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Britain's Current Economic Policy; the Continued Absence of Strategic Involvement

David Bailey and Roger Sugden

1. Introduction

The landslide election of a new British government on lst May 1997 ended five years in office for John Major's Conservative administration, and eighteen years of uninterrupted Conservative rule. Humiliated after the ERM debacle in 1992, with its credibility in tatters, the Major government never really recovered. Despite reasonably good economic performance (by Britain's standards) since then, the Major government was plagued by division over Europe, and weakened by a precarious parliamentary position. The Labour government, in contrast, now enjoys a huge parliamentary majority and is in a position to deliver on its election promises. The economy is also in reasonably good shape, superficially at least. The prospects look good - but do the policies? This paper will ask: what is the current British government offering in terms of economic policy? In doing so, it will focus on industrial policy,

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given the weakness of Britain's industrial base.

The paper will begin by setting the scene by outlining the broad characteristics of industrial policy in Britain over the past few decades, before moving on to outline what may be considered as the key economic problems faced by the government in promoting industrial development, and finishing with an evaluation of both what it is doing now and what it is offering for the future.

2. British Industrial Policy: a brief historical sketch

There is much disagreement on how best to characterise British industrial policy since the Second World War (Reynolds and Coates, 1996). Cutting through that debate, some of the key words which can arguably be used to outline policy would be: *discontinuity; inconsistency; reactive;* and *liberal. Discontinuity* has come with sharp reversals of policies as the ideologies of governments have differed, for example with nationalisation in the 1960s and 1970s followed by privatisation in the 1980s and 1990s. A concern to promote large firms or "national champions" in the 1960s and 1970s gave way to a desire to support smaller firms later on. Similarly, a desire to support the manufacturing sector in the 1960s and 1970s gave way to a neutral approach in the 1980s. One major exception to this has been the continuity seen in policy towards transnational corporations, with both foreign- and British-based transnationals being given a free rein over many years, and with an intensification of efforts to attract foreign transnationals in the 1980s (Bailey *el al*, 1994).

Inconsistency has also been seen in many areas of policy. In competition policy, for example, governments have accepted the need to correct

for market failures, whilst at the same time maintaining weak and ineffective monopolies and mergers policies (Pitelis, 1994). Moreover, some authors have argued that British experience has been one of industrial policies without an industrial strategy (Cowling and Sugden, 1993). Following Pitelis (1994), industrial policies can be seen as measures designed to improve the performance of industry, whilst an industrial strategy consists of a well thought-out set of industrial policies that are reasonably consistent and coherent with the aim of realising well-defined, long-term objectives. British experience is thus seen as different in comparison with perceived Japanese policy over many years.

Taking this further, *reactiveness* is seen in policy being characterised by re-active, *ad-hoc* measures taken in response to crises, whether the collapse of British Leyland, the crisis in the coal industry (Cowling and Sugden, 1993), or more recently the BSE scare in the beef industry. Reactiveness is also seen in the motivation of government intervention itself. A reactive policy can be defined in terms of a policy which solely reacts to correct market failures (externalities, public goods, monopolies...). In contrast, as Jacquemin (1987, in Oughton, 1997) notes, a more positive policy goes beyond market failure, and considers strategies which "deliberately influence the transformation and the industrial reorganization of sectors, and nations", noting that "in many sectors comparative advantages are based on partially controllable elements". He points to policies that might alter the accumulation of physical and human capital over time, which in turn might alter relative capital endowments. The experiences of MITI up until the 1970s at least could be seen as such a pro-active approach, in contrast with British experience. A proactive strategy would also be necessary to address some of

the systemic deficiencies arising in market based economies; problems of transnationalism, centripetalism and short-termism (Cowling, 1990).

Finally, and connected with this reactive approach, it can be argued that British industrial policy has been *liberal*, built on a belief that industrial performance is best left in private hands, assisted only at the margin by state activity (Reynolds and Coates, 1996). As Wilks (1983, in Reynolds and Coates, 1996) notes;

a major operational value of British industrial policy is not maintenance of market principles (as in Germany)... or the productivity of the enterprise (as in Japan) but rather a concern to sustain the autonomy of the firm. This concern might be regarded as the purest of market principles or, more correctly, as the ultimate market ethic, since it really presupposes that national economic benefit (good of all) is derived only from the individual's (in this case the individual firm's) interpretation and unfettered pursuit of personal benefit.

More recently, the government's 1994 Competitiveness White Paper noted that the "essential conditions for Britain's economic success are low inflation, low taxes, free trade and freedom from excessive state interference".

This is not to say that there have not been specific interventions at certain points in time, for example in intervening in the 1960s and 1970s to encourage large size and to "pick winners" (Pitelis, 1994). However, these sectoral measures were arguably withdrawn in the 1980s (a period of withdrawal of support, and a decline in regional expenditure and privatisation), with a refocusing around horizontal measures with the aim of "providing the right underlying conditions to catalyse and facilitate growth in the context of declining trade barriers and increased competition" (Oughton, 1997). However, as Oughton notes, such

a withdrawal was not complete; with 60% of the government R&D budget remaining spent in just two sectors - defence and civil aerospace.

With this concern for productivity growth, so-called "competitiveness" became the key goal of industrial policy under the previous Conservative government, and is set to continue under Labour with the appointment of several business people to key advisory and ministerial posts, such the former chairman of BP, Lord Simon, now Minister for Trade and Competitiveness in Europe. However, whilst the role of investment in broad capital was seen as essential to improving the growth rate of the economy, the previous Conservative government did not identify any British under-performance in investment in fixed and intangible assets, and therefore felt no action was necessary to improve the rate of investment. Thus there were key differences in objectives between the EU and Britain. The former prioritised the promotion of full employment, and hence the need to raise investment rates in Europe so as to increase capacity and productivity, whilst this was not explicitly recognised in Britain (Oughton, 1997). It seems that the new government has shifted the position on this, recognising British deficiencies in this respect, although it is not clear at this stage what the government is willing to do to tackle the problem.

3. Promoting Economic Development

Before outlining what might need to be done to promote economic development, one needs to examine and identify the problems faced by the British economy. In doing so, attention will be given to the regional dimension, using the example of the West Midlands economy, the

manufacturing heartland of Britain.

With this in mind one particular concern is the fundamental deficiencies that result from the concentration of decision-making power in large corporations. These corporations are where the strategic planning takes place for our economies. In other words, these large corporations make their decisions over investment, the rate and direction of technological change, wages, where and what to produce, levels of employment, etc. in their own interests, and these decisions have a dominating influence on the regional and national economies in which the firms do or do not operate. For example we have seen this in the past over decisions by car producers in Britain, and one of the worries about Rover being controlled by BMW is that decisions over Rover's future are now taken in Bavaria, Germany. Likewise decisions crucially affecting the future of Rover's suppliers in the West Midlands and elsewhere. Similarly there is worry over Jaguar's position with Ford, the relationship between Detroit and Coventry. Some may argue that all of this is fine-after all, for example, Ford is to produce the new Jaguar XK8 in the West Midlands. However, it is only doing so after intense lobbying, a subsidy of several hundred million pounds from the government and arguably increasing job insecurity and worry for both the employees of Jaguar and for all of those smaller firms in the region dependent on Jaguar's existence. Overall, then, a fundamental difficulty faced by an economy such as the West Midlands is its position at the periphery, and its dependence on key decisions made elsewhere (see Cowling and Sugden, 1994, for more details).

Associated with this difficulty, the economy is allegedly plagued by so-called "short-termism". In part this arises because the key long term decisions are made within the large corporations which are divorced in

many instances from any long term commitment to a particular locality. But also it might be argued that the British economy in general suffers from the short-termism imposed on it by the institutional arrangements making up its market system, including the City of London, the banking institutions, and government competition policy (ie the lack of effective takeover regulation). A key outcome of such a problem has been inadequate investment. Despite the Conservative government's belief that this is not a problem, international comparisons of investment per employee indicate that Britain has one of the worst performances amongst OECD countries (see Oughton, 1997). The reasons for this are complex, but may include: heavier use by British firms of equity finance, and the associated problem of the arms-length relationship between banks and industry; the tax treatment of retained earnings and dividends; high variation in cyclical demand; low rates of return in British firms; and the weakness in competition policy which allows a highly active market for corporate control. As we will see, some of these factors are being considered by the new Labour government, whereas others are not.

What should done about these problems? One of the most crucial areas to consider, if one accepts the argument that concentration of key decision-making in the large corporations is a major problem, is to nurture the successful development of smaller firms. Moreover in addressing this issue there is widespread evidence from successful, in particular regional, economies around the world that what really matters is the nurturing of appropriate groups of small firms. These might be seen in terms of what Miller and Sugden (1995) term "small firm webs"; the idea is that smaller firms can mutually support each other in evolving close, long term and trusting relationships, which

experience suggests would be especially innovative and dynamic. What seems to matter is not simply that firms work in groups, but that these groups comprise firms that systematically and coherently link together across a range of activities to exploit jointly R&D opportunities, training initiatives, marketing activities, and so on, rather than coming together to exploit an essentially *ad-hoc*, short-run opportunity.

Associated with this, it might be seen to be crucial to foster appropriate institutional arrangements to promote long term planning of industrial activity within and by the smaller firms. For example, this would ideally include the development of a banking system solidly rooted and growing out of the traditions and culture of a particular locality, fully aware of the needs of industry in that locality. Again there is international experience - for example from Italy, Germany and Spain - implying that this is vital.

This also leads on to the issue of competition policy. It seems clear that there is an acute need for a policy which prevents takeovers that establish and further the dominance of the large corporations. This would in turn force and enable many firms to think long-term because they would realise that growth through acquisition might not be viable, and because they would be free from peering over their shoulders at potential predators in the takeover market. This might imply, for example, a total ban on mergers over a certain size. Of course arresting the adverse spread of large firms would not be simply negative; it might positively assist smaller firms to enter the market; what has been said already about encouraging smaller firms is itself a crucial aspect of competition policy.

Developing still further this concern with small firms, training must be given a high priority. Transferable skills and adaptability as well as

best practice in particular industry sectors must form the basis of any training policy. Again what appears to be especially important is to identify the needs of smaller firms. This would seem to imply the need for coherent regional policies on education, whereby appropriate partnerships are formed between groups - or webs - of small firms and local educational institutions, schools, colleges of further education, universities, technology centres and so on. These initiatives need to be designed and implemented within the regions; the idea of a national blueprint seems ill conceived.

Lastly, tax policy needs to be consistent with, and as far as possible support, the activities of smaller firms, and to be conducive to long-term thinking and planning. Some fairly simple taxation changes could have quite dramatic effects on small companies, for example in freeing up working capital for them. However it would also appear that tax policies alone would be far from sufficient to achieve the sorts of effects contemplated here. It's to this that we turn first.

4. The Government's Approach

4.1 Changing the Tax System

One idea Labour floated in its election manifesto was to create tax credits for R&D. Whilst increasingly seen as having been beneficial in the US, there is an inherent danger involved in their use, in that tax credits for R&D are likely to benefit large firms most of all - because it is these firms which have formal R&D labs, and which formally account for most R&D expenditure - yet not necessarily for actual R&D output (See Geroski, 1990). Small firms are therefore not likely to benefit greatly from such as approach. In other words we need to look

beyond tax policy to foster innovation in small firms.

An aspect of tax policy which might be useful, however, is concerned with short-termism. Here the Chancellor Gordon Brown acted virtually immediately, altering the tax system in the first budget to eliminate the tax advantage to firms from paying out dividends rather than retaining profits. The hope is that the latter will be boosted, in turn helping investment. Whether this will have much impact is debatable - we will have to wait and see on this, but it seems at first sight a useful *initial* step. Another government proposal is to change the tax system to encourage longer term shareholding. Details have not been spelled out yet, but this could involve a sliding scale capital-gains tax (implying that the tax reduces the longer the shares are held). This would arguably be a move in the right direction although again one doubts the strength of its impact if taken as an isolated measure.

4.2 Training

On training, Labour has dropped its unpopular idea of a levy (where firms not training up to a "desirable" level were to face a levy, or tax). Instead it now proposes "Individual Learning Accounts", to which individuals, the state and employers are asked to make financial contributions, but with the individual making the decision over the direction of the training. On face value this may be beneficial, but alone will not be enough to tackle Britain's training deficit. The failure of the TECs ("Training and Enterprise Councils") also needs to be addressed, both in terms of their lack of democratic accountability and their lack of responsiveness to regional needs. As Mawson (1996) notes, the imposition of a national training "straightjacket" has made it difficult to adjust to local needs and circumstances. New, local organisations will

need the freedom to identify local needs and to construct strategies to tackle them, a freedom which is missing at present.

4.3 Competition

On competition policy, Labour's proposals have been consistently watered down. It had proposed before the election a new institution responsible for administering takeover rules, and under these the bidding firm would have to demonstrate that the takeover would lead to an increase in efficiency and serve the public interest. This would represent a change in the onus of proof compared to existing legislation, and such a body would also, it is claimed, be more active in seeking out and addressing anti-competitive practices. During the election, however, such (already limited) ideas were diluted further, for fear of offending the business community (Labour being keen to be seen as the pro-business party). All that is left is the desire to enforce existing legislation more effectively, as was seen in the initial refusal to allow the takeover of Carlsburg by Bass in the brewing industry shortly after the election.

In general, the government seems excessively timid over competition policy. It has rejected the idea that it should "throw some grit in the wheels of the takeover mechanism". But why not? Study after study show the disruptive impact of takeover on companies' activities, with post-takeover profits usually not rising (ie extra monopoly power post-takeover being negated by other efficiency losses). Furthermore, the constant threat of takeover forces management to waste time over putting in place defensive arrangements and to think short-term. The takeover-mechanism simply does not operate the way many text books tell us. It is not inefficient firms which are acquired by efficient ones,

and as a result the benefits of such a high level of takeover activity are largely illusory. This is compounded by the hundreds of millions of pounds wasted every year through takeovers on merchant banks' fees and the like. A tougher approach is needed.

4.4 Regional Development

Perhaps most promising is that the government proposes the creation of Regional Development Agencies to co-ordinate economic development, encourage technology transfer (albeit it is unclear between whom and for what purposes), to bridge the gap between small firms and providers of finance, and to improve small business advice and support through more effective cooperation between local agencies. This is clearly in line with some of the suggestions above concerning what would be desirable. In principle there is considerable scope for more imaginative policies via these Regional Development Agencies in encouraging the creation of small firm "webs", perhaps through tying in with the Chambers of Commerce, thus taking advantage of existing links between firms, and with Local Authorities. However, at the time of writing, there appears to be something of a conflict going on between the Deputy Prime Minister (who is also responsible for the Regions, Environment and Transport) and the Education Secretary who wants to keep control of training. Who wins will determine the shape of these new agencies; the danger is that they will end up as agencies simply attracting inward investment, which may do little to build indigenous capabilities.

4.5 Finance

In another promising angle to policy, Labour had developed ideas

before the election for a government investment agency, on which talks with major banks and leading venture capital companies have been held. The idea is for the proposed agency to underwrite a certain proportion of the equity invested by a venture capital firm in fledgling firms. This effective subsidy could be repaid out of profits, with the government thus retaining an interest in the firm. Such an agency would be located in the Department of Trade and Industry and would also be a focal point for assistance for small firms (The Guardian, 28/8/95). This is very promising.

However, critics might point to the perceived failure of the National Enterprise Board under the last Labour government in the 1970s, which was accused of taking on and rescuing "lame ducks" like British Leyland. The purpose of any investment agency under the current government would have to be diametrically opposite in fostering the development of small firms. An appropriate regional structure to such an agency might help to prevent any central tendency towards protecting large firms again emerging to hijack policy. This does not mean that large firms would not benefit at all from such an agency. It might facilitate the development of industry-specific strategies which could benefit all firms in that industry. However, its focus will have to be in encouraging small firms if past mistakes are to be avoided.

Therefore the government might usefully think about extending such an investment agency into the regions, perhaps in the form of Regional Development Banks (RDBs). There is certainly a strong case to be made for these. The idea is that the RDBs could build closer, long-term links with local industry (especially local small firms) than exist at present, hopefully offering advantages in terms of lower information costs, accelerated bank-learning after recessions, avoiding high collat-

eral demands, and in assisting the development of clusters or webs of local firms (Kelly et al, 1995). It is quite feasible that they could operate as private sector entities. Much might be learned for example from the operations of the 3i venture-capital company: it is regionally-based, lends long-term and was originally established through state initiative but now operates in the private sector. Such banks might also act to spread stakeholder values (see Bailey and Clancy, 1997).

Such an approach could go some way to overcoming the short-termism inherent in the banking system. At the moment we see arms-length, uncommitted banking with finance for small firms often provided on an overdraft basis. Reinforcing this hands-off attitude towards small firms has been a trend towards increasing centralisation of decision making over lending decisions outside the region, in banks' head offices (Cowling and Sugden, 1994). Whilst Soskice (1996) makes an important point in arguing that Britain cannot simply import elements of, say, Germany's or Japan's (more long-termist) banking system as transplanting institutional policies across systems rarely works, there is still scope for government initiative, for example in setting up RDBs, providing a catalyst for change of the present system from within.

Labour has flirted with such ideas. Its pre-election policy document *Winning for Britain* proposed establishing regional investment agencies which would in part "act as catalysts for new regional investment banks dedicated to mobilising savings generated in each region... focusing particularly on the needs of small and medium sized firms". What is ultimately needed is a network of regionally-based organisations supporting webs of small-firms, and which need to be receptive to, and supportive of, initiatives coming up from the local level on such

matters as joint training, marketing, R&D and so on. This also links into reform of local democratcy; for example what will be the relationship between regional development agencies and the proposed new structures for regional government?

4.6 Corporate Governance

The government's proposals on corporate governance and the so-called stakeholder economy are perhaps worthy of comment. Here at least there is a recognition that stakeholders are not just shareholders but also workers, suppliers, customers and banks. Evidence from dynamic regional economies elsewhere suggests that Britain has much to learn in recognising a wider community of interests. There would seem to be a role for government here at least in spreading what is seen to be best practice, and the dispersion of interests perhaps seen in the stakeholder concept is possibly in line with concerns above regarding the concentration and centralisation of key decision-making in the large corporations. Potentially, the concept is far reaching. However Tony Blair's statement that stakeholding will not involve any legislative changes suggests little will be done to alter corporate governance arrangements which put the shareholders first. It requires a change in business culture so profound that it is impossible to achieve on a purely voluntary basis. Only recently the President of the Board of Trade (in effect the Minister for Trade and Industry) Magaret Beckett criticised business' proposals for changing corporate governance, arguing that short-termism would not be curbed without more far reaching measures. However, the government is being naive in thinking business will do much of its own accord - this is one area where government action is essential in driving change. Much might be learned from experience

elsewhere, such as Germany and Japan, where corporate governance structures seem to help in fostering more long-term thinking (see Hutton, 1995).

4.7 Europe

Turning to look at economic policy more generally, a number of issues will impact on how British industry will perform in the short- and medium-term. The issue of EMU (European Monetary Union) is never far from the headlines. Getting the decision right on this (whether, and if so, when to join) will impact on businesses in various ways. Firstly it will impact on the value of sterling as international investors look to see what will happen. Entry, if it finally happens, will also impact by reducing uncertainty and exchange costs for business, whilst at the same time removing the devaluation option as an adjustment mechanism for the economy.

In reality the government is set to continue the inherited Euro-sceptic outlook, critical of further political integration in Europe. There has been symbolic change, for example in adopting the Social Chapter on workers' rights, but little else has altered. The government has kept the previous "wait and see" attitude to joining EMU, having ruled out membership for this parliament (ie until 2003 at the latest). However, it has indicated that it could consider joining after the next election, assuming that both Labour wins and that EMU appears to be working. Desperate not to be accused of being "soft" on Europe, Labour anyway committed itself during the election to a referendum on membership. This is now a key political constraint for the government, as public opinion is overwhelmingly negative, and the government would lose any vote if it put EMU membership to the test in the short run. Time is

needed to campaign for a "yes" vote.

On the economic side there are two problems; one cyclical and the other structural. Cyclically the British economy is further ahead than continental Europe, reaching the peak of its cycle, with correspondingly higher interest rates than the rest of Europe which is just emerging from recession. A single monetary policy across Europe would mean much lower interest rates in Britain than at present, with either the risk of unleashing inflation or a much tighter, off-setting fiscal policy being required. As the latter is deemed off-limits politically, the government hopes to hold things steady until the rest of Europe catches up in the cycle. This is a risky strategy, though, as so much can happen in the mean time.

Structurally the British economy is different in a number of ways from the rest of Europe, for example in being more sensitive to short-term interest rates, with both companies and individuals holding more debts exposed to variable interest rates. Britain could hardly be said to form part of any "optimal currency area" comprising Germany, Denmark, Austria, the Benelux and maybe even France. Little is being done to tackle such structural differences and to prepare the British economy for entry, however, raising questions about the government's real commitment to join, or perhaps questions about its appreciation of the economic consequences.

4.8 Macro-Economic Policy

On monetary policy the government acted immediately on entering office by handing over control of interest rates to the Bank of England. Giving the Bank operational independence meant that the interest rate rises deemed necessary by the government could be taken without

political criticism for itself. This was a shrewd move in party-political terms, but raises fundamental questions of democratic accountability. After all, a key reason why the previous government was not re-elected was because it had made a mess of monetary policy during the 1992 ERM crisis. Whatever the failings of the British democratic system, the government was held accountable for what happened. The Bank faces no such democratic accountability. We also wonder whether this is just another "miracle cure" for the British economy, like the ERM and the "Medium Term Financial Strategy" were under Thatcher, and incomes policies under the previous Labour government. A correlation between Central Bank independence and low-inflationary performance does not imply causation, and simply imposing independence may do nothing to improve long-term performance. Where independent central banks appear to have worked, as in Germany, it may be due more to a shared value-system in favour of a tight monetary policy, a consensus built in this case on experiences earlier this century with hyper-inflation. There is no such shared value system in Britain and the "top down" imposition of an independent Bank of England may not have the same effects.

Not surprisingly, the move is having very severe consequences for industry. The Bank, which always took a more hawkish line on the inflationary outlook than the previous Chancellor Kenneth Clarke, is keen to establish anti-inflationary credibility, and has raised interest rates on several occasions since the election. The result of this tight monetary policy has been a rapid appreciation for sterling, which has got back to levels not seen since pre-ERM crash days in 1992. The fear is that Britain is repeating the mistakes of the early 1980s, when the manufacturing base collapsed under an excessively tight monetary policy and over-valued exchange rate.

This raises the question of whether the mix between monetary and fiscal policy is right. It can be argued that macro-policy is too unbalanced for the health of industry, that monetary policy should be loosened (benefiting industry by lowering interest rates and aiding a depreciation of sterling) and instead fiscal policy tightened. Unfortunately the government has given itself no room for manoeuvre. In another election pledge, it committed itself to not raising income tax during this parliament. It seems determined to stick to this commitment, even though on entering office business leaders actually called for tax rises to stem inflationary pressures rather than interest rate rises. The irony is that the government is keen to be seen as pro-business, but on this occasion ignored business' advice.

A looser monetary/tighter fiscal mix would not only have direct benefits in terms of assisting industrial development, but could also offer the prospect of raising revenue for the government to spend on education, infrastructure and an industrial policy with teeth. In summary, macro-economic policy is too orientated towards what may be seen as politically acceptable (ie not raising taxes) than what is needed for industrial development. This is probably the most telling evidence that the government has no concept of an over-arching industrial strategy, as it would not be imposing such an austere macro-economic policy if its main objectives were industrial development. The Thatcherite neo-liberal agenda of low-taxation and a minimalist role for the state remains firmly in place.

5. Conclusion

Industrial policy in Britain over the past few decades has been

described as "discontinuous, inconsistent, reactive and liberal". Whilst a few important and useful measures are likely to be made by the new government - such as tax changes to encourage more long-term thinking and the creation of regional development agencies - it might seem little is set to change fundamentally (except that at least there will be a degree of continuity!). Thatcher may have been replaced by Major and now Blair, but the Thatcherite agenda remains firmly in place. The new government offers nothing in the way of an "industrial strategy" which will tackle the key problems of the concentration of decision making power within large corporations, and short-termism. As several other critics now note, Britain is not in a position where growth and prosperity can be achieved without strategic involvement by the government and other actors. Problems are being further compounded in the short run by an unbalanced macro-economic policy which is handicapping industry. The danger is that as soon as the current boom fades, the old symptoms of stop-go, low-growth, unemployment, insecurity and declining public services will re-emerge, and with it may be lost the chance to restructure the economy.

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