

UK Industrial Policy and its Challenges

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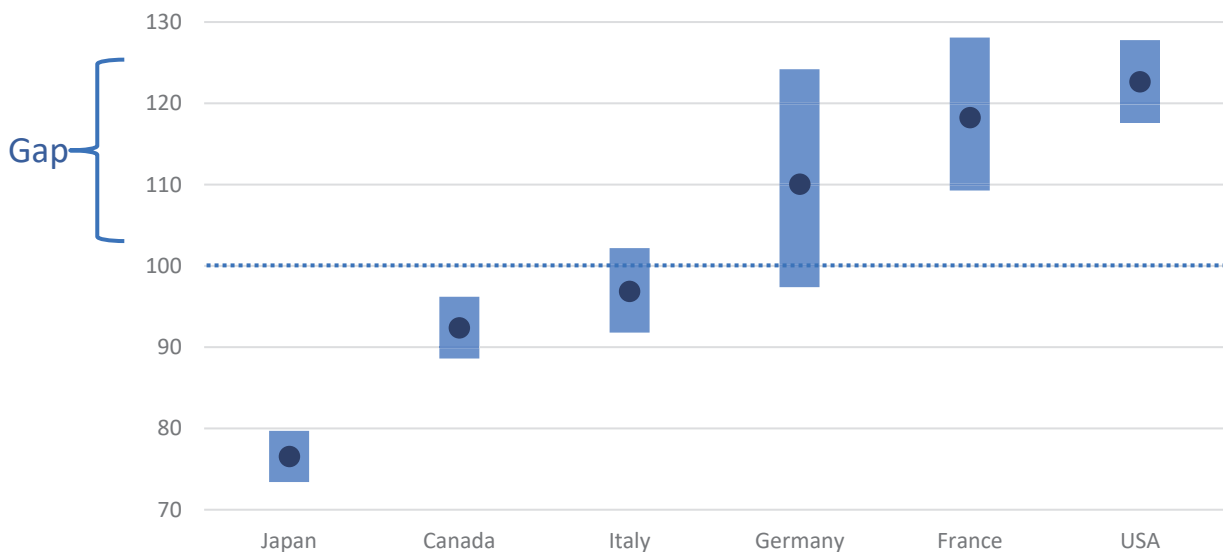
Background



The starting point for modern UK Industrial Policy is our relatively weak productivity performance

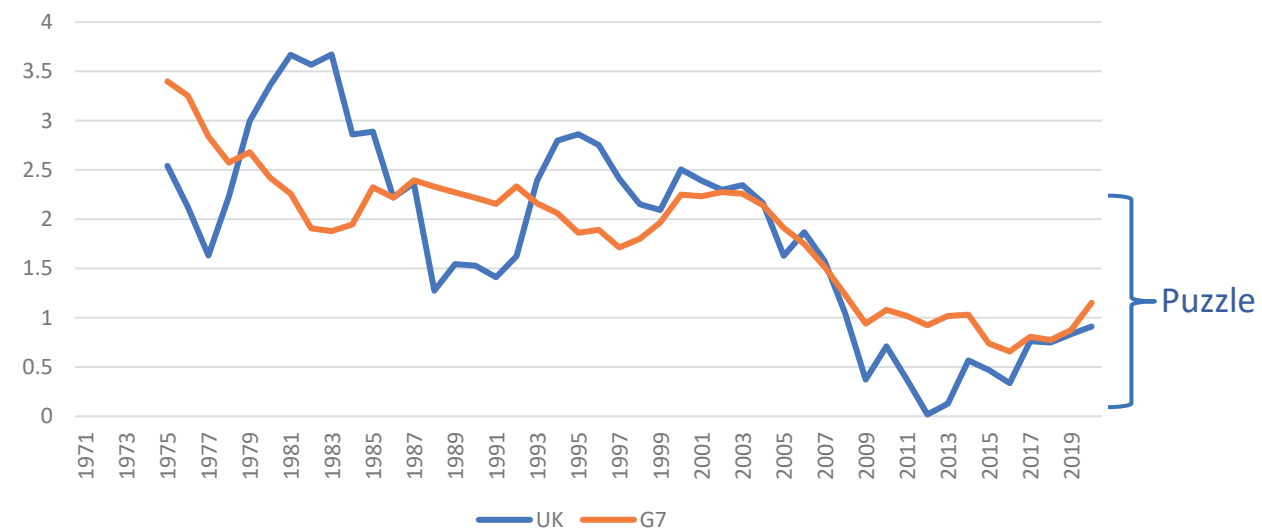
The UK has a longstanding **productivity gap** with France, Germany and the USA

Output per Hour Worked (2020, UK =100)



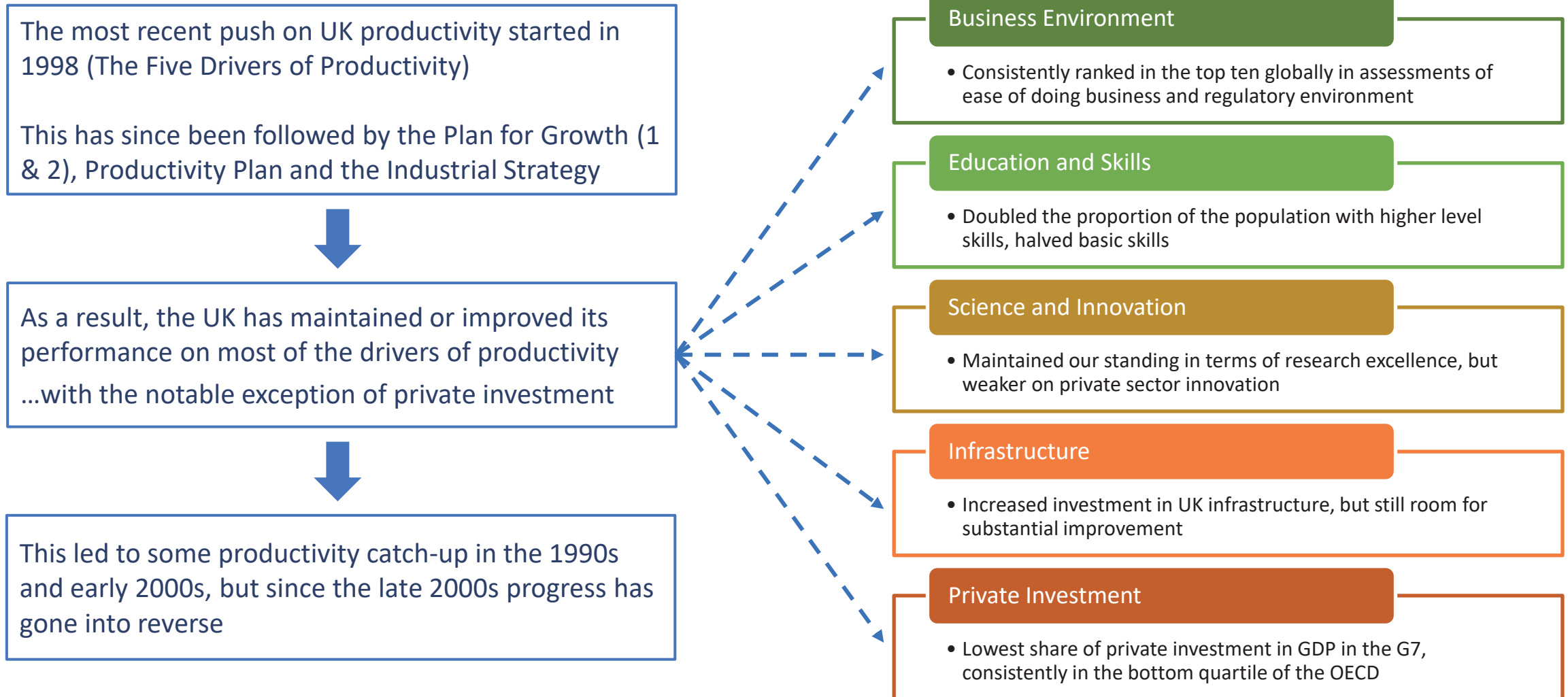
The UK has also had a more severe productivity slowdown (**productivity puzzle**) than other G7 countries

Annual Productivity Growth (% , 5 year Rolling Average)



- Although at least some of the UK's recent productivity weakness is likely due to a slowdown of the productivity frontier (Fernald and Inklaar 2022) – this does not help explain our longer run under-performance or why we were harder hit

This has been the subject of successive policy initiatives – but the end result is less than the sum of its parts



What have we been missing? UK policy has tended to focus too much on the What and not enough on the Who, How and Where

What (Horizontal Policies)

The common theme of the last three decades of UK growth and productivity strategy is a strong focus on **horizontal policies**
This is driven by the UK's bad experience of industrial policies in the 1960s – 1970s ('Picking Winners')

Who (Sectors)

Horizontal policies have differential effects across sectors and types of firms

Lack of thinking about the effects of policy across sectors leads to '*industrial policy by accident, rather than design*'

How (Institutions)

UK has been successful in establishing stable macro policy institutions (Bank of England independence, OBR etc.)

But micro-policy has been characterised by constant change

Where (Place)

An implicit policy assumption was that labour markets clear – people will move to places with jobs and businesses will move to places with spare labour

Although there is *some* truth to this, it is contradicted by falling mobility rates and long term under-performance of many UK towns

Change in UK Approach

Who: Our prioritisation framework considers sector potential, HMG objectives and the role for government

As part of the work to develop **Build Back Better: Our Plan for Growth**, we developed a framework to prioritise sectors, incorporating lessons learned from the Industrial Strategy 2017

(1) Future Growth Potential



Comparative advantage:

Specialisation creates economies of scale, leading to higher growth & productivity.

(Focus on what you are good at)



Future growth potential:

Seek to capitalise on growth to generate benefits for the wider economy.

(Focus on where future growth lies)



Technological progress:

Shift of the productivity frontier of sectors, and the economy, to boost long run growth.

(Focus on where the technology is going)

(2) Strategic Government Objectives



Net Zero: HMG has a legal obligation to achieve NZ by 2050, which will create new businesses, jobs and other opportunities across the economy.



Levelling Up: HMG has made regional growth a key priority, to rebalance the economy away from London & South East.

(3) Government Additionality



Market Failures: When left to market forces, the allocation of goods & services in certain sectors may be sub-optimal.

- Externalities, e.g. positive spillovers from R&D like new knowledge, or negative costs caused by pollution.
- Imperfect information between agents can create coordination failures or other imbalances.



Missing Markets: In new, emerging tech sectors, private investors may be unwilling to invest due to uncertain returns and the associated risk profile. This can lead to a missing market with no supply despite potential future demand.

Government can make the first move to establish the market and provide a signal to private actors to invest.



Infant Industries: Nascent markets are often too small and face high barriers to operate in global markets.

In narrow cases there can be an argument for HMG to support these sectors to support them scale-up and attain economies of scale, to enable these industries to eventually capitalise on global trade opportunities.

How: We have made some progress in building more long-term micro policy institutions



NATIONAL
INFRASTRUCTURE
COMMISSION
Better infrastructure for all

National Infrastructure Commission

Founded in 2015, this provides independent and expert advice to the UK government on how to meet its infrastructure challenges; and monitors progress on meeting these objectives



THE
PRODUCTIVITY
INSTITUTE

Productivity Institute

Founded in 2021, although primarily an academic institute it is specifically tasked with engaging with businesses and policy makers to provide practical solutions to their productivity challenges

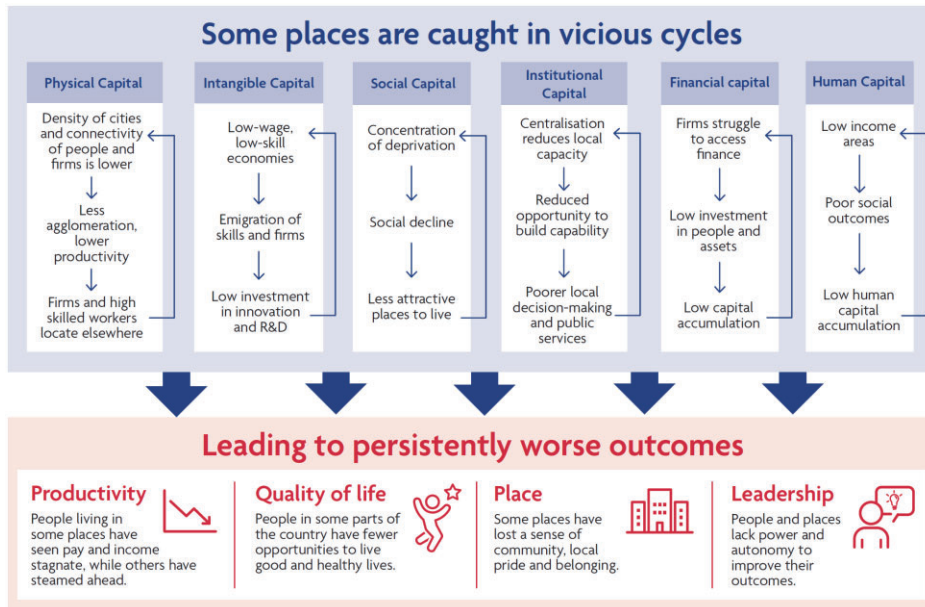


Levelling Up Strategy

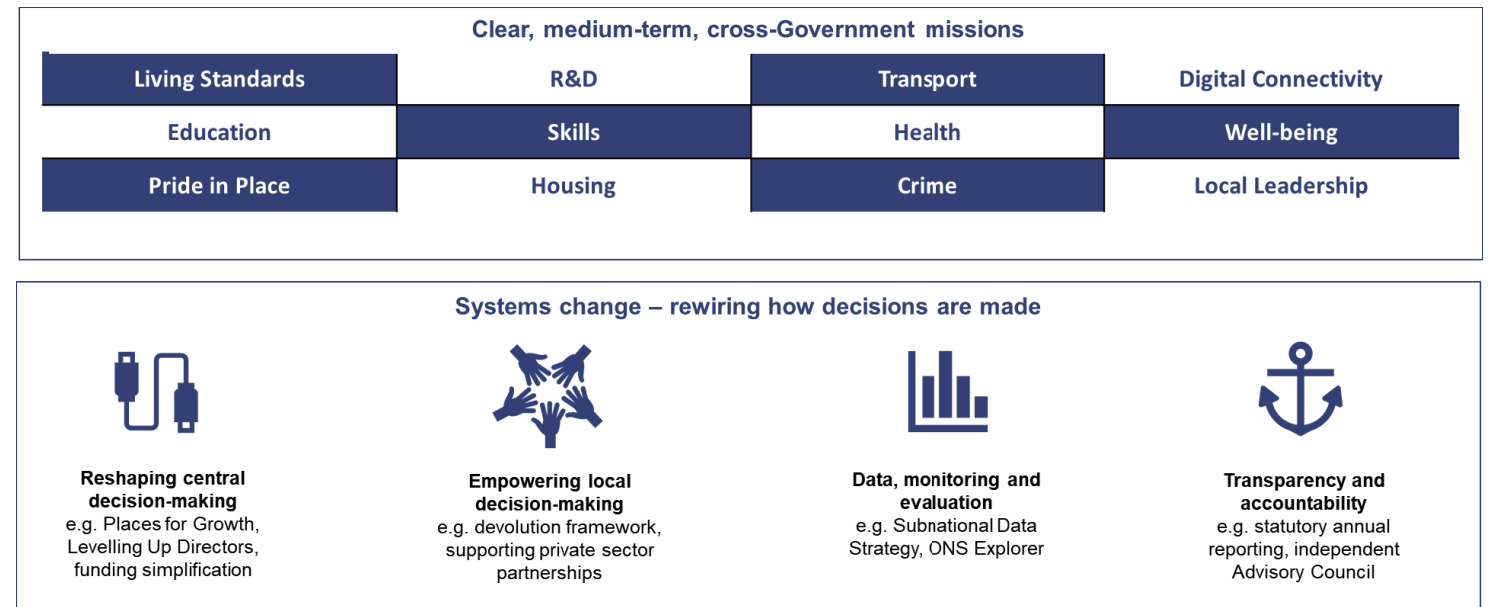
Published in 2022 – key recommendations focus on improving the institutions which make place based policy decisions, both at the national and local level

Where: The Levelling Up strategy is anchored in a wider view of what makes places successful and 'rewiring' government

Six Capitals Framework



Changing how (local) government decisions are made



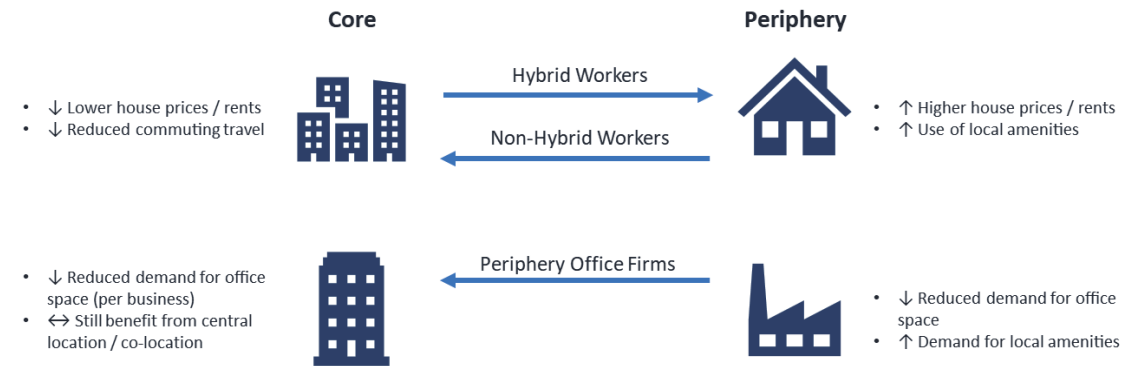
- **Six Capitals framework** tackles more than just low productivity and moves beyond a narrow definition of productive assets to incorporate social and institutional capital
- Key focus is building a **policy response with longevity, strategic co-ordination and local empowerment** – supported by better evidence, transparency and accountability

Challenges for the Future

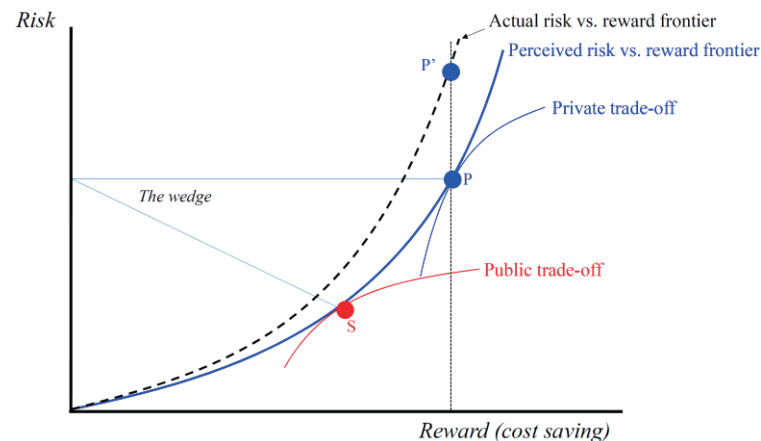
Following Covid-19 we are not returning to previous trends, but to a 'New Normal' – whose ultimate shape is not yet clear

- Shift towards **hybrid working** in the UK looks likely to be persistent and large (in those occupations who can do it)
- We do not think this will change the **central role of cities** in modern growth
- But it will **change when and where people live and work** – with implications for 'office adjacent' sectors / activities

Possible impacts of shift to greater teleworking



Risks vs Efficiency Trade-offs in International Supply Chains

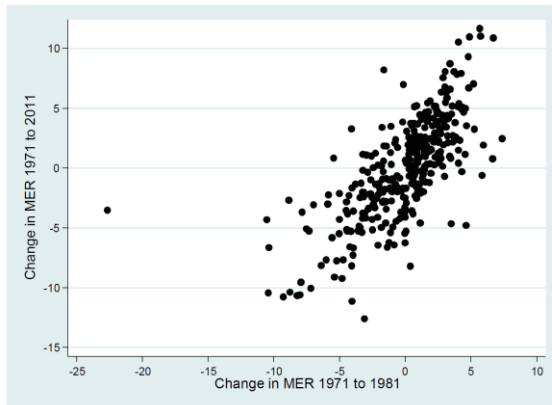


- Covid-19 along with the Russia-Ukraine crisis have also focused attention on **supply chain resilience**
- In particular the trade-off between **risk versus efficiency**, with the public having a lower appetite for risk
 - Supply chains using **Just in Time** production models are more efficient but also more vulnerable big shocks (Ortiz 2021)
 - But **nationalisation of supply chains** does not remove risk – it simply changes what and where those risks are

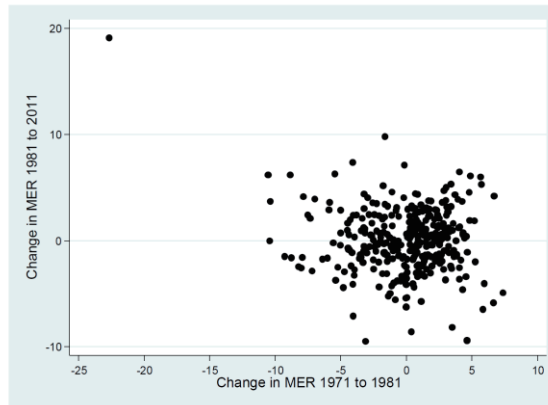
We cannot ignore the effects of path dependence which makes it difficult to disentangle sector and place based policies

Almost all UK towns who suffered a negative shock in the 1980s still lagged behind in 2011

(a) Change in MER 1971-2011 vs the shock.



(b) Change in MER 1981-2011 vs the shock.



Note: Male Employment Rate (MER)

Large scale government expenditure in one location has significant leakage to other locations

Heatmap of vacancies mentioning Hinkley Point



- New Economic Geography and Complexity Economics emphasise the importance of the different bundles of productive assets across places – these incentivise businesses who need those assets to co-locate
 - But very difficult for policy to create clusters or incentivise businesses to relocate to an underperforming area
- Once a location loses its more productive / higher skill activities, it can easily slip into a lower skill equilibrium as more productive firms locate elsewhere

Which is a challenge as the ‘big transitions’ – Automation, Digital, Net Zero etc. – play out differently across the economy

- Experience of the 1980s suggests policy has to get out ahead of any economic restructuring, or else it can be very expensive and difficult
- Some examples of where a proactive approach this has been a success (e.g. switch to natural gas, digital switchover) but the coming transitions much bigger in scale and scope

Automation



Although on balance likely to be neutral or positive for employment – will still *change* large numbers of jobs

Risk of job polarisation affecting the lower skilled (particularly the young)

Wider questions around job quality, wellbeing, legal accountability etc.

Digital



Some evidence of ‘J-Curve’ type effects in the adoption of digital technologies

Could widen productivity divergence as ‘followers’ lack the capacity to make the necessary complementary investments

Which in turn could lead to a slowing of knowledge diffusion and adoption

Net Zero



Smaller employment reallocation implications than automation

But potentially a much bigger challenge for business investment

Requires a wholesale ‘greening’ of our capital stock across all sectors – ‘nowhere to hide’

Any Questions?
