The Future of the Welsh Economy
A Hodge Foundation Research Project
Biographies

**Brian Morgan** is Professor of Entrepreneurship at Cardiff Metropolitan University and Director of its Creative Leadership and Enterprise Centre (CLEC). He has also worked at Cardiff Business School and was previously Chief Economist at the WDA.

**Gerald Holtham** is Hodge Professor of Regional Economy at Cardiff Met. He is also honorary professor at Cardiff Business School and a Fellow of the Learned Society of Wales. He chaired the Welsh government’s Independent Commission on Finance and Funding for Wales.

**Selyf Morgan** has worked as a researcher at both Cardiff Metropolitan and Cardiff Universities, on research for the Welsh Government, and on a range of economic development areas including food and agriculture, the construction industry, and urban development.

**Pedro Marques** is a Research Associate at Cardiff University, where he works on an European project studying the implementation of smart specialisation strategies. He has experience of working in several European countries on issues related to regional growth and governance.

**Robert Huggins** is Chair of Economic Geography and Director of Research and Innovation at Cardiff University’s School of Geography and Planning. His areas of research interest and expertise include regional economic development and he is the originator of the European Competitiveness Index.
The Future of the Welsh Economy: An Economic Research Project

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This research project is kindly supported by funding from the Hodge Foundation. It will last for two years. The team will consist of Gerald Holtham – Hodge Foundation Professor at Cardiff Metropolitan University – who will oversee the research project alongside Professor Brian Morgan. The project will also appoint two other researchers and will collaborate closely with Professor Robert Huggins of Cardiff University.
1. Introduction

Must Wales remain poor?

With output per head in the Welsh economy at only 72% of the UK average, Wales remains the poorest part of the UK. Is that inevitable? What, if anything, can be done over the next decade to start to catch up?

The main objective of the Hodge economic research project will be to identify the best measures and policy options for triggering transformational change in the Welsh economy. Achieving a step change in our economic fortunes will require more than just another economic strategy report. Wales will need to be ambitious in setting challenging targets, encouraging an entrepreneurial culture supportive of business growth and improving the targeting and execution of public policy.

Success will require collaborative working with both businesses and policy practitioners. Our aim is to work with both groups to develop a plan with a high degree of consensus that can lead to action.

In designing the Hodge research programme for the next two years we have identified three inter-related work streams:

(i) Governance structures and the role of political leadership
(ii) Specific strategies for economic development, such as ‘smart specialisation’.
(iii) Generalizing growth: achieving balance and fostering the ‘foundational economy’.

(i) Political Leadership

Recent examples of successful economic development have highlighted the important role played by political institutions in tackling uneven regional growth. The first stream of this research project will investigate how improved economic performance in Wales could be facilitated by an examination of the governance structures that are supposed to deliver economic development. Are our institutions optimal to support the political leadership in its ability to make timely decisions about competing economic objectives? And are the subsequent delivery mechanisms in place? To benchmark performance we will compare Wales to other regions in the UK and Europe.

(ii) Strategies for Economic Development

Priority areas for economic development need to be identified so that the existing skills base and capabilities of the regional economy can be harnessed more effectively. Risk-taking entrepreneurs will detect the most
profitable areas for specialisation but they may require policy interventions and financial support to help them exploit these opportunities. Therefore a second theme of the research project will be to create a ‘heat map’ of Welsh companies with growth potential and identify concrete instances where policies such as ‘smart specialisation’ could work.

(iii) Achieving balance

Any strategy for raising productivity and prosperity across Wales must be conscious of the disparities that currently exist in economic wellbeing. It is necessary to ensure that improving growth does not leave many behind and worsen disparities. Hence the research project will highlight the need for both innovation policies and poverty alleviation policies in different parts of Wales – this type of balanced approach which integrates industrial policies with social policies will be particularly important in assessing policies to regenerate more deprived areas.

Overall, the focus of the project will be as much on implementation as on economic models of growth. The objective is to make a difference by building an evidence base and consensus for policy actions by the Welsh Government and other actors in the Welsh economy. Furthermore, we will ensure that the outcomes from the research are timely – we would wish to see the prosperity gap with the rest of the UK closing during our life time!

2. Institutions, Political Leadership and Economic Development

How can we deliver?

Recent academic research has advanced our understanding of the sources of economic development. A greater role is now given to the nature of institutions and, in particular, political institutions. In general, institutions can include both formal laws and informal conventions. They can be further categorised as: (1) economic institutions, such as individual property rights and contracts; or (2) political institutions, which underpin territorial governance.

Devolution can improve the focus with which problems are addressed and there are examples of development benefiting from a strategic political vision. However, if devolution leads to a situation in which the public sector is large and better paid relative to the private sector it can also create problems of its own. The principal one is known as “rent-seeking” behaviour whereby resources are focussed more on sustaining institutional influence rather than productive activity. Recent research on the quality of governance at the regional level across the EU indicates that Wales scores poorly on some governance measures compared with comparator regions.
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The chart indicates the variations in ‘Quality of Governance’ by region. Those regions shaded in blue are above the sample mean, while those in red are below. Darker colours represent regions on more extreme ends of the data range, while lighter colours are closer to the mean. It indicates that in Wales the quality of governance (very light blue) is above the EU average but it is below the average of the rest of the UK.

Less than effective governance structures may account for the fact that despite devolution and a range of policy initiatives, Wales’ relative competitiveness and economic performance has scarcely improved over the last three decades. That raises the question as to how positive an influence devolved government has been and how far its efforts have been compromised by rent-seeking behaviour. However, new institutions take time to learn and acquire experience and the potential for improved economic performance in Wales undoubtedly now exists. It would be facilitated by a serious examination by government of its own structures and practices and their impact on competitiveness.

The chart below shows the ranking of regional competitiveness (WCIR) within Europe for 140 regions. Clearly, the pattern is not one of gradual decline from the most competitive region to the least competitive. There are some ranges where the competitiveness of regions changes quite rapidly. For instance, the top nine most competitive regions are atypical of the other top 20 European regions. At the other end of the spectrum, there appears to be an accelerated decline in competitiveness. Some of these differences are likely to reflect groups of specific types of regions within nations; for example, capital cities.

Wales is positioned towards the middle of the chart at No. 58, whilst Scotland is at No. 45. The research project will analyse the elements of competitiveness to identify which are the most important and draw lessons for economic institutions and policy making in Wales.

We will examine these issues in three ways. First by a statistical analysis of competitiveness. Secondly, by a comparison of government and other institutions in Wales and other places that have substantial but not complete autonomy, like the Basque provinces of Spain, some German lander, and areas of the UK. Thirdly, we plan to develop case studies of particular policy
initiatives in Wales and elsewhere to see how they were framed and influenced by institutional factors. Both these approaches of learning from experience elsewhere, and learning from the past, should help to put Welsh experience into perspective and determine best practice.

Devolution processes in the UK are creating differing institutional arrangements. This diversity provides useful comparators. The North West region of the UK is an interesting case study because areas within the region, such as the City Regions of Greater Manchester and Liverpool, are developing at different rates, whilst there is no overarching regional governance structure.

The Scottish experience is more similar to Welsh devolution but is noticeably different in areas such as the continuity and use of executive agencies. The main economic development agency, Scottish Enterprise, is long established, whilst the newer Scottish Future Trust (an agency dedicated to infrastructure development) also operates at arms-length from central government. In both Scotland and the North West ‘city deal’ investments are already having an impact.

Looking beyond the UK the German Lander are a good example of well-developed governance systems, which are capable of producing continuous innovation and high standards of living. Their model is characterised in general by the following features: a clear division of labour between the different levels of government, which stays stable over time; a rich governance system that includes the regional ministries, which set out strategy, well-funded executive agencies which co-design and implement policies, and third sector organisations (such as chambers of commerce) which collaborate in this process; and a diverse set of organisations producing knowledge, including Universities and independent research institutes. Despite differences in size and economic success, regions such as Bavaria, Bremen and Schleswig-Holstein, all share these common features.

Similar models have been implemented in less successful regions such as the Basque country or Navarre in Spain. The governance systems are based on high levels of decentralisation between the region and local authorities, and between different branches of government, with strong executive agencies with the capacity to influence policy and be responsible for delivery. There are also well-funded business associations and good research institutes. The system as a whole is held in place by a tradition of stakeholder engagement and coordination between different actors.

We shall undertake an audit of current institutional structures for delivering regional development interventions. Our aim will be to compare the plethora of pro-bono organisations and committees that currently exist in Wales with the more substantive and more strategic delivery vehicles that are driving forward economic regeneration in other European regions. The audit will include a number of case studies on what works and why.

We shall draw out the lessons of these comparisons for the governance structures of city regions as well as the institutions of the Welsh Government itself.
3. Economic Policy and the Growth Strategy

How can we grow?

While government is important, economic growth in a market economy depends eventually on the enterprise of many businesses and entrepreneurs. The government has to supply certain public goods like infrastructure and education, and address certain market failures to stimulate growth.

The constraints tree below shows how policies relate to obstacles to growth.

How should the government direct these efforts? Theory and observation both indicate that the more diverse an economy the easier it is to absorb new skills and know-how and put them to profitable use. However, it may need State intervention to promote the acquisition of essential know-how by subsidising R&D and encouraging collaboration between academia and business. These are the policies stemming from the market failure node in the diagnostics chart.

The concept of “smart specialisation” (which is the new prevailing orthodoxy in EU regional policy) seeks to identify those very areas where existing capabilities in the economy mean diversification is most likely to be successful. Entrepreneurs are the likeliest people to identify such areas but the government can act as a catalyst to promote their growth.

The work of AnnaLee Saxenian, of Berkeley, illustrates how difficult it is for government to contribute constructively to the development process beyond supporting fundamental research. Silicon Valley and Taiwan flourished through clusters of initially small firms that co-operated and outsourced extensively in developing new products. That model, which Robert Huggins of Cardiff University terms ‘recombinant innovation’, is unpredictable and hard to plan. The lesson of Taiwan, however, is that a peripheral region can enjoy great prosperity if it can develop the skills and know-how to insert itself into a global supply chain.

Our project aims to apply these insights to Wales and to make them concrete so that they lead to specific courses of action by local, regional or national authorities. The project will survey growth companies in Wales, starting with the Cardiff region. The aim is to find where growth companies are located in the product and services space. What are they selling? Are they plugged into international networks? Are there clusters of progressive businesses?
Are their supply chains local? We will answer these questions by creating a heat map of Welsh companies that will indicate where the greatest development opportunities may be found and be of benefit in focusing business support policies.

The ‘heatmap’ will be available to support other initiatives such as the Welsh Government’s sector panels and their “anchor” companies. It will also be useful for ‘Industry Wales’ and its three forums of Aerospace, Automotive and ESTnet which aim to develop co-operation and encourage innovation. Our programme will draw on these groups to construct the ‘heatmap’ of Welsh competitiveness.

A complementary approach will look at trade data to see what Wales exports. Such data is not currently as available as it might be, however, by obtaining export data that is highly disaggregated by product group, it should be possible to trace both the extent of Welsh comparative advantage in trade and in which product areas it is located. Identifying the hotspots should enable the government to set a strategy and better co-ordinate the policy instruments at its disposal.

4. Achieving Balance in the Economy

Can we reduce inequality?

There is evidence that Wales has an unusually high proportion of innovating firms and Wales’ strengths in the aerospace and automotive supply chains could explain this.

Indeed there is some evidence that the Cardiff Capital Region is well-poised to connect with one of the more economically dynamic regions of the UK which stretches from Cambridge through Oxford and along the M4 corridor as far as Gloucestershire. This ‘arc of innovation’ is driven by a combination of university-led R&D, manufacturing clusters (like Oxfordshire and Formula 1) and cutting edge technology procurers like GCHQ and the MoD.

Innovation: Share of innovation active firms

Source: ERC Warwick
There are indications that this arc is being extended westwards, partly through the presence of some major R&D-intensive companies e.g. Airbus and IQE, but also though the digital and creative industries. Both Cardiff and Swansea featured in the UK’s top 10 for digital GVA growth in the recent Tech Nation report.

However, despite this potential for innovation it has not yet resulted in a strong growth of Welsh productivity overall. Welsh GVA growth ranks fourth among the 12 regions and nations of the UK since 1999 but the growth of GVA per hour worked in Wales between 1999 and 2014 ranks a lowlier eighth. In terms of GVA per head, Wales is rock bottom, owing to a lower participation rate in the workforce.

This pattern suggests that simply developing the innovative side of the economy or leading edge firms will not be enough to bring generalised prosperity. Such companies will not offer large numbers of jobs, especially for the lowly skilled, so other measures will be needed to ensure a spread of prosperity. Not least important will be improving levels of education and training. Wales has over 10% of the working age population without any qualifications at all. And while the proportion in higher education is rising it still lags behind the rates in the Irish Republic, for example. Bringing up average levels of literacy and numeracy will remain an essential element of policy.

If prosperity is to be general, policy will also need to pay attention to the more mundane activities that are grounded in the locality. Focus is not the issue here. In fact, the Welsh government has tended to focus more on issues of poverty and regeneration than on generating leading edge growth. That is demonstrated by the studies it has commissioned from the Public Policy Institute for Wales. Of 58 commissioned studies, 27 have been on public services, alleviating poverty, or health and social care. Just 8 have been on economic policy or transport.

It has also been argued that the concentration on social issues and regeneration could produce better results if they were focused more on growing the ‘foundational economy’. This is part of a significant critique advanced by Karel Williams at Manchester University. Whilst acknowledging the importance of pursuing widely agreed policies to develop skill levels and infrastructure, and to improve financial support for SMEs, a much clearer focus is called for on deficiencies in the local provision of foundational goods and services. These include transport, housing, utility supply, health, education, care, and food, and in developing the capacity to source and deliver such goods and services using local suppliers.

Also, the Welsh economy provides a number of examples of local businesses that have initially grown but then been taken over, and this change of ownership has led to either relocation or reduced linkages to local enterprises. Too many of these companies then end up sucking spending power out of the economy rather than nurturing local growth.
The argument continues that the Welsh Government should focus more on the specific conditions and character of existing Welsh industry to build a local industrial ecosystem that would in turn be attractive to investors. Such a focus could, for example, encourage continuity of ownership for SMEs and help build an enduring Mittelstand sector.

The project will synthesize the copious work on poverty alleviation and regeneration of local economies and take forward the foundational economy work.

5. Making it happen – An Engagement Strategy

Can we work together?

From the outset we intend to involve decision makers and practitioners in the project. We shall relate everything we do on the project to parallel work being undertaken on projects such as the Metro, City Deals etc. We will translate our research into action points and policy options and link our work directly to the concrete options for economic development already being considered.

We shall set up a web site and invite researchers and practitioners to engage with the project. For example, we will ask for inputs in areas such as refining the heat map and developing a better understanding of the strengths and weaknesses of the foundational economy. We shall also organise workshops, seminars and other outreach activities.

Part of the initial research programme will be to analyse and synthesize existing and ongoing research on economic development including the publications by PPIW – the aim is to see to what extent these proposals can be used to identify policy actions consistent with the thrust of our research.

Our approach of producing outputs jointly with practitioners will hopefully directly influence policy-makers and encourage buy-in from other organisations that often work independently on economic development issues. The ultimate aim is to make a difference in practice to the Welsh economy by collaboratively developing a diverse suite of policies which have the potential to transform Welsh competitiveness and develop the City Regions into engines of growth.
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