggested that policy should begin by recognising the UK's unique starting point and find appropriate 'triggers' capable of producing similar advantages to our leading competitors.

Many of the enabling micro-economic institutions that foster the high-trust relationships characterising coordinated market economies already exist in the UK, albeit in fragmented and embryonic form. For example, the Construction Industry Training Board oversees intra-sectoral coordination of technical training in the building industry, funded through a compulsory training levy. Studies of the operation of similar schemes in other sectors in France have concluded that training levies can increase the supply of well-skilled workers, helping to correct for the endemic under-provision of skills in private-sector economies.⁵⁸

Perhaps the most prominent set of coordinating institutions lacking in the UK is an industrial relations system managed by the kind of disciplined, centralised trade unions which, in Germany and Sweden, enable firm restructuring to take place in a largely consensual manner devoid of the industrial strife which scarred attempts to do this in the UK in the 1970s and 1980s. However, with membership of private sector unions in the UK edging below 15% of the workforce, this is not necessarily going to be a critical problem.

Government does not therefore have to 'create' a new set of micro-economic institutions from scratch, it simply needs to identify existing patterns of collaboration between firms and attempt to build on these.

What, then, is the right approach to reforms that are incentive-compatible, coordinated and congruent so far as is possible with the

58 Christine Greenhalgh, "Does an employer training levy work?" *Fiscal Studies*, 23,2, (2002).



UK's existing pattern of institutional comparative advantage? With a new government in place and an ambitious program of structural reform being set in motion, now is a good point to evaluate the approach of the coalition government and suggest improvements.

1. LABOUR MARKETS AND SKILLS

Out of the range of economic institutions discussed here, the UK's inadequate system for technical training seems to offer the most egregious example of political and institutional failure, and therefore a good starting point for reform. Sorting out industry's haphazard approach to training could provide a catalyst for other sets of policies helping to close off the 'low road' option for some manufacturing employers.

The Coalition Government has accepted the conclusions of the Leitch Review about the need to build a 'world class' skills base, although it thankfully departs from the latter's emphasis on targets and centralised controls in favour of more local autonomy. The focus of the Coalition's strategy is firmly on apprenticeships. Despite significant budget cuts, BIS still intends to fund 75,000 new positions a year, but offer a more flexible system of vocational qualifications with training providers (colleges or training institutes) given more independence.⁵⁹

The replacement of Labour's Regional Development Agencies with Local Enterprise Partnerships (LEPs) that are, supposedly, business-led may also present opportunities to provide a bespoke and integrated response to training and employment issues at a sub-regional level.

Overall, the devolution of responsibility for training to firms and local training providers is a welcome departure from Labour's over-

59 Department for Business, Innovation and Skills, *Skills for sustainable growth*.

centralised ‘predict and provide’ approach to training. It indicates an implicit acceptance by policymakers that central government is unable to generate solutions to coordination problems involving skills investments because it lacks the right information and incentives. However, it remains to be seen whether the instruments nominated to manage these responsibilities instead – primarily LEPs and the colleges and training institutes themselves – will themselves be robust and proactive enough to meet manufacturing firms’ requirements.

Moreover, if ‘low road’ manufacturing firms are to be incentivised to upgrade their product strategies to compete in higher value markets, then a necessary, although not sufficient, component of this is to remove endemic uncertainties surrounding workforce skills acquisition. This could be tackled by sharply increasing the number of Advanced Apprenticeships, if necessary at the expense of less demanding technical qualifications, and linking these more explicitly to membership of and registration through professional bodies to guarantee their status.

Government should increase the number of Advanced Apprenticeships and guarantee their professional status.

Reforms to the welfare state, and particularly unemployment benefit, may also be necessary if firms and individuals are to be persuaded to undertake costly training programmes to upgrade skills levels. There should be a gradual move towards a welfare system offering ‘flexicurity’, offering higher out-of-work benefits with tight job-search conditions to those undertaking technical training.

Government should develop a flexicurity system to encourage individuals to upgrade their skill levels.

Raising the minimum wage offers a different route to the same destination. The currently low minimum wage is not really the market-making mechanism its proponents claim it to be, as the state simply subsidises the low wages paid by many 'low road' employers through in-work tax credits. Research by the OECD indicates that higher minimum wages produce higher productivity in low wage industries compared to other industries as firms substitute skilled for unskilled workers, with no overall impact on employment.⁶⁰

The Government should set out a strategy to significantly raise the National Minimum Wage over the medium term in order to encourage firms to take a strategic approach to up-skilling their workforces.

2. CORPORATE GOVERNANCE AND FINANCE

The institutions of the UK political economy are currently biased towards activities that reward short-termism. This is a particular problem for manufacturing, which is more capital intensive and has longer investment horizons than most other parts of the economy.

There are welcome signs that the Coalition regards this as a real challenge to be addressed, and the Treasury's recent growth paper proposed a review of corporate governance to try to generate solutions. It promised that: "Government will consider the role of directors and shareholders and ask fundamental questions about shareholder engagement, market short-termism and the long-term sustainability of UK companies."⁶¹

60 Andrea Bassanini and Danielle Venn "Minimum wages and productivity in OECD countries: A cross-country, cross-industry approach", http://7769376750840697240-a-1802744773732722657-s-sites.googlegroups.com/site/bassaxsite/home/files/BV-minwages.pdf?attachauth=ANoY7cqscmOgiY1waSivDf9qFFQ5Di3F0h1txT8X2mlIn3KTeQC0rx4Ib5XpknQBDOQAQNUmXQRx-txMsXnVRZN2U9oZMqU_-xH9G9ui0MzE-i5h3KscuoQtoa4pXq-EYIC7dYTSKLnoLBM9k9T1LGUuoVbSZeWCmGCga5Em5JnH4s0Wh3N1VeEOAG8rfynK-IYrL4-6mn_heq-ZWdycoD4UbfGDd7d_Q%3D%3D&attredirects=0.

61 HM Treasury *The path to strong, sustainable and balanced growth*, (London: HMSO, 2010), 14.

A recent survey of manufacturers by the EEF suggests that accessing capital is an acute problem for companies planning ‘transformational growth.’⁶² The Rowland Review for the BIS department in 2009 also found that, for some fast-growing SMEs, capital for growth was not being provided by the market.⁶³ Some obvious, although not necessarily straightforward, solutions to this include increasing competition among lenders and restructuring existing government-backed schemes to make them more transparent.

But the German experience shows that providers of finance that are as close as possible to the enterprise are more likely to foster long-term restructuring aimed at raising quality. There is no need to attempt to recreate the ‘hausbank’ system here in the UK. However, experience does suggest limits to the effectiveness of centrally-managed and provided pools of finance, particularly in view of the apparent disinterest of many UK high street banks in low-margin lending to industry.

Only when they have been divested of their ‘casino’ operations and split into investment and retail operations will the UK banking system be able offer manufacturing firms the responsive, long-term banking services needed for them to engage in the costly and uncertain process of industrial upgrading. A set of regional investment banks, prepared to share more of the risks of the companies they are funding, could help ensure that firms have the access to the kind of capital they need, and on more agreeable terms.

Structural reforms to the banking sector should consider the need to encourage regional investment banks with a focus on offering ‘patient’ capital.

62 Engineering Employers Federation “The shape of British industry: Growing from strong foundations,” (London: Engineering Employers Federation, 2010).

63 Department for Business, Innovation and Skills, *The provision of growth capital to UK small and medium-sized enterprises*, (London: HMSO, 2009).

The approach of the Coalition Government suggests it is caught in two minds about how to deliver non-market provided finance to promising SMEs. On the one hand, the replacement of the RDAs by more locally-responsive and business-led LEPs could provide the missing institutional link between firms and the sources of finance and support they rely on that is most appropriate to the UK's economic environment.

However, the EEF, among others, have warned about LEPs lacking the funding that was available to RDAs as extra money is diverted to centralised schemes such as the Growth Capital Fund. Clashes between other employers' organisations over how LEPs are to be governed and funded also suggest that their structure has not been fully thought out.

Fundamentally, if they are to succeed, then LEPs need to lose any lingering association they still appear to have with central and local government and become fully-fledged, business-led industrial development associations promoting a wide range of public goods for industry, including training and technology transfer, as well as finance.

LEPs should evolve into business-led industrial development associations promoting training, technology transfer and finance.

There is no reason why such bodies should not co-exist with other institutional features of a liberal market economy which support radically innovative, high technology firms, such as a well developed venture capital and private equity industry.

3. INNOVATION

The Coalition Government is currently reviewing innovation policy, which forms a significant plank of the BIS department's growth

review for high-tech manufacturing, launched in late November 2010.

Encouragingly, one of the key barriers to more innovative manufacturing has been identified as being due to problems in knowledge transfer stemming from a commercial and institutional approach which prioritises competition over collaboration: “Knowledge of the latest industrial technologies and their application to manufacturing processes is often difficult to assess, particularly for SMEs. Information is often contained within a particular sector, and not disseminated widely across sectors where it could be beneficial.”⁶⁴

The transfer of knowledge processes and formation of best practice between networks of firms is easier to aspire to than achieve, however, in the competitive commercial environment of the UK. The tensions between the need for firms to collaborate on innovation and their impulse to compete with each other may be exacerbated by the country’s rigorous competition regime.

One way around this might be to modify the remit of the Competition Commission to allow firms in the same industry or sector to collaborate more on product development and standard setting without falling foul of competition law.

Competition law should be responsive to the need for firms to collaborate on product development.

The Labour Government was alert to the complications surrounding knowledge transfer and tried to resolve these by founding the Technology Strategy Board (TSB) in 2006 as an

⁶⁴ Department for Business Innovation and Skills, *Growth review framework for advanced manufacturing*, (London: HMSO, 2010), 5.

'arms' length', non-departmental body. The TSB launched a series of Knowledge Transfer Networks which many firms have found helpful. The Coalition Government plans to expand these by launching a network of 'innovation centres' at a cost of £200m.

On the whole, however, firm-led solutions are preferable to ones administered by central government or a quango, in order to avoid the risk of creating another series of 'white elephants'. The TSB should certainly be given control of government innovation funding for university technology incubators. However, if possible, responsibility for technology transfer should ideally be transferred to business development associations, such as beefed-up LEPs. At the very least it should be ensured that existing links between the Research Councils, the TSB and the current RDAs are fully transposed to the new LEPs.

Business-led LEPs, rather than government quangos, should take on the role of, and budgets for, promoting technology transfer.

The key factor that all these proposals have in common is that solutions to coordination problems hindering industrial upgrading *must ultimately come from firms themselves*. Government is neither the solution here, nor the problem; it is an enabler. Policy can no more force, or bribe, firms to move into higher value-added activities than it can ensure that they make big profits.

Many of the micro-economic institutions discussed in this paper sit at the frontier between the state and the market. In order for them to function, government should set out the broad parameters of policy and then work to ensure that institutional obstacles to industrial upgrading are removed or reformed.

CONCLUSION

Success in global manufacturing demands more than simply the ability to produce goods competently and cheaply. There is always somewhere else that can make things to an adequate standard, but for less. In an ever more competitive global economy, advanced industrial nations will increasingly need to compete on value and service, not low prices.

Policymakers are at last realising that manufacturing is vitally important for the UK: one of the few bright spots in the poor GDP growth figures for the latter half of 2010 was manufacturing's vibrant performance. But how much of this was because the weak pound gave UK exporters a temporary price advantage over their competitors?

It has been argued in some quarters that the recession has wiped out most low cost manufacturing in the UK, and perhaps it has for the moment. However, without institutional reform, the economic conditions which provide a niche for low cost producers in the UK will simply lead substantial parts of industry down this road again when the economy recovers.

Less than a year since the General Election, the Coalition Government has the measure of some of manufacturing's problems, and seems keen to unearth solutions.

But these need to move beyond the familiar routine of selective tax breaks and centrally administered investment funds. All businesses, not just manufacturers, like low taxes, but they are often not the crucial ingredient in competitive success. Ireland kick-started its 'Celtic Tiger' phase in the late 1980s by slashing corporate taxes. But over the last decade it neglected other factors responsible for its industrial success – its innovation base, education and skills – and fell behind again. We must not make the same mistake.

A low tax regime will only foster high-value added manufacturing if it is set against the backdrop of a highly-skilled and motivated labour force; a competition regime which supports value-creating collaboration and incremental as well as radical innovation; a financial sector intent on contributing to the long-term success of businesses; and, above all, management equipped and incentivised to pursue high quality product strategies.

Governments can work behind the scenes to foster the conditions which allow workers, companies and their financiers to form the kind of collaborative, forward-thinking relationships needed for industry to move up the value chain and compete in higher quality markets.

This, the presumption that business performs best when firms themselves are encouraged to craft their own solutions to problems which they have identified, is surely the very essence of localism and the 'Big Society'.

However, to use another policy buzzword, business can still be 'nudged' to do this by enlightened institution-building. In the LEPs, the government has, in embryo, an institution that could potentially provide this impetus. But, in order to succeed, the LEPs need to be properly funded, statutorily equipped to take on an important coordinating role, and have the resources and confidence to develop industrial training, undertake knowledge and technology transfer and oversee links between industry and financiers.

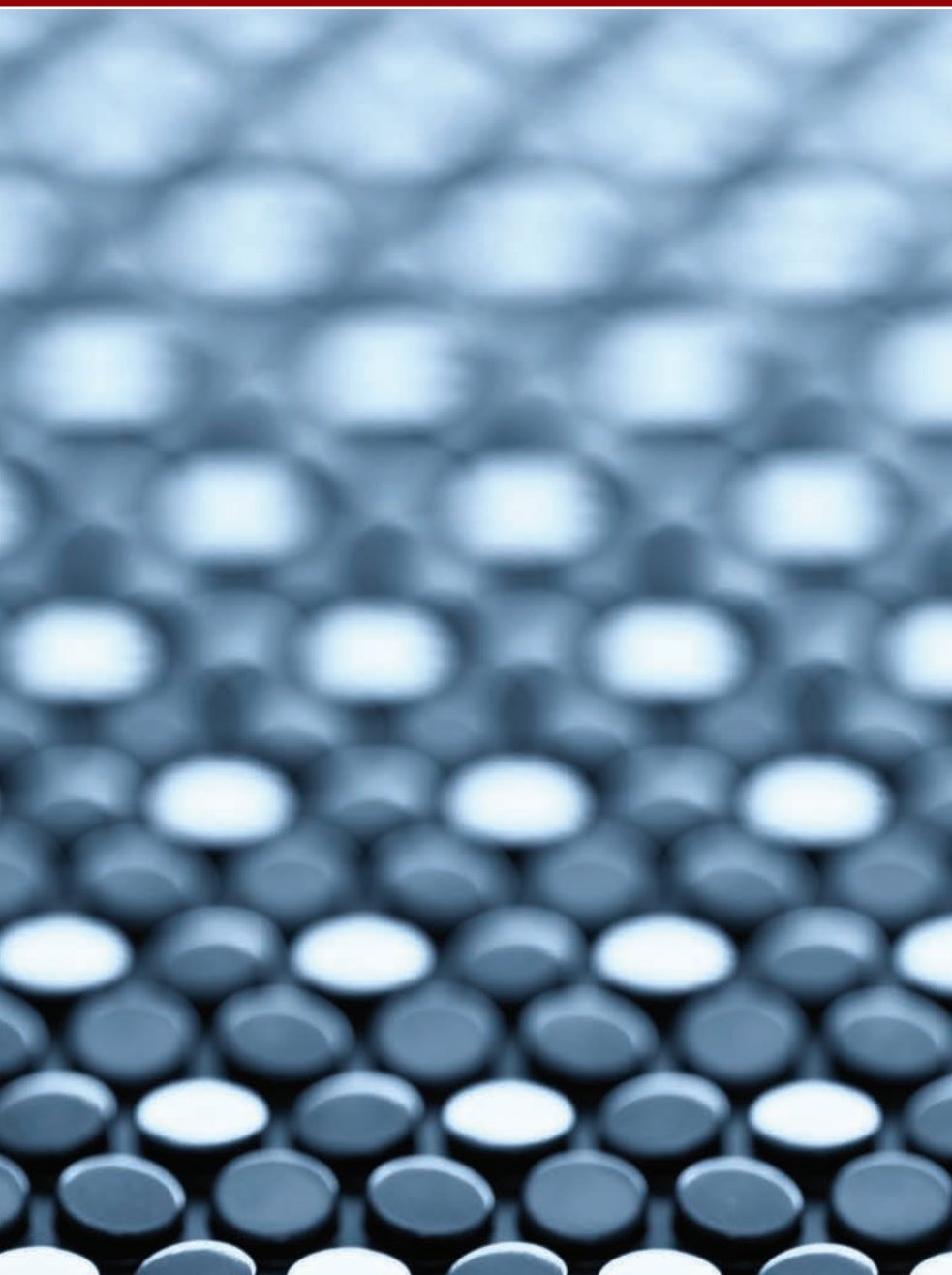
Above all, the LEPs must be business led, not government-sponsored talking shops or instruments to foist Whitehall diktats on industry. And they will function optimally if other far reaching reforms are undertaken simultaneously in the fields of corporate governance, the welfare state and the labour market discussed above that encourage the short-termist tendencies that frequently bedevil British industry.

The goal of this should be to preserve the UK's global market share in high-tech industries, while capturing a larger segment of the medium-high technology markets currently dominated by Germany and Japan. This is where our industrial future lies.

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With the UK economy struggling to gain traction in the wake of recession, the Government needs a strategy for growth. 'Rebalancing' the composition of UK economic output – away from a reliance on finance and toward manufacturing – has long been discussed, but concrete policy ideas have been thin on the ground.

In this timely paper, Steve Coulter argues that the Government needs to take an institutional approach to driving UK manufacturing up the value chain. Coulter argues that Local Enterprise Partnerships should be led by business, freed from their lingering association with local government and strengthened. They should foster technology transfer between manufacturers, facilitate access to 'patient' rather than short-term finance, and coordinate industry training needs. In addition, government should consider raising the minimum wage as a tool to reduce the state's effective subsidy of low-skilled manufacturing.

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