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# **REBALANCING THE ECONOMY (OR BUYER'S REMORSE)**

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# REBALANCING THE ECONOMY (OR BUYER'S REMORSE)

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**ABSTRACT<sup>1</sup>**

*This paper argues that 'rebalancing the economy' is an empty rhetoric which does not engage with long standing problems in the British national business model which is distinguished by an unsustainable dependence on publicly funded job creation and an unproductive reliance on housing equity withdrawal. Equally, New Labour and Coalition policies do not engage with problems about broken supply chains and long-run problems about cyclicalities without output growth in manufacturing. Hence the case for new kinds of sector specific tax incentives to expand output, invest in capacity and upskill the workforce.*

**KEY WORDS:** *rebalancing, manufacturing, supply chains, value added promotion*

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<sup>1</sup> Free download available from <http://www.cresc.ac.uk/publications/rebalancing-the-economy-or-buyers-remorse>

## **REBALACING THE ECONOMY (OR BUYER'S REMORSE)**

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“our economy has become more and more unbalanced, with our fortunes hitched to a few industries in one corner of the country, while we let other sectors like manufacturing slide.....It has become far too dependent on the public sector, with over half of all jobs created in the last ten years associated in some way with public spending”

*David Cameron, new PM's first speech on the economy, 28 May 2010*

“(buyer's remorse is) an emotional condition whereby a person feels remorse or regret after a purchase (because of) the person's concern they purchased the wrong product...Buyer's remorse can be caused or increased by the knowledge that other people will later question the purchase or claim to know of better alternatives”

*Definition in legal dictionary by the free dictionary.com*

‘**R**ebalancing’ is a novel trope that has recently come into widespread use in discussion of British economic problems amongst the political classes and the metropolitan media. As in the quote above from David Cameron, to talk of “unbalanced” is to point to unease *inter alia*, about the dependence on public spending, the sectoral composition of private economic activity, regional disparities and the question as to where new jobs will come from in the future. Unsurprisingly, when the problems are so multifarious and diffuse, it is easier for the political classes to discover “unbalance” than to identify the policy levers that will deliver any kind of rebalancing solution.

In some ways, this new discourse on ‘balancing’ represents a welcome shift by mainstream British politics in the post-financial crisis world. The move takes us from previous hubristic complacency about the role of the State, the decline of manufacturing, the rise of financial services and knowledge industries and the capacity of the economy to create jobs. However, we suggest that thus far the shift represents no more than a kind of buyer's remorse by the political classes. Buyer's remorse is another recently popularised trope which only entered the Oxford English Dictionary in the 2005 revisions, and is still best defined on the web by freedictionary.com. Buyer's remorse denotes regret about a purchase that cannot be easily or

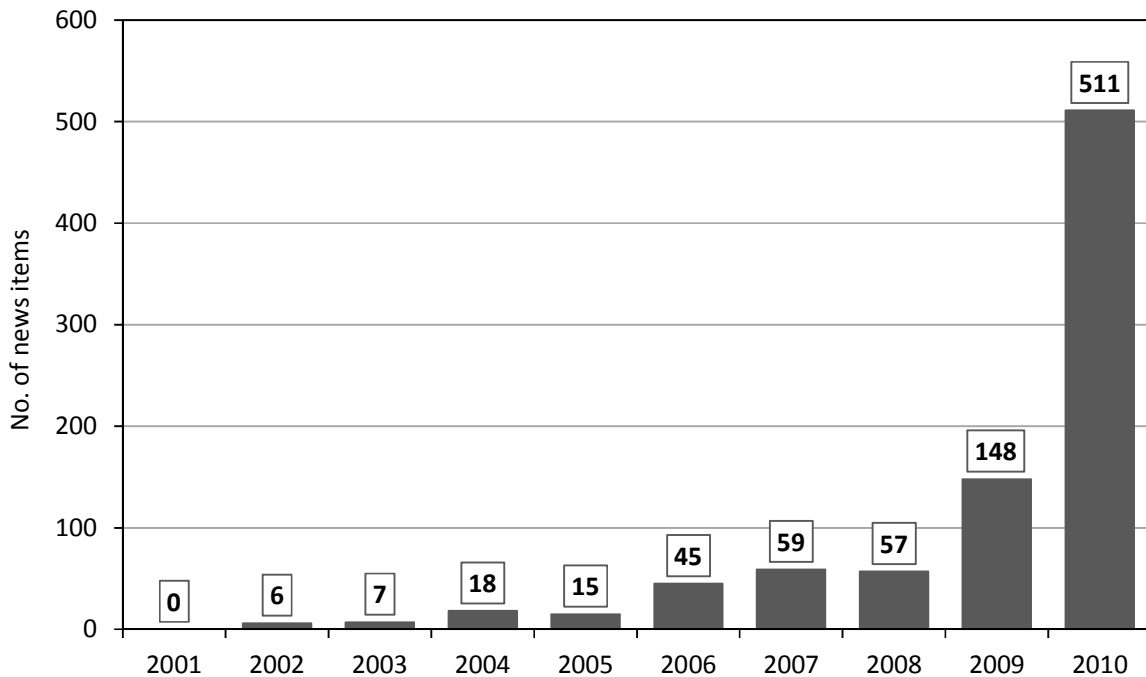
costlessly reversed. And that, we will argue, is the immediate problem with the unbalanced economy because the multiple symptoms of 'unbalance' are not easily addressed, managed or reversed by the mix of available policy instruments carried over from the previous period of complacency. Crucially, discussion of the absence of balance fails to recognise that these deficiencies are not recent pathological developments of the New Labour years but are embedded in a long-standing national business model where issues about dependence on public sector job creation and private sector imbalances date from the Thatcher years in the 1980s. So, as we argue in our conclusion, an altogether more radical approach is required which starts by exploring the underdeveloped 'how' of rebalancing.

In the first section of this report, we explore *what* is to be rebalanced. We present a brief account of the very recent growth of a new discourse, based on a simple content analysis of media coverage and major political speeches which illustrate the changing usage and growing popularity of the balancing trope. This first section is about 'what' is to be rebalanced and it ends by focusing on the policy *a priori* assumptions embedded and implicit in the discourse of rebalancing, assumptions that are challenged in the next two sections of empirically based political arithmetic. In the second section, about the 'when' of balance, we note that while complaints about unbalance are recent, problems of regional imbalance or dependence on public sector job creation date back to the 1980s. We then argue that such symptoms are best understood as integral to a British national business model whose distinctiveness is established by a brief comparison with that of Germany. In Section three we focus on the *practical difficulties* of rebalancing the British business model which is both an established configuration and a trajectory. Specifically, we explore the possibility of reviving British manufacturing and the difficulty of reducing the significance of finance. Finally, in the concluding section 4, we propose to address the problems of British manufacturing with a series of imaginative proposals for sector specific tax privileges which would incentivise manufacturers to expand output and invest in capacity and workforce skills.

## **1. GROWTH OF A DISCOURSE: WHAT IS TO BE REBALANCED?**

So there is a new discourse about rebalancing. But where does it come from? We answer this question by briefly surveying media coverage. Our questions are: what, according to the media, has to be rebalanced? And who is speaking? Then we briefly consider the *a priori* assumptions embedded in this talk. We argue that the discourse of rebalancing is a recent innovation by the political classes and the media, especially in a British context. Then we suggest that like most discursive innovations, talk of rebalancing is a framing device that smuggles in all kinds of empirically contestable assumptions about British national problems that sections two and three argue are larger, darker and undisclosed.

**Exhibit 1:** A Google News search for news items including the terms 'rebalancing the economy' and 'rebalance the economy'<sup>2</sup>

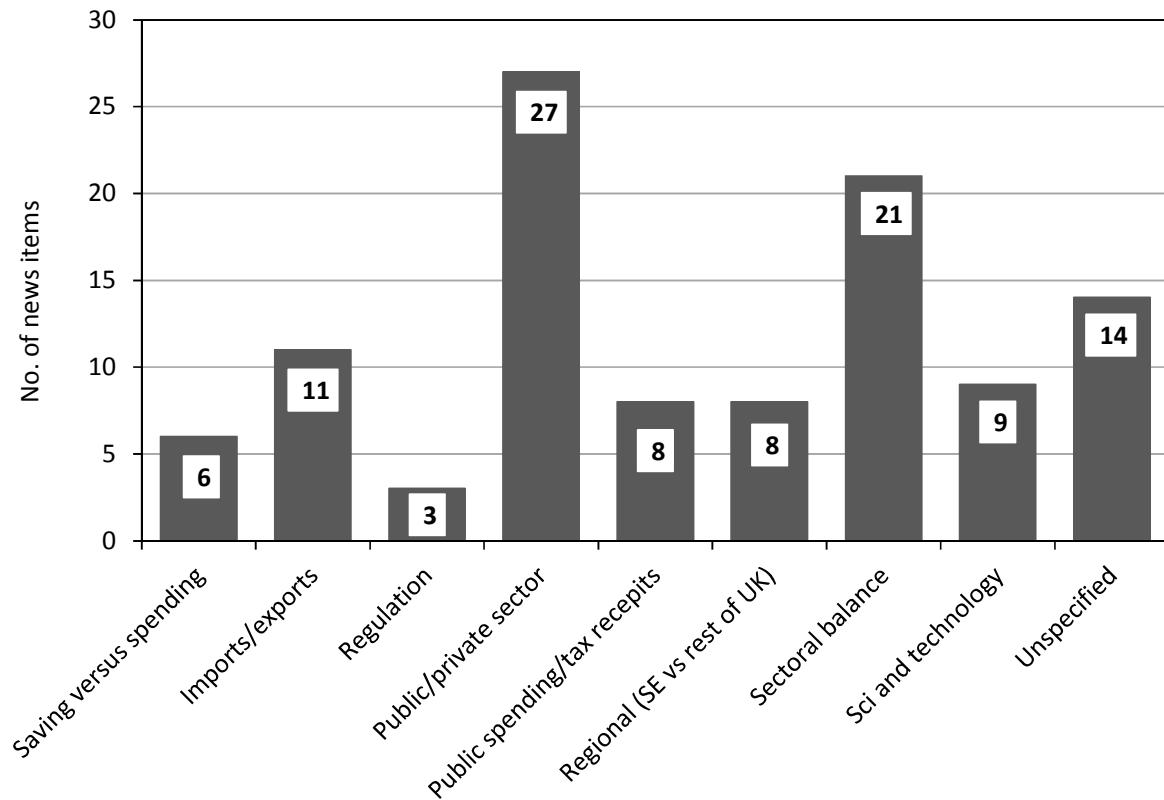


Google News searches are a blunt tool, but even so they tell us something about world-wide media coverage. If we search for the two phrases 'rebalancing the economy' and 'rebalance the economy' we first discover that the balancing trope is a recent innovation. Indeed, according to Google News, these phrases weren't in the media at all in 2000. And then, second, we find there has been an interesting and even more recent shift in usage since the beginning of the financial crisis in 2007-08. In the early and mid-2000s, rebalancing was about the international China-US trade imbalance. Here the primary problem was a set of dysfunctional global relations, in particular the way in which China's large trade surpluses were invested in US\$ denominated assets, which financed US national and household debt and led to a ballooning of domestic house and asset prices.

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<sup>2</sup> Source: Google News

**Exhibit 2:** A UK Google News search for news items on 'rebalancing the economy' or 'rebalance the economy' and the topic of the news item, July-December 2010<sup>3</sup>



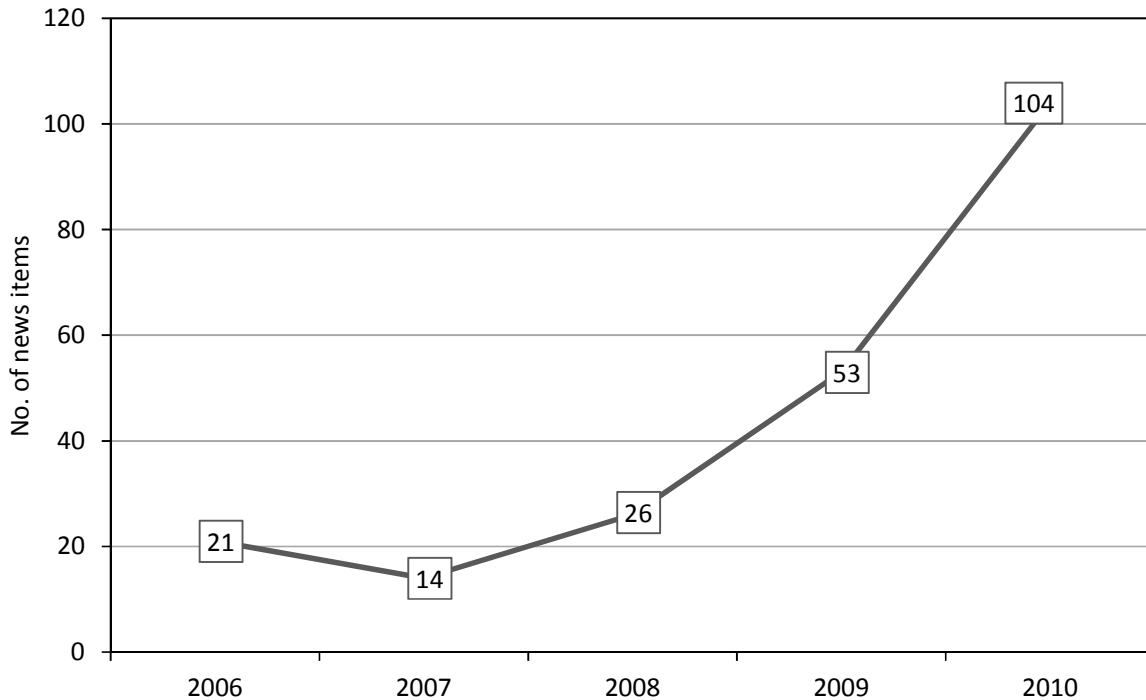
While this concern with global trade imbalances continues, the onset of financial crisis in summer 2007 encouraged a mutation in usage. Specifically, imbalance was increasingly treated as a problem internal to the national economy in high income countries, and especially the UK. "Many economists", said the BBC on September 20<sup>th</sup> 2007, "believe that the [sub-prime and the Northern Rock] crisis is also an opportunity for rebalancing the economy, which has become overly dependent on consumer spending financed by cheap credit and government borrowing."<sup>4</sup> As the Google search in exhibit 2 indicates (this time it is of UK news sources alone), the new discourse of rebalancing really took off in late 2009 and 2010 when the term started to proliferate. As in the speech by David Cameron cited at the beginning of this article, there were now said to be many imbalances (public and private, sectoral and regional), so that British national economic performance could be and was increasingly discussed through this trope.

<sup>3</sup> Source: UK Google News

<sup>4</sup> BBC News Online (2007), 'Is the Credit Crunch Finally Over?' <http://news.bbc.co.uk/1/hi/business/7003139.stm>, updated 20 September 2007, (accessed 20 January 2010).

With this a context, it is worthwhile turning from Google News, which treats all news sources indifferently, to the *Financial Times*. This is an economic journal of record with an international audience but strong UK coverage. In its columns the British political classes are able to recognise their achievements and problems. And what happens to 'rebalancing' here? It turns out that if we search by the same two key phrases the trends are much the same.

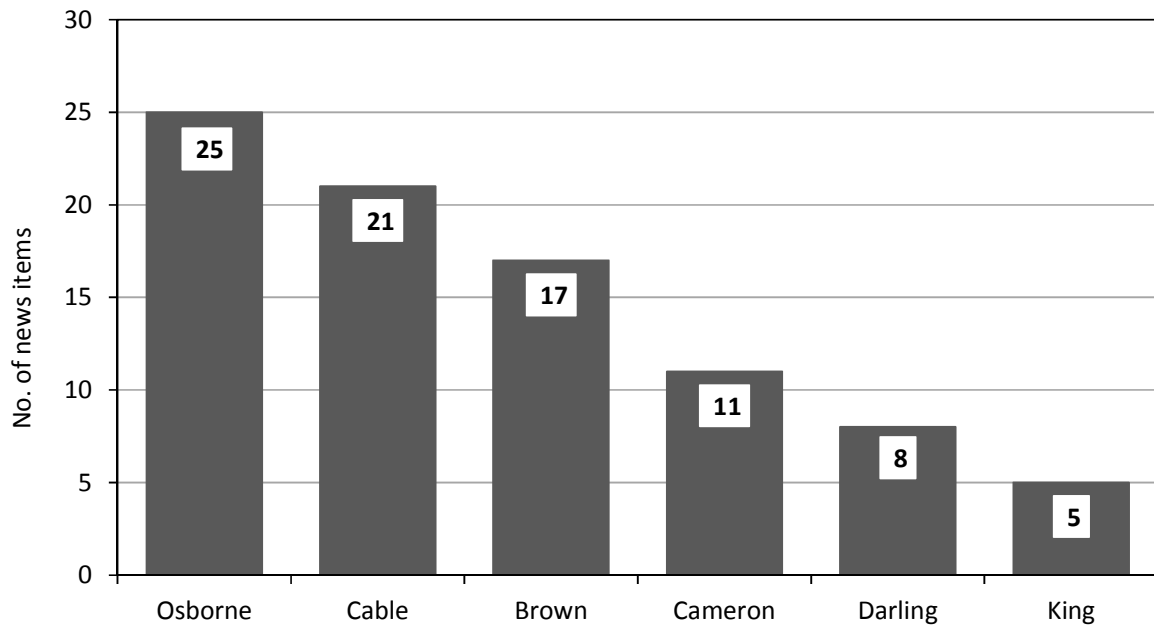
**Exhibit 3:** An ft.com global search for news items including the terms 'rebalancing the economy' and 'rebalance the economy'<sup>5</sup>



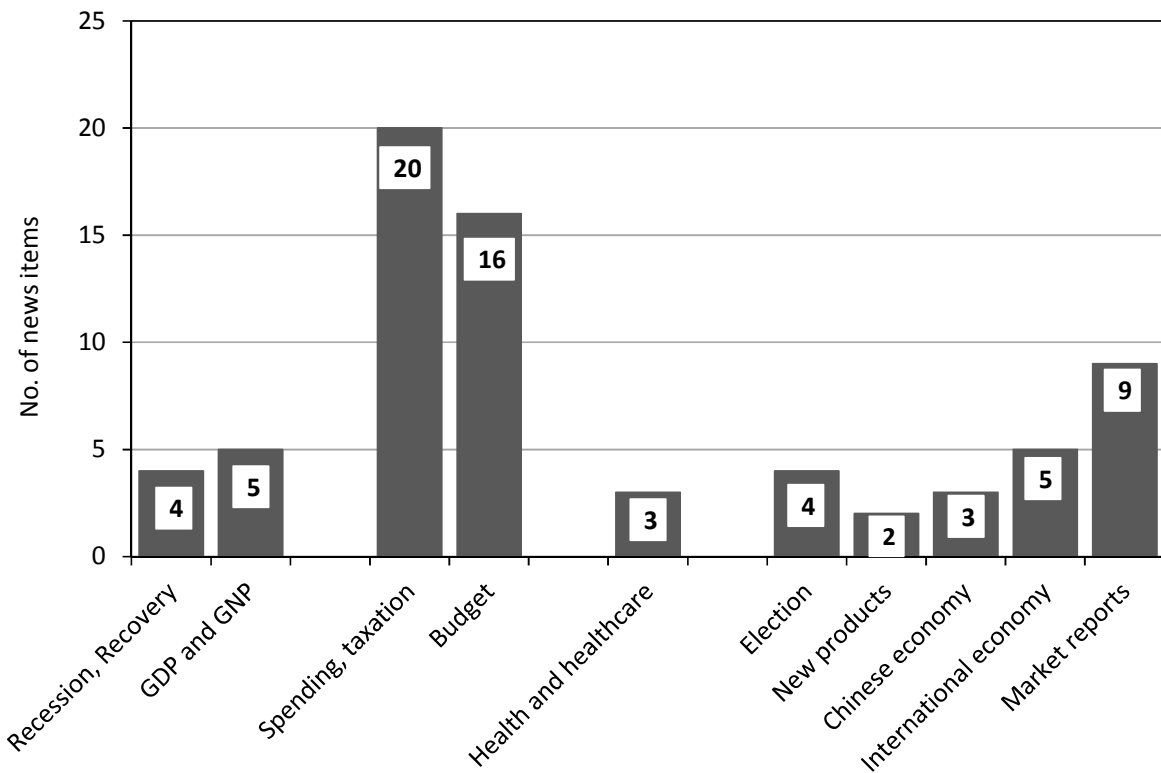
There is some double-counting in these figures which are not complete in other ways, and the archive only goes back to 2006. However, they suggest a similar take-off in usage of the terms in 2009 and 2010. And when you drill down, there is the same pattern of change and proliferation around increasingly national usage. In these *Financial Times* (FT) reports in 2006 and 2007 the rebalancing term was used twice by UK figures (Gordon Brown and Mervyn King) and six times by Chinese leaders. By 2009-2010 the Chinese leaders have disappeared, and the terms are used 87 times by British public figures (from a total of 157). The listing of British speakers is also interesting because it reveals that the phrase was being used by front bench politicians from all three main parties, and that the three most frequent users of 2009-10 in the FT were the Conservative George Osborne, the Liberal-Democrat Vince Cable, and Labour's Gordon Brown.

<sup>5</sup> Source: ft.com

**Exhibit 4:** Results from ft.com identifying the use of the terms 'rebalancing the economy' or 'rebalance the economy' by leading UK figures during 2009 to 2010<sup>6</sup>



**Exhibit 5:** An ft.com search for news items on 'rebalancing the economy' or 'rebalance the economy' and the primary subject of the news item, 2009-2010<sup>7</sup>



<sup>6</sup> Source: ft.com

<sup>7</sup> Source: ft.com



And what are these leaders talking about? The pattern in the *Financial Times* replicates Google: talk of 'rebalancing' signals a series of different ills. It is clear that there are many versions of imbalance.

These figures reveal that within the UK 'rebalancing' has become a *standard economic and political trope*. The economics editor of *The Independent* newspaper made this point after the May 2010 general election:

"From the refusenik right-wing of the Conservative party to the Greens to Mervyn King to the International Monetary Fund, there is a broad consensus about "what went wrong" with the British economy. We became too reliant on financial services; we got into too much debt, both personally and as a nation; we consumed too much; we invested too little; we became mesmerised by house prices. Industry has shrunk to less than a fifth of the economy; the growth in bank lending has been dominated by real estate (largely "socially useless", as some might say); investment and savings have collapsed. The agreement on the need to "rebalance" the economy was one of the outstanding features of the recent election campaign."<sup>8</sup>

But with this something else is happening too. The rebalancing discourse has become so general that it is often being evacuated of specific meaning and rendered into a general and uncontroversial marker for the economic good. Like motherhood and apple pie, no one from the political mainstream can possibly resist the need for 'rebalancing'. And as a part of this the term has also become polysemic, for it is possible to discern at least five threads in the weave<sup>9</sup>.

- The older China-derived arguments about *balanced trade* are still there in talk of the need for balance between imports and exports.
- But now, post-2008, balance has also become a *fiscal issue* because government income and expenditure need to be balanced so that public sector expenditure cuts are rebalancing.
- Apart from the immediate problem of deficits, there is larger issue about the balance between *public and private sectors* and over-reliance on public-sector job creation.
- This connects with an older discourse about the *regional disparities* between the South East and outer regions which is now recast as a matter of balance.

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<sup>8</sup> O'Grady, Sean (2010), 'The Big Rebalancing Act: Cable's Plans for Broken Britain', *The Independent*, 3 June 2010 2010, also available at <http://www.independent.co.uk/news/business/analysis-and-features/the-big-rebalancing-act-cables-plans-for-broken-britain-1989899.html>.

<sup>9</sup> Shanmugalingam, Shantha, Ruth Puttick, and Stian Westlake (2010), *Rebalancing Act*, London: National Endowment for Science, Technology and the Arts, also available at [http://www.nesta.org.uk/library/documents/rebalancing\\_act\\_080610.pdf](http://www.nesta.org.uk/library/documents/rebalancing_act_080610.pdf).

- Finally, *sectoral issues* within the private sector, and especially the relative importance of finance and (knowledge-based) manufacturing, are also being treated as matters of balance.

So that's the mish-mash, and frequently, to be sure, its various components come together. Here, for instance, is Chancellor George Osborne in his 2010 budget speech and then again in a 2011 speech at the Davos World Economic Forum:

“Our policy is to raise from the ruins of an economy built on debt, a new, balanced economy where we save, invest and export. An economy where the state does not take almost half of all our national income, crowding out private endeavour. An economy not overly reliant on the success of one industry, financial services –important as they are – but where all industries grow. An economy where prosperity is shared among all sections of society and all parts of the country.”<sup>10</sup>

“Over the last decade our economy became perhaps the most extreme example of any major economy of the dangerous imbalances that now need to be unwound....That is why we need to build nothing less than a new model of economic growth, built not on unsustainable debt in the public and private sectors, but on the entrepreneurial dynamism that creates lasting prosperity. Not overly concentrated in one region of the country or one sector of the economy, but more balanced both geographically and economically. A model in which investment and exports replace debt-fuelled consumption in the public and private sectors as the drivers of growth.”<sup>11</sup>

In such speeches rebalancing is the operating trope that has allowed a decisive shift in the tone of the economic discourse of our political classes. By 2009-10 all are critical of Britain's economic performance and achievements just as they were hubristically complacent in 2007 and before. And, it should be emphasised, this didn't happen with the change of government in the May 2010 election. New Labour had already made this adjustment when in office in 2009-10. For instance, compare and contrast the treatment of the City and the finance sector in two speeches by two architects of the New Labour Project, before and after rebalancing. The first, from June 2007 as the financial crisis is breaking, is Gordon Brown's last Mansion House speech as Chancellor of the Exchequer. This started with a paean of praise for the enterprise of the City of London:

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<sup>10</sup> Osborne, George (2010), 'Budget 2010: Full text of George Osborne's statement', *The Daily Telegraph*, 2010, also available at <http://www.telegraph.co.uk/finance/financetopics/budget/7846849/Budget-2010-Full-text-of-George-Osbornes-statement.html> (accessed 27 June 2010).

<sup>11</sup> Osborne, George (2010), 'Extracts from George Osborne's Davos speech', London: PoliticsHome, [http://www.politicshome.com/uk/article/21392/extracts\\_from\\_george\\_osbornes\\_davos\\_speech.html](http://www.politicshome.com/uk/article/21392/extracts_from_george_osbornes_davos_speech.html), updated 28 January 2010, (accessed 31 January 2010).

“By your efforts Britain is already second to none:

- for our openness, pro Europe, pro free trade,
- a world leader in stability, and we will entrench that stability, by ensuring Britain's macroeconomic framework remains a world benchmark, and
- we are flexible, and in being vigilant against complacency, we must be, as I believe we are ready to become even more flexible.”<sup>12</sup>

Brown went on:

“The financial services sector in Britain and the City of London at the centre of it, is a great example of a highly skilled, high value added, talent driven industry that shows how we can excel in a world of global competition. Britain needs more of the vigour, ingenuity and aspiration that you already demonstrate that is the hallmark of your success.”<sup>13</sup>

If we fast forward to January 2010, we find Peter Mandelson, Secretary of State of Business, Innovation and Skills, in an agenda-setting speech at the Industrial Society. He's talking about the “politics of production”:

“And let me say this quite bluntly. For the past decade we allowed ourselves to become over-dependent on the City and financial services for growth and our tax revenues. That is why, without wishing the financial sector to be smaller, we need other industrial strengths and sources of revenue to grow faster.”<sup>14</sup>

This aligns perfectly with what George Osborne as Chancellor was saying a few months later when (as we saw above) he wanted, “An economy not overly reliant on the success of one industry, financial services –important as they are –but where all industries grow.”

Thus our argument is that the rebalancing discourse in the political classes has been fed by buyer's remorse: unease, fear or regret that one has been sold a pup. But then again, rebalancing is a very particular way of handling that remorse, because it comes with a powerful set of associations drawn from its earlier technical (pre-economic) usages. If we turn to the OED definitions of rebalance, the examples of usage variously invoke brakes and tyres,

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<sup>12</sup> Brown, Gordon (2007), 'Mansion House Speech', Berlin: British Embassy, <http://ukingermany.fco.gov.uk/en/news/?view=Speech&id=4616377>, updated 20 June 2007, (accessed 20 January 2010).

<sup>13</sup> Brown, Gordon (2007), 'Mansion House Speech', Berlin: British Embassy, <http://ukingermany.fco.gov.uk/en/news/?view=Speech&id=4616377>, updated 20 June 2007, (accessed 20 January 2010).

<sup>14</sup> Mandelson, Peter (2010), 'Going for Growth: Building Britain's Future Economy', London: The Work Foundation, page 6, <http://www.theworkfoundation.com/Assets/Docs/Peter%20Mandelson%20speech.pdf>, updated 6 Jan 2010, (accessed 20 June 2010).

emotions and power. And we can distinguish a whole series of technical meanings of rebalancing in health care, financial management and mechanical engineering which all in one way or another invoke equilibrium, natural order or smooth motion. In medicine, care in diabetes is a matter of balancing metabolism by normalising blood sugar levels; in finance a diversified portfolio is rebalanced when securities are bought or sold to re-establish target weightings for different asset classes; in engineering workshops, tyres and brakes are rebalanced to restore smooth movement or stopping.

Resonating associations such as these are very convenient for the British political classes because it means that rebalancing makes it possible to admit that there are multiple economic problems and at the same time to suggest that the problems are manageable and so deny the need for radical change. Think about what rebalancing connotes in medicine, finance, engineering (and now in elite economics)?

- One: there *was* balance, but things have now gone 'too far'.
- Two: though things aren't currently in balance, this can be *put right*. It can be technically controlled.
- Three: all the bits and pieces that are out of balance will *still be there* once things are back in balance. The system as a whole –and its components –will be preserved.
- Four: therefore, it follows that there *isn't any need for radical change*. Indeed, radical change would undo the possibility of rebalancing because it would precisely disrupt the balancing act between the bits and pieces.
- Five: and to put the same point slightly differently, it's a matter of *quantitative* rather than qualitative change. A bit of adjusting. More or less. You mess with the figures and the technical specifications, and but you don't change anything in kind.

This helps to explain why, though Labour politicians also use the discourse of rebalancing, the Conservative LiberalDemocrat Coalition find it especially congenial. It is a positive explanatory element in the governmental project of a coalition which, on its own account, has no enemies except misunderstanding, and seeks to represent its draconian public expenditure cuts as 'fair' and 'progressive'. The logic of balance is also endlessly extensible insofar as new 'imbalances' are discovered and assembled, as in Osborne's mish-mash version above; this opens onto a whole new discursive logic of listing unbalances which could extend itself ever further, and undo any possibility of radical or discontinuous change. In one way, then, the discourse of rebalancing may be understood as the latest in a long list of political/managerialist ideologies that seek to undo radical difference by acknowledging and colonising it. At the very least, rebalancing offers a tendentious view of the world, as we can show by presenting some empirics which show that problems of unbalance long predate the political discourse that discovered them.

## **2. CHRONOLOGY: WHEN WAS UNBALANCE?**

The discourse of rebalancing does not do chronology based on systematic evidence and time series statistics where breaks and inflections can be judged. Rebalancing therefore fits the needs of political elites seeking to educate voters by turning economic management into a moral fable whose lesson is that their party is economically competent whereas the opposition is not (while in their back story Mrs Thatcher is everybody's heroine). The story is always the same, only the identity of heroes and villains switches with changes of government. When imbalance was discovered, New Labour was in government, and Peter Mandelson's January 2010 speech to the Industrial Society represented imbalance as the blemish on its otherwise credible record (which builds on the achievements of Mrs Thatcher). After the coalition government took office, George Osborne's 2010 budget speech blamed New Labour mismanagement for what are explicitly identified as recently created problems of imbalance (which betray the legacy of Mrs Thatcher); more generally, the coalition has worked hard to rubbish Gordon Brown's claims about "the end of boom and bust" and to label New Labour as economically incompetent because that damages Ed Milliband's electoral prospects<sup>15</sup>.

This section takes a rather different approach which counters the fables with time series empirics with output trends used to give an overview of the changing imbalance of regions and sectors; and then adds some national business model analysis as a way of thinking through the preconditions of economic welfare and political success. By adding evidence and conceptualisation, our evidence and argument challenge the moral fables of our political elites. George Osborne is wrong when he claims that problems of imbalance originated recently under an (incompetent) New Labour chancellor because the output figures tell a different story. More interestingly both Mandelson and Osborne are deluded about Mrs Thatcher's achievements because, in business model terms, there is a fundamental unity between the Conservative years after 1979 and the New Labour years after 1997. In both periods, the UK had an undisclosed and unsustainable national business model which relied on publicly funded job creation to distribute economic welfare across the regions while housing equity withdrawal boosted consumption and created the feel good so necessary for re-election. The business model concept opens a revisionist history about Mrs Thatcher's achievement and challenges the assumptions of main stream politicians who assume that the flexibilization of the labour market, privatisation and all the rest liberated the private sector and shifted the UK off a trajectory of national decline.

The question of imbalance has been raised in ways which make several indicators relevant and various time series will show different trends. A comprehensive analysis would consider

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<sup>15</sup> Rawnsley, Observer, 16 January 2011

employment, output, private and public debt, private consumption and public expenditure. But, if the aim is to test George Osborne's moral fable about New Labour irresponsibility and betrayal of Thatcher's legacy, we can simplify matters by considering output figures because regional, sectoral and public/private imbalance arguments all imply changes in output growth trends or output distribution which in turn are important drivers of income differences. In the argument below, we use the Gross Value Added (GVA) output measure because this is a standard measure of output which is readily available for regions and sectors; value added is of course a measure of net output with adjustments to eliminate double counting and gross value added gives this result without adjustment for government taxes and subsidies. If we use this measure, we can make three points which refute Osborne's fable.

1. The UK has a long standing regional problem which generally gets slowly worse on the GVA per capita measure because entrenched disparities in regional output per head increase slowly before and after 1997. Exhibit 6 presents basic data on the variation of regional GVA per capita from the UK average in 1989, 1997 and 2008. The pattern is one of sustained and gently increasing inequality. Over the whole 20 years, per capita GVA in the South East region is more or less at the national average and London's GVA per capita is always more than 50% higher; but the other seven English regions plus Wales have GVAs which are below the national average and their shortfall increases unsteadily but fairly inexorably in the long run.

**Exhibit 6:** Regional variation of Gross Value Added per head from the UK average

	1989	1997	2008
	%	%	%
North East	-18.2	-21.3	-24.9
North West	-10.5	-13.0	-17.0
Yorks and Humber	-12.3	-12.9	-19.2
East Midlands	-7.0	-9.1	-14.7
West Midlands	-10.0	-9.8	-17.4
East	-6.6	-7.2	-7.9
London	53.8	53.4	64.5
South East	-1.8	1.7	2.6
South West	-9.9	-9.6	-11.2
Wales	-17.2	-21.3	-27.9
Scotland	-5.9	-4.7	-5.0

Source: ONS

Notes: GVA based on a five period moving average and allocated to the region the economic activity takes place. Northern Ireland included in UK total and excludes assignable GVA; per head refers to total population.

Thus North East GVA per capita is already 18% behind the national average in 1989 and the deterioration then continues so that the North East is 24.9% behind in 2008. Some regions like the North West or South West in the 1990s hold their position relative to national GVA for one decade, only to lose ground in the next.

2. The UK has an historically entrenched pattern of dependence on the public sector which is revealed in the GVA series by a high public sector's contribution to total GVA growth over time (exhibit 7). In London and the South East, the contribution of the public sector is held to less than 20% of total regional output growth over all three sub periods from 1989-96, 1997-2008 and 1989-2008. But elsewhere for the other seven English regions and Wales, the contribution of the public sector ranges from 20%-70% depending on the region and the sub period. On this measure, the dependence on the public sector as a source of output growth does not generally increase after 1997. Indeed in five English regions and Wales, the contribution of the public sector to output growth is conspicuously higher in 1989-96 than in 1997-2008. In the earlier period from 1989-96 the public sector accounted for 60-70% of output growth in the North East, North West and Wales.

**Exhibit 7:** Public sector contribution to growth in real Gross Value Added growth split by regions

	1989-2008	1989-1996	1997-2008
	%	%	%
North East	37.8	33.3	61.4
North West	30.7	70.1	24.3
Yorks and Humber	28.5	31.4	27.8
East Midlands	25.2	31.4	23.6
West Midlands	28.4	23.7	29.8
East	20.2	19.9	20.2
London	11.6	0.6	12.8
South East	16.6	17.2	16.4
South West	23.0	30.5	21.4
Wales	43.2	60.8	38.8
Scotland	24.4	16.0	26.9
UK	21.1	24.2	20.5

Source: ONS

Notes: GVA to where the economic activity takes place. Northern Ireland excluded in UK total and includes unassignable GVA. Public sector is classified as education, health and public administration.

3. These persistent regional disparities relate to enduring differences in regional specialisation which is disclosed in the GVA if we consider the distribution of different activities across the regions (exhibit 8). If we consider London and the South East as the economic centre of the UK, the two most centralised activities are real estate and business services and financial intermediation. Over the whole period from 1989-2008. London's share of UK financial intermediation GVA ranges between 40% and 45% with the South East accounting for another 10-12%. Well over half of all UK financial intermediation GVA has been steadily concentrated in London and the South East and none of the other English regions ever manages to get its share of GVA into double figures. By way of contrast, other activities including public services, retail and manufacturing are fairly evenly distributed. Manufacturing was never an activity of the Northern periphery and is now very evenly because seven of the eight English regions currently have shares of manufacturing GVA in the range from 8 to 13%.

**Exhibit 8:** Regional shares of finance and manufacturing Gross Value Added in 1989, 1996 and 2008

	1989		1996		2008	
	Finance %	Mfg %	Finance %	Mfg %	Finance %	Mfg %
North East	2.5	5.1	1.9	4.8	1.9	4.6
North West	8.2	14.6	7.0	13.3	7.2	13.2
Yorks & Humber	4.9	9.4	5.5	9.6	5.7	9.9
East Midlands	4.1	8.7	3.2	9.5	3.2	9.0
West Midlands	5.8	11.6	5.7	11.7	4.4	9.5
East	7.1	8.8	6.4	8.5	6.1	9.5
London	40.2	10.1	42.1	9.5	46.0	8.9
South East	12.4	11.4	12.0	11.4	10.0	12.6
South West	6.3	6.6	6.8	7.4	6.2	8.2
Wales	2.0	5.4	2.2	5.6	2.0	5.2
Scotland	6.5	8.3	7.2	8.7	7.3	9.4
UK	100.0	100.0	100.0	100.0	100.0	100.0

Source: ONS

The patterns are complex but overall it is hard to find break or rupture as supposed in the political fables and easier to find persistence and path dependence over the past 25 years. The question arising then is how did Mrs Thatcher and Blair succeed in representing this mixed performance and so many unsolved problems as a domestic success which justified re-election? The concept of national business model can help us answer this question.



The idea of a firm or industry business model is already familiar as a way of combining analysis and description about how organisations meet stakeholder expectations; in our own work we have shown how it can be used to analyse how non-profit organisations like the BBC meet diverse stakeholder expectations<sup>16</sup> as well as how firms and industry in the corporatized private sector generate shareholder value.<sup>17</sup> We have also argued that the term can be extended to show what measures of performance matter and how they fit together in a distinctive national configuration.<sup>18</sup> From this point of view a national economy is a kind of assemblage which may be more or less stable or sustainable. If we are considering a national business model, two sets of expectations about employment and real income increases are important in a high income, mass democracy. Employment matters because jobs are the primary way of distributing welfare; and the national business model issue is whether and how the economy can generate the quantity and quality of employment necessary to distribute welfare and diffuse prosperity across regions and social groups. Real income increases matter because they create political feel good that confirms the status quo and validates institutions and the party of government.

If we begin by considering the sources of jobs, there has been very little empirical analysis of whether and how the private sector responded to Mrs Thatcher's new framework. Quite fortuitously, North Sea oil came on stream and prevented balance of payments crises –the old index of failure. And it was then not easy to judge outcomes when the categories of official statistics flattered the record of private sector job creation and obscured the increasing importance of publicly funded employment. Some of the basic statistics are presented in exhibit 9 below where the rising total of numbers employed is unambiguous but many of the subtotals should be treated with caution. In the 1980s, privatisation and outsourcing were a kind of bookkeeping adjustment, which effectively reclassified public workers and inflated private sector employment totals in the Thatcher years. In the 1990s and afterwards, outsourcing and subcontract make the total of public sector employees working in the state sector an increasingly poor measure of publicly funded employment. An increasing number of workers, in activities from refuse collection to nursery education, have private employers in a growing para-state sector where private jobs are publicly funded. It is however possible to estimate the numbers transferred by privatisation in the 1980s from company accounts. Just as it is possible to estimate the numbers employed in the para-state sector using the simple but robust CRESC method of reworking Annual Business Inquiry (ABI) employment totals after estimating the weight of public expenditure or subsidy in sustaining employment within each

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<sup>16</sup> Leaver et al. (2009)

<sup>17</sup> Froud et al. (2006) 'Financialization and Strategy: narrative and numbers, Routledge, Abingdon.

<sup>18</sup> Buchanan, J. *et al.* (2010) Undisclosed and Unsustainable: problems of the UK national business model, CRESC Working Paper No.75, <http://www.cresc.ac.uk/sites/default/files/wp%2075.pdf>

sector.<sup>19</sup> When these complications are factored in, the empirics show that the UK has had since Thatcher an unsustainable business model of reliance on publicly funded employment to compensate for weak private sector job creation.

**Exhibit 9:** Analysis of manufacturing, finance, state employees and total jobs 1971-2008

		Manufacturing (GB)	Finance (GB)	State employment (UK)	Total workforce jobs (UK)
		No.	No.	No.	No.
Pre-Thatcher governments	1971	7,886,059	620,324		
	1978	7,123,476	730,294	5,598,000	26,861,000
	Change	-762,583	109,970		
Pre-Thatcher government - immediate post 'Big Bang'	1978	7,123,476	730,294	5,598,000	26,861,000
	1987	5,107,180	939,824	6,248,000	27,052,000
	Change	-2,016,296	209,530	650,000	191,000
Post 'Big Bang' to New Labour government	1987	5,107,180	939,824	6,248,000	27,052,000
	1997	4,059,561	978,415	6,676,000	28,697,000
	Change	-1,047,619	38,591	428,000	1,645,000
Post New Labour	1997	4,059,561	978,415	6,676,000	28,697,000
	2008	2,709,080	1,062,977	8,009,000	31,661,000
	Change	-1,350,481	84,562	1,333,000	2,964,000

Source: Nomis, ONS

Notes: Breaks in series end 1981, 1991 and 1997 related to changes in SIC classifications. The employment data for manufacturing and finance relate only to employees and excludes N. Ireland. 1978 is used as the full year prior to the Conservatives winning the general election on 4th May 1979. 'Big Bang' reforms were enacted on 26th October 1986. New Labour won the general election on 2nd May 1997. Total jobs and state employment relates to the UK and the latter is the summation of jobs in public administration, education and health.

Manufacturing employment fell from 7 million in 1979 towards 4 million by the mid 1990s because manufacturing never recovered from the policy induced recession of 1979-82 which took out 20% of manufacturing capacity. The government gambled on the capacity of the service sector to create jobs, but financial services did not deliver. As exhibit 8 shows, the

<sup>19</sup> *Ibid*, pp.17-18.

increase in financial services employment from a small base of around 650,000 was all over by the time the effects of deregulation kicked in at the end of the 1980s. The numbers employed in private sector (non financial) services did apparently increase substantially. But, based on company accounts totals of the numbers employed in each firm in the year of privatisation, we calculate that some 750,000 workers were transferred into the private sector by privatisation; and they account for some 71 per cent of the apparent overall increase in private sector employment from 1979-1997.<sup>20 21</sup> In terms of job creation, the more substantial and durable achievement of the Conservative years was a one million plus rise in state employment sustained by Mrs Thatcher's pragmatic acceptance of increasing public expenditure regardless of her rhetoric about rolling back the state.

All this set the scene for New Labour after 1997 which inherited the historically engrained economic problems that had defeated Mrs Thatcher who could beat the miners but not transform private sector capabilities. The numbers employed in British manufacturing continued to decline every year from 4 million in 1997 to 2.7 million in 2008. And, quite remarkably, in the fifteen years after 1992, the numbers employed in finance did not increase at all from a base of one million which by 2008 accounted for less than 4% of the total British workforce; over the same period finance increased its share of output to 9.1% and its share of profits to 12.8% just before the bubble burst.<sup>22</sup> There was a large apparent increase in (non-financial) service sector private employment which includes many para-state jobs. After the utilities had been privatised, New Labour leant more heavily on the state to fill in for a private sector, which was incapable of creating jobs. On our calculations, the para-state employed 1.7 million in 2007, or roughly one-third of the 5.7 million total employed directly by the state.<sup>23</sup> On this basis, state plus para-state employment increased by nearly 1.3 million between 1998 and 2007 so that these two sectors account for no less than 57% of the total increase in the number of employees on the ABI measure (of employees which excludes the self-employed, defence and Northern Ireland). By 2007, state and para-state were our leading sectors and together employed 7.5 million, or 28% of the employee workforce.

This was never a deliberate economic strategy but an unintended effect of New Labour's political strategy of spending on health and education to hold swing voters. However, New Labour's increased expenditure on health and education did then operate as a kind of undisclosed regional policy. State and para-state (S&PS) employment expanded right across the national economy, but was particularly critical where private sector job creation was weak or

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<sup>20</sup> Our calculations of numbers transferred are based on numbers employed by privatized firms in the year of privatization as disclosed in report and accounts.

<sup>21</sup> *Ibid.* at 18

<sup>22</sup> *Ibid.*, pp. 13-14

<sup>23</sup> *Ibid.*, pp. 18-19

failing. Exhibit 10 shows that, in London and the South, S&PS accounted for no more than 38-44% of employment growth between 1998 and 2007; while in the Midlands, North, Wales and Scotland it accounted for between 43% and 48% of the employment growth over the same period, with most of the rest induced by public expenditure multiplier effects.

**Exhibit 10:** Change in employment by major regions and the source of change by major sector 1998-2007

	Total change		Sectoral contribution to change	
	Private sector	State and para-state sector	Private sector	State and para-state sector
	No.	No.	%	%
London	392,358	120,155	76.6	23.4
Midlands	209,893	193,198	52.1	47.9
North	431,737	337,801	56.1	43.9
South	659,596	260,320	69.5	30.5
Wales	106,685	81,936	56.6	43.4
Scotland	192,738	168,266	53.4	46.6
UK	2,180,203	1,272,502	63.1	36.9

Source: Annual Business Inquiry, ONS.

Note: Data relates to employees and excludes Northern Ireland.

Increasing state and para-state employment was crucially important in former industrial areas like the West Midlands and the North East, where declining large scale manufacturing was not replaced by any other significant autonomous private sector activity: in the North East and West Midlands, for instance, S&PS accounts for 55% and 61% respectively of job increase 1998-2007.

New Labour's reliance on publicly funded employment only continued Mrs Thatcher's practice with fiscal policies that were not grossly irresponsible. But real public expenditure increased sharply: after 2000 by nearly 50% to £606 billion by 2008 and the public sector deficit reached 3%, which was the formal limit under EU rules. Further expansion of state and para-state employment was then unsustainable even in advance of the financial crash. These problems were compounded because the national business model from Thatcher onwards had separately relied on housing equity withdrawal to generate final consumption demand and political feel good under a system where the over funding of house purchase generated the house price increases that allowed many to remortgage and take the capital gain as income. It was deeply ironic that, just before the onset of the financial crisis in 2007, the British had one of their panics about the growing scale of private equity and the effects of its buy, hold and sell model of churning corporate ownership. Many doubted whether an expanding private equity

sector was committed to production and job creation with social benefits as it claimed in its industry narrative; and instead feared that private equity was committed to redistribution and asset trading with private benefits, especially for the general partners of private equity firms who bought with borrowed money and could cash out on any increase in asset prices. The political classes and the media did not see that this was more or less what the whole country had been doing since the early 1980s through housing equity withdrawal after remortgage whose technical equivalent in private equity was the “dividend recap” after debt refinancing.

It is relatively easy to demonstrate the importance of housing equity withdrawal (HEW) using standard official statistics (exhibit 11). The Bank of England has a time series which gives a consistent and fairly conservative measure of HEW explained in an accompanying note:

“HEW occurs when lending secured on housing increases by more than investment in the housing stocks. Investment comprises new houses, home improvements, transfers of houses between sectors, and house moving costs, such as stamp duty and legal fees (although these fees do not add to the value of the housing stock, they are measured as investment, so reduce the funds available for consumption). So HEW measures mortgage lending that is available for consumption or for investment in financial assets (or to pay off debt)”.

(Bank of England –Explanatory Notes: The Bank’s Estimate of Housing Equity Withdrawal)

The Bank of England totals for HEW exclude remortgage for home improvement and all transaction costs which are officially classified as investment costs; the unresolved issue is how much of the HEW is then applied to fund consumption in the form of cars, holidays and such like or used to fund investment in assets like shares and buy to let property or to pay off credit card debt and such like. Our guesstimate is that over the whole period two thirds or more of HEW was applied to consumption; and percentage was probably higher before the 2000s when buy to let property became important.

On this basis, it is sensible to relativize HEW against national income measured as gross domestic product and also against household post tax income. It is equally sensible to measure HEW in real terms because house prices are, just like GDP, rising in real and money terms.

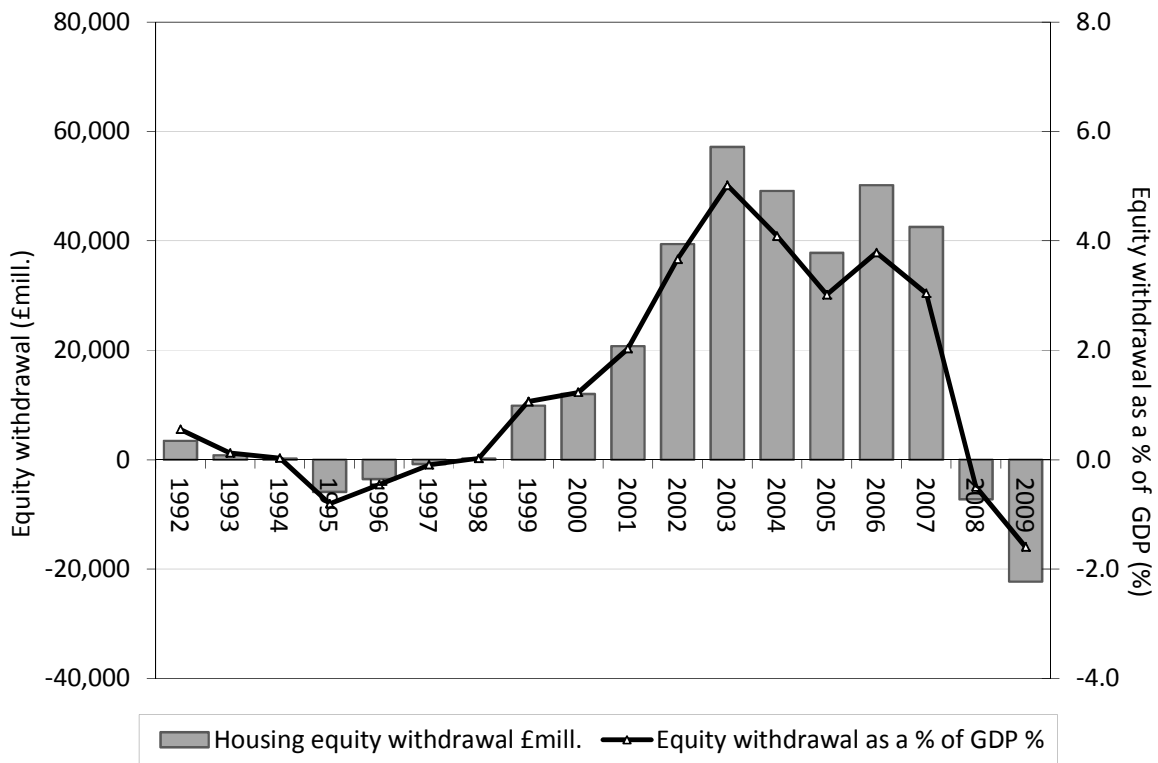
**Exhibit 11:** A comparison of UK housing equity withdrawal and growth in gross domestic product (money values in 2009 prices)

	Real housing equity withdrawal	Change in real Gross Domestic Product	Equity withdrawal as a share of GDP growth	Annual change in real GDP
	£mill.	£mill.	%	%
1970-1974 Edward Heath	22,168	60,569	36.6	2.5
1975-1978 James Callaghan	24,790	68,523	36.2	2.6
1979-1990 Margaret Thatcher	251,179	241,066	104.2	2.8
1991-1996 John Major	10,829	127,664	8.5	2.2
1997-2007 Tony Blair	364,645	352,922	103.3	2.9
2008-2009 Gordon Brown	-29,451	-51,691	57.0 (neg)	-1.8
1970-1978 Heath-Callaghan	46,958	129,092	36.4	2.4
1979-1996 Thatcher-Major	262,009	368,730	71.1	2.8
1997-2009 Blair-Brown	335,194	301,231	111.3	2.1

Sources: Bank of England and ONS.

Notes: Data is annualised, seasonally adjusted and underlying money values in 2009 prices.

**Exhibit 12:** UK household equity withdrawal compared against GDP<sup>24</sup>



The basic data are presented in exhibits 11 and 12 above which usefully go back from the present day to 1970, nearly a decade before Mrs Thatcher became prime minister. Even more strongly than with jobs, any time series on HEW brings out the long term continuity between New Labour, Mrs Thatcher and her predecessors. There is always limited equity withdrawal as estates are liquidated but equity withdrawal for consumption is not a recently invented practice because our middle class parents were at it in the 1960s and 1970s when HEW accounted for 36% of GDP growth under Heath and Callaghan. It became very much more important under Thatcher and Blair because their governments presided over booms fed by unregulated credit creation which generated house price bubbles from 1986-89 and 2000-07. As exhibit 11 shows, the remarkable result is that under Mrs Thatcher from 1979-90, just as under Tony Blair from 1997-2007, the real value of HEW is larger than the real value of GDP growth; equally, HEW is a crucial support of final consumption demand because under Mrs Thatcher as under Blair when HEW peaks at more than 5% of household post tax income. The graphical comparison of Thatcher and Blair again brings out how, just as with publicly funded job creation, accumulating unsolved problems meant New Labour was even more reliant on unsustainable developments. As exhibit 12 shows, in every year from 2002-07, HEW runs out at

<sup>24</sup> Source: Bank of England and ONS. Notes: All underlying data is in nominal values, annualized and seasonally adjusted.

4% or more of GDP in the UK and the implication is that there was very little increase in national wealth over this period if we exclude the HEW which turned capital into income in a period of rising asset prices.

**Exhibit 13:** A comparison of German balance of payments and growth in gross domestic product (GDP). (All money values in 2009 prices)

		Balance of payments surplus /deficit	Change in real Gross Domestic Product	Balance of payments as a share of GDP growth	Annual change in real GDP
		Euro mill.	Euro mill.	%	%
1970-1974	Willy Brandt	64,467	179,364	35.9	3.7
1975-1982	Helmut Schmidt	17,250	184,391	9.4	1.7
1983-1998	Helmut Khol	244,376	733,836	33.3	2.9
1999-2005	Gerhard Schroder	257,825	85,670	301.0	0.5
2006-2009	Angela Merkel	758,214	3,232	23,462.2	0.0
1970-2009	All	1,219,479	1,189,027	102.6	2.5
1979-2009	Schmidt/Khol/ Schroder/Merkel	1,100,331	874,145	125.9	1.9

Sources: Derived from OECD data

Notes: All money data is in 2009 prices. Averages are calculated by summing annual changes and dividing by the GDP in the year prior to entering government. All data is the summation of GFR and GDR totals.

It could be argued that HEW is the way of the world in financialized capitalism where a home is an investment as well as somewhere to live as house property then becomes the piggy bank of every middle class household. But, the peculiarity of the British model is brought out if we make the comparison with Germany, where home ownership is much less important and the business model is much more productive. The surplus on manufactured trade has recently had much the same role in underpinning final demand in the German business model as HEW has long had in the UK. As exhibit 13 shows, from 1970 onwards, the manufacturing surplus is a significant element which helps to reflate the economy and underwrite the German social settlement; under Schroder and Merkel since 1999 the manufacturing surplus becomes crucial because GDP growth slows and the manufacturing surplus rises to an unprecedented 6.4 % of GDP. If all economies are productive, some are clearly more productive than others in a way



that has implications. The UK currently has an £84 billion trade deficit on manufactures with 40% of that deficit accounted for by just two countries China and Germany and 18% accounted for by Germany alone. From this point of view, the EU is a kind of German co-prosperity sphere with British manufacturing failure the reverse of German success and the British deficit on manufactures a massive deflationary force on the domestic economy which is never discussed in polite circles.

### 3. PROSPECTS: MANUFACTURING RENAISSANCE OR DIRE STRAITS?

Rebalancing means many different things. But, if we consider the discourse of rebalancing as buyers' remorse, one recurrent theme is that Britain was overcommitted to the financial services sector before the financial crisis, neglected manufacturing and now needs to redress the resulting sectoral imbalance. In both the New Labour and Coalition government variants on these discourses, figures such as Peter Mandelson and George Osborne have always added the key condition that this should occur through the faster growth of *other* sectors rather than the downsizing of finance. So, inter alia, we need a renaissance of manufacturing. But how will this be achieved? In this section we look at the historical record and the current structural characteristics of the manufacturing sector and argue that, with present policies, it is exceedingly unlikely that sectoral rebalancing will be achieved through sustained over-performance and growth of manufacturing.

Let's start with an apparent paradox. Recent newspaper reports imply that rebalancing is already underway and is building on manufacturing strength. British manufacturing output is currently growing at an annualised rate of 3-4% which is considerably faster than overall GDP. In early 2011, after the release of late 2010 output figures, one City analyst claimed that "the manufacturing recovery remains in rude health"<sup>25</sup>, while a British Chamber of Commerce survey showed the sharpest growth of export sales and orders since 1994<sup>26</sup>. At the same time the Coalition has been talking up the British manufacturing sector. In David Cameron's 25 October speech to the CBI he proclaimed that "we have great industrial strengths across our country, underpinned by world-beating companies"<sup>27</sup>. What to make of this? Our contention is

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<sup>25</sup> Goodley, Simon (2011), 'Triumph for UK manufacturing as motorbike firm overtakes rivals', *The Guardian*, 6 August 2011, also available at <http://www.guardian.co.uk/business/2011/jan/13/triumph-sales-boost-uk-manufacturing>.

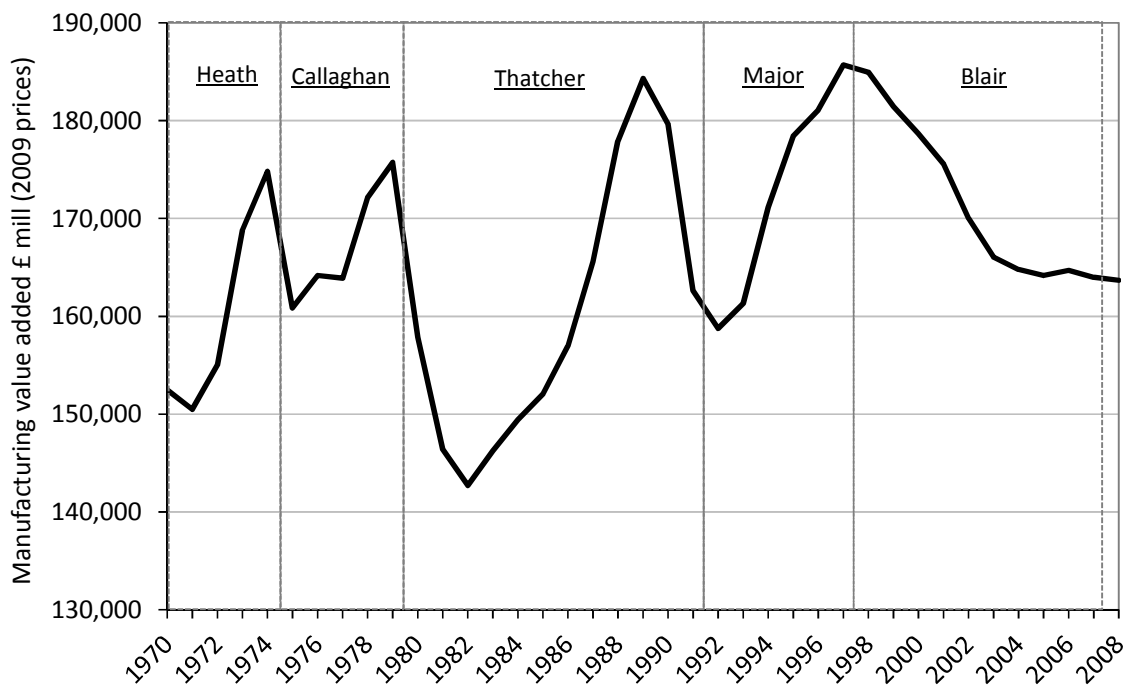
<sup>26</sup> Pimlott, Daniel (2011), 'Weak services slow economic growth', *Financial Times*, January 11 2011, also available at <http://www.ft.com/cms/s/0/89d0a0f0-1ce8-11e0-8c86-00144feab49a.html#axzz1CFNWtvWp> (last accessed 27 January 2011).

<sup>27</sup> Cameron, David (2010), 'Speech to the CBI Annual Conference', London: 10 Downing Street, <http://www.cbi.org.uk/pdf/20101025-cbi-pm-conference-speech.pdf>, updated 25 October 2011, (accessed 3 January 2011).

that this narrative –and its numbers –offers a profoundly over-optimistic diagnosis of the prospects of the sector. This is because it decontextualizes manufacturing performance in two ways. First, in terms of the numbers, the impression of success depends on selectively citing (some) current indicators in a period of cyclical upturn. Second, the coalition's narrative preoccupation with “world-beating companies” fails to attend to the structural conditions and constraints on British manufacturing. The story that really needs to be told here has to do with broken supply chains. Sadly, these mean that any renaissance is likely to be wishful thinking, at least in terms of current policy.

Let us begin by considering aggregates and the long term performance of British manufacturing as a whole. Exhibit 14 below, using the real value added measure, presents historical data on manufacturing output growth.

**Exhibit 14:** UK real manufacturing value added 1970-2008<sup>28</sup> (in 2009 values)

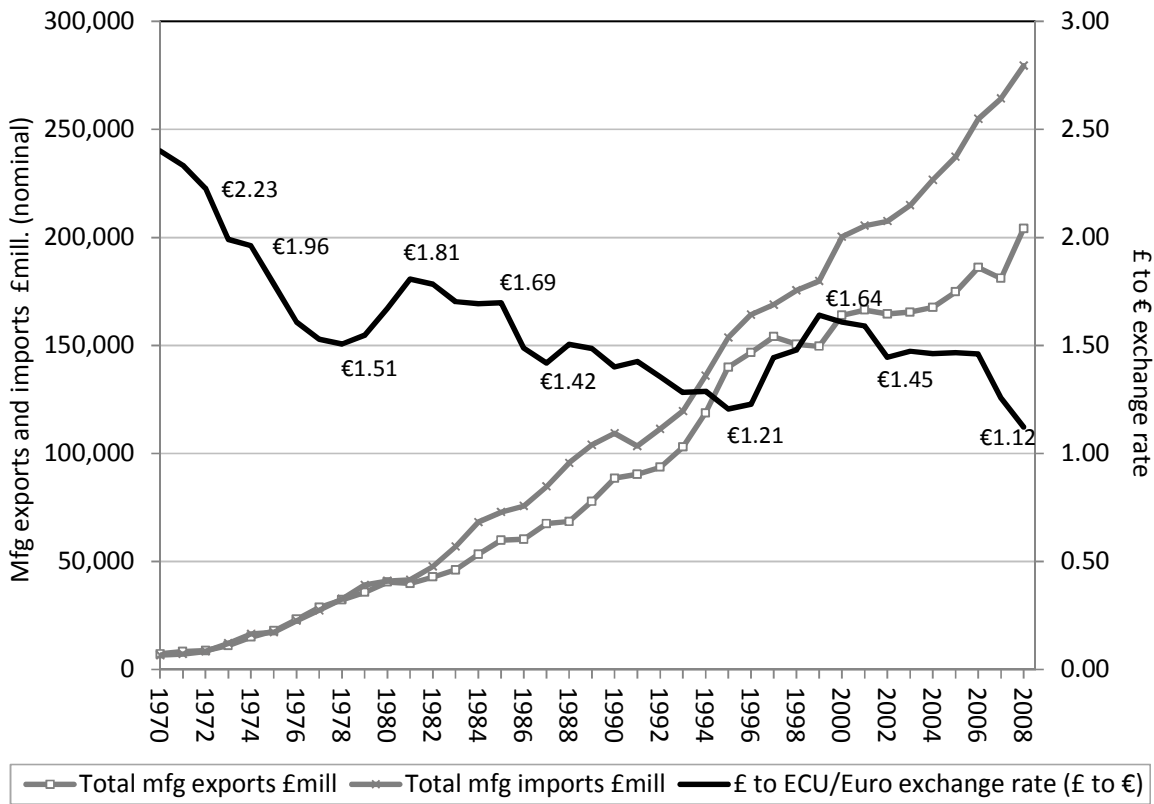


It shows that there is no long term growth in real output because the general pattern since 1970 has been one of cyclical fluctuation with periods of manufacturing output growth when the economy turns up then balanced by periods of manufacturing output loss in economic downturns. From this point of view, recent manufacturing output trends are alarming and, when considered alongside other indicators like investment, suggest we may have left a period of reversible cyclical fluctuations and may be entering a period of secular decline.

<sup>28</sup> Source: OECD

Most worryingly, the British economy boomed from 2002-07 but there was no cyclical upturn in British manufacturing output as there had been in the general economic recoveries of the late 80s and 90s. Furthermore, a 25-30% depreciation of the pound against the Euro is driving British export sales at present; but in longer term perspective, the trajectory of the curves in exhibit 15 suggest there is a secular problem about British dependence on continuous depreciation.

**Exhibit 15:** Trends in UK manufacturing exports, imports and the exchange rate against the ECU/Euro 1970-2008<sup>29</sup> (nominal values)



The curves over the past five years suggest that substantial depreciation of the currency is now necessary just to hold exports on their historical trend rate of growth; and that observation about reliance on currency depreciation, in turn, implies that British manufactured exports continue to have problems about their unattractive non-price characteristics. Going forward from 2011, any revival of British manufacturing will have to take place in an unfavourable macro-economic climate. British and other European governments have (probably self-defeating) macroeconomic policies of reducing their deficits by public expenditure cuts which,

<sup>29</sup> Sources: Eurostat and OECD

as in the Irish case, then undermine the sustained growth that is the prerequisite for reducing public sector deficits. As Martin Wolf has argued<sup>30</sup>, the only plausible source of increased final demand in the UK case is export growth, but that is unlikely insofar as many European markets are depressed and European countries are trying to export their way out of a crisis.

The aggregate performance of British manufacturing is dismal because there is a broadly based problem about weak export performance and high import penetration across most of the larger subsectors which are not naturally sheltered and open to international competition. The problem is not that UK based manufacturing has collapsed in some sectors while being successful in producing other kinds of consumer or producer goods. The worsening problems of British manufacturing relate to long-established structural weaknesses in the two key sectors of machine tools and equipment, and motor vehicles (plus an emerging problem in chemicals). These three sectors account for over half of British manufacturing output, and just under 80% of the value of total British manufacturing exports while over two-thirds of their output is sold abroad. Their commitment to exporting is commendable until we look at what's being imported because these three key sectors also account for nearly half of the manufacturing trade deficit. Why? Essentially the answer is that their total output can only cover 80% of domestic consumption.

The conclusions so far from aggregate evidence could have been taken from any of the classic 1960s or 1970s studies of British manufacturing trade performance which registered how exports grew faster than imports. The subsequent improvement of labour productivity growth rates to some 3% per annum (1997-2008) is small consolation because, in the long term, flat output and increasing productivity means steady decline in the overall size of the manufacturing workforce: British manufacturing, which employed 7 million in the 1970s and 4 million in the mid-1990s, now employs no more than 2.4 million. And the resulting national manufacturing sector is not a finely tuned high productivity machine because the result of continuous retreat and recurrent cyclical rout is cumulative damage and increasing internal disorder of the ambitions and capabilities of individual firms and of interconnections between the populations of firms which drive the aggregates.

These issues about conditions, capabilities and connections are exactly what the Coalition –and its New Labour predecessor –sidestep when they assume that individual companies can succeed in global markets if they have good quality management: this is the romantic logic of the prime minister's rhetoric about how our industrial strengths are “underpinned by world beating companies” and the task now is to back high growth new technology companies that

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<sup>30</sup> Wolf, Martin (2010), 'UK economy must perform a rebalancing act', *Financial Times*, 13 April 2010, also available at <http://www.ft.com/cms/s/0/1bf3ffb0-472c-11df-b253-00144feab49a.html#axzz1CFNWtvWp> (accessed 27 January 2011).

are “the big businesses of tomorrow”. Against this, we would argue that a successful national manufacturing system is better understood as an ecosystem in which supply chains profitably connect the different competences of a diverse population of firms from small to medium and giant enterprises which sell branded, finished products. And, from this point of view, the political arithmetic is discouraging because the evidence suggests that British manufacturing has disabling problems with broken supply chains and fragmented networks which leave small players hugely vulnerable to the sourcing whims of large behemoths and make poor trade performance a consequence of the way in which manufacturing is organised.

The first relevant constraint is the absence of what we might think of as *biodiversity* in British manufacturing. The latter, we suggest, requires a balance between large, medium and small firms and establishments that are connected by a dense network of chains which depend on higher level firms with the ambition and capability to construct national supply chains. Here again the aggregate statistics are misleading. These tell us that manufacturing is unexceptional in Britain in terms of its relative size, since, for example, it accounts for much the same share of GDP as manufacturing does in France. But its internal ecology is different because it suffers from a significant corporate absence. British manufacturing has relatively few large, domestically headquartered corporate players with global reach, broad capabilities and more than 50,000 employees –like, for instance, Michelin, PSA or Valeo in the French automotive sector. This absence is crucial because these type of players boost cost recovery by selling branded finished products, sustain civil R and D and build technological competences which are organisational overheads; they also connect backwards to domestic suppliers. The absence of such chain-sustaining players in the UK is the disastrous consequence of the doctrine of shareholder value, the break up of (relatively unprofitable) giant manufacturing firms, and inept government policy over, for example, rail and electric power privatisation where no regard was paid to a domestic supplying industry.

The ecology of British manufacturing is certainly peculiar because at the top of the UK manufacturing chain large and medium British headquartered manufacturing firms are a nearly extinct species. GEC, ICI, Lucas, TI and all the rest have all been broken up and sold off; while British Aerospace is the national defence contractor which depends on military orders since it sold its stake in the Airbus consortium in 2006; and pharma companies like GSK or Astra Zeneca have success built on aggressive marketing of property rights. This means that the Rolls-Royce Group stands out because it employs 40,000 as the world's second largest producer of aero engines, and is the UK's only large, world class, high technology contender which makes a complex, high value, finished product for civilian markets. The second tier then includes less than a handful of publicly quoted firms such as Smiths Group or GKN who each employ more than 20,000 worldwide and are credible first rank global suppliers of assemblies such as detection systems or components like drive shafts for cars. There is then a big step down to

firms such as JCB in back hoe loaders or Weir in pumps and valves, which have big brands in small market segments and typically employ 5-10, 000 worldwide.

If we turn from absences to presences, the official statistics on establishment size provides an important supplementary insight into the character of British manufacturing. They reveal that the legacy of Thatcherism and New Labour is a British manufacturing sector dominated by small workshops. The big British-owned factories of the 1970s are mostly closed or sold off either because of shareholder value demands for profit which encouraged retreat, or as a result of inept privatisation which destroyed supply chains. As exhibit 16 below shows, the number of factories with more than 200 employees has halved over the past 25 years, so that the UK now has no more than 2,000 factories employing more than 200 workers; by way of contrast, three quarters of manufacturing establishments now employ 10 or less workers and the number of these workshops has doubled in the past 25 years.

**Exhibit 16:** Size of UK manufacturing establishments

	1983		2008	
	No. of establishments	Share of total	No. of establishments	Share of total
	No.	%	No.	%
1-10 employees	53,067	51.8	107,315	76.2
11-49 employees	35,770	34.9	23,980	17.0
50-199 employees	9,076	8.9	7,502	5.3
200 or more employees	4,532	4.4	1,984	1.4
Totals	102,445	100.0	140,781	100.0

Sources: CSO and ONS.

Notes: In 1979 there were 108,767 manufacturing establishments.

This peculiar ecology of workshops rather than factories and small rather than large firms, is related to the problem of broken supply chains which both constrain firm ambition and undermine the possibility of high British content. In considering firm ambition, it is essential to distinguish between British and foreign owned firms. These now have very different characteristics because, after thirty years of welcoming inward direct investment and foreign takeovers of British firms, the end result is not some kind of levelling up in capability but a kind of bifurcation.

Put simply, the British owned firms are poorly placed in a workshop sector which generally lacks any capability to move up the supply chain; while foreign owned firms with larger factories often have ambitions limited by their role in global supply chains. More than half of British manufacturing output comes from the British owned firms which have an average of 14 employees. This is a workshop sector whose output includes new style high tech suppliers to aerospace and old style low tech fabricators of plastic windows or metal railings. It is hard to distinguish the weight and importance of these two groups because both kinds of firm tend to have similar key ratios of low purchases and high labour share. The workshop sector as a whole has a low purchase to sales ratio of 55% and a high labour share of value added which runs at 75-80%<sup>31</sup>. Maybe the balance between old and new is much less important than it appears in government speeches because the key point is that neither kind of British owned small firm typically has much independent capability to export.

The factory sector of UK manufacturing is capable of export. But that is now dominated by foreign owned firms which are much larger than their British-owned counterparts because the foreign owned firms have an average of 200 employees and together all the foreign owned firms account for one-third of UK manufacturing employment<sup>32</sup>. But these foreign owned factories are mainly branch assembly plants, as with the Japanese-owned car assembly plants, whose ambitions for expansion are limited by their role in a global division of labour established by a corporate parent for whom the UK is an important market but a relatively high wage cost production base whose export profitability is complicated by currency fluctuations against the Euro. More than 25 years after the opening of Nissan Sunderland, all the Japanese manufacturers in the UK employ no more than 50,000<sup>33</sup> and it is unlikely that they ever will, given the fact that Sony and Matsushita have already closed British factories and shifted electronics production to low wage countries.

Meanwhile, broken supply chains undermine high British content and limit domestic backward linkages; with broken chains, much of the higher level spend on components and other intermediate products leaks abroad so that the benefits for domestic firms and British workers are seriously limited. In this context, any renaissance of British manufacturing policy would feed component imports and create jobs abroad. This point is not empty rhetoric because, on the available evidence, it is no longer possible to construct a large, heavy engineering product with a high British content. According to a junior coalition business minister, JCB provides a

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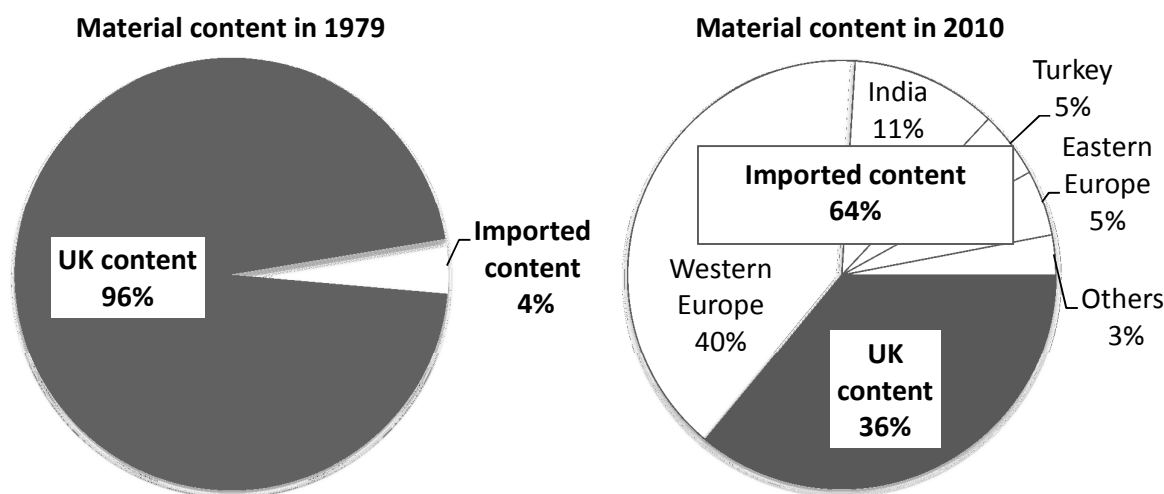
<sup>31</sup> ONS

<sup>32</sup> ONS

<sup>33</sup> ONS

“shining example of British design, engineering and manufacturing”<sup>34</sup>, and since starting engine production in 2004 the firm certainly now makes more of its diggers in-house. But, according to JCB’s chairman, the British content of its diggers has declined from 96 % by value in 1979 to just 36% by 2010; most of that fall has been concentrated in the last ten years when many British suppliers have exited and much of their business has been picked up by mainland West European suppliers who now account for 40% by value of the JCB digger<sup>35</sup>.

**Exhibit 17:** Source of purchases in a JCB digger split by region in 1979 and 2010



It is of course true that we live in a world in which the manufacturing sectors of all high income countries are increasingly dependent on imported components and assemblies. But in the UK, the propensity to import is much higher, no doubt because of the reliance on foreign owned assemblers operating in global systems: in British machinery and vehicles 50% of intermediate purchases are imported as against just 30% in Germany where the propensity to import is much lower<sup>36</sup>. Older readers from manufacturing districts of the UK, like the Potteries, the West Midlands or South Wales will remember the infrastructure of forges, foundries and

<sup>34</sup> Department for Business Innovation and Skills (2010), 'BIS HQ showcases UK manufacturing to attract new talent', London: Central Office of Innovation, <http://nds.coi.gov.uk/content/Detail.aspx?ReleaseID=415318&NewsAreaID=2>, updated 6 September 2010, (accessed 27 January 2011).

<sup>35</sup> Bamford, Anthony (2010), '30 years ago 96 per cent of a JCB digger was made in Britain. Today it is just 36 per cent. WHY?' *Daily Mail*, 12 October 2010, also available at <http://www.dailymail.co.uk/debate/article-1319223/30-years-ago-96-cent-JCB-digger-Britain-Today-just-36-cent-WHY.html> (accessed 27 January 2011). See also Jones, Digby (2010), 'The JCB build with foreign parts - and the truth that our politicians don't want to talk about', *Daily Mail*, 25 April 2010, also available at <http://www.dailymail.co.uk/debate/article-1268616/LORD-DIGBY-JONES-The-JCB-build-foreign-parts--truth-politicians-dont-want-talk-about.html> (accessed 27 January 2011). Our pie charts are re-drawn from this *Daily Mail* article.

<sup>36</sup> OECD



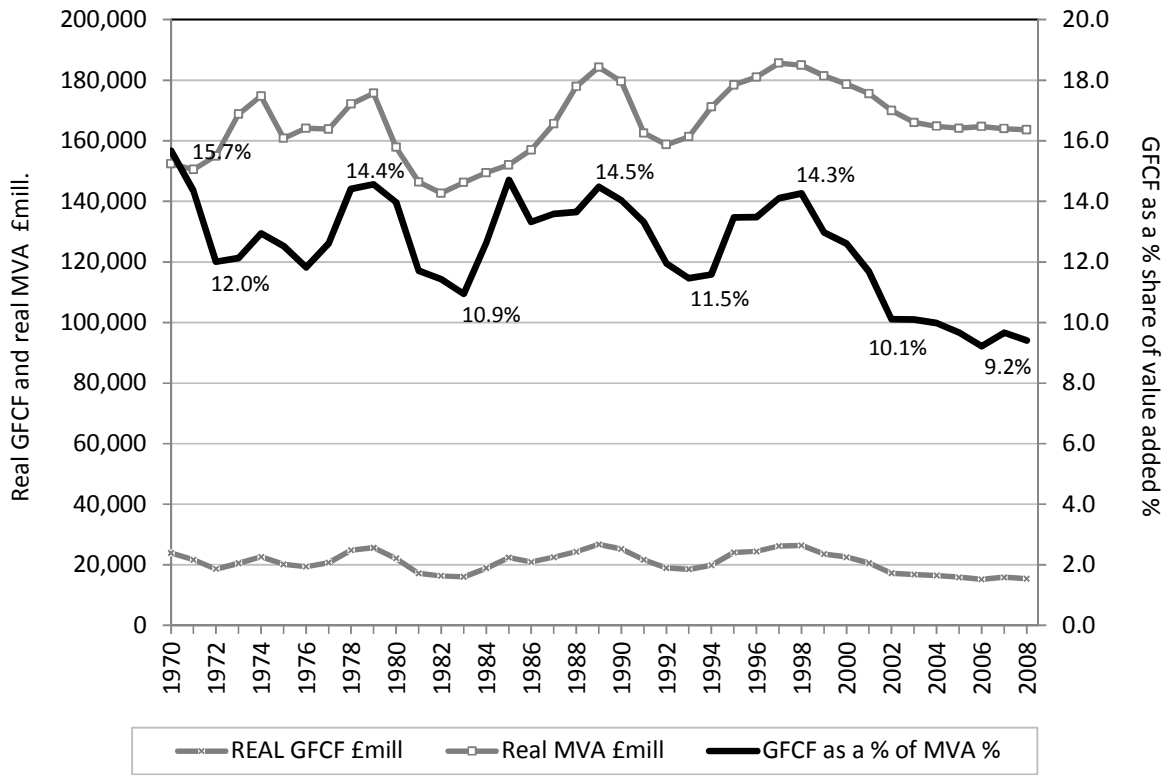
machine shops whose engineering capabilities serviced and supplied downstream assembly and process factories so that you could source components and support services from within the region or even one large town. When the big factories closed, the supporting infrastructure decayed. Import dependence is the legacy. All very ironic for those who remember Piore and Sabel's arguments about flexible specialisation because British manufacturing has downsized into workshops, as it loses its industrial districts<sup>37</sup>.

If British manufacturing does have a problem about broken supply chains, some of the evidence of decline is also ambiguous, if we accept that manufacturing is not always the same and its characteristics may be changing. Consider, for example, the record on British manufacturing investment which has collapsed in an unprecedented way since the late 1990s. Exhibit 18 below presents the basic data on manufacturing investment using the measure of gross fixed capital formation in relation to net output. The established historic pattern was that fixed capital investment, like much else in manufacturing, varied cyclically but did so within fairly predictable upper and lower bands: for 25 years after the early 1970s, manufacturing investment varied in a fairly narrow range between 11% and 15% of output. But, in the decade after 1998, manufacturing investment then declined continuously but unsteadily to an unprecedented level of under 10%. But, maybe this reflects not decline but changing activity characteristics which make fixed capital investment less important and human capital more important. There is some empirical evidence about the tertiarisation of manufacturing which supports this more optimistic position about the growing importance of development, support services, sales and marketing and logistics. According to one report, production's share of total manufacturing employment fell from 53.4 % in 1994 to 48.7 % in 2009.

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<sup>37</sup> Piore, Michael J., and Charles F. Sabel (1984), The Second Industrial Divide: Possibilities for Prosperity, New York: Basic Books.

**Exhibit 18:** Comparison of UK manufacturing real gross fixed capital formation, real value added and investment as a share of net output 1970-2008<sup>38</sup> (GFCF and MVA in 2009 values)

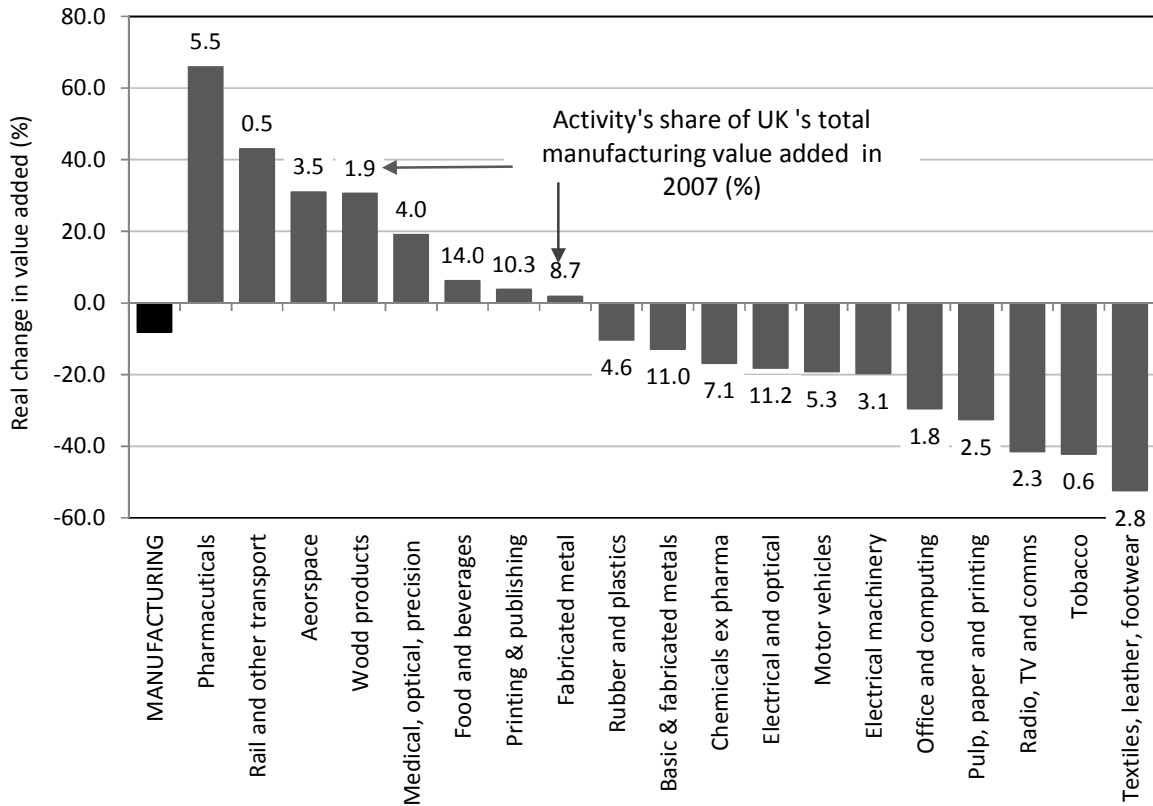


If the characteristics of manufacturing are changing, we are unlikely to see a sunrise development of new high tech manufacturing sectors (at least under existing policies) and any analysis of district success and firm level evidence only increases our reservations. In any large and complex entity it will be possible to find examples of success but the problem is that these local exceptions are small and lack weight. As exhibit 19 below shows, eight sectors generate an increase in real output between 1995 and 2007, before the economic downturn. And though this list of sectors includes aerospace, pharma and instruments and account for just over 12% of UK manufacturing output, the growth sector which sustains the largest employment base is food and drink which accounts for 15% of all manufacturing employment and 14% of the UK's total manufacturing value added; and does not figure at all in coalition or New Labour speeches. A closer examination of the output data does show that growth in some sectors offset decline in others but it also highlights the importance of the State in aerospace and the significance of the relatively sheltered food manufacturing sector. In the largest traded goods segments of electronics and motor vehicles the performance is dismal. The search for growth districts produces similarly disconcerting results about significant percentage growth rates in some small towns (with negligible larger effects on the regional and national

<sup>38</sup> OECD

economy). Manufacturing employment is growing fastest in Aberdeen, Truro and Falkirk where between 13% and 16% of manufacturing companies are “high growth” so that they increase employment by an average of 20% a year between 2005 and 2008<sup>39</sup>.

**Exhibit 19:** Change in UK real value added in selected activities between 1995 and 2007<sup>40</sup> (underlying data in 2009 values)



New corporate exemplars of success, such as ARM in chips for smart products or Dyson in vacuum cleaners, have adapted to broken domestic supply chains by outsourcing everything except design and maybe chain organisation. Low wage outsourcing of production, plus design and branding which yields luxury trade margins, has made James Dyson a billionaire while his privately held company apparently probably employs less than 2,000 in the UK. Dyson Limited employs around 2,500 worldwide (and it manufactures in the Far East). In spring 2010 the company announced that the recruitment of 350 more engineers would in due course increase total numbers employed at its Malmesbury headquarters to 1,600<sup>41</sup>. From a social point of

<sup>39</sup> FT, 25 January 2011

<sup>40</sup> OECD

<sup>41</sup> News, BBC (2010), 'Wiltshire inventor James Dyson 'to back UK engineering'', London: BBC News Channel, <http://news.bbc.co.uk/1/hi/england/wiltshire/8643505.stm>, updated 26 April 2010, (accessed 27 January 2010).

view, this is not the solution but another instalment of the manufacturing problem via pathological adaptation.

There are many good reasons for supporting British manufacturing because it is still a source of more than 2 million jobs, but successful defence means finding sustained increases in output which therefore break with the long-run trend of flat output since the 1970s (which implies declining employment as productivity increases). Realistically, we could hope to slow the rate of job loss but the prospects are not good given the internal problem of broken national supply chains and the external conditions of competition from Germany, Japan and China. In short, manufacturing is operating in an unfavourable environment.

#### **4. POLICY IMPLICATIONS: WHAT CAN WE DO?**

Talk of rebalancing began under New Labour (we've cited Peter Mandelson's speech to the Industrial Society in January 2010) and it has continued with Coalition policy announcements by Vince Cable, George Osborne and David Cameron and others since May 2010. We've suggested that the phrase is a shifting and more or less vacuous trope. Perhaps it reflects buyer's remorse, but it is unlikely to lead to effective policy interventions to reverse manufacturing decline. Neither it is likely to affect the inequalities that separate London and the South East from the rest of the UK. A different approach is needed, and this is what we start to explore in this section. We begin by briefly considering the limited relevance of the government's policies and registering some caution about old style industrial policy for picking winners. And then we show how an analysis which starts from the specifics about broken supply chains might lead towards innovative tax policies for boosting output, employment and skills and how such policies could then be combined with more interventionism. The rationale is straightforward, The lawyers and accountants of the finance sector have put huge ingenuity into devising tax minimisation policies for private advantage and enrichment of the few; now is the time for politicians and civil servants to adjust tax rates for the social benefit of output and employment for the many. First, however, some further thoughts on the Coalition's policies for rebalancing.

There are policy differences between New Labour and the Coalition and the process of electoral competition works to highlight their importance. The speed of the public expenditure cuts, and the desirability or otherwise of New Labour's National Insurance increase or the coalition's January 2011 VAT increase from 17.5% to 20% -these have been matters of dispute. In regional and industrial policy, the coalition ostentatiously scrapped the Regional

Development Authorities and Vince Cable withdrew loans previously offered by Peter Mandelson to Sheffield Forgemasters<sup>42</sup> while promising aid for Rolls Royce<sup>43</sup>. But such differences are put into perspective if we look at what some of the major figures have been saying. So what was Peter Mandelson planning in January 2010 when he talked of the “politics of production” and “the importance of emulating other governments” that were actively investing in their industrial strength? And what did David Cameron intend in October 2010 when he claimed not only to have an ideological view of government’s role, but also wants to build on “industrial strengths” and “world beating companies” as well as encouraging new companies as part of a “a new economic dynamism”? Our answer is that for most purposes, the similarities are more striking than the differences. Indeed, there’s a case for saying that the departmental policy agenda hardly changed when Vince Cable replaced Peter Mandelson as Secretary of State for Business, Innovation and Skills. So what *is* that agenda? Three of its features are particularly obvious:

- **Rebalancing policies reflect a concern to support few small sectors which symbolise the manufacturing of the future, and they simply don’t engage with most of manufacturing.** So, for instance, David Cameron wants to support (regional) private sector investment in green technologies, creative industries, financial services, pharmaceuticals and advanced engineering<sup>44</sup>, while Peter Mandelson’s earlier and overlapping list covered the ‘digital, energy, transport and low carbon infrastructure’<sup>45</sup>.
- **There is a shortlist of preferred policies that are intended to help those privileged sectors by supporting knowledge or improvements in infrastructure.** Thus Vince Cable and Chancellor Osborne are now introducing the policies outlined by Mandelson in his January 2010 speech about the importance of partnership between universities and industry in Fraunhofer networks, a new growth capital fund with bank support for SMEs and public/private investment in infrastructure.
- **Most of manufacturing is offered nothing more than a low tax, generic pro-business environment.** The Coalition is marginally more aggressive than New Labour about low business taxes, but the first coalition budget offered similar solutions. George Osborne’s 2010 budget reclaimed the radical low tax rate patrimony by symbolically cutting

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<sup>42</sup> House of Commons (2010), 'Written Ministerial Statements, Business, Innovation and Skills, Sheffield Forgemasters', *Hansard*, 514: (39), Col 79WS, (27 July 2010), also available at <http://www.publications.parliament.uk/pa/cm201011/cmhansrd/cm100727/wmstext/100727m0001.htm#100727000002>

<sup>43</sup> FT, 4 June 2010

<sup>44</sup> Cameron, David (2010), 'Speech to the CBI Annual Conference', London: 10 Downing Street, <http://www.cbi.org.uk/pdf/20101025-cbi-pm-conference-speech.pdf>, updated 25 October 2011, (accessed 3 January 2011).

<sup>45</sup> Mandelson, Peter (2009), 'Going for Growth: Building Britain's Future Economy, Speech to Labour Party Conference, 28 September 2009', London: The Labour Party, <http://www.labour.org.uk/peter-mandelson-speech-conference>, updated 28 December 2009, (accessed 3 January 2011).

corporation tax from 28% to 24% in order to try to “create the most competitive corporate tax system in the G20”. It also offered more incentives to create jobs by symbolically reversing Labour’s national insurance increase in order to “promote employment by reducing the cost of retaining and rehiring staff”. But we’ve been arguing that these are policies that have been tried and failed over thirty years. The problem is that over the long term a general pro-business low-tax regime has conspicuously failed to encourage industrial growth, innovation and the creation of skilled jobs.

Against this background, we have sympathy for those like Ha-Joon Chang who have rediscovered something completely different in the form of an old style industrial policy for picking winners. This is a rediscovery, because what is being recommended is an approach to policy which existed in 1970s Britain before Mrs Thatcher, and has continued elsewhere to the present day. Thus Ha-Joon Chang<sup>46</sup> argues that governments can pick winners, “especially if it is done in close...collaboration with the private sector”, and gives French, Norwegian and Korean examples. This is not wrong, but we would argue that selective industrial policy and targeted assistance for specific firms and industries is only one (initially small) part of the answer. Instead, or in addition, it is vital to address underlying British problems which include broken supply chains, and cyclical fluctuations of manufacturing output. We also need to remember that the abolition of the Regional Development Authorities by the Coalition completes a process of centralising industrial policy in BIS, a Whitehall Department with a limited capacity to manage any kind of reconstruction.

The first move that would help would be to **change our metaphors**. We need to stop talking about rebalancing. We’ve shown that it is empty –and it’s simply being used to defend a traditional mix of failed approaches to policy. Instead we need to think about policy objectives in quite different terms. For instance, what about thinking of manufacturing in the kinds of terms sometimes used to talk of food or energy? We might, for instance, talk of **manufacturing security**. Like food or energy supply, this could be turned into an object of national policy. The rationale is straightforward. The country needs some manufacturing because it simply cannot afford to import everything. This is in part simply how it is, and partly because it would be healthy if it were less dependent on finance. (The latter’s importance in terms of a balance of payments surplus means that it is currently difficult to restrain and regulate despite its manifest weaknesses). We should not be apologetic about pursuing manufacturing security. It was successfully achieved in the US, when the Federal Government bailed out GM and Chrysler in 2007-08. This secured the future of two large branded manufacturers with big US employment bases and preserved the diverse balance of activities within the US economy.

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<sup>46</sup> Ha-Joon Chang, *23 Things They Don’t Tell You about Capitalism*. London: Allen Lane

And, who knows, in the long run GM may even be able to make profits by selling big Buick saloons to Chinese businessmen.

The second move that would help would be **to recognise the history, the scale and the gravity of the problems in manufacturing**. It is clear that these have failed to respond to continuing post-Thatcherite, generic pro-enterprise policies including those of the Coalition. And there are at least four such weaknesses: **fragmentation**; limits to **manufacturing capacity**, the organisation of **investment decisions**; and a serious **shortage of skills** at all levels. More broadly, the worsening regional UK economic problems are intertwined with an unsustainable and unproductive national business model. Let us start by recognising that existing policies have failed. With shareholder value in the capital market and low taxes in the product market, market- led decisions to invest in strong areas and disinvest in weak areas will simply make the situation worse. State policies for intervention are needed.

These are the reasons why all the stakeholders around manufacturing need to press both government and opposition to think *radically* about the scale of the problems and the structures that have led to long term underperformance and retreat. There is an urgent need to think *imaginatively* about the interventions required to meet those challenges. What's required are not reforms that 'pick winners', but something much more structural. The need is to create the conditions necessary for the future sustainability and productive success of the UK economy.

It will take a generation to "solve" the problems that have built up undiagnosed over the past thirty years, but the starting point is to recognise that the tax system offers us one way of addressing many of these problems. The finance sector shows us a model of tax minimisation for private advantage ever since the first Euro bonds were (for tax reasons) floated at Schiphol airport. Every hedge fund and private equity firm now relies on tax accountants and corporate lawyers to advise on how to route its cash flows through tax havens so the partners can take out more profit. Why not socialise this model for manufacturing and apply some civil service brain power to adjusting the tax regime and offering aggressive rebates and incentives for firms that deliver social benefits of output, investment and employment? That is the principle of all our recommendations below and this fiscal approach is peculiarly suitable for manufacturing because it engages with the specifics of the activity. In our discussion elsewhere of the problems of re-regulating for safer finance, we have emphasised the limits of any kind of technocratic intervention for stability.<sup>47</sup> In the case of finance, the problem is that financial innovation takes the form of "bricolage" and therefore regulation in finance is not an external constraint but a major input for a fluid process of improvisation which often defeats the

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<sup>47</sup> Engelen, E., Erturk, I., Froud J., Leaver, A. and Williams, K, (2010) 'Reconceptualising financial innovation: frame, conjuncture and bricolage', *Economy and Society*, 39 (1) pp. 33-63.

purpose of regulation. But this condition does not apply in workshop manufacturing which must suffer whatever tax rules the national government decrees; here there is an opportunity to change the tax rules in order to encourage the activity of manufacturing firms. Why not break with the generic low tax, pro enterprise policies and offer sector specific incentives in manufacturing for more focused purposes.

### **Increasing British manufacturing output: fiscal policies for increased capacity and investment**

Here's another part of the output problem. Capacity is constrained which means there's an imbalance between domestic capacity and domestic demand. Counterfactually, if *all* UK domestically produced manufactures (including exports) were consumed in the UK, production would meet only 81% of total domestic demand. This is frightening, but perhaps this 'output gap' would be a useful way of thinking about long-term manufacturing security (and just as useful as measuring trade deficits in the short to medium term). The one substantial study of the UK's balance of trade prospects by Coutts and Rowthorn<sup>48</sup> projects an unsustainable increase in the UK deficit which will constrain macro-economic policy options and require permanent deflation to damp down demand for imports. From this point of view, manufacturing security is not an empty trope, but an urgent priority. We need to achieve it if we are to have the capacity and output to deliver the UK from payments constraint.

Our earlier arguments suggest that under current conditions it is exceedingly unlikely that our manufacturing firms will install the capacity to deliver the output we need. And this conclusion about capacity stands with or without the 4% reduction in corporation tax promised by George Osborne who is at the same time reducing investment allowances which impact significantly on manufacturers; just as the conclusion stands with or without a 'growth strategy' that makes it easier and cheaper to hire and fire workers and removes regulations like planning constraints. It is the *sectoral* structures and conditions around so many of our manufacturing firms which inhibit investment in capacity building.

As we have seen, the surviving British-owned firms are typically small, and are embedded in global value chains organised by large, branded, foreign owned players. It is not xenophobic to say that this involves lost economic sovereignty. Small UK manufacturers are routinely exposed to the sourcing decisions of overseas multinationals and the vagaries of economic decisions that are beyond their control. Again as we have seen, foreign owned branch plants form part of this global logic. Policy commitments to shareholder value and willingness to see the purchase of British companies by foreign multinationals have led to broken supply chains. The Dyson

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<sup>48</sup> Coutts, K. and Rowthorn, R. (March 2010), 'Prospects for the UK Balance of Payments', Civitas, London.  
<http://www.civitas.org.uk/pdf/RowthornCouttsBalancePayments.pdf>



effect delivers pockets of dynamism and competitive strength in a small number of small firms, but this kind of success built on uncoupling from national supply chains will not deliver a broad-based increase in capacity and output.

In addition there are problems with cyclicality. This spreads real insecurities and encourages defensive, low investment, safety-first strategies as firms manage their way to decline. The newspapers may be celebrating this year's and even this month's output growth in manufacturing, but on past form it will not be sustained over the long term. Indeed, a prescient CEO in manufacturing would be throttling back investment right now. The boom of 2002-07 in the UK and its main export markets had little or no effect on UK manufacturing output, and the current spur to growth is a depreciation of the pound by 25-30% which cannot continue. All this tells us that British manufacturing output is likely to fall as deflationary government policies bite and recession or low growth continues in Britain and Europe. And then, if and when recession lifts, without sufficient UK production capacity to meet domestic demand, any upturn sucks in imports from other countries that do have capacity.

The result is a kind of vicious ratchet effect. Fragmentation and broken chains together with a back story of cyclical downturns mean that capacity is not installed or upgraded in the upturns; and then in the downturns, the weakest manufacturing firms go under along with their skill sets and capabilities, while import penetration broadens and increases to new levels. That is what we predict over the next 10 or 20 years if we continue to face the business cycle. But it is important also to consider what might come 50 or 60 years hence, with rising populations and diminishing resources. Many would then envisage sharp conflicts over energy and food supply, and there is every reason to believe that manufacturing would be drawn into such conflicts.

Suppose manufacturing decline continues in the UK (and suppose by some miracle we are delivered from medium term payments constraints by another happy accident in resource discovery which does for us in the 2050s what North Sea oil did in the 1980s). If Britain were then an importer of manufactures we would find we were exposed to either a lack of tradable goods with which to barter or, in the worst case, shortages of final consumption and intermediate goods. If this sounds far-fetched, we would note that such outcomes can already be seen in food production, where in Russia and across the developing world export bans are in place for a range of commodities so as to divert scarce output to meet domestic demand.

All these different arguments lead to a single conclusion. To meet the challenge of stagnant output and broken supply chains we need to encourage capacity building and investment right across the board in manufacturing. And the good news is that there are new fiscal policies which the British government could introduce, that would offer incentives for capacity building and investment. If manufacturing output were stabilised or increased, this would also increase

UK manufacturing jobs and help to rebuild broken supply chains. So what's the basis of the policy?

- **A targeted reduction in manufacturers' corporate tax for increasing output.** First, we recommend that **corporate tax for manufacturing sector companies** (and only manufacturing companies) **should be reduced for every year in which they increase UK generated value added** (and not value added generated by overseas subsidiaries or subcontractors). Remember, organically generated value added is the lifeblood of any manufacturing firm and it is generated by employees who turn purchases of raw materials or semi-manufactures into finished or semi-finished products which are then sold to either the final consumer or to other firms. The difference between sales revenue and purchases is value added from which the company satisfies its various stakeholders such as paying the workers' wages, reinvestment and profits.

How might this be done? We envisage a sliding scale of corporate tax reductions in which manufacturing firms that increase internally generated value added by more than 3% annually receive a reduction in corporation tax levied on profits. We set the hurdle rate of output growth at 3% because the UK's historic manufacturing productivity growth rate is around 3%. Without sustained output growth and with sustained 3% productivity growth, the British result has been a steady *reduction* in employment. Our argument, then, is that any increase in output above 3% (of a firm running at near full capacity) will lead to an increase in the headcount.

For 30 years or more our accounting led management culture, shareholder value and deference to an ideal of the market economy has privileged superior *financial* results. But there is a problem. These financial results are difficult to obtain in manufacturing, and especially in workshop firms where financials are often mixed up with other objectives such as employing family or sustaining the owner's lifestyle. Our proposal is simply intended to move back a little, by offering financial incentives for increasing output by value and/or volume. They would be available for all manufacturing firms, but are likely to be most effective for smaller British owned firms that do not have the possibility of offshore tax strategies which are being used by our few large British based multinationals.

And, if this principle is sound, the government might lever the effects in manufacturing by offering more financial incentives for investment. In a much diminished sector where investment has fallen and the total employed is now under 2.5 million, government could and should be generous with such incentives for manufacturing firms before they go further down the road of underinvestment, poor productivity and low value added.

- **Enhanced depreciation allowance.** If the manufacturing sector's investment level is a concern, how can the state find ways of fiscally encouraging manufacturers to increase investment in capital equipment? Here is a second possibility. It could be achieved by

manipulating the tax regime on retained profits and offering **enhanced depreciation allowances**. For example we could enhance the tax benefits by using retained profits for reinvestment –manufacturing overall uses retained profits for investment rather than raising debt –and at the same time discouraging dividends. Again, it would be necessary to work out the detail but this is possible if we remember that the objective is to increase output and capacity. As for capital allowances such as enhanced depreciation/amortization on R&D, these could be used to make the activity cheaper and encourage increases in output and capacity.

- **Targeted national insurance relief**. The government might also **reward any increase in employment through new manufacturing job creation with a national insurance holiday** for each additional new worker, tapered over 3 or even 5 years. Again, this is another way of providing a specific sector with a grant for behaving in a socially useful way because capacity, investment and employment are all output-related variables and output is what is most needed. This policy could be made more sophisticated by webbing in extra payments for an employer taking on a new employee who had previously been on job seeker's allowance for six months or more. Again, the incentive could be generous because taxes from the new employee would increase tax receipts and reduce welfare costs.

Our proposals offer a variety of incentives for manufacturers to grow output which will drive an increase in employment and capacity. We are not sure at what level to set the sliding scale (we have not done the detailed work) but we would set it steeply because, from a tax revenue standpoint, income and employment taxes –levied on employer and employee –generate 11 times more revenue than corporate tax levied on firms. Increased employment would actually generate increased tax receipts. The proposal is essentially an interesting way of giving manufacturers grants for behaving in a socially useful way. Potentially this would encourage relocation to the UK and a reintegration of value chains because that too would boost value added. All these policies would work most strongly in encouraging domestically-based small firms to increase output.

### **Building workforce skills and firm capability**

British manufacturing is not a machine with gears and ratios that set a predetermined relation between inputs and outputs. The relation between manufacturing investment and output and the productivity of the workforce also depend on organisational and human factors. And the joint determinants of these outcomes are workforce skills and firm capability. We will concentrate in this section on workforce skills, not because we think it is the more important of the two variables but because we think that workforce skills are more amenable to the fiscal levers approach that we recommend. Technical education and training, especially for the

intermediate groups that in Germany attend a Fachhochschule, has consistently fallen out of systematic government thinking. Now is the time to use the tax system to make amends.

The fiscal regime we have described above would create some more UK manufacturing jobs, but only some. The scope and nature of global competition has changed. No fiscal incentive would be large enough to bring back many of the low-skill jobs that moved to China and other low-wage economies. Whatever happens, Foxconn will not be opening an iPad assembly plant in Birmingham; and the ex-Rover auto-development engineers now working in consultancies on Chinese contracts should realise that their jobs will go too. Skilled jobs are not as immobile as once thought<sup>49</sup> and, in the next phase, emerging economies will develop new competences that will challenge those of high income countries. It is ironic that UK universities are equipping Chinese and Indian students for new roles, while the UK government does not focus on the need to rebuild our skills base in workers and firms so that we maintain a competitive global presence in this sector.

The current skills problem in UK manufacturing has several dimensions:

- First, if we consider top end skills, manufacturing firms struggle to attract talented new graduates. This is because both generalists and those with engineering backgrounds are drawn to better paid jobs in finance which offer the prospect of becoming one of the working rich. Those who would have joined a big firm's graduate entrance scheme in the 1970s, or an accounting or consultancy firm in the 1980s, now send their resumes to JP Morgan or Barclays. In the world as it is there is even a web site which advises early career engineers on how to break into finance (<http://www.mergersandinquisitions.com/getting-a-finance-job-from-engineering/>). The movement of young talent into finance has an opportunity cost for manufacturing, even though the benefits of employing engineers in finance are uncertain. Here is another reason for restraining banking salaries (they distort the labour market) while the further challenge is to think of building a clear career track from University to the manufacturing sector.
- Second, the problem is not simply one of lining up young graduates to enter occupations where current manufacturing skills reside in older workers whose knowledge will be lost on retirement or through redundancy. This is partly because the work of too many British universities has been distorted by the requirements of the Research Assessment Exercise; so the lack of applied research in Universities is a theme already noted by a number of studies<sup>50</sup>. Unsurprisingly in many cases, courses in the applied sciences are too theory-

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<sup>49</sup> E.g. Lazonick, W. (2008), Sustainable Prosperity in the New Economy? Business Organization and Employment Opportunities in the ICT Industries, W. E. Upjohn Institute for Employment Research.

<sup>50</sup> Rose Wiles, Nicholas Bardsley, Jackie Powell (2008) Assessment of the Training Needs in Research Methods in the UK Professional Social Research Community, ESRC National Centre for Research Methods

oriented and lack practical application in a workplace setting. A greater use of industry placements could also be used on these courses, while universities could be prevented from closing engineering departments so as to ensure a reasonable spread of regional provision. At University level, students on engineering courses might be provided with a bursary, with tuition fees waived for those who take applied engineering (mechanical and electrical) courses.

But the skill deficit cannot be sensibly addressed by sending half the age cohort to university from 18-21 and then insisting that universities offer practical courses. We need to envisage different kinds of local and regional institutions, and offer fiscal incentives for a revival of broadly based technical education for 16-18 year olds and afterwards on day release as well as a dramatic expansion of training within firms. Thirty years ago, the large British firms in every major town accepted the costs of apprenticeship and technical education as a kind of social overhead which they willingly paid; now it's 'can't pay and won't pay' from both the small firms and those that are large. So how do we incentivise them to do the right things?

Of course, institutions matter, especially in more high-tech areas. The Universities are important and the Fraunhofer model could work if the government puts enough resource into the initiative. There are also some indigenous models that seem to have worked in the UK. In pharmaceuticals for example there is a strong link between conceptual work and applied research. Universities lay down the basic conceptual foundations for students, whilst foundations such as the Wellcome Trust in tandem with the Medical Research Council ensure that new research translates into practical innovations that can be used in an industry setting. Similarly the partnership between pharma firms and University departments goes some way to channelling research towards commercial goals. The lack of innovation in *applied* sciences outside of pharma is one key area that government should attempt to redress.

But lower level skills and training also need to be addressed, and here our proposal is to use fiscal incentives to re-embed training in labour market policy. Here, regrettably, government policy is still moving in the wrong direction when the context is unfavourable. Government is now perversely focused on making it easier to hire and fire workers, rather than rewarding firms that invest in staff they aim to retain. The context of cyclicity plus pressures from shareholder value encourage short termism in larger firms in a culture in which labour is the input most likely to bear the burden of adjustment in response to the vicissitudes of the macro-economy. When German policy offered incentives for firms to retain skilled workers in the downturn after 2008, British firms were on their own and let workers go.

So what might be the tax policies for training?

- **Reinventing apprenticeships.** We need to begin at the beginning by incentivising in-firm training to encourage the **reinvention of apprenticeship** in a form which is relevant to small firms as much as those that are large; skill retention then needs to be encouraged through promotion of partnership between employee and employer. This might be done through **national insurance holidays for manufacturers that take on apprenticeships in-house on structured schemes.** Manufacturers could be offered tapered relief on national insurance once the apprenticeship is completed and s/he employed full-time. If the employee left voluntarily for a job opportunity elsewhere, the relief might be continued so that employers would benefit financially from the training even though they may not benefit from the person's skill.

It also needs to be recognised that the skills problem is not simply about workers. It is also about firm activity and competences and it is important to take stock of firm capabilities and consider ways in which such capabilities might be nurtured and applied outside the firms' current supply chains and used for profit in different *industry* and regional settings. The policy proposal? This is for **firm and locality reviews of competences** which might be transferable to other chains in different sectors. Such reviews would include firms in both sunrise and sunset industries, It is important to stem precipitous decline in pottery, textiles, leather goods as well as finding nodes of growth; and to see whether we could do in a sector like pottery what has happened in motorbikes, where reskilling and a programme of innovation has led to a revival of fortunes. These reviews should acknowledge that there is little or no future in low wage and price sensitive competition, and instead explore how a combination of building activities and competences within and across sectors could begin to address the issues of broken supply chains.

This kind of task would have a further spinoff. Handled properly, it would help to build new in-house capabilities in central government departments such as BIS. This implies that departments should be prevented from outsourcing this work to consultants because government needs to have some intelligence and capability of its own beyond the capacity to commission research. Sector reviews would also highlight the need to develop regional institutions which had the vitalising combination of sound technocratic judgement and local political connections. After thirty years in which the Treasury has become a kind of neoliberal think-tank and local government has been trivialised, the task of rebuilding skills is as important in government as in the manufacturing sector. And the manufacturing sector could therefore be seen as a kind of laboratory in which government and other stakeholders developed policies which could be tested, modified, and transposed to other areas.

## **Other policy areas...**

If this report began by discussing the many aspects of rebalancing, this section has mainly concentrated on tax incentives for output, capacity and skills in the manufacturing sector which employs no more than 10% of the workforce but is responsible for 80% of visible trade and 50% of total exports. Other sectors have grown, particularly services but the focus is deliberate because manufacturing is important to all our futures and it allows us to make the case for a new kind of tax policy which illustrates an approach that can be applied in other policy areas. Consider, for example, the issue of increasing regional disparities and how the South East has had such a centripetal pull, sucking in investment, jobs and new activity, when what the UK economy ideally needs is a number of centres around the country which throw out jobs and opportunities to their localities. Clearly there are practical and physical limits to growth in the South East, not least in terms of available housing stock and increasing pressures on social resources and infrastructure. If expansion in the South East is not sustainable over the long term and new ideas need to be implemented now, rather than later. So what are the selective tax policy possibilities?

**Land value tax.** Strategies of relocation and new regional agencies could be backed up by the introduction of a **land value tax** which would go some way towards reducing the attractions of the South East. Land value tax is an annual tax on the rental value of land (not on the property or infrastructure built upon it). Because land is difficult to hide in an offshore account, the tax is difficult to evade, and it provides an incentive for owners of vacant and under-used land to use their resource more productively or to make way for others who will. By definition a land value tax would therefore bear less heavily on those regions where land has little value, and it would work to divert economic activity away from the centre and into the regions. It could also be used as a substitute for other taxes on labour or firms in order to encourage investment in the regions where land values are lower. The tax could be used imaginatively to promote a range of local social and economic initiatives.

This report aims therefore to open up a broad ranging debate about the scope for imaginative, new kinds of intervention which could really help to rebuild the economy rather than make empty promises about rebalancing. For more than thirty years successive British governments have pursued generic policies that make the business world look more like an introductory micro economics text books or at least those chapters dealing with competition. If we consider the problems of the national business model or the broken supply chains in manufacturing, the conclusion has to be that the thirty year experiment has failed and it is time to make an honest inventory of those failures and move on with more selective and activity-specific policies. Why ever not?