

### 3 | STEPPING UP, NOT STEPPING BACK

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*To succeed in Labour's political project – of rising and shared wealth – we must rethink the relationship between governments and markets. There must be a greater consistency between the progressive ends that we seek and the means that we choose – between the ways we create our national wealth, and the contribution this makes to the society we want.*

*The challenge is to combine the best of the market with the best of the state: to shape markets to achieve both social as well as economic objectives. The role of government is not stepping back, but stepping up: developing a modern industrial strategy to help businesses compete on the basis of high-value, not low pay.*

**A**s the economy has slid back into recession, economic debate is rightly focused on the short-term: on macroeconomic management, on unemployment and the cost of living crisis, and on the continuing high levels of business failure. But although we desperately need growth, we also need much more than a return to business as usual.

In office, Labour did much to improve the functioning of the economy. Since 1997, output per person in the UK grew faster than all other leading industrialised countries, even as the number of people in employment reached record levels. Real growth in the economy led to real improvements

in standards of living for many, and real improvements in our public services. But the global financial crisis of 2007-08 exposed long-standing problems with the economy that had not been properly acknowledged. Growth had become concentrated in too few sectors, and in too few regions of the economy, making us especially vulnerable to a crisis with its roots in finance. Too few of the rewards from rising productivity found their way into the wage packets of average earners, who saw their wages stagnate from 2003. Even as employment reached record levels, too many people remained distant from the labour market or in insecure employment.

In the longer term we need an economy where growth is more inclusive, balanced and sustainable: inclusive, so that risks are fairly managed and rewards are fairly shared; balanced, so that it is less vulnerable to rapid global shifts; and sustainable, in every sense of the word. We need a more productive, more responsible capitalism to underpin a more inclusive and cohesive society.

This is what Ed Miliband has been calling for, from his 2011 conference speech to today: long-term value creation, not short-term profit extraction; employees in good jobs, engaged as partners in business success; sustainability at the core of the business model. To get there he is clear on the active role that government must play, setting the rule of the game to encourage businesses that build for the long-term. Not stepping back as the Conservative ideologues would have it, but stepping up: developing a modern industrial strategy to help our firms and sectors compete on the basis of high-value, not low pay.

## **A world of change**

We must make these changes at a time of seismic global and technological shifts. These shifts are challenging many of our historic sources of strength as competition intensifies, but also creating new opportunities on a

breadth and scale that is difficult to comprehend. Within the next two decades, the size of the global middle class will almost triple in size to 5 billion people.<sup>1</sup> That's a whole lot of new demand we should be preparing our economy now to meet. As Europe struggles, the global centre of economic gravity is moving south and east.

The challenge is clear. For our businesses to thrive in this new world, and to create a more balanced, sustainable and responsible capitalism, we must do three things. First, we must position our economy to compete, understanding where our sources of comparative advantage lie in markets that are set to grow. Success in this new landscape won't come from being *quite* good at lots of things. There is a premium on being *the* best. We must develop our areas of existing strength where we are already world class, like advanced manufacturing, aerospace and automotive, financial and business services, the creative industries, and higher education. Our focus should not only be on high end, export industries, but also on increasing productivity across the economy; on the diffusion of new technologies, as much as on their initial creation.

Second, we must develop the national capabilities we will need to succeed, from the infrastructure, to the skills, to the finance, to the research base and all the other components of successful national innovation systems. As Ed Miliband laid out in his 'Made in Britain', we should celebrate, take pride in and back the best of British business, products and services. And third, we must manage the process of change, so opportunities are open to all and no one bears an undue burden or is left behind.

## **Governments and markets**

How can we achieve this? For the last generation, economic debate in the UK has been constrained by the primacy of markets, on their inherent efficiency and stability, and on

the rationality of market actors. The role of government was to get out of the way. The only purpose of business was profit.

The financial crisis of 2008/09 has shaken the intellectual foundations of this approach. It has challenged the faith of some of its more reflective disciples, from Alan Greenspan's identification of a "flaw" in the reasoning, to Chicago School economist Richard Posner's post-crash rethinking in *A Failure of Capitalism*.

Even if confidence in free markets had been justified, there remained important roles for government: in addressing pervasive market failures and the unfairness of market outcomes. In government, Labour sought to correct these market failures, as well as address the unfairness of market outcomes. We prioritised developments in human capital, innovation and scientific research. We strengthened the rights of vulnerable workers, and the competition regime. Through tax credits and other redistributive measures, we made work pay and sought to reduce the inequalities in market outcomes.

So Labour's approach sought to improve the quality of inputs to the market; to change power relations *in* the market; and to correct the unfairness of market outcomes. This approach proved to be successful on many important measures. Our GDP per capita growth outstripped our main rivals. We created proportionately more jobs, and our productivity growth measured per hour was second only to the US.

But for all the successes, it also resulted in an uneven and narrow geographical and industrial pattern of economic growth, and large inequalities in market opportunities and outcomes.

It left government with too much to do to correct problems generated by the market. Even as transfers paid to working families increased, they struggled to keep pace with the speed at which market driven inequality was

increasing. My predecessor as shadow business secretary, John Denham, described this phenomenon eloquently when he said that chasing the market in this way became like ‘running up the down escalator’.

### **A new consistency between means and ends**

Where does this leave us now? Healthy, competitive markets reward the innovator, the insurgent and the risk taker. They keep incumbents on their toes, benefitting consumers. Labour must remain as committed as ever to fair markets.

But to succeed in our political project – of rising and shared wealth – we must rethink the relationship between governments and markets. We must set aside the old dogma that markets are the domain of efficiency, and that equity is for governments.

We need to build on the successes of the Labour years, but so that a fairer and more cohesive society results from the way that markets function, not in spite of it. Our welfare policy must begin with our business policy. Our business policy must reinforce our environmental vision. There must be a greater consistency between the progressive ends that we seek, and the means that we choose – between the ways we create our national wealth, and the contribution this makes to the society we seek.

### **A new partnership between productive business and active government**

Achieving this means encouraging more businesses to take the high road to business success – building value for the long term; creating good, well-paying jobs; investing in their people; nurturing their supply chains; participating actively in community life.

Business has always been an important source of social progress. For a while, some businesses became distracted by the idea that their corporate social responsibilities must be distinct from the way they made their money. Although this approach resulted in many social benefits, these were – essentially – costs to the businesses involved.

Increasingly we are seeing companies incorporating wider social and environmental concerns into the heart of their business models, in their own self-interest – not as an additional cost to the business but as integral to their long term success. Marks & Spencer call it ‘Plan A’: working with their customers to reduce the company’s environmental footprint and encourage healthier lifestyles. B&Q focus on what they call their ‘community footprint’: the positive impacts that their stores have on their local communities.

These companies are in the vanguard of a much wider trend, identified by Harvard Professors Michael Porter and Mark Kramer as the “next major transformation in business thinking” and already evident in the approaches of a growing number of ‘hard-nosed’ businesses, including GE, Google, IBM, Intel, Johnson & Johnson, Nestlé, Unilever, and Wal-Mart. They call the approach ‘shared value’: “creating economic value in a way that also creates value for society by addressing its needs and challenges”. It is not “social responsibility, philanthropy, or even sustainability, but a new way to achieve economic success. It is not on the margin of what companies do but at the center”.<sup>2</sup>

Governments can and should take action to support this approach – in how they shape markets, how they tend markets, and how they act as consumers in markets. Like it or not, in a modern economy governments can’t help but influence the shape and functioning of markets, for good or ill. The point is not to deny these influences, or even try to minimise them. It is to foster positive interactions

between governments and markets in the interests of both efficiency and equity.

Governments must frame the rules of the game in such a way that the businesses which are the most socially valuable and sustainable are also the most profitable. If markets are generating more rewarding, well-paying jobs, government has to involve itself less in remedial action: pre-distribution, as Jacob Hacker has called it, not redistribution. Instead of focusing on expensive, corrective action for problems arising from the operation of markets, government can focus on actions to create and maintain the conditions for business led success.

Put crudely, the immediate post-war period emphasised the role of the state in the economy. Through the Thatcher-Major years the role of the state was supplanted by the dominant position ascribed to the market. From 1997, Labour sought to use the state to improve the functioning of markets while limiting their worst excesses. Today the challenge is to combine the best of the market with the best of the state.

Government has many levers that it can use to shape markets and support business success. The challenge is to do it well – consistently, strategically and intelligently. The starting point is establishing a stable macroeconomic foundation upon which active government policies can build. It then means being clear about the purposes – as well as the limits – of active government policies, and having a disciplined framework for action.

## **The role for active government**

The first thing active government can do is to make markets work better on their own terms. Efficient, well-functioning markets are not naturally occurring. Even where policy frameworks can correct market failures,

markets still require active stewardship, with constant vigilance to maintain competition and prevent unhealthy concentrations of power.

Building on that, active government can steer markets towards additional goals that we value as a society. Markets have no particular destination in mind. Markets might lead us towards growth with continuing high unemployment, but we might prefer growth with low unemployment. Determining these societal preferences in aggregate is, of course, the job of politics. Realising them is the task of governments.

Here the argument is not that governments know better than markets. It is that governments make use of different sources of information, and have particular destinations in mind. Part of the challenge for governments is to understand where a different, better trajectory for the economy is possible, and then to create the framework needed to draw it in that direction.

Governments can, in some circumstances, improve on the efficiency of market outcomes by doing things that – left to their own devices – markets cannot or will not do. For example, markets can't set strategic direction. Governments, working with business, can. There are risks in doing so, so caution is necessary. But knowing that government is behind an industry or a technology can reduce uncertainty and promote investment.

Similarly, early stage, fundamental research is often too risky for businesses to undertake. The role the US government played in financing or buying many of the innovations behind the technology and communications revolution is increasingly being recognised. Silicon Valley venture capitalists took the plaudits, but they were standing on the shoulders of federal government investment and support over many years.

Through regulation, governments can also create entirely new markets, as Labour did by requiring all new



homes to be zero-carbon within ten years; or they can help foster clusters and other institutions which enable pre-market coordination and support.

Finally, we need to pursue active policies to keep pace with what our competitors are doing. Countries around the world are already pursuing active government approaches, and much more aggressively than we are. It is not just in the obvious places like South Korea, China and Singapore. It is the international mainstream. Just because the Americans preach a gospel of free markets does not mean that their government has not made huge interventions in markets through vehicles like DARPA (Defense Advanced Research Projects Agency), the Small Business Innovation Research programme, and the National Institutes of Health.<sup>3</sup> This raises the costs of inaction, and risks allowing others to capture future markets.

### **A framework for action**

If that is why government should act, how should government operate and what should be the priorities? Traditionally, active government approaches have tended to divide between ‘horizontal’ policies that seek to improve the functioning of the whole economy, and ‘vertical’ policies that focus on the development of particular sectors, technologies and even individual businesses.

The first big lesson is that the further policy moves from the whole economy towards particular sectors or firms, the riskier it gets. The surest foundation for active government must be effective horizontal policies. The most important horizontal policy for active government remains encouraging fair competition in markets. Next must be a suite of other horizontal policies like skills, finance and infrastructure investment, effective corporate governance and incentives that reward long-term value creation over short-term value extraction.

But the second big lesson is that just because the risk increases as the policy becomes more targeted, it doesn't mean that vertical, sectoral policies should be ruled out. Between risk and reward there is a balance to be struck. On this basis, sectoral policies can be extremely successful, sometimes because they are very low cost: for example, government can use its convening power to solve co-ordination problems in a sector without spending much money at all. The Automotive Council is a very good example of this – a Labour innovation that the government have continued. Other times they are low risk because a small amount of initial public investment can leverage in a large amount of private investment, or build on things that government would be doing any way – like using its procurement power to develop UK sectors strategically and to support innovation and jobs here in Britain. And sometimes sectoral policies are successful precisely because it is government taking the biggest risks: like investing in mission-focused fundamental research of the kind that allows for the development of new classes of drugs, not just incremental developments of existing drugs.

Ultimately, the key to good sectoral policies is the quality and independence of the decision-making process concerning what to prioritise, and how.

The third big lesson concerns institutions. Look at Germany with their national investment bank, KfW; their centres of technical and vocational training and research, the Fraunhofer Institutes; their network of 426 local banks providing credit to businesses, the Sparkassen. Look at the US with its Small Business Administration, and its Small Business Investment Companies. Look at Singapore with SPRING, the government agency that promotes growth.

Institutions like these can help both horizontal and vertical approaches. They can support business development

and growth; provide stable finance; allow for information to be shared; foster innovation and encourage its dissemination; and develop the skills base on which business can build. This is why we are looking at plans for a British Investment Bank and why we have said we need to open up schools to let industry in, not have it shut out. We must foster institutions that are right for the UK today, not just copying what happens elsewhere. We must build on our existing institutional strengths – like our universities, our business organisations and our trade unions.

The fourth big lesson is that sometimes establishing the end matters more than dictating the means. Create the dream. Much of the innovation funded by the US government was a by-product of the space race and the cold war. What are our visions of the future? What great challenges must our generation meet? Government can set goals or standards at the product level and let business figure out how to get there.

And finally, the last big lesson. Too often in the past, governments have reached for the levers of industrial policy when everything else has failed, responding to demands for immediate action. To be successful, active government policy must be about shaping the future, not just reacting to events. Just as macro stability is conducive to business investment, so policy induced uncertainty undermines it. If government wants business to think long-term, it should do likewise.

This means it will not be enough to get individual parts right. It is about the system as a whole, across all departments, engaging with business in new ways. It means competition policy being reinforced by procurement policy; taxation and regulation reinforcing each other; ensuring that the finance, the skills, and the infrastructure are there for business. It is about joining up this activity across government, and government engaging with business in new ways.

## Conclusion

There is a clear alternative to stalled growth today and national decline tomorrow; to an economy run to serve the interests of the few. It is a choice between the current government stepping back and leaving our national future in the hands of the market, or a Labour government that would step up to support productive business, and shape our economy to serve the needs of our society. It means a new consistency between the goals we seek and the means we choose, with government working through markets.

The growth that we need is private sector growth, but it is Labour that understands the critical role that government has to play in achieving this. The scale of our task is large but so is our ambition: “a new direction for our economy” as Ed has said. But the prize is great: we can look to the future with confidence in our ability to succeed in a fast changing global economy, with a transformed economy, producing better and fairer outcomes for all of people. And we will have a stronger, richer, more dynamic society as a result.

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### Endnotes

- 1 19 Oct 2011 McKinsey report [www.bit.ly/HVuTsO](http://www.bit.ly/HVuTsO) quoted in Independent [www.ind.pn/wT9ihP](http://www.ind.pn/wT9ihP).
- 2 Porter, M. E., and Kramer, M. R., *Creating shared value: how to reinvent capitalism – and unleash a wave of innovation and growth*, Harvard Business Review, January–February 2011.
- 3 Mariana Mazzucato *The Entrepreneurial State* [www.bit.ly/r0ehf4](http://www.bit.ly/r0ehf4).