INTEGRATIVE CASE 5

ENHANCING UK EXPORT COMPETITIVENESS

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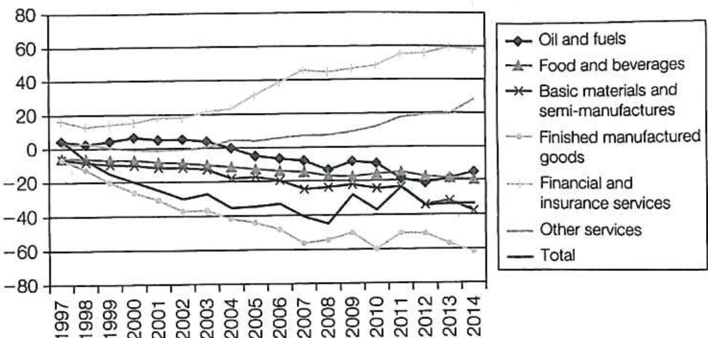
The UK has over the past decades experienced persistent deficits on its trade balance. While service industries, in particular the financial sector, regularly generated a surplus, the manufacturing sector has recorded persistent deficits. The oil and gas sector used to record surpluses in the 1990s, but with depletion of North Sea oil reserves, even this sector recorded a deficit. The sharp depreciation of the pound at the onset of the financial crisis in 2008 helped the slide, but was insufficient to trigger a turnaround.

In view of this situation, the UK government launched a major consultation on how to strengthen the UK manufacturing sector. Among other experts, the authors of this textbook have been asked to share their views. Below is an abbreviated version of the recommendations delivered in our report early 2013. The full 55-page report is available at www.bis.gov.uk/foresight. Following the framework of this textbook, we have derived our first three recommendations (1–3) from a resource-based view, and our next six recommendations (4–9) – the bulk of our advice – primarily from the institution-based view.

This case is an abbreviated excerpt from a consulting report commissioned by the UK Government Office for Science as part of the two-year (2011–2013) Foresight Project 'The Future of Manufacturing'. The report was published as M.W. Peng & K.E. Meyer, 2013, Winning the future markets for UK manufacturing output, Future of Manufacturing Project Evidence Paper 25, *London: Foresight, Government Office for Science. It is in the public domain at www.bis.gov.uk/foresight. The views expressed are those of the authors and do not represent the policy of any government or organization. Reprinted with permission.* *© Crown copyright.*

Figure 1 UK balance of trade in goods and services (in £ billion)



Source: Authors' creation using data from Office of National Statistics (www.ons.gov.uk).

NINE RECOMMENDATIONS FOR GOVERNMENT POLICYMAKERS

1: Support pre-competitive manufacturing capabilities and future technology platforms

The UK government, like all EU governments, is restricted in the ability to provide direct subsidies to firms. In global competition, this may place UK (and EU) firms at a disadvantage relative to their rivals in the US and Asia, which can benefit from more direct government support. However, there are ways for the UK government to be more active. For example, the Technology Strategy Board (2012) announced its funding of at least £50 million a year to support pre-competitive manufacturing capabilities and future technology platforms. Such much-needed investments will speed up the process for successful commercialization, and help firms jump through the hurdles associated with the 'valley of death' (good ideas flame out before emerging technologies become competitively and commercially successful).

2: Push firms to reach for the high end and do not support competition on low cost for the sake of jobs

Bucking the trend that low-cost manufacturing jobs are migrating to low-cost countries is neither advisable nor realistic. The UK government should encourage firms to reach for the high end, which thrives on high productivity. Focusing on low cost may generate short-run benefits, but will in the long run result in severe stagnation of manufacturing productivity. Thus the UK should steer away from attempts to compete on lower cost – for example, through policy measures that lower labour cost and lengthen permissible work time. Such policies may encourage manufacturing in sectors where the UK would be competing with countries that have much lower per capita income (such as Eastern Europe or East Asia). In the medium term, the UK would be squeezed out of this market segment. In other words, attempts to build such low-cost sectors (such as final assembly of low-end electronics or cars) may generate job growth in the short run, but are not sustainable in the long run – unless the UK is willing to accept a fall in average incomes to the level of, say, Poland or Romania.

3: Strengthen human capital to enable advanced manufacturing

While hardly an original recommendation, this point must be emphasized: UK manufacturing will not (re) gain world-class competitiveness in the absence of high-level human capital. UK firms' endeavours to build high-end, high-productivity-based capabilities are essentially efforts to engage in human capital-intensive manufacturing. Effective government support can help to build human resources that enable such advanced

manufacturing. This leads to two ideas. First, the UK has leading-edge universities and technology clusters, yet the gap between the top end and the 'average' human capital is rather large. Therefore, the UK ought to foster its elite institutions while at the same time enhancing the diffusion of knowledge and skills from the elite institutions to the second and third tier.

Second, the UK needs to build capabilities in the *workforce* that enable world-class manufacturing. This would entail investing heavily in human capital development. Such investment should in part come from the government. This is because the positive spillovers of skills and capabilities (especially from low to medium levels) from productive individuals to society at large are substantive. Essentially we advocate the raising of skills beyond the elite institutions, because sustaining a high income for an entire nation requires high performance capabilities possessed by a broad segment of the population, and not only by the elites. Specific priorities can be:

- Providing more resources for primary education in the state system to enable children to enter a path of personal development and human capital formation that is independent of their parents' ability and willingness to invest in their education.
- Prioritizing vocational training, which has been severely weakened by past policies. One stream of action may extend initiatives to re-introduce vocational training through apprenticeships, which requires multi-year courses in collaboration between industry and educational institutions.

4: Remove uncertainty by clarifying the UK's commitment to stay within the EU

As rules of the game, institutions serve to reduce uncertainty. Managers hate uncertainty, especially when it comes to long-term commitments such as constructing a new manufacturing plant. Despite the EU's problems, the UK's periodic threats to leave the EU – such as Prime Minister David Cameron's speech in January 2013 (while we were in the middle of doing this research) – heighten uncertainty and undermine UK trade and investment. In view of the large and growing importance of regional integration in supply chains and of the fact that the EU accounts for more than 50 per cent of UK exports, an exit of the UK from full EU integration would be *disastrous* for much of UK manufacturing. Given that emerging economies only collectively purchase less than 8 per cent of UK exports, the loss of exports to the EU will not be compensated by the additional exports to emerging economies.

Uncertainty over the status of the UK's membership in the EU – and hence the specific rules applying to trade between the UK and other EU countries – is in particular likely to depress inward FDI, especially manufacturing investment by non-EU firms in regional platform investment. Historically, the UK has been quite successful in attracting investors looking for a base to serve EU markets – *Toyota*, *Nissan* and *Honda* come to mind. But such investment in particular will be on hold or go elsewhere if the uncertainty about the future status is not removed. Moreover, participation in regional value chains (and hence intra-regional trades in components) enables benefiting from exports of downstream products eventually destined for countries outside the EU. Given the relatively slow growth in the EU, future marginal increases of benefits for the UK to stay within the EU may be less than what they have been in the past. However, we see no reason to put at risk the existing benefits, which are very substantial (i.e. over half of UK exports).

5: Enhance certainty by negotiating more free trade agreements (FTAs)

Firms from FTA member countries typically increase their trade and investment activities due to the tremendous certainty brought by FTAs. The EU currently has FTAs with 28 countries: Albania, Algeria, Andorra, Bosnia and Herzegovina, Chile, Colombia, Croatia, Egypt, Faroe Islands, Iceland, Israel, Jordan, Lebanon, Liechtenstein, Macedonia, Mexico, Montenegro, Morocco, Norway, Palestinian Authority, Peru, San Marino, Serbia, South Africa, South Korea, Switzerland, Tunisia and Turkey. The EU recently concluded negotiations with Singapore, and is also currently negotiating with three individual countries (India, Japan and Russia) and three regional entities (Association of South Eastern Asian Nations [ASEAN], Gulf Cooperation Council [GCC] and Mercosur).

Firms clearly prefer multilateral agreements to bilateral FTAs. Bilateral FTAs tend to create different rules applying to different pairs of export/import countries, which greatly increase the bureaucracy that exporters and importers have to deal with and reduce the scope for scale economies. Therefore, we prefer a multilateral FTA between the EU and ASEAN to a bilateral FTA, for example, between the UK and Singapore. Thus we recommend that the UK advocate more EU efforts to negotiate the following FTAs, a transatlantic FTA with the United States and Canada, an FTA with the Australia-New Zealand Closer Economic Relations Trade Agreement and, in the long run, with China.

6: Create a tax regime that is competitive, stable and fair

Global competition is also about tax competition. While the UK corporate tax rate of 28 per cent appears to be relatively pro-business, the tax regime has recently given a decidedly *mixed* message to UK firms. Legislation designed to encourage R&D spending in the UK was followed by cutbacks in tax deductions for capital expenditure (PwC, 2009: 33). Some of the UK's competitors have aggressively used favourable tax as a means to lure investment and jobs. For example, Ireland only levied 10 per cent corporate income tax on manufacturing income between the 1980s and 2002 and 12.5 per cent since 2002, thus attracting many investors to locate in Ireland. In addition, new EU members Hungary and Bulgaria have aggressively reduced their corporate income rates to 16 per cent and 10 per cent, respectively.

A tax system will, however, only be stable if it is generally accepted by the population (i.e. the electorate in a democracy) to be fair. Some corporate taxation systems *de facto* do not tax firms at the location where the profit is generated, but (by default or through consciously created loopholes) allow firms to shift profits from high tax locations to low tax locations through practices such as transfer pricing and excessively high licensing fees. This is likely to undermine the legitimacy of an international system of tax competition. In other words, if nations compete on taxes, there also need to be commonly agreed rules (i.e. institutions) by which this competition takes place. Perhaps surprising for most UK observers, the UK may actually benefit from more integration in the EU on this matter because it would prevent incidences such as *Google* and *Starbucks* paying virtually no tax in the UK.

7: Attract more inward FDI and promote more outward FDI

Given that foreign multinationals generate approximately half of UK manufacturing exports, it seems imperative that the UK continues to attract inward FDI in order to increase exports. The most important policies to this end are the same that also promote domestic investment in manufacturing: free trade within the region and valuable, rare and hard-to-imitate resources that foreign investors can tap into.

Exports are generated by a combination of 'push' and 'pull' effects. While UK-based firms (including UK-based foreign multinationals) 'push' exports, UK multinationals – via outward FDI abroad – 'pull' UK exports into their host economies, often in the form of high-end products, components and service exports. Given that the UK has the second-largest stock of outward FDI, it seems natural that efforts be strengthened to promote more outward FDI, especially into downstream and service activities. Incorporating the protection of FDI into FTAs (fostering a formal institution) and promoting the views of businesses 'out in the world' as ambassadors and supporters of the British economy (creating an informal institution) are likely to help.

8: Facilitate the mobility of highly qualified individuals into and out of the UK

Mobility of people is an essential precondition for successful international trade, especially in the high end of both manufacturing and services. The UK benefits from being a more multicultural society than most of its EU peers. This attraction enables many knowledge-based, creative industry sectors to thrive, and facilitates the coordination of global operations out of the UK. In this regard, the UK government policy has been confusing to say the least. On the one hand, Deputy Prime Minister Nick Clegg (2013) wrote in *The Economist*: 'We will continue to be one of the most open economies on the planet, welcoming trade and investment and welcoming talented individuals who wish to make a contribution to Britain.' On the other hand, shrinking immigration quotas, more visa application procedures, abstention from Schengen area free-travel arrangements, and increased requirements in citizenship tests all send a very strong, disconcerting message that – in a complete reversal of UK policies over the past century or more – the UK no

longer welcomes skilled immigrants or temporary workers. In summary, if the UK is serious about promoting export competitiveness, it will have to be serious about making it less cumbersome for highly qualified individuals to move into and out of the UK.

9: Lead efforts to lift regulatory trade barriers such as the EU arms embargo on China

Removing regulatory trade barriers can obviously facilitate more UK exports and generate more jobs. Commanding a 6 per cent world share, aerospace and defence represent one of the UK's most globally competitive manufacturing industries. China has expressed an interest in importing arms from the UK. But the UK has declined, because of an institution-based trade barrier: the EU arms embargo on China since 1989 due to the Tiananmen Square incident.

From a resource-based perspective, the defence sector – and the aerospace industry in particular – is an area where the UK has cutting-edge capabilities that it can exploit, but needs to continuously renew to remain globally competitive at the high end. From an institution-based view, already in 2004, the EU planned to lift the embargo by 2005. But intense US pressures forced the EU to abandon the plan. In 2009, UK Business Secretary Peter Mandelson stated that the ban should be phased out. China is an officially recognized Strategic Partner of the EU. Not surprisingly, China has called the ban 'absurd, puzzling and political discrimination' against a Strategic Partner.

CONCLUSION*

In global competition, no advantage is forever. As the first industrial nation, the UK enjoyed significant first-mover advantage. In 1900, with 2.2 per cent of the world's population it generated 15 per cent of exports. But it is not realistic to sustain this level of pre-eminent performance in the face of increasingly strong global competition. However, it is important to note that the UK is still punching *above* its weight: with 0.9 per cent of the world's population, it currently generates approximately 3.3 per cent of the world's exports – including 6.6 per cent of service exports and 2.6 per cent of goods exports.

What does the future hold for UK manufacturing exports? Lacking crystal balls, we have to gain a deeper understanding of the past if we endeavour to engage in the perilous exercise of predicting the future. The data that we have analyzed suggest that the UK's relative decline in manufacturing appears to have accelerated in the last decade, not only *vis-à-vis* emerging economies, but also relative to European peers. In the 1980s and 1990s, there was a widespread belief in the UK that service growth would more than compensate for the relative loss of manufacturing capabilities. Today, in part as a consequence of policies launched two or three decades ago, the UK is indeed a global leader in many service sectors with a service trade surplus. The problem, however, is that the corresponding deficit in the trade of goods is so large and growing that it cannot be compensated by the success of service exports. In the future, reviving and strengthening UK manufacturing seems to be a must.

In conclusion, our review suggests that UK manufacturing firms have good opportunities to compete in both old and new segments within 'high-end' industries, if they can create and occupy *deep niches* for themselves. To this end, we recommend focusing policy efforts on developing world-class competitiveness of both individuals and firms (and hence of the nation), and to enhance an open and pro-competition trade and investment environment. From the resource-based and institution-based views, the key to winning the future markets for UK manufacturing exports lies in (1) UK firms' possession of valuable, rare and hard-to-imitate resources and capabilities that can translate into products appreciated by customers, and (2) the UK government's resolve and courage to embrace policy challenges that will ultimately make the nation more competitive and prosperous.

**This is the conclusion to the entire 55-page report, not just the recommendations above.*

DISCUSSION QUESTIONS

1. From a resource-based view, how can UK firms and their managers enhance their export competitiveness?
2. From an institution-based view, how can the UK government help British firms to enhance export competitiveness? Drawing from the list of recommendations, what specific actions do you recommend to undertake in the short run, medium run, and long run?
3. Recommendation 9 on military exports triggered considerable debate between the co-authors. How should government policy makers balance economic interests and geo-political considerations?