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Working Paper 19-029



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# UK Competitiveness after Brexit

By Michael E. Porter (Harvard Business School)

On June 23<sup>rd</sup>, 2016 52% of UK voters opted to put their country on the path to leave the European Union by March 29, 2019. This result was a surprise to many, and went against the advice of the vast majority of economic experts and business leaders.

Two years later, and after a remarkable period in UK politics, key questions about the future relationship between the UK and the EU remain unresolved. Various models have been proposed; the latest one by Prime Minister May<sup>1</sup> triggered the resignation of a number of key ministers. All of them struggle to deal with a fundamental tension: how to square barrier-free trade between the UK and the EU, especially across the border between Ireland and Northern Ireland, with both full policy sovereignty for the UK and adherence to the ‘four freedoms’ at the heart of the EU’s Single Market. A ‘no deal’ Brexit by default remains an option, despite the costs to UK businesses<sup>2</sup> and the wider UK economy.<sup>3</sup>

The public debate over Brexit before the June 2016 referendum was almost entirely devoid of a fact-based understanding of both these transition issues and the actual state of the UK economy. The problems facing the UK were not caused by the EU, but rest squarely at home. A ‘good Brexit deal’, at its best, will not eliminate these problems. The real issue is a pattern of persistent weaknesses in UK competitiveness, and its consequences for citizens. These problems were blamed on Europe, but EU membership never really hindered efforts to address them. And it is clear that leaving the EU will erode UK competitiveness further. The lack of effective action on upgrading UK competitiveness has been a fundamental failure of the UK government.

Brexit could trigger long over-due strategy and action by the UK government; this, rather than a wave of new trade agreements outside of the EU that some are hoping for,<sup>4</sup> is the real opportunity for making Brexit a positive difference. The Industrial Strategy White Paper<sup>5</sup> released in November 2017 raised

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<sup>1</sup> HM Government (2018), *The Future Relationship between the United Kingdom and the European Union*, cm 9593, HM Government: London.

<sup>2</sup> Peter Sands, Ed Balls, Sebastian Leape, and Nyasha Weinberg (2017), *Making Brexit Work for British Business*, M-RCBG Associate Working Paper No. 77, Harvard Kennedy School of Government: Cambridge, MA.

<sup>3</sup> Chancellor letter to Chair of Treasury Committee on ‘no deal’ Brexit economic analysis, 23 August, 2018.

<sup>4</sup> Liam Fox, A free-trading Britain can prosper after Brexit, *Financial Times*, Op-Ed, 11 November, 2017

<sup>5</sup> HM Government (2017), *Industrial Strategy. Building a Britain fit for the future*, HM Government: London.

some of the key issues the UK must address, which was encouraging. But similar declarations under prior governments proved to be more talk than effective action, and many observers are skeptical that it will be different this time.<sup>6</sup> What's more, the political debate has been completely overwhelmed by the negotiations with the EU, with little public attention devoted to the policies the UK will want to pursue once it has left the common European structures.

This paper addresses the post Brexit economic strategy for the UK. While much of the attention so far has been on the deal between the EU and UK, there is a pressing need for the UK to agree on and implement a clear strategy that has been lacking. We set forth such a strategy here, based on a fact-driven assessment of the nation's competitive position, including the effects of leaving the EU. We believe the UK must address five key elements: Building a new value proposition for the UK as a place to do business, moving to a cluster-based approach to economic development, embracing regional decentralization in implementing competitiveness upgrading, articulating a strategic agenda that enables inclusive growth, and minimizing the costs of leaving the EU.

The balance of the paper consists of the following sections: First, we discuss the UK's economic performance and policy approach in the run up to the Brexit referendum. Second, we look at the impact of EU membership and loss of membership on UK competitiveness. Third, we set forth a new strategic agenda to enhance UK competitiveness in the post-Brexit era.

## **1. UK productivity, competitiveness and policy in the run-up to Brexit**

Measured by overall GDP growth, the UK economy has performed relatively well since the Thatcher reforms in the mid-1970s. In the aftermath of the 1992 currency crisis, and particularly after the Bank of England was granted independence in 1997, further progress was made on reducing macroeconomic volatility, an issue that had traditionally haunted the UK. The 2008 global financial crisis hit the UK hard, not surprising given its large and internationally linked financial sector. However, GDP growth recovered and the political debate centered on how much fiscal austerity was appropriate to reduce the major government deficit that had been worsened by the crisis.

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<sup>6</sup> A majority of UK-based economists welcomed the government's intention to launch a new industrial strategy, but were skeptical that the government can deliver. See Wouter den Haan, Martin Ellison, Ethan Ilzetzki, Michael McMahon, Ricardo Reis (2017), UK industrial strategy: Views of economists on its desirability and prospects for success, <http://voxeu.org/article/views-industrial-strategy-economists>, accessed 20 March 2017

While overall growth looked encouraging, however, UK prosperity has been lagging. GDP per capita remains well below Germany, Nordic and other Western European countries in level and growth. The UK's overall GDP growth reflected a flexible labor market with low barriers to hiring and firing that led to high employment. Yet wage gains have been stagnant, and the UK's standard of living has continued to lag peers. And importantly, prosperity has been highly uneven: Since the early 1990s the UK registered the greatest income inequality of any European OECD country, and intergenerational income mobility has lagged European peers.<sup>7</sup>

Why is this? We know that changes in prosperity over the long term depend on productivity. Productivity is the central measure of competitiveness and a key driver of a nation's standard of living. The UK's enduring weaknesses in productivity and productivity growth is the root cause of the nation's disappointing economic trajectory.<sup>8</sup> UK productivity is not only lower than in peer countries, but there is a much greater variation across regions within the UK than in other OECD.<sup>9</sup> The UK also registers a major gap between its limited number of world class companies and a long tail of more local firms with below average productivity levels.<sup>10</sup>

In the decade before the financial crisis, there were some signs that the UK was finally making some progress on improving productivity. The gap versus European peers started shrinking, especially after 2001. While some saw this as a sign that the UK was making progress on upgrading competitive fundamentals, GDP and productivity growth were driven primarily by strong household consumption financed by rising private sector-debt and, to a lesser degree, increasing public expenditures.<sup>11</sup>

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<sup>7</sup> Zolt Darvas, Guntram Wolff (2016), *An Anatomy of Inclusive Growth in Europe*, Blueprint Series No. 26, Bruegel: Brussels.

<sup>8</sup> UK Office for National Statistics (ONS) (2016), *International comparisons of productivity - final estimates: 2014*, ONS: London.

<sup>9</sup> Andrew Haldane (2016), *One Car, Two Car, Red Car, Blue Car*, Speech manuscript, Bank of England: London; BIS (2010), *Understanding Local Growth*, BIS Economic Paper No. 7, Department for Business Innovation & Skills: London; and OECD (2016), *OECD Regional Outlook 2016*, OECD: Paris; *OECD Economic Surveys: United Kingdom 2017*, OECD: Paris; Philip McCann (2016), *The UK Regional-National Economic Problem: Geography, Globalisation and Governance*, Routledge: Abingdon.

<sup>10</sup> Jonathan Dimson, Vivian Hunt, Daniel Mikkelsen, Jay Scanlan, and James Solyom (2016), *Productivity: The route to Brexit Success*, McKinsey Discussion Paper. See also Charles Manfield (2016), *How good is your business really*, Productivity Leadership Group: London.

<sup>11</sup> John Van Reenen (2013), Productivity under the 1997–2010 Labour government, *Oxford Review of Economic Policy*, Vol. 29, No. 1, pp. 113 – 141. On the argument about private debt see Ken Coutts, Graham Gudgin (2015), *The Macroeconomic Impact of Liberal Economic Policies in the UK*, Centre For Business Research, Judge Business School, University of Cambridge: Cambridge. On the growing role of government spending in GDP see BIS (2010), *Economic Growth*, BIS Economic Paper No. 9, Department for Business Innovation & Skills: London. Note that by 2008 UK public debt was still below the level a decade ago; other European countries, however, had seen

The financial crisis put the brakes on UK productivity growth, which has been flat. Since 2008, all of the gains in per capita income came from increasing labor mobilization not productivity and wage growth.<sup>12</sup> This so called UK 'productivity puzzle'<sup>13</sup> was often explained by short term issues in the wake of the crisis. Lately, it has been the top performing firms<sup>14</sup> and sectors<sup>15</sup> that have been disappointing.

We believe that ultimately the weak growth of UK productivity is due to the continued and long term failure to improve the UK's fundamental competitiveness. The short-term dynamics matter but should not distract from the underlying issues: UK competitiveness, reflecting the quality of the business environment and the capabilities of UK based businesses, was losing ground before the global financial crisis. The UK was then hurt more than most peers by the crisis, and its competitiveness has recovered slowly ever since.<sup>16</sup>

Overall performance has been mediocre despite the competitive advantages the UK has traditionally enjoyed: an open economy; competitive local markets with high degrees of rivalry; relatively low regulatory costs of doing business; and a strong financial system that has attracted international investors. The UK also has a strong science base, including world-class universities, leading global positions in clusters like finance, life sciences, and some areas of advanced manufacturing. Finally, with London a truly global city the UK has attracted talent and activity from around the world.

So why is the UK underperforming? The answer lies in largely-known weaknesses in competitiveness fundamentals: infrastructure quality is weak and insufficient to support further growth.<sup>17</sup> There are

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significantly stronger improvements. Robert Chote, Rowena Crawford, Carl Emmerson, and Gemma Tetlow (2010), *2010 Election Briefing Note No. 6*, Institute for Fiscal Studies: London.

<sup>12</sup> Daniel Tomlinson (2017), *You're hired!*, Resolution Foundation: London.

<sup>13</sup> See for examples Alina Barnett, Sandra Batten, Adrian Chiu, Jeremy Franklin and María Sebastián-Barriel (2014), *The UK Productivity Puzzle*, *Quarterly Bulletin*, 2014 Q2, Bank of England: London; Vicky Pryce (2015), *Why Should We Care About Productivity*, *National Institute Economic Review*, No. 231, R30-R35; Alex Bryson, John Forth (2015), *The UK's Productivity Puzzle*, NIESR Discussion Paper No. 448, NIESR: London; IMF (2015), *United Kingdom: Selected Issues*, IMF Country Report No. 16/58, IMF: Washington, D.C.; and OECD (2015), *Economic Survey: United Kingdom*, OECD: Paris.

<sup>14</sup> Rebecca Riley, Ana Rincon-Aznar, and Lea Samek (2018): *Below the Aggregate: A Sectoral Account of the UK Productivity Puzzle*, ESCoE Discussion Paper 2018-06, NIESR: London

<sup>15</sup> Patrick Schneider (2018), *The UK's productivity puzzle is in the top tail of the distribution*, BankUnderground blog post, 29 March 2018.

<sup>16</sup> World Economic Forum (multiple years), *Global Competitiveness Report*, WEF: Geneva. For the framework to analyze the raw data from the WEF's global executive opinion survey see Mercedes Delgado, Christian Ketels, Michael Porter, and Scott Stern (2012), *The Determinants of National Competitiveness*, NBER Working Paper No. 18249, NBER: Cambridge, MA.

<sup>17</sup> See the analysis in Graham Atkins, Chris Wajzer, Raphael Hogarth, Nick Davies, and Emma Norris (2017), *What's wrong with infrastructure decision making?*, Institute for Government: London.

major skill shortages, especially in so-called ‘middle skills’.<sup>18</sup> UK spending on innovation lags leading European and global peers. Companies compete mostly on price and cost, rather than on advanced innovation-based strategies.<sup>19</sup> Although the number of strong clusters in the UK is roughly in line with its peers, almost 2/3 of these are located in the London region.<sup>20</sup> And it is the performance of exporters outside of London that drags down the country’s overall productivity record.<sup>21</sup>

Today’s profile of UK competitiveness is disturbingly similar to the one we found in 2003, when a Labour-led UK government asked us to conduct an in-depth/comprehensive review.<sup>22</sup> The government at the time was particularly concerned that too many UK companies and their managers were lagging in productivity and innovation.<sup>23</sup> We found that although the UK had some business environment strengths, the pattern of competitiveness strengths and weaknesses had led too many companies to compete on cost cutting and leveraging existing capabilities rather than to building the skills and capacity for innovation-based competition.

Subsequent governments have launched a range of initiatives to deal with these problems. On innovation and industrial development, the UK has restructured Innovate UK<sup>24</sup> and NESTA,<sup>25</sup> and

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<sup>18</sup> UKCES (2014), *The Labour Market Story: The State of UK Skills*, UK Commission for Employment and Skills: London.

<sup>19</sup> European Innovation Scoreboard 2016, European Commission: Brussels.

<sup>20</sup> Analysis of data from the European Cluster Portal, accessed 22 February 2017,

[https://ec.europa.eu/growth/smes/cluster/observatory/cluster-mapping-services/mapping-tool\\_en](https://ec.europa.eu/growth/smes/cluster/observatory/cluster-mapping-services/mapping-tool_en).

<sup>21</sup> Centre for Cities (2018), *The wrong tail: Why Britain’s ‘long tail’ is not the cause of its productivity problems*, Centre for Cities: London. High-tech and creative skill-intensive activities, areas seen as having favorable growth potential, are also strongly concentrated in London and the South East. Hasan Bakhshi, John Davies, Alan Freeman and Peter Higgs (2015), *The Geography of the United Kingdom’s Creative and High-Tech Economies*, NESTA: London. See also Sandra Bernick, Richard Davies and Anna Valero (2017), *Industry in Britain – An Atlas*, CEP Special Paper No. 34, Centre for Economic Performance/London School of Economics: London, and Kierzenkowski, R., P. Gal and G. Fulop (2017), “Where to get the best bang for the buck in the United Kingdom?: Industrial strategy, investment and lagging regions”, OECD Economics Department Working Papers, No. 1426, OECD: Paris.

<sup>22</sup> Michael Porter, Christian Ketels (2003), *UK competitiveness: moving to the next stage*, DTI Economics Paper No. 3, DTI: London

<sup>23</sup> Subsequent cross-country studies of management quality find the UK slightly behind the US, Germany, and Sweden but ahead of many other OECD countries, see Nicholas Bloom, Renata Lemos, Mingxuan Qi, Raffaella Sadun, and John Van Reenen (2011), *Constraints on Developing UK Management Practices*, BIS Research Paper No. 58, BIS: London.

<sup>24</sup> Innovate UK, the country’s innovation agency was initially created as the Technology Strategy Board within the Department of Industry. It became an independent agency in 2007, changing its name to Innovate UK in 2013. See for a discussion Alex Glennie, Stian Westlake (2016), *Where Next for Innovate UK*, NESTA: London.

<sup>25</sup> NESTA was created in 1998 with an endowment from the national lottery, and focused first on supporting individual innovators and education. It was given a broader mandate to reviving the innovative capacity and the innovation systems of the UK in 2003. In 2010, it was then turned into an independent charity

launched new efforts like the Catapult program<sup>26</sup> and the Advanced Manufacturing Supply Chain Initiative<sup>27</sup>. However, the overall funding available for innovation and R&D in the UK remains significantly below the level in peer countries.<sup>28</sup> After the financial crisis, DBIS Secretary Vincent Cable's 2012 speech laid out a new direction for industrial policy, focusing on upgrading specific sectors and technologies with evident UK strengths, improving access to capital, skill development, and the use of public procurement as a catalyst for innovation.<sup>29</sup> Generous tax rules were enacted for investors and a British Business Bank launched to enhance access to capital, especially for SMEs. Some cluster-based steps were taken, such as the creation of the Automotive Council<sup>30</sup> and national public-private partnerships in other fields.<sup>31</sup> Many of these programs appear individually sensible but their coherence and integration is questionable, especially between innovation and industrial policy efforts.<sup>32</sup>

In regional policy, initial steps in the right direction were later undone. Regional Development Agencies (RDA) were launched in 2003 to create public-private collaboration to foster often cluster-based economic development efforts across the UK. In June 2010, however, the newly elected UK government announced the abolition of the RDAs, questioning their effectiveness. RDA responsibilities were shifted to local enterprise partnerships (LEP), which suffer from their narrow localized focus.<sup>33</sup> Hence top down

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<sup>26</sup> Herman Hauser (2014), *Review of the Catapult network*, BIS: London

<sup>27</sup> BIS (2015), *Advanced Manufacturing Supply Chain Initiative (AMSCI): Process Evaluation Study*, BIS Research Paper Number 223, BIS: London

<sup>28</sup> Tera Allas (2014), *Insights from international benchmarking of the UK science and innovation system*, BIS Analysis Paper Number 03, BIS: London

<sup>29</sup> Industrial Strategy: Cable outlines vision for future of British industry, Speech delivered on 11 September 2012, Imperial College, <https://www.gov.uk/government/speeches/industrial-strategy-cable-outlines-vision-for-future-of-british-industry>, accessed 14 December 2016. Cable's efforts themselves build on earlier policies initiated during the Labour government by Peter Mandelson and earlier Lord Sainsbury: HM Government (2009), *New Industry, New Jobs*, HM Government: London and HM Treasury (2004), *Science & innovation investment framework 2004-2014*, HM Government: London.

<sup>30</sup> Automotive Council UK (2013), *Driving success – a strategy for growth and sustainability in the UK automotive sector*, Automotive Council: London.

<sup>31</sup> BIS (2011), *Innovation and Research Strategy for Growth*, BIS: London, and Chris Rhodes (2014), *Industrial policy, 2010 to 2015*, SN/EP/6857, House of Commons Library: London; BIS (2014), *Industrial Strategy: Government and Industry in Partnership, Progress Report*, BIS: London

<sup>32</sup> Ann Dowling (2015), *The Dowling Review of Business-University Research Collaborations*, BIS: London. David Bailey, Philip R. Tomlinson (2017), *Back to the Future? UK Industrial Policy after the Great Financial Crisis*, in: Phillip Arestis, Malcolm Sawyer (eds.), *Economic Policies since the Financial Crisis*, Palgrave Macmillan: Basingstoke.

<sup>33</sup> See Pike, A., D. Marlow, A. McCarthy, P. O'Brien and J. Tomaney (2015), Local institutions and local economic development: the Local Enterprise Partnerships in England, 2010–, *Cambridge Journal of Regions, Economy, and Society*, 8 (2), 185–204; Hildreth, Paul, David Bailey (2013), The economics behind the move to 'localism' in England, *Cambridge Journal of Regions, Economy, and Society*, 6 (2), 233–249; Shutt, J., L. Pugalis and G. Bentley (2012), *LEPs – living up to the hype? The changing framework for regional economic development and localism in the UK*, in M. Ward and S. Hardy (eds), *Changing Gear – is Localism the New Regionalism?*, London, UK: Smith Institute, pp. 12–24.

national-level policies continued to dominate, out of synch with what is occurring in many other successful economies. While the world has increasingly recognized the need for regional and cluster-based development, the UK has relied instead on vague and ineffective national networks in specific technologies or in particular sectors.

The government efforts of the recent past have largely failed to address the UK's productivity challenge, despite these often well-intentioned initiatives. Macroeconomic management and national, top-down policies dominated. Without a real strategy and the lack of vigorous regional autonomy, the efforts undertaken had significant unintended sectoral and regional implications, despite their largely 'horizontal' nature. Areas of cluster strength such as in finance and advanced business services, life sciences and some areas of IT, and narrow fields in advanced manufacturing, continued to succeed. The concentration of economic activity in the South West and London, in particular, continued.<sup>34</sup> The divergence in prosperity levels across regions and parts of society fueled the discontent that found a welcome outlet in the Brexit campaign.<sup>35</sup>

## 2. The EU and UK competitiveness

In this context, the campaign on whether or not the UK should stay within the European Union was a surreal discussion that failed to confront the real issues and the root causes of citizen discontent. Instead, the Brexit campaign was largely fought on an exaggerated debate on national sovereignty as well as on the short-term transactional costs and benefits of EU membership.<sup>36</sup> The actual conditions of the UK's EU membership were matters of fact, but during the campaign disinformation reined. Europe became a scapegoat for issues that were squarely British, and the failure of UK policies. In addition, the

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<sup>34</sup> This trend towards divergence within countries vs the convergence across countries is not unique to the UK. OECD (2016), *OECD Regional Outlook 2016*, OECD: Paris.

<sup>35</sup> Diane Coyle, *The anger of de-industrialised Brexit towns goes far beyond immigration*, Financial Times, 22 Nov 2016

<sup>36</sup> For some of the major assessments on the economic aspects of Brexit prior to the referendum see: OECD (2016), *The Economic Consequences of Brexit: a Taxing Decision*, OECD Economic Policy Papers No. 16, OECD: Paris; House of Commons Library (2016), *In brief: UK-EU economic relations*, Briefing Paper 06091, House of Commons: London; HM Treasury (2016), *The long term economic impact of EU membership and its alternatives*, HM Government: London; Centre for Economic Performance (2016), *Brexit 2016*, London School of Economics: London. John van Reenen (forthcoming), *The Long Run Effects of Brexit on the UK Economy*, Brookings Papers on Economic Activity.

entire campaign suffered from an almost total absence of an understanding of what the alternative would be, a catastrophic mistake.<sup>37</sup>

EU membership was a major plus in terms of maintaining an open market, limiting market power and government intervention, raising the UK's attractiveness for businesses.<sup>38</sup> EU membership has enhanced competitive dynamics, with positive implications for UK productivity.<sup>39</sup> Outside of the EU the UK government will have more freedom to give subsidies and firm-specific tax relief to companies, something that could in turn increase the demand for such interventions.<sup>40</sup>

Membership in the EU's Common Market put trade and investment policies under the control of common EU institutions and decision making procedures. The UK gained free access to the Common Market but had to submit to traditionally more protectionist EU policies. However, the EU became increasingly liberal in its trade policies<sup>41</sup> and was as one of the largest markets globally able to negotiate beneficial trade agreements with other countries. Outside of the EU the UK will have more freedom to remove remaining restrictions to imports and inward FDI. But it will see new barriers emerge to serve the Common Market. And it will face difficulties in securing favorable market access to other markets negotiating on its own.

Much was made of the costs of subscribing to EU rules and regulations. Complying with EU rules creates costs. But a closer look at the data reveals that these costs depend largely on how EU members implement them: On the World Bank's Doing Business assessment, for example, the same EU regulation allows Denmark to rank 3<sup>rd</sup> globally while Malta ranks 76<sup>th</sup>.<sup>42</sup> Outside of the EU the UK will have more

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<sup>37</sup> House of Commons Treasury Committee (2016), *The economic and financial costs and benefits of the UK's EU membership*, HC 122, House of Commons: London

<sup>38</sup> For an analysis of how the Common Market leads to much deeper economic integration than mere removal of trade barriers see Mulabdic, Alen, Alberto Osnago, and Michele Ruta (2017), *Deep Integration and UK-EU Trade Relations*, Policy Research Paper No. 7947, World Bank: Washington.

<sup>39</sup> Nauro F Campos, Fabrizio Coricelli (2017), *EU Membership or Thatcher's Structural Reforms: What Drove the Great British Reversal?* Discussion Paper 11856, Centre for Economic Policy Research: London; and Nicholas Craft (2016), The Impact of EU Membership on UK Economic Performance, *The Political Quarterly*, Vol. 87, No. 2, pp. 262 – 268.

<sup>40</sup> Nicholas Crafts (2017), Brexit and State Aid, *Oxford Review of Economic Policy*, Vol. 33, pp. 105-112, and James Blitz, *Brexit Briefing: Theresa May's Secret Deal with Nissan*, Financial Times, 28 October 2016.

<sup>41</sup> In 2014, the 27 other EU members accounted for 45% of the UK's exports and 53% of imports.

<sup>42</sup> World Bank, *Doing Business 2016*. Indicators on product and labor market regulation show the same pattern, e.g. Koske, I., et al. (2015), The 2013 update of the OECD's database on product market regulation: Policy insights for OECD and non-OECD countries, *OECD Economics Department Working Papers*, No. 1200, OECD Publishing: Paris, and OECD (2013), Protecting jobs, enhancing flexibility: A new look at employment protection legislation, in: *OECD Economic Outlook 2013*, OECD Publishing: Paris.

freedom to set its own regulations. But given the UK's beneficial position today – its ranks 7<sup>th</sup> globally on the Doing Business index - there is no evidence that significant cost benefits are available.<sup>43</sup> So far businesses are more concerned by the regulatory uncertainty that threatens to rein following Brexit.

Much was also made of labor migration, focused on the burden migrants might pose to the social security system and the negative impact they had on labor market opportunities for the local population. Evidence, however, is that any negatives were small and far outweighed by the positives. Migration added significantly to the UK's skill pool.<sup>44</sup> UK policy makers had leeway to use national policies to limit problems from differences in social security systems across the EU. There is no evidence that these problems were significant, or that the UK lacked ability to deal effectively with abuse.

EU membership also significantly benefitted UK universities and research institutions, which have been increasingly successful in attracting funding from European research programs. Indeed, the UK became the largest recipient of such funds ahead of Germany. UK institutions have attracted large number of students and researchers from other parts of the EU, often supported by EU grants. Again, significant benefits occurred for UK skills and the UK innovation system. The UK government has vowed to replace EU funds, but even then less scientific collaboration will hurt UK (and EU) research.

EU membership benefited all the UK's key clusters, opening up a large, integrated market, and improving the ability to attract additional firms, skills, and investments to the UK. This benefit has been especially important for the automotive cluster, where activity in the UK is driven by foreign-owned plants serving the EU market. Outside of the EU these type of activities will be under severe threat.

The EU's regional policy has in terms of spending levels not been a major factor in the UK. But it has added valuable policy instruments to support lagging regions that will be missed after Brexit.<sup>45</sup>

A final major topic in the political debate was the size of net transfers the UK has made to the EU budget. The absolute size of the UK's net contribution to the EU budget is tiny compared to the UK's overall budget. The real issue, never clarified, was the UK's own fiscal policy and its impact on funding

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<sup>43</sup> Note that the government has vowed to first translate all existing EU regulations, known as the *acquis communautaire*, into UK law as part of the planned 'repeal act'. This also includes a commitment to keep the existing level of workers' rights, a topic often debated in the UK. See *The government's negotiating objectives for exiting the EU*, PM speech <https://www.gov.uk/government/speeches/the-governments-negotiating-objectives-for-exiting-the-eu-pm-speech> accessed 20 January 2017.

<sup>44</sup> Wadsworth, J., S. Dhingra, G. Ottaviano, and J. Van Reenen (2016). Brexit and the Impact of Immigration on the UK. Brexit Analysis No. 5, Centre for Economic Performance, London School of Economics and Political Science.

<sup>45</sup> John Bachtler and Iain Begg (2017), Cohesion policy after Brexit: the economic, social and institutional challenges, *Journal of Social Policy*, Vol. 46, No. 4, pp. 745–763

UK public services.<sup>46</sup> Proponents of staying in the EU avoided discussing the role of the fiscal austerity that they supported. Those arguing for Brexit were only too eager to make the EU the scapegoat for decisions actually taken in London.

There is little doubt, then, that leaving the EU will inflict a significant cost on UK competitiveness. EU membership neither created nor solved the UK's competitiveness challenges. But leaving the EU will undermine some of the UK's key competitive strengths and deepen some of its existing weaknesses. While the resilience of the UK economy in the months following the Brexit referendum is welcome, it is important not to misread the short term: A lower exchange rate and accommodating macroeconomic policies support current growth but are not a foundation for higher prosperity in the future.

### 3. The need for a new UK Economic Strategy

A welcome dialog on how to enhance the UK's fundamental competitiveness after Brexit has started to take shape. The Green Paper on Industrial Strategy<sup>47</sup> revealed a willingness to explore new thinking on the domestic agenda. The Industrial Strategy White Paper then published in November 2017 is honest on where the UK's performance has been weak, in particular in productivity and in creating broad-based opportunities across the country and society. But it remains quiet on the root causes that are behind these weaknesses. Without such a hard-hitting analysis of what went wrong the strategy ends up with a range of actions on skills, innovation, infrastructure, and regulations that do not move significantly beyond what has been already tried.<sup>48</sup> Where it takes a new stab is in launching so-called 'mission-oriented' efforts to address grand challenges.<sup>49</sup> Here the UK embarks on a path that may be narrowly profitable but that remains entirely detached from what is really holding the country back.

A UK economic strategy going forward needs to focus on the 'how' as much as on the 'what'. There is considerable consensus on what improvements in the business environment are needed,<sup>50</sup> and the

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<sup>46</sup> There is some evidence that the exposure to the effects of fiscal austerity was indeed a key driver of the decision to vote for Brexit. See Sascha O. Becker, Thiemo Fetzer and Dennis Novy (2016), *Who Voted for Brexit? A Comprehensive District-Level Analysis*, Working Paper No. 305, Warwick University: Warwick

<sup>47</sup> HM Government (2017), *Building our Industrial Strategy. Green Paper*, HM Government: London.

<sup>48</sup> Similar criticism has been voiced in Business, Energy and Industrial Strategy Committee (2017), *Industrial Strategy: First Review*, HC 616, House of Commons: London.

<sup>49</sup> Mariana Mazzucato (2017), *Mission-oriented Innovation Policy: Challenges and opportunities*, RSA/UCL Institute for Innovation and Public Purpose: London.

<sup>50</sup> See, for example, LSE Growth Commission (2017), *UK Growth: A New Chapter*, LSE: London, and Inclusive Growth Commission (2017), *Making Our Economy Work for Everyone*, Royal Society for the Arts: London

Industrial Strategy White Paper is broadly consistent with any of them. But the government's strategy pays very little attention to how these policies can be organized in a way that is more effective than in the past. There is some talk about regional strategies and about public-private partnerships to develop 'Sector Deals'. But on both of these the UK fails to draw on the rich experience with location- and cluster-based approaches that has been gained across the world in the recent past.

Our recommendations are centered on five major priorities: First, the UK needs a new value proposition to replace an implicit value proposition that drew heavily on EU membership. Second, the UK must make the long overdue shift from a purely horizontal economic development approach to a cluster-based model. Third, in parallel, the UK must shift from a highly centralized, top down strategy to a more decentralized regional model. Regions are the most important unit of competitiveness today, not the nation as a whole. Fourth, the UK must articulate a strategic agenda that enables inclusive growth, addressing the tensions in UK society that ultimately fueled the Brexit vote. And finally, the UK must take forceful steps to minimize the costs of leaving the EU.

The first and the final issue are a direct consequence of leaving the EU, and politically most contentious. Defining a new value proposition is hard because the groups that supported Brexit share little common ground on most other aspects of economic strategy. Negotiating a deal with the EU is difficult because of the denial that still exists in large parts of the UK about the real costs of leaving the EU. The other three issues have been on the UK's agenda independently of its EU membership but have now even more urgency. Failure to progress in these areas is a key cause of the Brexit vote. A successful approach towards upgrading UK competitiveness will in our view not only require changes in what the UK does, but fundamentally also changes in how the country is organized to take and implement these decisions.

**Redefine and Articulate the UK's Future Value Proposition.** At the core of its strategy for competitiveness needs to be clarity on the value the UK aims to provide as a place to do business in the global economy. A key pillar of the UK's current explicit positioning, being an efficient location for serving the EU market, has been seriously undermined.

So far, the government is not off to a good start. Its stated ambition is to become an even more business-friendly location through reducing corporate taxation, an area where the UK already has lower rates than all other EU countries except Ireland. Unstated is that devaluation of the British Pound has made the UK more attractive from a cost perspective. However, lower taxes and a lower exchange rate do not enhance competitiveness, productivity, or prosperity for citizens. They benefit private sector

profitability, but at the expense of UK citizens. This is in direct conflict with the stated goal of the May government to create a fairer economy that delivers broader prosperity. Proposals to reduce chief executive pay and add employee representation in company boards are motivated by these goals, but sit uncomfortably with the ambition to unleash free market dynamism.<sup>51</sup>

The Industrial Strategy White Paper focuses much on innovation as a key quality of the UK. And this is indeed an area where the UK is well-placed, given its strong science system and traditional openness for talent. But the challenge for the UK has never been coming up with new ideas, it has been translating them into businesses that scale and provide well-paying jobs in the UK. The Industrial Strategy has few new answers as to why such business should want to choose the UK in the future.

A new value proposition for the UK must be anchored in the competitive assets that the UK has, or is going to build. It must also identify the clusters and areas of advantage that will underpin success. The UK has major knowledge assets around its universities, as well as the part of the work force that is highly skilled. The UK enjoys strong clusters around it can build further activity, especially in finance, business services, and advanced manufacturing. The UK is also a highly international country, with a diverse population and deep linkages with nations around the world. The UK could play the role of an international knowledge hub, a bridge between Europe and emerging markets. There are clear assets to build on, and opportunities to pursue. The UK needs to have a serious discussion about how to leverage them, and with what ambition.

**Adopt a Cluster-based Approach towards Economic Development.** There is broad consensus in the UK that the country must strengthen its efforts to upgrade the industrial base without repeating the mistakes of the flawed industrial policies of the 1970.<sup>52</sup> The Industrial Strategy Green Paper identified ten pillars or action areas, including infrastructure, energy, skills, the innovation system (including public procurement), trade and FDI as well as support for new businesses. There are also aspirations for how to work with specific clusters, and proposals for a number of new sectoral partnerships. The plan covers key dimensions of competitiveness the UK has to address. But it is also close to what previous governments have put forward with little impact.<sup>53</sup>

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<sup>51</sup> Rt Hon Theresa May MP (2016), *CBI Annual Conference: Prime Minister's Speech*, GOV.UK, 21 Nov 2016

<sup>52</sup> See Nicholas Craft, Allan Hughes (2013), *Industrial Policy for the Medium- to Long-Term*, Future of Manufacturing Project: Evidence Paper 37, Foresight, Government Office for Science: London; and Vicky Pryce (2012), *Britain needs a Fourth Generation Industrial Policy*, CentreForum: London; and Geoffrey Own (2010), *From Empire to Europe: The Decline and Revival of British Industry Since the Second World War*, HarperCollins.

<sup>53</sup> HM Treasury (2015), *Fixing the foundations: creating a more prosperous nation*, CM9098, GPO: London.

We believe that a more ambitious effort is needed to move away from sectors and commit to a true cluster-based model. Competitions to select private sector-led cluster groups based on the strength of the underlying cluster, the quality of its backbone collaboration platform, and its strategic action plan have worked well in other countries.<sup>54</sup> Concerns that such efforts might fall victim to entrenched interest groups have in the international experience not materialized.<sup>55</sup> But it is critical to keep these competitions open and let market signals drive the decisions as to what initiatives to engage with. Having government pick them – even if based on hard-nosed analysis - inevitably makes policy makers responsible for firms’ market success, creating pressure to sustain support of failed initiatives.<sup>56</sup>

National programs on innovation, skill development, and investment attraction can be implemented through such cluster efforts, connecting the UK-level funding mechanisms with the bottom-up needs and actors in specific places. The UK has related but often isolated government efforts like the Catapult initiative and a range of private and private-public organizations that show the potential of this approach in the UK.<sup>57</sup> In their current form, however, these efforts lack clout and integration with the policy making mechanisms in Whitehall. The national-level ‘Sector Deals’ now proposed in the Industrial Strategy will fail to make a meaningful difference if they stay focused on the national level issues that are naturally their scope, i.e. overall funding shares for specific sectors, and national rules and regulations. The competitive success of companies in these sectors rests on the dynamism of the regional clusters that they are part of, and on the region-specific business environments surrounding them.

Clusters need to become the core organizing principle across efforts on infrastructure, skills, innovation, access to capital, and the upgrading of firm sophistication. It is at this level that functional policies

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<sup>54</sup> See the French Pole de Competivite program that empowered regional action in a traditionally centralized policy environment, and the German Spitzencluster-Competition that created new networks between existing strong universities and leading firms and the SME networks in their vicinity.

<sup>55</sup> Business, Energy and Industrial Strategy Committee (2017), Industrial Strategy: First Review, HC 616, House of Commons: London; Henry Overman (2017), <http://spatial-economics.blogspot.se/2017/03/what-should-we-do-to-help-make-our.html>. Blogpost accessed March 15, 2017. Fernández-Arias, Eduardo; Sabel, Charles; Stein, Ernesto H.; Trejos, Alberto (2016), Two-to-Tango: Public-Private Collaboration for Productive Development Policies, IADB: Washington, D.C.

<sup>56</sup> Sarah Gordon, Brexit Exposes the UKs weak business strategy, Financial Times, October 10, 2017

<sup>57</sup> A well-known example is the Cambridge Network (<https://www.cambridgenetwork.co.uk/home/>) but there is a much wider community including efforts like the High Performance Manufacturing Cluster around the Silverstone race track (<http://silverstone-park.com/vision-silverstone/high-performance-technology-cluster/>) or the North East of England Process Industry Cluster (NEPIC); <https://www.nepic.co.uk/>. For a discussion of NEPIC and other such efforts see NIESR, SpazioDati and City REDI (2017), Industrial Clusters in England, BEIS Research Paper No. 4, Department for Business, Energy, and Industrial Strategy: London.

ultimately work, and it is here where they need to be integrated to achieve a powerful impact on firm level performance.

**Develop Regional Capacity to drive Competitiveness Upgrading.** The core of competitiveness resides at the regional level, not the national level, a serious flaw in historical UK thinking and development practice across the country. There is growing support for affirmative steps to strengthen the role of regions. The Green Paper argues for a combination of regional investment in skills, infrastructure, and research capacity as well as efforts to strengthen local institutions that can orchestrate bottom-up action. These ideas echo and build on earlier efforts, like the Northern Powerhouse Strategy<sup>58</sup>, a plan to strengthen the North of England launched by then Chancellor George Osborne in June 2014. However, earlier efforts made little impact as they remained narrow infrastructure plays devised at the national level. They have, however, set a process in motion that has mobilized stronger regional initiatives in some parts of the UK. The recent mayoral elections show a growing appetite to strengthen also the political structures at the regional level.

We suggest to develop a new set of regional private-public institutions to drive competitiveness upgrading. A careful assessment of the RDA experience should inform this process. Private sector leadership and autonomy from political interference is critical. It needs to be combined with access to the policy instruments available through the national government, and ideally elected accountability of matching regional government entities. The existing Local Economic Partnerships (LEPs) do provide a connection to the public sphere but are individually too small to achieve meaningful impact. Without supporting the emergence of regional entities with roughly the same geographic scope as the old RDAs it will be hard to overcome this challenge.

The Industrial Strategy has disapprovingly little to say about the role of location. There is some talk about local industrial strategies, about investment in infrastructure links, and about strengthening education in places lagging behind. The UK needs to become significantly more ambitious if these efforts should stand a chance of delivering meaningful change. Crucially, they need to be connected with the cluster-based approaches outlined above. The debate in the UK has been hampered by seeing location and sector/cluster as alternative ways to organized policy.<sup>59</sup> Instead, they are complements that exert

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<sup>58</sup> HM Government (2016), *The Northern Powerhouse Strategy*, GPO: London. For a review see Neil Lee (2017), Powerhouse of cards? Understanding the 'Northern Powerhouse', *Regional Studies*, Vol, 51, Issue 3, pp. 478 – 489.

<sup>59</sup> See, for example, Centre for Cities (2017), *The role of place in the UK's productivity problem*, Centre for Cities: London.

their full power in an integrated approach: Strong clusters thrive in strong regions, and strong regions are based on a portfolio of strong clusters.

The UK is not alone with its traditionally centralized government structure. But where countries like France and Sweden have aimed to regionalize policy, the UK has reacted to inefficiencies in the RDA structure by backtracking. A new course is needed.

**Focus on Achieving Inclusive Growth.** Inclusive growth is rightly a key priority of the UK government and strongly interlinked with competitiveness.<sup>60</sup> The UK's poor track record in this area has been a major contributor to the frustration that found its outlet in the Brexit vote. However, the types of actions the government has proposed so far seem unlikely to improve the economic opportunities and shared prosperity. Changes in corporate governance might be worth considering but addressing the root causes of what went wrong is much more difficult than addressing some of the symptoms like high CEO pay, especially when the government also aims to raise the attractiveness of the UK for business.

Enhancing the productivity of locations and people that have fallen behind is ultimately key. A cluster-based strategy can help to organize these efforts. Companies can and need to play a central role, pursuing strategies focused on Shared Value opportunities.<sup>61</sup> The Shared Value concept helps companies to systematically identify actions that are in their business interest as well as contributing to broader societal and community objectives. Asking businesses to support creating a fairer society, as Prime Minister May has done, is only going to work if business sees this as part of its competitiveness.

There is no inherent trade-off between higher productivity and more inclusive growth. Productivity at the economy-wide level is higher if all parts of the society are part of the economy. Cluster and regional policies are powerful tools to create opportunities for a wide range of skill needs. The public-private partnerships that are critical to implement these policies are also central to achieve a broader impact on regional economies beyond the highest skilled employees and the best performing firms.

**Minimize the Costs of Leaving the EU.** The UK faces a major disconnect between what the Brexit campaigners promised, and reality. What was promised was full access to the Common Market while regaining national sovereignty on migration and regulation. This was actually never an option. Labor mobility is politically non-negotiable for the EU, particularly for its Eastern European members. Being

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<sup>60</sup> OECD (2016), *The Productivity-Inclusiveness Nexus*, OECD: Paris.

<sup>61</sup> Michael E. Porter, Mark R. Kramer (2011), *Creating Shared Value*, Harvard Business Review, January/February 2011 edition

part of the Common Market while reserving the right to impose a different set of regulations is untenable. This will be resisted all across Europe by those rightly concerned about unfair competition.

The real task is to create the structure of a new relationship. The UK needs to outline a clear set of principles for the negotiations with the EU, starting with an accurate view of the different scenarios that are feasible. The 'have my cake and eat it' rhetoric might have had some role as a negotiation tactic but needs to quickly acknowledge the real trade-offs that exist. The UK also needs to clarify its own preferences, specifically on the economic costs it is willing to bear in order to achieve more sovereignty. This is politically daunting in an environment where compromise is brandished as treason by some British tabloids. But the UK needs to develop a negotiating strategy that really gets the best deal for the UK. EU leaders have a responsibility to behave fairly, and with a view to the long-term. Ultimately a strong UK is good for Europe, and vice-versa.

The UK must also negotiate trade agreements with the UK's non-EU trading partners. A daunting task, with no broad consensus on opening trade given populist dreamers. And the UK will need to replace EU institutions in many critical areas, from implementing anti-trust policy to administering food safety standards. Preparing to go it alone in these two areas is critical to avoid major costs for the UK economy, and is needed to strengthen the UK's negotiation position versus the EU.

#### **4. New policy approaches in the post-globalization world**

Progress on this strategic agenda will require political vision and even courage to break out of the left-right cycle of politics. EU membership has been made a scapegoat for domestic policy failures in the UK; UK leaders need to face up to this legacy.

Globalization and technological change have created new policy challenges for many countries, challenging the ability of political systems to react.<sup>62</sup> In the UK it was EU membership that became the symbol for these much broader trends. The reality is that the UK is going to continue to face these same challenges outside of the EU. The strategy we have outlined will be necessary for the UK to deal with them. The UK will need active engagement with other nations if there is any hope for a positive new path outside of the EU.

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<sup>62</sup> See for example Dani Rodrik (2011), *The Globalization Paradox*, Norton Publishers.

There is a much wider need for a new framework to enhance competitiveness that moves beyond the pitfalls of old-style industrial policies and the traditional cross-cutting structural reforms.<sup>63</sup> The strategy we have outlined provides a foundation for a new policy approach, focused on enhancing productivity and anchored in public-private collaboration with a strong emphasis on the role of regions. Steps in these directions will bring the UK far closer to best policy practice in a wide range of successful advanced economies. The question is whether the UK can learn, or will continue to be stalled by the same old ideologies, delusions and mindsets. The future prosperity of UK citizens of all backgrounds is hanging in the balance.

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<sup>63</sup> See for example Manuel Agosin et al. (2014), *Rethinking Productive Development: Sound Policies and Institutions for Economic Transformation*, Inter-American Development Bank: Washington; Lin, Justin Yifu (2016), *The Quest for Prosperity: How Developing Economies Can Take Off*, Princeton University Press: Princeton; Christian Ketels (2017), *Structural Transformation: A competitiveness-based view*, Working Paper Series No. 258, African Development Bank: Abidjan, Côte d'Ivoire.