Centre for Policy Studies

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Economic Bulletin

THE GREAT PRODUCTIVITY SQUEEZE

Why fixing Britain's efficiency problem is now our only path to growth

- **Low productivity is a crippling problem for the British economy. And it shows little sign of improvement: levels have been virtually flat since 2011. Hourly productivity is now 20% below its pre-crisis trend.**
- **This week, the Office for Budget Responsibility is set to slash productivity forecasts. If there is no improvement to productivity levels, Philip Hammond is on course to breach his deficit targets.**
- **In recent years, low productivity has been offset by growing employment. But unemployment is now so low that expanding the job market can deliver little extra growth.**
- **Productivity is therefore the only game in town – and raising it is critical in both the short term and the long.**
- **The Government cannot be blamed for poor productivity, which is largely caused by factors outside its control. But the Budget represents a last chance to act before growth is squeezed.**
- **This report sets out a plan for how the Chancellor can boost productivity without large short-term fiscal costs.**

1. INTRODUCTION

Paul Krugman once famously said *"productivity isn't everything, but in the long run it is almost everything"*. It's why – as the head of the OECD pointed out last month – a German, Dutch, Danish, French or American worker can produce in four days what a British worker can in five. It's one of the main reasons why those same British workers have seen their wages stagnate in recent years. And it's why Britain faces a bleak economic future, unless it can get its act together.

Productivity is lagging across the Western world. But in Britain, the problem is particularly severe. Having grown by an average of 2.1% a year over the 35 years prior to the financial crisis, productivity has been virtually flat since 2011. Hourly productivity is now a staggering 20% below its pre-crisis trend.

The Government has made efforts to address this. In 2015, it launched a productivity plan called "Fixing the Foundations". In last year's Autumn Statement, Philip Hammond announced a National Productivity Investment Fund of £23 billion over five years, pointing out that matching US levels of productivity would raise UK GPD by 31 per cent, the equivalent of an extra £21,000 per household.

But as the Chancellor prepares his latest Budget, the situation has become critical. In recent years, the negative impact of poor productivity growth on GDP, and the public finances, has been cushioned by the stellar performance of the labour market. Since 2010, forecasters have consistently underestimated the growth in employment – and overestimated productivity increases (see Figures 1 and 2).

But the UK economy now faces a turning point. With an unemployment rate of just 4.3%, there is limited scope to increase economic activity from higher employment levels.

This means that if growth is to be sustained, we will need a strong expansion in productivity. Without it, GDP will falter, the public finances will come under acute pressure, and wages will likely continue to stagnate.

2. WHAT IS AT STAKE?

In July, the Office for Budget Responsibility (OBR) published its Fiscal Risks report. It pointed out that a further period of stagnant productivity would have major short- and long-term consequences for the UK's public finances.

Productivity growth is currently expected to pick up in the next few years, to reach 1.9% by 2021 (according to the OBR's March 2017 Economic and Fiscal Outlook). But more recently, the OBR has indicated that it will slash its productivity growth forecasts at this Budget. This would have significant consequences.

Figure 1: Productivity – output per hour forecasts and outturn

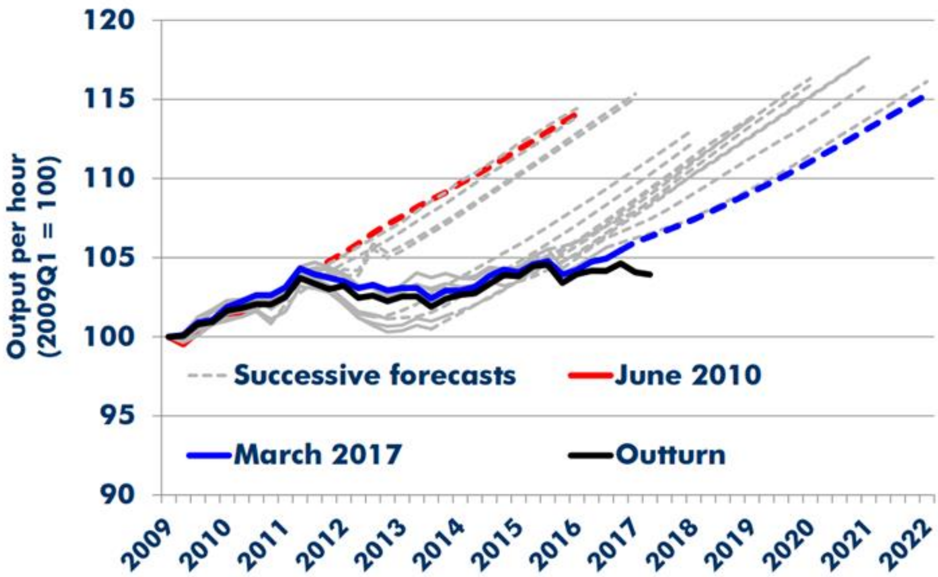
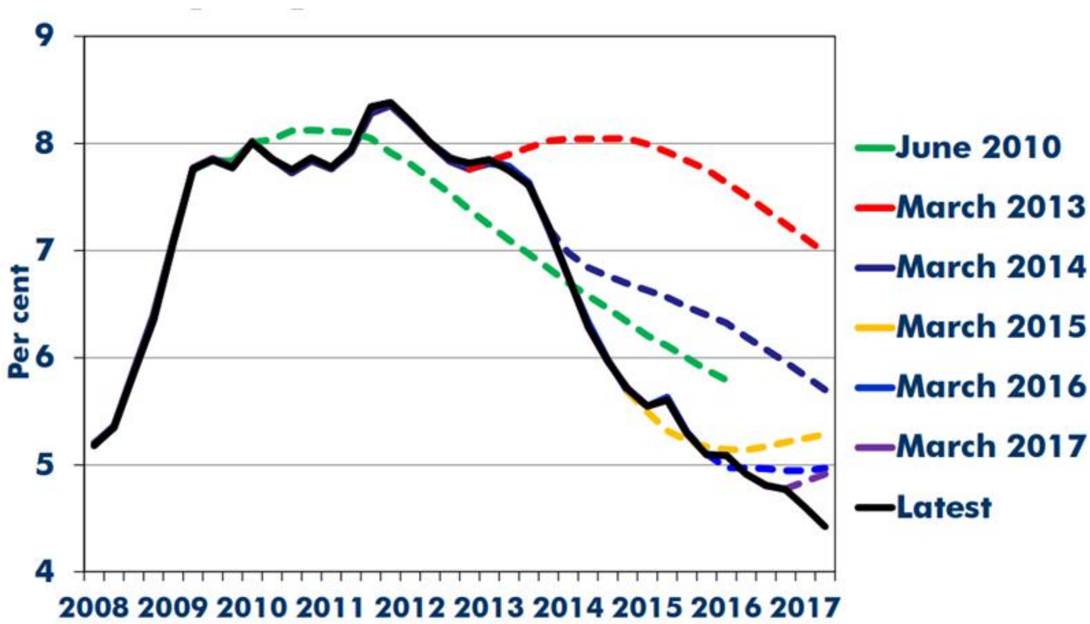


Figure 2: Unemployment rate – forecasts and outturn



Source: Office for Budget Responsibility (Forecast Evaluation Report)

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The OBR argues that:

- In the immediate term, if trend productivity and GDP growth were 0.3 percentage points a year lower than expected, half of the Government's headroom against its already modest 2% target for the structural deficit would be lost by 2020-21.

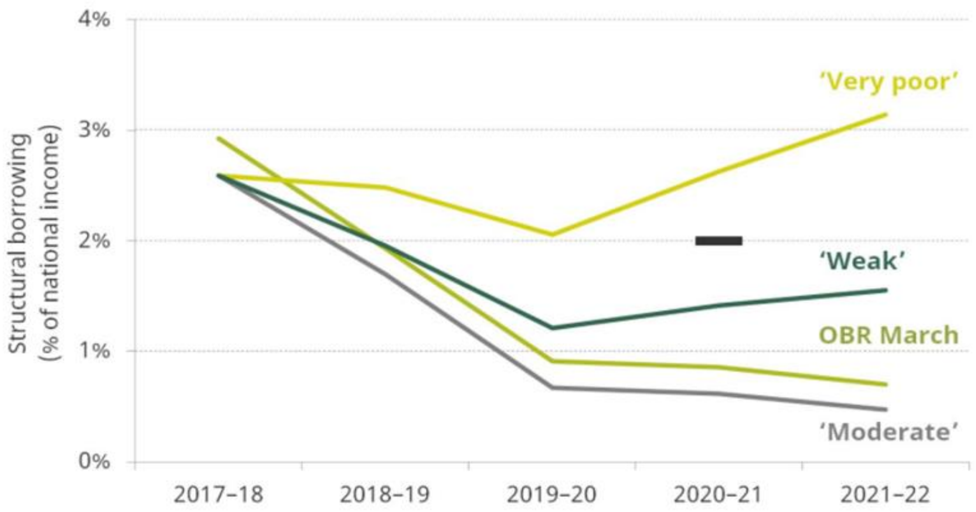
- In the longer term, if the growth rate of GDP and receipts was just 0.1% lower than projected over the next 50 years, and spending growth remained unchanged, the debt-to-GDP ratio would end up 50 percentage points higher.

The Institute of Fiscal Studies has outlined the short-term impact of faltering productivity (see Figure 3). In a "very poor" productivity scenario – where productivity growth remains at roughly 0.4% (similar to current levels) – the UK's structural borrowing would increase to over 3% of GDP by 2021-22. This would breach Philip Hammond's budgetary rule of achieving a structural budget deficit that is no higher than 2% of GDP by the end of the Parliament.

These projections do not even take account of the possibility of a recession in the next few years. Since 1970, no decade has passed without a downturn, so statistically speaking there is a reasonable chance of a recession in the medium-term, adding to the urgency of increasing productivity growth in the UK economy.

Furthermore, low productivity also entrenches low wage growth, which is another of the UK economy's major problems. One new study claims that a one percentage point increase in productivity growth is associated with a rise in pay of between two-thirds of a percentage point and one percentage point for the median worker. This implies that salaries will remain stagnant if output per capita increases continue to be weak.

Figure 3: Structural borrowing under different productivity growth scenarios



Source: Institute for Fiscal Studies ('Very poor' scenario assumes productivity growth of 0.4% per annum and the 'weak' scenario assumes productivity growth of 1% per annum. Structural borrowing refers to the part of the budget deficit that cannot be eliminated through growth.)

3. WHO IS TO BLAME?

One of the reasons that productivity has been especially disappointing in Britain is that employment has been very buoyant since the financial crisis – see for example this analysis by the Bank of England. Low productivity and high employment are, to some extent, mirror images of each other: work is shared among more than one person, rather than one person doing it more efficiently.

Businesses have also, to some extent, had a preference for labour over capital in recent times, which helps to explain Britain's low capital-labour ratio. For example, as outlined in a recent Centre for Policy Studies report, there are just 71 robots per 10,000 manufacturing employees in the UK, against over 300 in Germany.

Some people have also argued that Britain's productivity problem is more a statistical problem than a real one. They suggest that current measurements are not capturing the full scale of technological innovation – especially in service industries, where Britain is strongest. An app which encourages people to travel a shorter distance to work, for example, might have the effect of reducing GDP because they are no longer paying as much for their tickets – even though their wellbeing will have increased.

Others argue that comparing British productivity figures with their European equivalents is comparing apples to oranges. For example, the same low-skilled labourer who has a menial, low-productivity job in the UK might simply be unemployed in France.

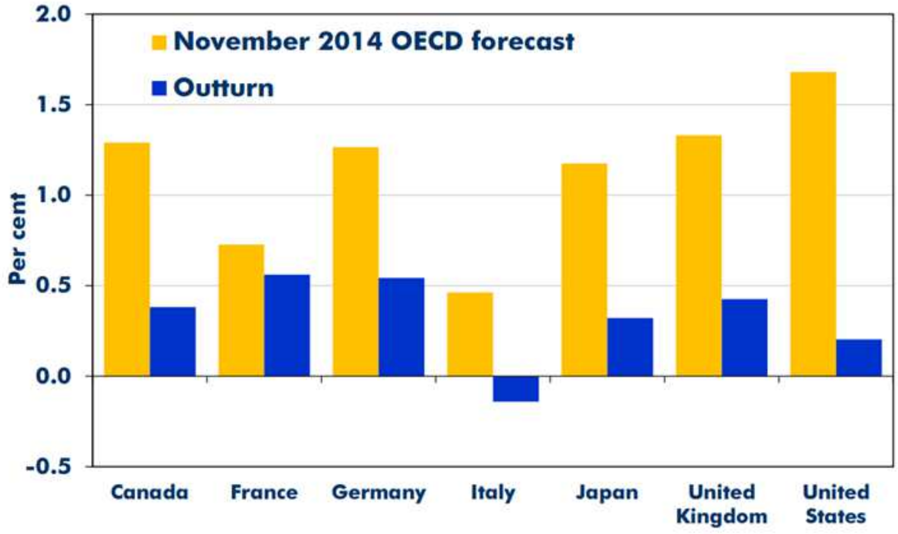
There is some justice to these points – but such mismeasurement is unlikely to account for the full scale of UK underachievement. The Bank of England suggests that measurement issues account for up to four percentage points of the productivity gap, representing just a fifth of the difference between the pre-crisis trend and the actual outturn.

It is true, of course, that the productivity problem has become global in nature. Although the UK's productivity does lag many G7 counterparts, other developed nations are now observing disappointing productivity growth. Indeed, all G7 nations have had to dramatically revise down their forecasts since 2014 (see Figure 4).

Partly, this may be a consequence of monetary policy. It has been argued that ultra-low interest rates are sustaining "zombie firms", leading to an increase in loss-making firms. This, of course, is a competence of the independent Bank of England.

The OBR also suggests that problems in the financial system – particularly the weak balance sheets of many companies – have prevented the efficient reallocation of labour and capital from weaker to strong firms.

Figure 4: G7 productivity disappointments – average of 2015 and 2016



Source: Office for Budget Responsibility (Forecast Evaluation Report)

4. WHAT CAN BE DONE?

As previously stated, there is now limited scope to increase economic growth via higher employment levels – meaning that boosting productivity is the only game in town if we are to see strong growth rates and sound public finances.

The Government's goal must now be to target the same level of productivity increases that were achieved before the financial crisis. The Chancellor will be aided in this by the tightness of the UK labour market, which should in theory help boost productivity without any ministerial action.

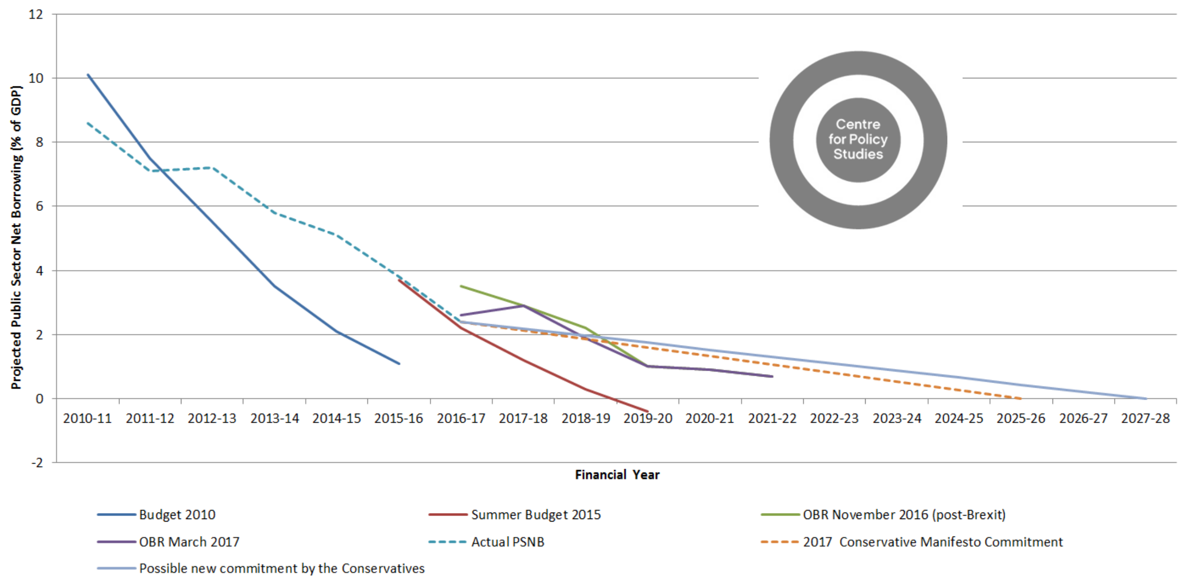
Some people – even on the Conservative side – have argued that the productivity problem is so pressing that Mr Hammond should abandon his deficit reduction targets in favour of a pro-productivity spending splurge.

This, however, would be short-sighted. The Government's deficit reduction programme is already very modest, with the Conservative Party's manifesto implying that the Government will only seek to achieve an overall budget surplus in 2025 (see Figure 5).

Deficit reduction is important not just to avoid handing on ruinous debts to the next generation, but because the UK currently has limited tools at its disposal to react to any future economic shocks. Measures to boost productivity should not therefore depend primarily on new spending commitments. Instead, the Chancellor should focus during his Budget speech on supply-side measures that do not cause short-term fiscal damage.

Fortunately, there are a wide variety of supply-side measures that could help promote productivity, and turbo-charge growth.

Figure 5: Changing public sector net borrowing forecasts



Sources: Budget Red Books, Office for Budget Responsibility and the 2017 Conservative Manifesto

Housing

Fixing the housing crisis is not just important for its own sake – it is vital for improving productivity. One of the most pernicious consequences of unaffordable housing is a mismatch between jobs and workers: people take jobs where they are less productive than they could or should be, because they cannot afford to live in (or anywhere near to) high-productivity parts of the country, especially London.

The Government's White Paper on housing earlier this year – which includes CPS proposals for de-regulated "pink zones" – is encouraging in many aspects. It suggests modest reductions to planning regulations and stipulates that councils must have an up to date local development plan. However, far more needs to be done in this Budget to increase the level of housebuilding across the country, and in particular in London and the South-East.

While the Treasury may seek to allocate more resources to this issue, there are two important caveats. The first is that the proposal should be broadly fiscally neutral – resources should be freed up from spending reductions elsewhere, or paid for by the gain in value created (for example when building on public land).

The second is that any additional resources should be matched with action on planning reform, to ensure that both the supply and demand sides of the problem are addressed.

Skills

Only 37 per cent of UK adults finish education at a level equivalent to A-Level, compared to an OECD average of 44 per cent. The UK also has some of the highest levels of "low literacy and numeracy" in the developed world.

Workers who are not educated enough are not productive enough. The Government's introduction of "T-Levels" is a step in the right direction, but further choice must be promoted in the education system to fix this problem – and vocational training must be overhauled and expanded in order to ensure that people's qualifications keep up with the changing job market.

Access to Finance

One of the most important ways in which businesses can improve productivity is via investment – for example in more efficient machinery. Yet between 1997 and 2017, the UK had the lowest level of investment as a percentage of GDP of any OECD nation, with private-sector investment 2.5% lower than any other G7 country.

Partly, this problem is down to restrictions on business finance, which is largely in the hands of a few big banks. It is estimated that more than half of UK SMEs struggle to gain access to finance. Rishi Sunak MP's recent proposal – published by the Centre for Policy Studies – to create a new exchange for SME retail bonds could help increase the flow of credit, but there is much more that can and should be done in addition.

R&D

In its recent survey of the UK economy, the OECD highlighted a lack of spending on research and development as another aspect of Britain's productivity problems. This is obviously bound up with the general lack of investment in the economy, but deserves attention on its own terms – not least given a recent official report, which the Government failed to publish for nine months, finding that we are "losing ground" in the global research race.

The Government has already increased public R&D spending, and has called on the private sector to do more: the Prime Minister recently observed that British firms currently invest around £1.70 in R&D for every £1 invested by the state, but that in Germany this figure is £2.40 and in the US £2.70. So while the Government has already done much to incentivise R&D spending, the Chancellor should undertake a speedy review of the tax credit system, and of how research spending is accounted for, to incentivise the private sector to invest more.

Mechanisation

The UK is already behind the curve in terms of automation, with an unusually low capital-labour ratio for a developed economy. It would a welcome step if the Chancellor were to set out the benefits that could come from increased mechanisation – particularly in terms of boosting the productivity of UK workers.

Greater use of machinery and technology would be one of the easiest ways to improve productivity – whereas, as set out in a recent CPS report, deliberately impeding automation with the explicit purpose of "protecting jobs" (an idea Labour has flirted with) would entrench our labour productivity problems, as well as the muted wage growth that has been the hallmark of our economy over the past decade.

We therefore need not a "robot tax", but tax incentives that promote automation as one of the best ways to raise productivity.

Infrastructure policy

Various aspects of infrastructure policy could be utilised to spur on productivity. Airport expansion, in particular, will be absolutely critical in not only satisfying new demand from passengers, but also alleviating growing constraints on air freight capacity, which is critical to boosting trade and economic activity. It is therefore deeply concerning that there may be further delays to making a final decision on Heathrow expansion. This Budget must make a re-commitment to expansion of London's aviation capacity on a speedy timetable.

Although important, airports are not the only area of concern in terms of infrastructure. There are major problems that are inhibiting competition in our rail, energy, water and broadband industries. Dieter Helm's recent review of energy costs, for example, highlighted just how damaging various government interventions have been on the energy market, which feed through into an anti-competitive environment for UK industry. The Government needs to promote a strategy to increase competition in all of Britain's utilities.

5. CONCLUSION

There is mounting pressure on Philip Hammond to engage in a spending splurge on measures to boost productivity. He should resist this temptation. There are a variety of areas that would kick-start productivity growth without adding short-term fiscal burdens to the Treasury. This is where the Chancellor's efforts should be focused at this week's Budget.

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FURTHER READING

Why capitalism isn't broken – Oliver Wiseman

Britain needs more than fiscal tinkering, Chancellor – George Trefgarne

The Government must strengthen the backbone of our economy – Robert Colvile

Ignore Corbyn: we need more robots – Daniel Mahoney