New Policy Institute

An Industrial Strategy for a post-Brexit Britain

A submission to the Industrial Strategy Commission by Dan Corry and Peter Kenway

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About the authors

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Introduction: Fighting complacency on the economy – and building an industrial strategy in the era of Brexit.

We see a dangerous complacency hovering over British economic policy making at present.

The failure of the economy to plunge following the Brexit vote has been taken to mean that all is well. The lack of debate so far in the General Election rhetoric about the health of the economy – from any of the major parties – is something that concerns us.

Yet a quick look 'beneath the bonnet' of the economy, something we have urged before, shows that that the fundamentals are not strong:

- The rate of economic growth continues to be poor. The provisional estimate for the first three months of 2017 – just 0.3 per cent – has caught the headlines but that is off the back of a below-average 1.8 per cent for the whole of 2016, the third lowest annual figure since 2010 and well below the long term average of 2¼ per cent.[1]
- Productivity growth remains next to non-existent, with output per hour worked just 0.4 percentage points higher in 2016 than 2007. By contrast, between the start of the 1970s and 2007, this measure of productivity growth averaged 1.5 per cent a year. At just 0.3 per cent, productivity growth in 2016 was derisory, with no sign of the long-awaited upturn.[2]
- While the public sector deficit has continued to come down, averaging 4.1 per cent of GDP in 2016, reductions since 2013 have been almost entirely at the expense of a rising deficit in the household sector. Borrowing to maintain living standards, households posted a record deficit of 1.2 per cent of GDP in 2016.
- With the 2016 balance of payments deficit (4.5 per cent) only fractionally below the 2014 all-time high and the corporate sector – which should be borrowing to invest – chalking up a financial surplus for the 14th consecutive year, the UK economy remains dangerously unbalanced. Anaemic growth, held up by unsustainable levels of consumer borrowing, leaves 2016 most closely resembling 2006, the year before the credit crunch.[3]

[1] Source, ONS, UK Economic Accounts (series identifier ABMI), released 31 March 2017
[2] Source, ONS, Output per hour worked (series identifier LZVB), released 5 April 2017.
[3] Source, ONS, UK Economic Accounts, (series identifiers RPYN, RPZT, RQBV, RQCH and YBHA) released 31 March 2017

In this context an Industrial Policy for Britain is urgently needed and it should build on the lessons from its history in the UK as well as from overseas.

But we believe that **Brexit changes fundamentally what is needed for a successful Industrial Policy**. For the last few decades we argue that the UK's industrial strategy has, in effect, been membership of the Single Market itself. Thinking about what an industrial strategy might entail going forward has therefore paid far too little attention to the realities that exit from the EU implies, something we explore below with particular reference to the labour market.

"Industrial Strategy" is a lovely phrase which people from all wings of politics, with widely differing views on economics, can assent to. Precisely because it can mean so many things, it is necessary to be clear what exactly it is – and is not – about if it is to be useful.

In our view, the Industrial Strategy needed now can be summed up in four propositions, namely:

- it is about the supply-side, with a special focus on labour as the element most impacted by Brexit;
- it should concern itself with the whole of industry;
- it should adopt rising labour productivity, industry by industry, as its goal, supported by greater equality of outcome in skills, opportunities and earnings;
- it should be owned (in England) by the city regions and/or LEPs, with a supporting national infrastructure overseen by a National Economic Council.

Each of the propositions both says something about what we believe the strategy is and also implies something about what it is not. For example: it is not about demand, or sales; it is not just about manufacturing industry; it is neither about, say, aggregate investment or aggregate employment nor does it involve picking winners; it is not just a top-down policy.

Reduced to a single sentence, we are saying that the institutions responsible for industrial strategy should have dealing with the UK's productivity problem as their primary goal. The productivity problem has two sides to it: the UK's low productivity compared with its major competitor nations; and the collapse in productivity growth since the financial crash.

Proposition 1: the focus should be the supply-side – and post Brexit, the supply of labour first and foremost

Industrial strategies take many forms. Evidence in support of some of the best-known elements – the identification of national champions, nationalised or not, the use of regional or national government purchasing strategies, support via tax breaks, etc – to support specific sectors has been found to not always deliver anything other than the infamous feather-bedded inefficient industries of yore.[4] And yet all the manufacturing success stories, whether the SE Asian tigers, Japan, Germany, Finland, the US or indeed the UK in the past, have pursued conscious, active industrial policies on the way to achieving and sustaining a strong overall economic position.[5]

Against this background – uncertain micro benefits yet evident macro ones – what should an industrial strategy be about? The timeless answer is the supply-side,[6] that is, the supply of labour, finance, research and development and infrastructure (both hard and soft – e.g. neighbourhood services). These require *policy*, that is, deliberate consideration and conscious organisation, for three reasons. First, some are provided collectively and externally (e.g. infrastructure, formal education): here producers can only be takers and there is no reason to assume that what is on offer is optimal. Second, others (e.g. skills, in-work training) require planning and co-ordination to ensure costs are internalised. And a third group, around technology, require deals between local/regional public centres of advanced research and foreign-owned firms.

But if these concerns are timeless, the context, however – an impending Brexit whose exact form remains unknown – is specific. In principle, Brexit could worsen every element of the supply-side challenge, as firms cut back on investment within the UK, universities and R&D capability shift their activities abroad and weaker public finances further curtails the scope for public spending on soft and hard infrastructure. These are all possible but the effect that is already certain is the impact on labour supply, with industries from farming to finance flagging concerns.

One way of looking at this is that Brexit marks the end of a 40-year period in which the UK has relied on the discipline of what has become the largest single market in the world to maintain the pressure for modernisation and adaptation. In a real sense, the UK's industrial strategy since late 1980s has been the Single Market itself. Over the years, different parties and administrations put different glosses of policies on top of it. The Conservatives put quite a free market topping on it before 1997. Labour

[4] Broadberry and Leunig, 2013, EP2
[5] Ha-Joon, Andreoni and Ming, 2013 EP4
[6] Following Driver and Temple (2012)

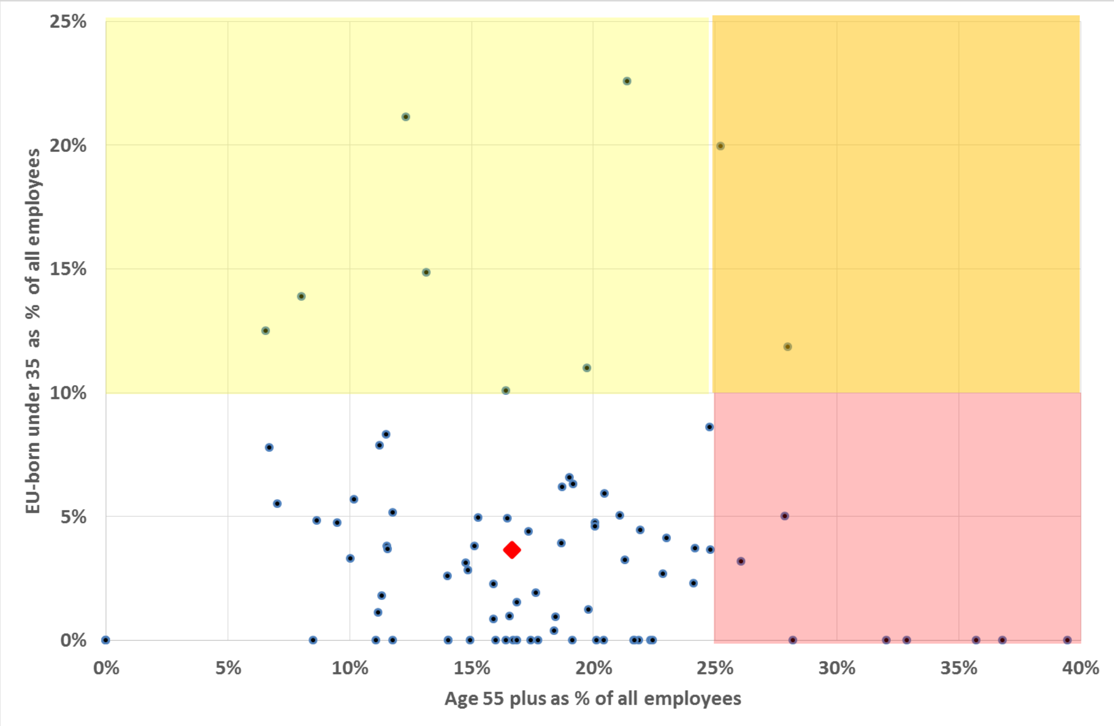
became more interventionist even when it did not dare mention the industrial policy phrase[7] and got even more interventionist post the financial crash. The Coalition with Vince Cable in the lead tried to be a bit more hands on. But in all cases the open flow of labour and capital was fundamental.

The future flow of capital is uncertain but no barriers are being placed in its way. By contrast, the ending of the free movement of peoples between the UK and the EU obliges the UK to consider explicitly what labour it needs, where it needs it, and where it is coming from. Skills possessed as well as the potential to acquire them are crucial dimensions of this. At the limit, the UK might need to go back to some sort of Manpower Planning.

So where might there be a labour supply problem post-Brexit? Figure 1, using data drawn from the Labour Force Survey (LFS) offers a hint about the industries which may experience a labour supply problem in the near future, due to one or both of two characteristics about their current workforce. The first is that a high percentage of their workforce is old (measured here by those aged 55+). Industries where this is the case therefore have an elevated need for new workers in the near future. The second is that a high percentage of their workforce aged under 35 is EU-born. These are industries in which labour supply from the rest of the EU has played an important part in providing new workers in the past.

[7] 'Labour and the Economy, 1997–2010: More than a Faustian Pact' Dan Corry, September 2010, Political Quarterly

Figure 1: percentages of old workers and young, EU-born workers; by industry[8]



The graph shows these two percentages for each of 85 industries. Overall, 17 per cent of the workforce is aged 55 or above while 4 per cent are under 35 and EU-born. The further to the right an industry lies on the graph, the higher its proportion of older workers while the further up it is, the higher is its proportion of young, EU-born workers. Using reasonable but arbitrary definitions, 11 of the 85 have more than 25 per cent of the workforce aged 55 or above while nine have young EU-born workers making up more than 10 per cent. Two industries appear in both groups.

Although the data is for one quarter only and so only illustrative, many of the industries flagged on this basis seem plausible candidates for concern. Agriculture, food manufacture, hotels and the pub and restaurant business all figure among those with high proportions of young EU workers. Curiously, industries to do with water, from water supply to fishing, figure among those with high proportions of older workers. The two registering high on both measures are clothing manufacture and domestic personnel. This last illustrates a point that not all industries with problems will necessarily merit active intervention.

Industrial policy is bound to range across the whole of the supply-side. One cluster of issues is to do with investment in science, the creation of innovation hubs and university spin-outs and tax credits for research and development. The role of government procurement is ever-pertinent. Employment regulation is fundamental. In

[8] Source: Labour Force Survey, Q4 2016. The red dot marks the average.

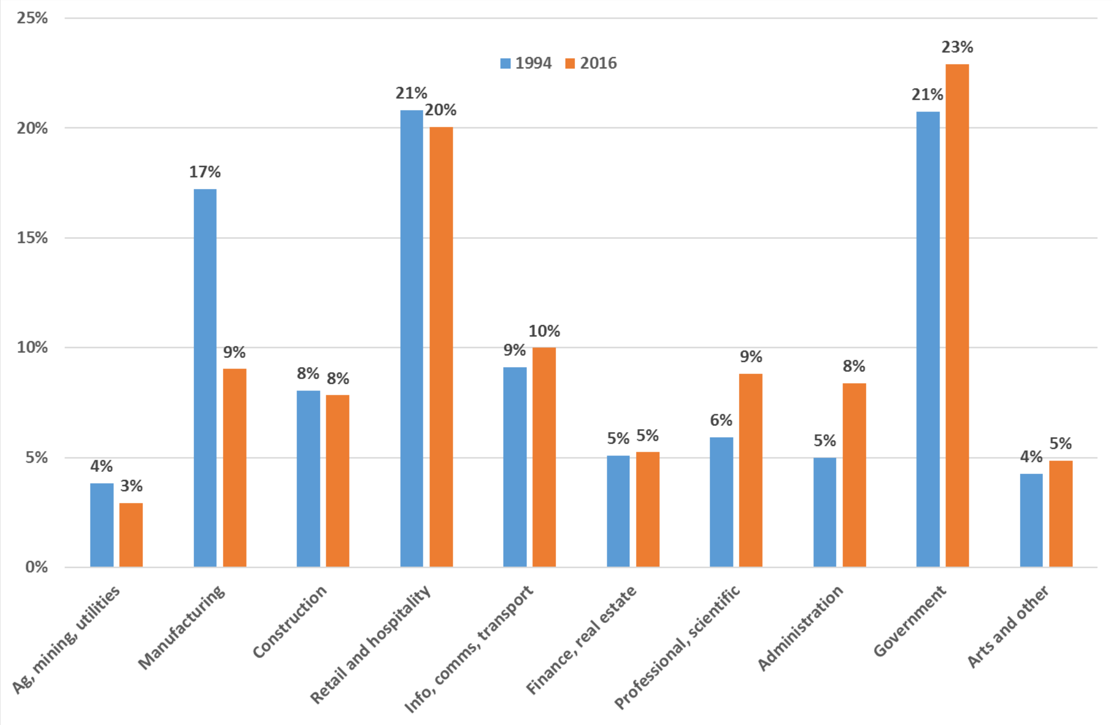
many of these areas the framework that surrounds these areas laid down by the EU will of course soon no longer be binding. In that sense Brexit opens up new possibilities for industrial policy – as well as dangers of following what in effect are protectionist and nationalistic policies that all experience shows leads to lower productivity and prosperity over the longer term.

Although no barriers are being erected to impede the flow of capital in the way that they are with labour from the rest of the EU, concerns – about say the consequences for intellectual property – might mean that not all capital inflows should be viewed equally. Nevertheless, given the rupture to the labour supply that Brexit represents, dealing with this particular aspect of the matter is now where the focus needs to be – if not a wholly new problem, at least one returned from the dead.

Proposition 2: The scope should be the whole of industry and not just the manufacturing sector

The Coalition government's 2013 Foresight project was constructed to focus on manufacturing. Manufacturing deserves a special status because as the means of production, manufacturing outputs can transform all other sectors, from agriculture to IT. But for at least three reasons, a new industrial strategy today should not restrict itself to manufacturing. First, because it is small, an exclusive focus on manufacturing is too narrowly drawn and leaves most production out of account. As figure 2 shows, manufacturing's share of total labour hours in the economy is now just 9 per cent, barely more than half of what it was at the start of the 1990s. Even if we leave the (largely non-market) government sector out of account, manufacturing hours are less than half those in retail and hospitality and comparable with those in any of construction, professional/scientific and administration.

Figure 2: share of hours worked by industry section, UK: 1994 and 2016 [9]



Second, manufacturing is by no means a productivity star, posting a GVA per hour of £34.50 in 2016, nearly 10 per cent above the all-industry average but far behind the values in both mining/utilities and finance/real estate. Third, even if manufacturing is special because of its transformative capabilities, a demand for manufacturing needs to be stimulated as part of a direct effort to improve the supply side of other industrial sectors.

Proposition 3: the goal of an Industrial Strategy should be rising labour productivity, supported by more equal skills, opportunities and earnings

If there is no case for focusing on manufacturing exclusively, that does not mean policies should be resolutely and exclusively horizontal, affecting all firms, rather than sectoral. The practical question for any industrial strategy is how to decide where to focus. We propose that the way to answer that is indirectly, by setting the strategy an overall goal and then leaving the institutions responsible for putting the strategy into practice working out what to do, and where.

We propose that the overall goal of the strategy should be to raise labour productivity. The basic argument for this is that the problem is widely recognised as

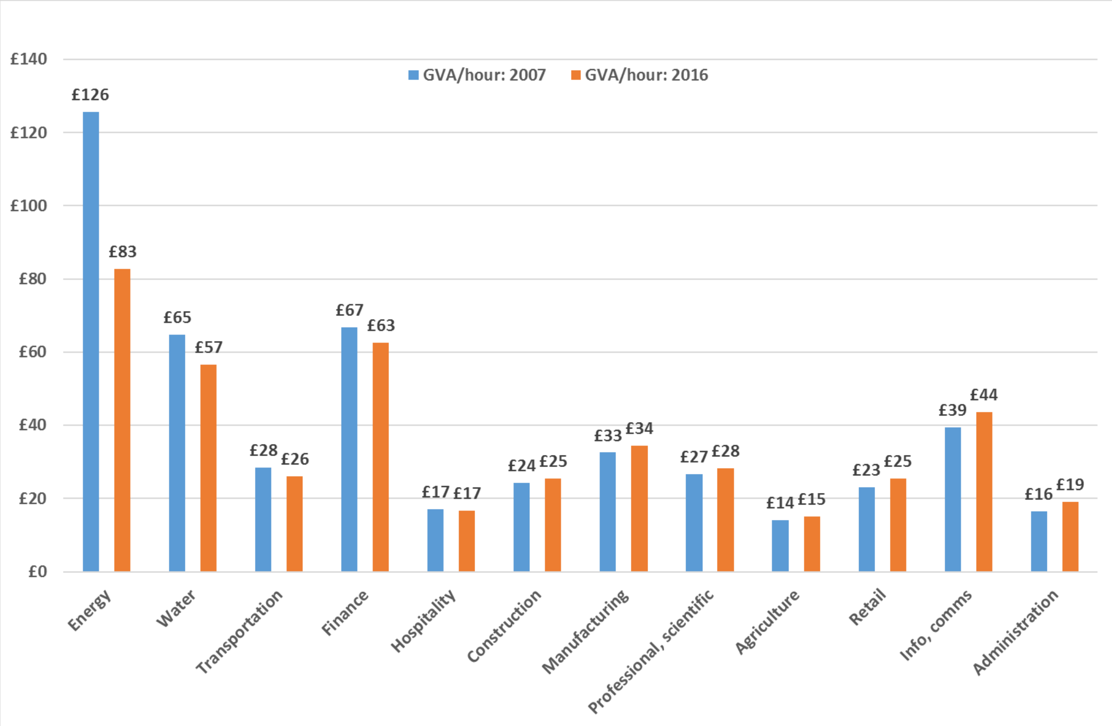
[9] Source: https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/labourproductivity/datasets/productivityjobsproductivityhoursmarketsectorworkersmarketsectorhours

the economic problem now facing the country. UK's labour productivity problem now has two dimensions. The first is the chronically low level of productivity relative to the country's principal competitors: 84 per cent below the average for the other members of the G7 (measured by GDP per hour), in 2015, slightly below the average of 87 per cent over the previous 21 years from 1995.[10] The second is the near disappearance of productivity growth since the financial crash, which is not a specifically UK problem.

We therefore propose that the aim of the strategy should be to raise labour productivity in pursuit of the eventual goal of closing the productivity gap with the rest of the G7 altogether. How should it start to do this? As figure 3 shows, both average productivity and the growth in average productivity are amalgams of individual industries where both the productivity levels and the rates of progress differ widely. Energy, water and finance have average levels of GVA far above the average of £34 an hour. The real outliers – mining and real estate both of whose averages around £230 an hour – are not even shown (for presentational reasons); neither is the government sector at £25 an hour. In terms of change, one of the notable features of the period since the crash is that productivity levels in the industries with the highest figure have dropped (energy, water, finance) while those in the industries with the lowest levels have seen some of the biggest proportional increases (administration, retail, agriculture).

[10] Source: https://www.ons.gov.uk/economy/economicoutputandproductivity/productivitymeasures/datasets/internationalcomparisonsofproductivityfirstestimates.

Figure 3: GVA/hour 2007 and 2016 (at 2013 pieces): selected industries[11]



The conclusion we draw from this data is that while raising the average level of productivity is the overall goal, the practical one must be stated at the industry level (probably at a lower level than the one shown in this graph). The point then is this: any increase in productivity in a single industry, all else equal, adds to the overall level of productivity. It doesn't matter whether the industry is already a high productivity one, or whether it has been one where productivity has been rising. It doesn't matter whether it has been deemed a "winner" on some criterion or "strategic" on another. Measures to boost productivity which cost public money need to face a cost benefit test: in essence, the potential gain measured against the cost to the public purpose (plus any opportunity cost to others). While we don't pretend this is either easy or uncontentious, it represents an approach in which details drive decisions, not high level decisions about politically important sectors.

What should social success look like? Unlike say investment (another candidate for the overall goal), productivity is an outcome, related to efficiency and ultimately income. This linkage is highly desirable but in itself, a more equitable distribution of income is not a proper measure of an industrial strategy. Rather, its human success measures should apply to the things over which it has greatest control. These are the labour supply outcomes, to do with skills, qualifications, opportunities and earnings. The still maturing inclusive growth agenda is interested in these matters. In

[11] Sources:
https://www.ons.gov.uk/economy/grossdomesticproductgdp/datasets/ukgdpolowlevelaggregates and https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/labourproductivity/datasets/productivityjobsproductivityhoursmarketsectorworkersmarketsectorhours

broad terms, the social impacts of the industrial strategy should be measured for the equity of its labour market outcomes as between the different equalities groups, especially gender, ethnicity and disability.

Proposition 4: much of the Strategy should be formulated and run at (in England) City Region level or, where that does not exist, by the LEP, with support provided by a National Economic Council.

Who should own it? In the UK's centralised state – just as true for Scotland as for the UK as a whole – central government needs to be part of the architecture to help initiate an industrial strategy and take the measures that are national and horizontal (like R&D incentives or competition policy) and also to bring broad sectors together.

But a plan owned and driven by central government alone is not enough. The problems of the supply-side identified above require; producer involvement and collaboration: a great deal of focus around place; and the bringing together of a number of policies and institutions.

We believe that as a rule, the sub-regional city-regions, especially where they have an elected mayor, are the key areas that should be running these strategies and they should be empowered to do so. Where this is not possible, LEPs are probably the best vehicle at present, although after the general election, it should be a priority to ensure that the powers which the city-regions are acquiring are extended to all corners of the country.

This gives far more chance that the business sector will become involved in and feel ownership of the strategy and it will encourage cooperation between industrial partners and coordination within and between industries.[12]

At national level we want to see a powerful body, chaired by the Prime Minister, which brings together at a high level all the departments that are relevant to our industrial strength (and that means many of them). The National Economic Council of the past is one model for this,[13] as is some of the architecture around the period that Michael Heseltine was Deputy Prime Minister.

In addition, one may want to add to this body – or more likely to supplement it with an independent body - that includes some of the key players from industry and so

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[12] However it is important to do this within a strong competition framework. EP2 describes competition policy as one of the successes of the past 20 years. If co-operation and co-ordination is not to decay into cartels, competition policy must remain paramount.

[13] https://www.instituteforgovernment.org.uk/blog/was-gordon-browns-economic-war-council-new-model-driving-pms-agenda

creates institutional arrangements that allow them to be party to decisions by others. Sectoral bodies may be needed in some cases.

As well as delivering the industrial strategy, this institution building improves the chances of continuity through periodic political change at the top. It also fosters a constituency to promote and defend the very idea of an industrial strategy: – those who would ‘rather … finance (and the landlord class) less proud and industry more content’.

Conclusion

Our analysis suggests that the British economy is far from being in rude health. An industrial strategy, based around the causes of this, and focused on productivity, delivered largely at the sub regional level is the way forward. Industrial policy is never easy and can quickly slide into special pleading. But this strategy must recognise the new situation that Brexit brings, especially with regard to the change that the end of free movement of (EU) labour brings.