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Targeting Competitive Industries



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Targeting competitive industries

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Markets and market failure

1

One of the more curious of Mrs Thatcher's achievements in eleven years of rule is that she made almost all of us into believers in the efficiency of markets. Or did she?

Most now accept the presumption that markets will handle certain kinds of problems far more effectively than administrative action, and some of us are willing to design administrative procedures that mimic the operations of markets in dealing with problems for which markets do not or cannot exist. The hoary traditions of paternal and planner socialism have (by and large) given way to new conceptions of market socialism which promise to be both more democratic and more effective than their predecessors. Of course, some believe in markets a little more fervently than others, and many see limits to the efficiency of market operations that others will not accept. The interesting question is, then, not so much one of 'markets or not' as of 'how much market, how much socialism'.

A natural way to start the search for an answer to this question is to look for systematic types of market failure, such as monopoly, uncertainty or the existence of significant externalities. The difficulty with using the market failures paradigm as a basis for designing a coherent industrial (and regulatory) policy is that one is almost inevitably reduced to thinking about policy on a case by case basis. Every market has its own peculiar mix of market failures, some more serious than others, and the appropriate solution to any particular type of market failure is bound to depend on the nature and severity of the other failures that occur in that market. However, any policy that begins with the presumption that every case is unique and requires its own unique solution will lack coherence, and is bound to degenerate into political expediency and opportunism sooner or later. What one requires to design a coherent policy programme is a set of presumptions about which types of market failure cause serious problems in a wide variety of settings. Our view is that the process of making or creating markets is fraught with market failures of the type discussed above, and, in particular, that it can result in an inadequate development of the infrastructure of many markets, leading to unsatisfactory market performance.

Properly functioning markets require the existence of certain supporting institutions, and the efficiency with which they operate depends on the quality

of this infrastructure. Firms operating in any particular product market rely on various input suppliers to provide the wherewithal to manufacture an attractive product, and on various distributors to get it to those consumers who wish to purchase it. The success with which a firm can produce and sell its product obviously depends on its relations with suppliers and distributors, as well as on their basic competitive abilities. Public policy problems arise because a market's infrastructure helps to support all of the firms who operate in it, and no one firm has an incentive to create the necessary infrastructure alone if this will benefit its rivals. Of course, many markets do exist, and that means that it has proved to be in someone's interest to create them. The problem is that many entrepreneurs may find it profitable to create a market only when their control over the infrastructure gives them market power in that market. That is, the conditions under which many markets are created may more or less permanently blight the efficiency of their operations.

Fixed costs

To appreciate the problems of creating markets, consider what might be involved in setting up even the simplest of markets – an exchange market (i.e. one where no production occurs). One needs a large building, often located in a high-rent area of town, to house the exchange, office buildings to house the individuals involved in each transaction, an elaborate record-keeping system to keep track of all the exchanges, and a system of monitoring and enforcement to ensure that the rules of the exchange are obeyed. One must also meet the cost of the time of all the people involved in the activity. These fixed costs are not inconsiderable, and it is not clear how an entrepreneur that tries to set up such a market might recoup these costs and make a decent profit. The problem is that a market like this creates positive externalities, providing valuable information and an opportunity for participants to realise gains from trade. All traders are likely to benefit from the existence of, for example, a futures market, but not so much that it is worth the while of any single one of them to create the market. The consequence is that very few organised futures markets actually exist, and many of those that are created fail. A study of futures markets in the U.S. suggests that about 40% of all newly-created futures markets fail within the first five years of life.

An example of the type of problem that may emerge in creating a market can be drawn from the computer industry. It is important to ensure that the basic hardware of a machine is compatible with both the kinds of software that users require and the various peripherals or add-ons they may wish to use. The existence of a basic standard machine and/or software operating system is, therefore, crucial to the development of the market simply because the existence of a standard enormously enhances consumer choice and the ability to make choices quickly and effectively. The more users there are of a basic software system, the more incentive software developers have to develop

packages (particularly specialist packages); the more standardisation there is in hardware, the more competitors there are likely to be on the market, and the less likely it is that consumers will get 'locked in' to any one of them. An 'open standard' is, therefore, an important part of the development of the market. However, it is rarely the case that firms participating in the market will have an incentive to develop an open system. Rather, it will be in each firm's interest to develop a 'proprietary system' that locks consumers into its product, restricts the number of competitors a firm faces and gives it leverage in bargaining with software or peripherals producers, that wish to gain access to its standard and sell in its captive market. When a single firm dominates the market in question (such as IBM in the case of computers) it is likely to be the case that the firm will develop a proprietary standard. The consequence can be under-developed infrastructure – less software packages, peripherals and add-ons are produced than could or ought to be – and a market in which the dominant market power becomes entrenched, perhaps for long periods of time.

The way in which market infrastructure develops plays an important role in determining the kinds of competitive strategies used by firms which operate in that market. The competitive skills which firms acquire are often developed co-operatively with upstream suppliers or downstream distributors and, as a consequence, the ability of firms to acquire certain types of skills depends on the strength and depth of supporting institutions upstream and downstream. Firms that operate in particular markets in different countries are bound to develop comparative advantages that reflect the different capabilities in the infrastructures in the national markets in which they operate. Differences in their performance can often be traced back to strengths and weaknesses in these infrastructures.

Kitchen manufacturers

For example, the U.K. kitchen manufacturing industry suffers from the lack of a well-developed domestic infrastructure of machine tools and materials and parts suppliers. U.K. manufacturers are disproportionately represented in the low quality, low value-added segment; German producers dominate the top, high quality segment. Kitchen furniture manufacture in the U.K. is a distinctly low-tech, low skill operation, but in Germany even small manufacturers use highly-sophisticated machines, almost all of which are made in Germany. Those British manufacturers who do use sophisticated machinery generally experience more breakdowns than their German counterparts, and are far less productive. The problem is that the U.K. users get no maintenance assistance from local agents, so need to carry large stocks of spare parts. By contrast, with machine manufacturers sometimes only half an hour away by car, German manufacturers call on their suppliers' specialised service engineers fairly frequently. The U.K. industry suffers from a structural weakness

that no amount of managerial talent or incentives applied to kitchen furniture manufacturing are likely to ameliorate.

It follows from this that those concerned with creating national comparative advantages in particular sectors should concentrate on developing the infrastructures of those sectors. Further, since the process by which market infrastructures develop is fraught with problems associated with monopoly, uncertainty and externalities, the promotion and development of market infrastructure should be a leading industrial policy concern for all but the most obdurate laissez-faire enthusiasts.

The challenge for public policy makers is to create markets which can then be used by entrepreneurs who do not enjoy monopoly power. Failure to develop such infrastructure can mean that certain types of markets fail to come into existence, that others are dominated by their creator in a way that inhibits subsequent market development, and, finally, that others fail to develop their full potential because their infrastructure is too poor to enable the firms that operate in them to develop genuine comparative advantages which enable them to operate competitively in world markets. Markets may work well as a rule, but 'the market for making markets' almost certainly does not, and it is the failure of this market above all that calls for the attention of public policy makers.

Market infrastructures

2

Competitive advantage is generally thought to depend on the possession of some 'special asset' or 'special skill'.

If the special asset or skill is both unusual and results in a product or service that creates considerable value added for consumers, then it will yield high rents to its possessor. If, in addition, it is an asset or skill that is difficult to imitate, then its possessor will enjoy these high rents in perpetuity. It follows, then, that to help restore the comparative advantage of U.K. industry in world markets, industrial policy must be designed around the problem of stimulating the development of such special assets or skills. Most discussions that stress the need for a supply side policy to rejuvenate the industrial infrastructure of the U.K. (which is nearly all of them) focus mainly on the need for more investment on R&D and training, and they typically advocate national policies that are general enough to benefit all firms and workers. Although it is clearly the case that market failures bedevil private sector efforts to make these types of investments (and have done so to a noticeable degree in the U.K.), our view is that this kind of public policy response is too limited in scope to be of much use in compensating for these market failures. Better targeted and more locally based policies are also needed.

In very general terms, the special assets or skills that create competitive advantage for a firm are those which enable it to produce better designed products more efficiently. The ability to do this depends (in part) on the firm's consumers, suppliers and on its rivals. Consumer needs can only be met if they are articulated, and firms cannot be expected to produce sophisticated, high technology products if consumers are unprepared or unwilling to use them. Although the size of the market is important in stimulating innovation, what matters more is the 'pull' that sophisticated buyers exert on innovators by demanding new and innovative products. To meet this demand, firms must develop efficient production processes, and their ability to do this depends (in part) on the quality of the suppliers of materials, machinery and labour that they deal with, and often on how closely they are located to the producing firm. Home-based suppliers create advantages in downstream industries when they deliver cost-effective inputs quickly and effectively. More important, supporting industries often stimulate innovation through a kind of supply 'push' that

is based on close working relationships that facilitate a quick and constant flow of information, and an ongoing exchange of ideas. Finally, it is one thing to have opportunities, but it is quite another thing to take full advantage of them. No matter how sophisticated their buyers and how technically adept their suppliers are, firms that enjoy protected positions of monopoly power usually fail to fully develop their skills simply because they lack the incentive to act that competition brings. Competitive advantages almost always emerge from the crucible of active product market competition.

Clusters

In short, the competitive ability of firms depends in large measure upon the infrastructure of the market that they operate in. Buyers make demands which, when reinforced by active competition amongst close rivals, leads firms to try to create new and innovative products. Their ability to respond to their buyers' needs depends on whether or not they can successfully manufacture the product efficiently, and this depends on the skills and abilities of suppliers (and on how effectively they are honed by the pressures of competition amongst suppliers). It follows, then, that the special assets or skills that create competitive advantage in any one sector depend (at least in part) upon those developed by firms in upstream, downstream and neighbouring sectors. The result is a whole **cluster** of (often geographically proximate) activities which has a competitive strength far in excess of the competitive strength of the sum of its parts. In a sense, the proposition that competitive advantage emerges from clusters of mutually reinforcing innovative activity means that economic development is inherently uneven: nations rarely develop comparative advantages across the whole range of manufacturing industry, and sectors that develop competitive advantages which enable them to grow rarely expand in a regionally balanced fashion.

The proposition that nations develop comparative advantages mainly in clusters of highly-related activities and not across the board is fairly evident to even a causal observer. Recent work at Harvard directed by Michael Porter has documented this pattern in some detail. For example, his team observed the U.K. to have competitive advantages in alcoholic beverages, confectionery and biscuits, cigarettes, cosmetics, perfume, various household products (such as toothpaste and soaps), financial services, consumer goods retailing, and petroleum and chemicals. Competitive advantage was seen to be weakest in textiles, office products, telecommunications equipment, consumer electronics and mechanically based consumer goods (such as watches). Japan, by contrast, was observed to have competitive advantages in transportation equipment, office machines, consumer electronics, steel and fabricated metals, electronic components and computing equipment, cameras and film. Relatively weak Japanese sectors included chemicals and plastics, food and beverages, packaged consumer products and nearly all types of services. West German firms,

to take a final example, were observed by Porter's team to have substantial competitive advantages in chemicals, metal and metal working, optical-related products and in a wide range of household goods (such as porcelain-related products, furniture and appliances). Relatively weak sectors were found to include all types of services, semiconductors and computers, electronics products and telecommunications equipment.

Both the rich interaction of upstream, downstream and neighbouring firms which defines clusters and their unbalanced regional development is evident in a wide range of cases discussed by Porter and others. For example, consider the world printing industry. West German dominance of the production of printing presses dates from the 19th century, and today the industry accounts for 35% of world production of printing presses. It has an export share of just over 50% and it exports to more than 120 countries. The six leading firms in the sector are all located within 150 miles of each other in southern Germany, and are part of a cluster that includes world leaders in the production of paper making machinery, paper producers and ink producers. That these several upstream and downstream producers form a richly interacting cluster is evident from even the most casual inspection of the process of innovation in this sector. The development of high-speed printing machines, for example, required the cooperation of paper makers (who developed paper that could withstand the pressures of high speed printing) and of paper machine producers (who developed the machinery necessary to product that type of paper). Similarly, ink producers played a major role in the development of inks that could be used in several generations of new printing presses. The whole cluster is supported at one end by the high standards and sophistication of German printers (the German market is only the sixth largest in the world), and, at the other end, by the work done in the German chemical industry on synthetic indigo and by a series of vocational schools set up by the leading firms to train skilled labour.

Robots

Japan produces more than 50% of the world's robots, exporting at least 20% of its domestic production. The industry started in 1970 with a licensing agreement between Kawasaki Heavy Industries (a major user of robots and a producers of related products and services) and one of the American firms which first developed robots (Animation). By 1980, there were 130 robot producers in Japan at the core of a cluster of activities driven by users and supported by a wide range of supplier industries. The major users of robots are automotive and domestic appliance producers, and much of the development of this sector can be traced to their actions. Cooperative trade unions and managements with solid engineering backgrounds made Japanese firms much more willing to invest in robots than their foreign competitors in a range of sectors. Nissan, for example, was an important early customer, helping

Kawasaki to design and service robots. In due course competitive pressures in the automotive industry led the other major Japanese car producers to help develop and install robots, and the growth and development of the robot market piggybacked (in part) on the growth of the Japanese car industry, providing a base market from which further applications of robotic technology could be developed (such as the electronics, plastics processing, general machinery and metal working sectors). Needless to say, the success of Japanese robotics producers in meeting this demand was due in no small part to the fact that the technologies employed in producing robots (numerically controlled machine tools, motors, optical sensors, and the like) have, in the main, been developed by Japanese firms who, as often as not, are leaders in these sectors as well.

The fact that economic development tends to be rather uneven, that nations tend to develop comparative advantage in clusters of activities rather than across the board, carries several important implications for the design of industrial policy. In particular, it means that policy must be targeted, that it must be designed and implemented locally, and that regional policy must focus on building up 'growth points' rather than on dispersing economic activity. We consider each of these in turn.

Targeting growth points

3

It seems clear that creating competitive advantage in particular sectors often requires developing the infrastructure of those sectors, building up clusters of mutually supporting activities which jointly develop a range of special skills or assets.

The needs of each sector are idiosyncratic. It follows that policy must be custom-designed and sector-specific in application. The infrastructure suitable for textiles has little in common with that suitable for cars, and any initiative that tries to address both simultaneously will almost inevitably be too general to be useful.

Although it does not seem to be particularly remarkable taken at face value, the observation that policy needs to be targeted cuts against the grain of recent U.K. industrial policy practice. In fact, most industrial support in the U.K. is not sector-specific, and much of it comes in the form of capital allowances and stock relief. The sole virtue of general non-discretionary support systems (such as those implemented through the tax system or general subsidies disbursed by the DTI) is that they are easy to administer, support being given on the basis of eligibility rather than need (which is, of course, much harder for civil servants to determine). As a consequence, some firms get support that they don't need, while others don't get what they need or don't get it in the form that they need it. Tax incentives encouraging investment are not needed by firms who elect to pay high dividends, and they provide little assistance for firms whose investment programme is disrupted by failures in capital goods-supplying industries. R&D tax credits do not stimulate the investment in human capital that is often necessary to exploit new technology, and encouraging R&D in technologically barren areas is pointless. In fact, most of the rather limited sector-specific support that has been given over the years in the U.K. has flowed to one of a small number of crisis sectors (such as steel, automobiles, shipbuilding, and so on), and often it has done so in response to short-term political pressures. As a result the application of industrial policy in the U.K. has often been a little confused, and many of the policies directed at crisis sectors have, in fact, been designed to slow adjustment rather than to facilitate it.

That support ought to be sector-specific is often described – and then dismissed – as requiring civil servants to ‘pick winners’. In fact, as an alternative to the current policy of being ‘led by losers’, picking winners has something to be said for it. Rather more subtly, ‘picking winners’ is a characteristic of a type of industrial policy that contents itself with handing out subsidies and then standing back to watch what happens. The only decisions involved in implementing this kind of policy are, of course, ‘who’ and ‘how much’. In fact, there is plenty of evidence to suggest that subsidies are both expensive and extremely inefficient. They encourage firms to develop lobbying skills rather than competitive skills, and they create a climate of dependency which saps their competitive vigor. Where government can play a positive industrial policy role that targets strategically important sectors is in the marketplace, subject of course to the potential and unexplored restrictions of the Single European Market after 1992. Governments are enormously large buyers of a wide range of goods and services ranging from electronics to pharmaceuticals, from office equipment to transportation equipment. Many of the sunrise sectors of the 1960s and 1970s started with help from government purchasing contracts (typically defence contracts), and government purchasing is likely to play a large role in stimulating the emergence of a number of sunrise sectors in the 1990s. As buyers of a range of such products, governments are in a position to act as a stimulant to supply by encouraging competition amongst suppliers, demanding products that are technologically sophisticated and innovative, and providing a large enough market for the new products to amortise most of the R&D expenditures needed to develop them. Although procurement polices can go disastrously wrong (as in the case of System X), when they are well managed they can stimulate the development of a range of highly-interrelated sectors. An intelligently managed procurement policy does not pick winners so much as create them.

Semi-conductors

A classic example of the successful use of procurement policy to develop a sector can be found in the early development of the U.S. semi-conductor industry. The development of both the early silicon transistor and the integrated circuit emerged at the prompting of the U.S. armed forces (although the original transistor appeared independently). The clarity of defence needs focused the innovative efforts of supplying firms. The size of military orders, the forces’ willingness to pay, and the high premium put on quality by defence procurement bodies enabled producing firms to learn about new products and processes in a way that simply would not have been possible had more market-driven (and, therefore, more short-term) commercial considerations been applied to product and production choices. Many of the early transistors were incredibly expensive to produce, and the sector would never have developed as it had if the sole source of demand had been the private sector.

Military demand enabled firms to scamper up the learning curve, and thus, in effect, subsidised the emergence of a huge private sector market (one whose size now far exceeds the defence-related market for semi-conductors). Similar effects of procurement policy can be observed in the US computer industry, in commercial aircraft and other sectors.

Top down or bottom up?

Of course, procurement policy is not the only form of targeted industrial policy available to policymakers. Government can facilitate the development of various types of infrastructure institutions or the restructuring of particular sectors, and government can ensure the provision of certain types of goods or services (such as training). There are several ways in which such policies can be implemented. 'Top down' policy strategies involve spending decisions made by policymakers that directly create market infrastructure institutions, while 'bottom up' policies are those in which such spending decisions are made by private sector agents in response to incentives created (or manipulated) by policy markers. Either way, the success of such policies depends on whether they can stimulate the development of competitive advantage; that is, on whether they help insure the emergence of a cluster of mutually supporting activities. The point is easy to see in the contrast between U.K. and Japanese industrial policies in the machine tools industry.

Japan is now the world leader in machine tools, having risen to a share of world production of about 25% in 1982 from less than 1% in 1955. Over the same period, the U.K. share declined from just under 9% to just over 3%. Both countries followed interventionist industrial policies. In Japan, R&D subsidies were provided to the industry, together with the usual range of soft loans, tax breaks and protectionist measures. However, the important policy choice was made in the early 1970s when one company, Fujitsu FANUC, was encouraged to become the dominant supplier of control units to the industry. This effectively standardised the parts used, making it very easy for producers to manufacture low-cost numerically-controlled lathes and machining centres. In the U.K., the policy of the 1960s (implemented through the IRC) was one of encouraging mergers, although no attempt was made to ensure that the new national champions realised any of the efficiencies promised by such rationalisation (Alfred Herbert was run as 24 separate companies for quite some time after rationalisation had turned it into the world's largest machine tools producer). R&D was supported, although in the U.K. money was channeled into highly ambitious products and very little of it diffused through the sector. Finally, although standardization was recognised as being important, import substitution was accorded far greater weight, and firms were encouraged to produce products that could be used as substitutes for those produced abroad and imported into the U.K..

It is clear that the success of the Japanese policy arose because policyma-

kers were able to help articulate desirable product choices for the industry as a whole, and they managed to support and sustain that choice by a very shrewd intervention in the infrastructure of machine tools production. 'By contrast, U.K. policy (which used many of the same instruments as were used by the Japanese) was dominated by attempts to develop over-ambitious 'big science' projects, as well as by a quite unwarranted belief in the proposition that mere size confers competitive advantage. Efforts to standardise crucial inputs and to develop products suited to the current competitive strengths of U.K. producers were neglected in favour of rather short-sighted efforts to ameliorate the U.K.'s chronic balance of payments problem. What U.K. policy lacked was a sense of the relationship between machine tools producers and both their suppliers upstream and their buyers downstream.

Research projects that corresponded to no real needs, and a total lack of effective interest in standardisation left U.K. policymakers with little to do but to create large giants in the 1960s and bury them in the 1970s.

Local industrial policy

4

Since clusters of competitive advantage develop in geographical proximity to each other, and specific firms in these clusters often require quite highly specialised, idiosyncratic infrastructures the design and implementation of industrial policy must inevitably be localised.

Any targeted policy worthy of consideration requires a good deal of highly detailed information about the target sector if it is to be properly designed and implemented, and there is no doubt that local policymaking units operating close to the targeted firm or sector will have a comparative advantage (relative to civil servants in Whitehall) in gathering such information. Further, broadly designed policies administered from afar tend to become more and more unwieldy as the number of agents involved increases, complicating administration in a way that often blunts the effective application of policies. Smaller, locally-based policies can often be far more effective in this respect, and, in addition, they may also prove to be more sensitive to local needs and preferences.

What is required to create and sustain an infrastructure in a particular sector is often little more than the coordinated mobilisation of local institutions, and it may require no more than helping to bring into fruition plans made by the firms in the sector themselves. Links with local universities and various vocational training institutions are needed to provide training for skilled workers of various types, something that these institutions may not do in the absence of a well-defined, clearly expressed local demand for these skills. Entrepreneurial activities in a wide range of related sectors need to be stimulated both by the development of clear mechanisms for expressing demand, and by the development of institutions to help overcome bottlenecks in supply. Most sectors are surrounded by a busy, buzzing hive of support activities, many of which are provided by small firms. To stimulate the development of these support activities and to keep them competitive, finance and hands-on managerial assistance needs to be made available and premises need to be provided. Private sector institutions are often uninterested in supporting this type of economic activity (because they are unable to appropriate enough of the gains to make their investments pay), and this means

that there is likely to be an important role to be played by enterprise boards of various types.

Indeed, practical experience in the U.K. and abroad (notably in Italy) has shown that local enterprise boards can often serve as a focus around which a number of richly interacting layers of local economic activity swirl, and one senses that this type of institution has a richer potential than has been realised thus far. Greater London Enterprise, for example, provides venture capital funding (often in partnership with private sector agents and occasionally on a sector-specific basis) coupled with hands on management of their portfolio of projects. Sector-specific funding projects (targeting tourism, film production, and so on) are more or less explicitly designed to create clusters of mutually supporting activities. More subtly and more important, bundling funds together into general or sector specific programmes helps to bridge the well-known financial black hole that afflicts small firms: the amounts that they wish to borrow are too small for most financial institutions, whose minimum lending levels can run to 250,000 or more. Greater London Enterprise effectively bundles a range of small loans together into a package large enough for private sector financial institutions to handle, and then manages the resulting portfolio. Part of the hands-on management component of the services provided to small firms consists of providing basic business skills to entrepreneurs who have a good idea but little business sense or experience, and part of it is delivered via a variety of training and consultancy services direct towards small local enterprises (and to various local authorities). Finally, Greater London Enterprise helps to develop industrial and commercial property in London (again, often in partnership with private sector firms), providing (amongst other things) managed workspaces for small firms. These are integrated workplaces that provide a range of premises (allowing individual firms to expand or decline without changing their business address) and associate support services (including creches, in-house printing and so on). Many of the newly formed TECs ought to be able to provide similar, complementary services on a local basis.

Networks

Regional Councils in Italy have proved to be successful in stimulating the growth of small and medium-sized firms, often creating networks (or 'industrial districts') of mutually supporting activities. The services provided include administrative activities like bookkeeping, auditing, industrial relations support, legal services and insurance provided in exchange for a subscription fee. More interesting have been a number of sector-specific initiatives. In clothing, for example, the Centro Informazione Tessile dell'Emilia Romagna offers a range of design, marketing and manufacturing services (including market research and forecasting, training and so on) to its 500 or so member firms, while other institutions offer quality certification, financial assistance, infor-

mation on subcontractors and so on. Finally, public policy has included a range of land use policies that have stimulated the development of industrial parks, and the provision of specialised premises for small artisan firms.

These various services – which help to co-ordinate the development of a sector and its infrastructure at a particular location – are analogous to activities which help create markets (such as futures markets). They convey positive externalities to all participants, but it is often difficult for the provider of these externalities to obtain a fair reward for his/her activities or a reasonable compensation for the risk involved. That is to say, the market for providing this kind of service is riddled with market failures, and this opens up a window of opportunity for a carefully designed pro-active industrial policy.

Regional policy

Maximising the benefits of clustering through the creation of growth areas of industrial development has been a feature of both French and Italian regional policy. In those countries, land use planning is perceived as being complementary to industrial policy, with a resulting recognition of the importance of 'economies of association'. These arise when the efficiency of a complete complex of firms is crucial to the performance of each individual firm in the group, exactly the effects that we have described as resulting from clustering. In France, this is expressed in the notion of a 'pole de croissance', a growth point at which interrelated firms are encouraged to locate in order to secure the efficiency gains from association that are available.

In Britain there has been some awareness of the potential value of clustering firms at growth points, and as long ago as 1940, the Barlow Commission argued that new industry should be located in 'key points'. However, there has been little practical implementation of the idea even in the halcyon days of U.K. regional policy in the 1960s and 1970s. In fact, the traditional U.K. regional policy stance is in part a legacy of the 1930s when high unemployment was highly localised, and it has led to a strategy that focused on palliatives for above average unemployment, one dedicated to dispersing activities evenly throughout the country. As a result, regional policy has encouraged the diversification of firms as an assurance against unemployment, and not their concentration to maximise joint efficiency. Not surprisingly, appraisers of regional policy in the U.K. have noted its favourable short-run impact on unemployment, but many have also commented on its disappointing effect on the long-run performance of the slow-growing regions at which it has been directed. Despite years of relatively lavish policy attention, regional imbalances in the U.K. have persisted over time (and, in some cases, worsened). If, as we have argued, the process of economic development is inherently uneven, then some regional imbalances must be expected. The policy failure comes from the fact that some regions have stagnated over long periods of time while

others have persistently prospered. The policy of dispersing the activity of successful enterprises or industries has not only led to the scattering of seeds on infertile ground, but also created a range of political hostages that have distorted industrial policy making in these sectors throughout the country (as the Wilson government's response to the Chrysler crisis illustrates).

There are other reasons for the neglect of the clustering approach in the U.K.. While there is general recognition of the right of public authorities to determine where industrial development occurs, there is a conspicuous reluctance to interfere (except within broad limits) with the rights of landowners to determine what development actually takes place. Land-use planning in the U.K. is, as a result, almost entirely reactive. The effect of this has been a pattern of haphazard land use for which it is difficult to find any economic justification. This passive policy stance also makes the implementation of a clustering strategy well nigh impossible. The only pro-active element in location policy in practice is the competition that takes place between planning authorities wanting to attract developers to their own area, a practice which tends to encourage excessive passivity in the public response to the pressure from private developers. It also prevents the realisation of the 'economies of association' that are so important to competitive advantage and economic performance. To regulate the competition between local authorities, the DoE issues Strategic Planning Guidance for Structure Plans. These are prepared by local authorities who are forced by this procedure to co-operate and agree to region-wide constraints on their own individual land-use planning. Although it does offer a promising framework for the kind of location planning that is required if market failures are to be overcome and the benefits of clustering are to accrue, it has been less than wholly successful in practice.

On its own, however, Strategic Planning Guidance is not enough. Local planning authorities need also to have the power and the responsibility to plan actively. One way forward is to give local authorities an explicit economic development role. To do this they need to be free of the financial restraints that prevent them acquiring development land and force them to dispose of that which they currently own. Alternatively and perhaps more appropriately, a region-wide agency could perform this vital role of land acquisition and disposal, while the detailed planning of the land could then be devolved to the lower tier authorities. Where land is in private hands, developers must not be in a position (as they are now) to win almost any application for planning consent on appeal, irrespective of the economic case for the development they propose. At the very least, they need to be required to demonstrate that their proposals do not prevent desirable clustering from taking place.

What should Labour do?

5

The Conservative years have been bad for British industry. A triumphalist adulation of free markets coupled with a succession of Industry Ministers lacking in vision and drive has done nothing to reverse the long-term decline of the U.K.'s manufacturing base or its international competitiveness.

It will not be hard to improve on this rather dismal performance. Indeed, the natural place to start is with one of the deeper flaws in the Tory conception of what governments can and ought to do. Insofar as Mrs Thatcher's government had a positive industrial policy, much of it centred around the perceived need to alter the environment in which business operates. Promoting something called the 'enterprise culture' and turning various conspicuously successful entrepreneurs into folk heroes were initiatives that sprang from the view that many of the U.K.'s industrial policy problems are cultural and have nothing to do with the way that markets operate or with the infrastructure that they operate in.

However plausible this view might, at first glance, seem to be, the hard truth is that one cannot change a culture or a business environment simply by renaming the DTI and lionising Richard Branson. Cultures and attitudes persist as they do because they are supported by institutions of various sorts, and real change requires that one remoulds these institutions.

The Labour Party can (and should) take the lead in trying to rejuvenate the U.K.'s manufacturing base, and that it must do this not only by introducing a coherent and active industrial policy, but, more deeply and more subtly, by changing the intellectual environment in which industrial policy discussions are staged. Industrial policy will never succeed where civil servants and politicians are so overawed by the apparent potency of market forces that they readily concede to doubts about their competence and ability to act. The analysis discussed above seems to us to provide a firm basis upon which to erect a productive policy programme, and a sturdy platform from which to assail the self-doubts that have long crippled the development and implementation of industrial policy in this country.

Training

Labour has already given explicit recognition to the fact that investment in R&D and investment in human skills through training are deeply complementary. There is simply no point in building scientific laboratories (or in giving tax breaks to firms who promise to do so) if there are no scientists capable of using them effectively. Policy in this area can be thought of in terms of creating a market for skills of different kinds. To create such a market, policy needs to focus and then articulate demand. It needs to organise and mobilise the sources of supply needed to meet that demand, and to set standards and provide the certification that individuals need if they are going to be active in a market for skills of different kinds.

The major problem in this regard is that training must have a major on-the-job component. The skills needed by firms often contain a large 'firm-specific' component—general educational establishments cannot provide that kind of training. The market failures that bedevil the provision of firm-specific training are well-known, and it is highly unlikely that they will be solved by TECs which are dominated by employers. TECs have the potential to stimulate the provision of training, but there must be more public sector representation on their boards, and they must be given responsibility to monitor and maintain the standards of any training activity that they support or that occurs in their area and is supported by public funds. Finally, trade unions have a major role to play, and also a responsibility to play that role. The market failures that inhibit private sector profit-seeking organisations from acting do not, and should not, always inhibit private sector non-profit organisations from acting.

Important as it is, however, training alone is not enough. The way forward might be summarised in the form of two further broad policy commitments.

Sector-specific policies

Both common sense and most of the available evidence suggests that sector specific policies must be the way forward. It is hard to believe that macroeconomic policy alone will have much effect on the U.K.'s international competitiveness, and there is little reason to think that pulling a few strings in the form of tax incentives or general subsidies will have much impact either. Thus, a commitment to sector-specific policies carries with it a commitment to avoid an exclusive reliance on certain types of policy tools, and to begin working with others. Our view is that procurement policy is an extremely potent industrial policy tool, one that involves government action dictated by the 'self interest' of its needs as a consumer within the context of an ongoing market process. In a sense, procurement policy provides one partial but rather natural solution to the question of 'who picks the winners', a solution that does not require civil servants to second guess private sector demand. Other policy initiatives that

are consistent with the spirit of employing sector specific policies involve creating or encouraging the growth of institutions that facilitate the emergence of sophisticated buyers and the development of supplier capabilities, encouraging the growth of enterprise boards that provide hands-on assistance to small and medium-sized firms, resisting the temptation to reduce the degree of competition in markets by creating 'national champions', and so on. Finally, no matter how well-conceived and well-designed a policy is, the success of its implementation will always depend on the abilities of those doing the work. A commitment to sector specific policies involves not only a commitment to breathing life into the DTI, but also a commitment to investing in the skills and capabilities of those who work there. The weakness of British management is not confined to the private sector.

Local and regional policy

The analysis discussed above suggests not only that policy should be sector specific, but that it ought to be conceived and implemented at as local a level as possible. There is little to gain and almost everything to lose from an excessive centralisation of policymaking in Whitehall. Our view is that local institutions ought to be given an explicit responsibility for encouraging economic development, and the means with which to do so. These powers and responsibilities might be vested in existing local authorities, or in a set of regional development associations. We prefer the latter arrangement for several reasons. Local authorities are, in a sense, 'too local', and even the most tight geographical clustering of economic activities is bound to span several local authority jurisdictions, creating unnecessary tensions and coordination problems. Further, local authorities often lack the expertise to take on an economic development role, and it seems to us sensible to consider clustering that expertise together into a smaller number of rather broader-based institutions. Finally, regional development authorities can (and should) operate at one remove from the political process, having the freedom to resist the politically convenient and the resources to do what many politicians cannot, namely, think about the long term. Of course, local institutions cannot operate simply as they wish. We see two roles for a central body (such as the DTI) to play in the policy process. First, regional development agencies must account for their actions on a regular basis, and steps need to be taken in order to prevent them from being captured or corrupted by local businesses. Second, the various plans and policies initiated by each region must be woven together to form a coherent whole that is in line with national priorities.

It goes without saying that creating a few regional development agencies will not solve the U.K.'s economic problems. There are a range of different activities which constitute a market's infrastructure, and many of these must be provided by specialised institutions. There are two models that might be used by policymakers to encourage the growth of these. One involves providing

tax (and other) incentives that encourage private agents to undertake desired activities (this might be called a 'bottom up' approach), while the other involves using subsidies (and other devices) to create these institutions directly (a 'top down' approach). For example, to encourage the development of financial institutions which support small-scale, high-tech firms, one might provide tax breaks for large firms or financial institutions that are willing to invest in small firms, or one might simply create local development banks and provide them with an initial capital base to work with (together with a Board of Directors drawn from the public and private sector to ensure that that capital base is used in a businesslike manner). Although we do not know of enough evidence to make a clear choice between these two types of policy, our inclination is to prefer the 'top down' approach. It seems to us that there are often situations in which habitual practice and uncritically examined conventional attitudes make private sector agents unwilling to undertake certain types of activities. If the lack of private sector activity really is caused by market failure, leading by example is the only way forward.

There is no doubt that regional policy must remain near the centre of any industrial policy programme introduced into the U.K.. However, it seems to us that policymakers must accept the unevenness of the process of economic growth by encouraging the clustering of economic activity, not resisting it. This, in turn, means that change in crisis sectors must be facilitated and not slowed, no matter how pressing the short-run concern with preserving jobs and rectifying the balance of payments. Clusters must be encouraged to grow and flower and then they must be allowed to decline and give way to other activities, and there is an important role for regional policy in both the birth and death process. What is more, it is a role that regional policymakers are unlikely to be able to play effectively unless they have the freedom to operate at some remove from short-term political pressures. For these reasons, we see some sense in delegating many of regional policy responsibilities to regional development associations that have some independence of action and are not directly controlled by ministers or civil servants in Whitehall.

This decentralised model roughly corresponds to what currently happens in the area of land-use planning, but we think that land-use planning must be much more explicitly tied into industrial policy programmes than has been the case so far. What this means is that the DTI must play a much greater role in the development and overseeing of planning decisions, and that this integration of the activities of the DOE and the DTI must extend down to the regional level. Again, regional development agencies seem to be the appropriate level at which to decentralise policy action, but it seems clear that if land use planning is to be used to help stimulate economic activity, then regional development agencies must have a strong local presence on their management boards, and they must be held accountable to, though not dictated by, local interests.

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