## UK Industrial Policy and its Challenges

Donna Leong

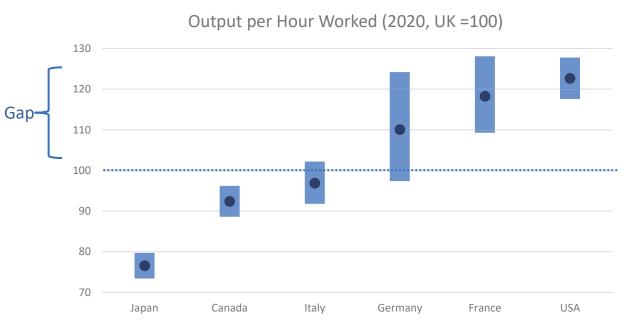
UK Department for Business, Energy and Industrial Strategy



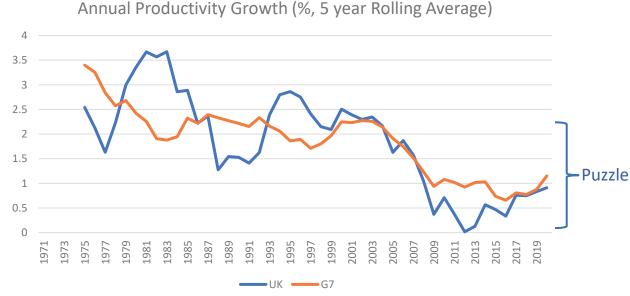
## Background

# 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



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



• 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

The most recent push on UK productivity started in 1998 (The Five Drivers of Productivity)

This has since been followed by the Plan for Growth (1 & 2), Productivity Plan and the Industrial Strategy



As a result, the UK has maintained or improved its performance on most of the drivers of productivity ...with the notable exception of private investment



This led to some productivity catch-up in the 1990s and early 2000s, but since the late 2000s progress has gone into reverse

#### **Business Environment**

• Consistently ranked in the top ten globally in assessments of ease of doing business and regulatory environment

#### **Education and Skills**

 Doubled the proportion of the population with higher level skills, halved basic skills

#### Science and Innovation

• Maintained our standing in terms of research excellence, but weaker on private sector innovation

#### Infrastructure

• Increased investment in UK infrastructure, but still room for substantial improvement

#### **Private Investment**

 Lowest share of private investment in GDP in the G7, consistently in the bottom quartile of the OECD

# 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.



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

### (3) Government Additionality

potential future demand.

**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

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.

# <u>How</u>: We have made some progress in building more long-term micro policy institutions



### **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



### **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**

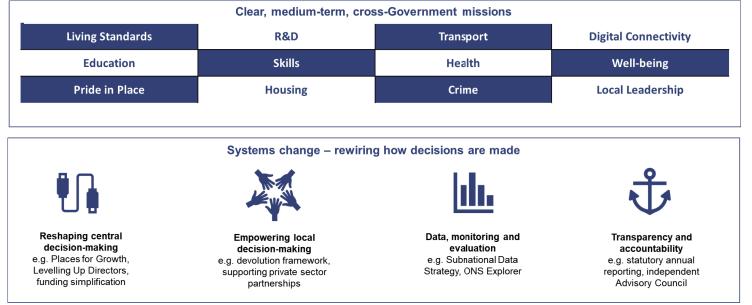
Published in 2022 – key recommendations focus on improving the institutions which make place based policy decisions, both at the national and local level

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

### **Six Capitals Framework**

#### Some places are caught in vicious cycles Institutional **Physical Capital** Intangible Capital Social Capital Financial capital **Human Capital** Capital Density of cities Centralisation Firms struggle Low-wage, low-skill Low income Concentration \_ and connectivity < reduces local to access of deprivation areas of people and capacity finance economies firms is lower Reduced Poor social opportunity to Low investment Emigration of Social decline outcomes agglomeration, build capability in people and skills and firms assets productivity Poorer local Low human Low investment Less attractive Firms and high lecision-making Low capital in innovation skilled workers places to live and public accumulation accumulation and R&D locate elsewhere Leading to persistently worse outcomes **Productivity** Quality of life People living in People in some parts of Some places have People and places some places have the country have fewer lost a sense of lack power and seen pay and income opportunities to live community, local autonomy to stagnate, while others have good and healthy lives. pride and belonging. improve their steamed ahead.

### Changing how (local) government decisions are made



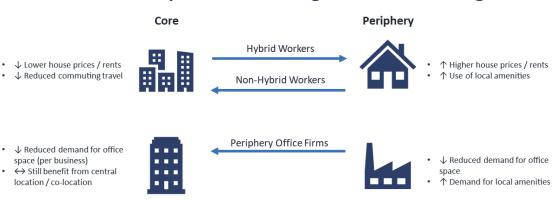
- Six Capitals framework tackles more than just low productivity and moves beyond a narrow definition of productive assets to incorporate social and institutional capital
- Key focus is building a policy response with longevity, strategic co-ordination and local empowerment supported by better evidence,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

## Challenges for the Future

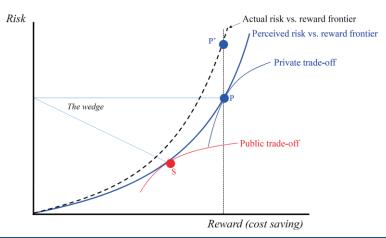
# Following Covid-19 we are not returning to previous trends, but to a 'New Normal' – whose ultimate shape is not yet clear

- 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

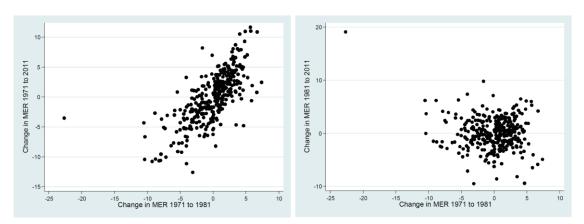
Source: Ortiz (2021) Spread Too Thin, The Impact of Lean Inventories; Baldwin and Freeman (2021) Risks and Global Supply Chains: What do we know and what we need to know

# 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.

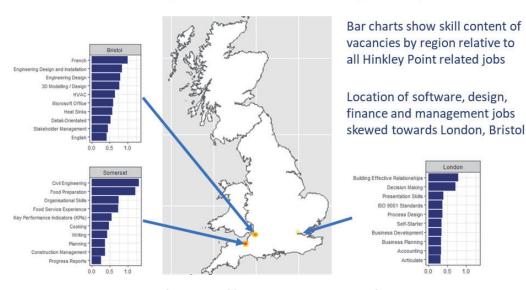
(b) Change in MER 1981-2011 vs the shock.



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 wholescale 'greening' of our capital stock across all sectors — 'nowhere to hide'

## Any Questions?