

Economic Report

Number 5 February 2013

- Recent productivity performance has been weak.
- The UK faces a chronic demand shortage which is holding back productivity.
- However the UK also faces supply side problems such a broken banking system, weak investment, skills policy and short-termism.
- We need a demand stimulus now and economic reform in the medium term
- Without these policies the UK risks becoming a demand constrained, cheap labour economy with lower productivity and lower living standards.

Indicator	Latest
GDP Growth (yoy)	0.0%
RPI Inflation	3.1%
CPI Inflation	2.7%
Average earnings Growth (Regular Pay)	1.5%
ILO Unemployment Rate	7.7%
Industrial production (yoy)	-2.4%
Manufacturing Production (yoy)	-2.0%
Trade in Goods & Services Quarterly Balance	-£8.3bn
Business investment (yoy)	+5.1%

Introduction

Since the crisis the UK's productivity performance has been weak. This has led some to argue that the economy is supply constrained, the output gap (the difference between current and potential output) is small and ultimately only a large programme of 1980s style deregulation can return the economy to growth. This analysis suggests that the recession has cause significant structural damage to the UK economy, and that unless we see significant deregulatory reform our prospects for ever making up lost output are limited.

This report looks in detail at the various explanations offered for low productivity since 2009 and finds that the deregulatory zealots are wrong. It concludes that many of our supposed supply side problems actually reflect problems with demand and have manifested themselves through falling real wages rather than job losses on the scale of previous recessions.

However this report also argues that there are some genuine supply side problems facing the UK – its previous over-reliance on the financial sector and a lack of access to credit for firms in particular. It argues that returning the UK to steady growth requires not only an immediate boost to demand but also wider reforms to how the economy works. Without such policies the UK risks becoming a lower productivity, cheap labour economy, where the living standards of the great majority remain depressed and potential trend growth declines.

The Importance of Productivity Growth

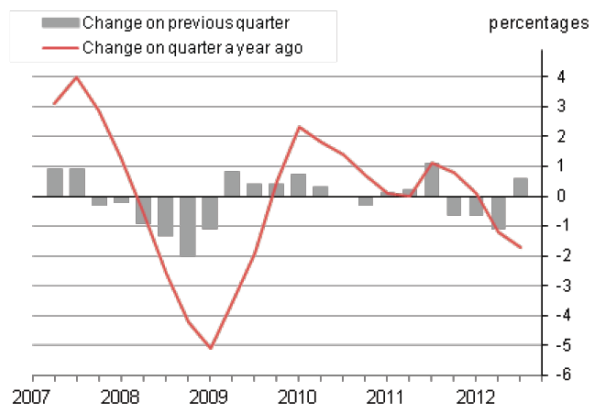
Productivity is the most important driver of long term growth and ultimately living standards.

Given the Government's fiscal mandate is based around eliminating the structural deficit (the size of which is, as this report explains, determined by productivity growth) it has recently become more important to the UK's short-run macroeconomic policy stance.

Productivity is best thought of as the relationship between the amount of economic input required to generate economic output. Rising productivity allows more output to be produced by the same amount of inputs and hence generates GDP growth in excess of population growth. It is increases in productivity that generates per capita GDP growth and hence rising living standards.

Productivity Growth in UK

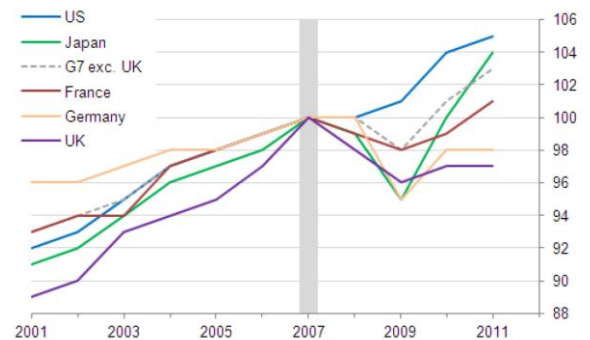
Since the financial crisis of 2008/09 the UK's productivity performance has been poor.



The chart above¹ shows that, after a bounce back following the recession, productivity growth has 'doubled dipped' with labour productivity falling in the first three quarters of 2012. This is in sharp contrast to other advanced economies. For example by the end of 2011 US labour productivity was some 5 to 6% above its

¹ Whole Economy Output per worker, Labour productivity Q3 2012, ONS
<http://www.ons.gov.uk/ons/rel/productivity/labour-productivity/q3-2012/stb-lprod-q312.html>

pre-2007 level whilst, UK productivity was flat². The UK's productivity performance before the financial crisis was, by most objective standards, reasonably good. The following chart³ from the ONS shows that over the period from 2001 until 2007, UK productivity growth (in this case output per worker) was faster than in the US, Japan, France and Germany⁴.



2012 has seen employment grow whilst output has fallen; the natural outcome of this is falling productivity (more people in work meaning more inputs, despite falling output). This has led to a wide ranging debate on the 'productivity paradox'.

Productivity, the Output Gap and the Structural Deficit

Whilst productivity is also an important economic indicator it has taken on a new short-term importance in the UK since the June 2010 Budget.

² International Comparisons of Productivity, First Estimates 2011, ONS

<http://www.ons.gov.uk/ons/rel/icp/international-comparisons-of-productivity/2011---first-estimates/stb-icp-sep2012.html>

³ Ibid

⁴ Of course it should also be remembered that beginning in the 1980s there was a rising disconnect in the UK between productivity growth and earnings growth, e.g.
<http://oecdinsights.org/2012/02/20/do-workers-reap-the-benefits-of-productivity-growth/>

Economic Report

The government's fiscal mandate is based around eliminating the structural deficit over a rolling five year period and, in theory, fiscal policy is set to meet this target. The structural deficit is an estimate of how large the deficit would be in the economy was growing at trend rate. However the structural deficit can never be measured, it can only be estimated and these estimates are highly uncertain.

To forecast the 'cyclically adjusted deficit on the current budget' the Office for Budget Responsibility (OBR) has to first estimate the underlying trend growth rate of the economy and then from this trend assumption estimate the size of the output gap – i.e. the gap between current output and potential output.⁵ The estimate of trend growth (and hence the output gap) is dependent upon forecasts of productivity growth. In other words one's views on potential productivity growth govern one's views on the size of the structural deficit.

The most recent OBR forecasts demonstrated this clearly⁶:

Table 5.4: Cyclically-adjusted current budget in 2017-18

Per cent of GDP	Output gap closes				
	2016-17	2018-19	2020-21	2022-23	2024-25
	-0.7	-0.5	-0.5	-0.5	-0.5
Output gap in 2012 Q3	-1.7	0.2	0.2	0.2	0.2
	-2.7	1.0	0.9	0.9	0.9
	-3.7	1.7	1.7	1.6	1.6
	-4.7	2.5	2.4	2.3	2.3

If one believes the output gap in late 2012 was -0.7% of GDP (i.e. the economy in Q3 2012 was operating at 0.7% below potential output) then the structural deficit in 2016/17 would be

⁵ Economic And Fiscal Outlook, June 2010, OBR

http://budgetresponsibility.independent.gov.uk/wordpres/docs/pre_budget_forecast_140610.pdf

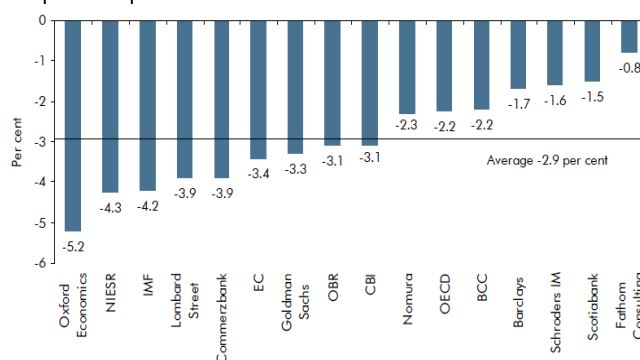
⁶ Economic And Fiscal Outlook, December 2012, OBR

<http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-december-2012/>

forecast to be -0.5% (i.e. even after four more years of austerity there would still be a structural deficit). However if one believes that there was a larger output gap then the figures are very different. An output gap of -4.7% of GDP in Q3 2012 would mean a structural surplus of 2.5% of GDP by 2016/17 at current forecast rates of growth. If this was the case then the Government, by its own target, would have 'over-tightened' fiscal policy by 2.5% of GDP.

If there was widespread consensus around the size of the output gap this factor would matter less, but this is far from the case. The OBR estimate the output gap at 3.1% of GDP but there are a wide range of views.

Output Gap Estimates 2012⁷



*NIESR estimate is 'between 4.0 and 4.5'

Source: HM Treasury, 2012, *Forecasts for the UK economy: a comparison of independent forecasts*, November, plus additions or updates where known. Goldman Sachs estimate refers to the fiscal year 2011-12.

The output gap estimates of Oxford Economics, NIESR and the IMF all imply that fiscal policy is overly tight (even given the Government's self-imposed mandate) whilst those of other forecasters imply it is too loose to hit the government's fiscal mandate.

Given the Government's decision to target eliminating the structural deficit, views on the trend rate of productivity growth now have a direct impact on the stance of fiscal policy.

The Current Debate

The IMF has noted that those in the UK productivity debate tend to fall to one of three two camps⁸:

⁷ Ibid

⁸ United Kingdom Article IV Consultation, 2012, IMF <http://www.imf.org/external/pubs/ft/scr/2012/cr12190.pdf>

“Supply pessimists” contend that the drop in productivity is mainly permanent, implying a small output gap. They argue that (i) the pre-crisis productivity level and trend reflect an unsustainable credit boom and (ii) historical evidence of past financial crises points to large and persistent output losses, in part due to tight post-crisis credit conditions that limit investment and the reallocation of capital to more productive activities. As further evidence of limited supply capacity, pessimists cite elevated inflation (exceeding 5 percent in late 2011), the relatively restrained increase in unemployment, and the limited spare capacity reported by businesses.

“Supply optimists” contend that such a large “technology reversal” from pre-crisis levels is implausible and that the pessimists’ points do not hold up to scrutiny: the financial crisis story cannot explain the much stronger productivity growth in other countries experiencing financial crises, such as the US and Spain; high inflation over the past two years can be completely explained by transitory shocks, such as indirect tax hikes and commodity price shocks; and business surveys of capacity are notoriously unreliable. Stories of structural shifts from high to low productivity sectors can explain at most a small part of the shortfall when quantified, as the productivity drop is broad-based across sectors. Optimists argue that restrained unemployment and low productivity can instead be explained by labour hoarding, as weak real wage growth points to significant slack in labour markets. This implies that the output gap is large and that, with more demand, labour hoarding would unwind and productivity would rebound toward its previous trend.

“Statistics sceptics” note that both labour market resilience and PMI readings during the last 18 months suggest possible underestimation of growth in official statistics, which are subject to large ex post revisions. Such revisions would shrink differences with the pre-crisis GDP trend. However, such revisions are very unlikely to be big enough to explain a majority of this gap.

To take the last group first, as the IMF notes,

whilst growth figures will be revised for years to come it is highly unlikely that the revisions will be large enough to explain away the entire gap between employment and GDP figures and hence scepticism about official data cannot explain the entire productivity puzzle.

It is therefore the debate between supply optimists and supply pessimists which cuts the heart of the UK debate on macroeconomic policy. Supply pessimists believe the economy is supply-constrained and hence a stimulus to demand would be more likely to generate inflation than growth. By contrast, supply optimists believe the UK’s primary problem is a lack of demand and that an expansion of demand (such as fiscal stimulus) would be a boost to growth.

In recent months this debate has become increasingly polarised, as partially demonstrated by the range of views on the size of the output gap. However it is perfectly plausible to believe that there are elements of truth in both positions. It may be the case that the UK faces *both* supply and demand problems.

There are then three possible positions to hold in terms of macroeconomic policy, depending on one’s views of the output gap and potential productivity growth. It may be the case that a demand stimulus would achieve little and supply side measures are required. It may be that a demand stimulus (from either fiscal or monetary policy) would be sufficient to restore the UK to steady growth or it may be that a demand stimulus would be helpful but that supply side measures are also required.

To determine which position is correct requires an explanation of why productivity growth has been weak since the crisis.

Explanations for Weak Productivity

Eight common explanations have been offered for the UK’s poor productivity growth since 2008, some of which are more plausible than others.

Over-regulation

One relatively common argument, popular with certain sections of the Government, is that

excessive regulation and 'red-tape' is constraining UK productivity. This notion provided the underlying logic for the Beecroft Report and was the basis for much of Budget 2011's 'Plan for Growth':

"So in today's Plan for Growth we take action:

- £350 million worth of specific regulations will go – including the Equality Act's costly dual discrimination rules;
- Lord Young's recommendations on health and safety laws will be implemented in full;
- The no-win no-fee legal services that prey on employers will be restricted;
- Existing regulation will be scrutinised by the public.

And from April, we are going to impose a moratorium exempting all businesses employing fewer than ten people – and all genuine start-ups – from new domestic regulation for the next three years.

We will take this fight against regulation to Brussels, where my RHF the Prime Minister is this week recruiting other European allies to ensure our continent doesn't price itself out of the world.⁹

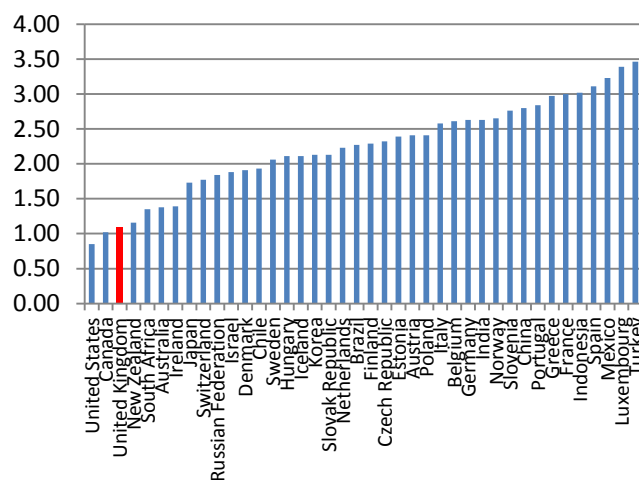
The argument is that excessive and burdensome regulation has constrained UK businesses from growing and innovating and hence retarded productivity growth. The implied solution is a supply-side policy of deregulation similar to that pursued by the Thatcher governments of the 1980s.

But there is no evidence that regulation is major factor holding back UK productivity or that further deregulation would provide a boost to growth.

To start with the UK is already one of the least regulated developed economies. For example, in terms of employment protection it has the third

lowest level of regulation of any OECD country¹⁰.

OECD employment protection index



Given this fact it seems highly unlikely that excessive regulation is a real drag on productivity. Many of the countries with higher levels of regulation also have much better productivity performance.

Second, as there has been no tightening of regulation 2008 (indeed since 2010 there has been deregulation) it is hard to see how regulation could have been a burden on productivity since 2008 but not before. As the UK's productivity performance was relatively good in the decade before 2008, over-regulation cannot be used to explain weak performance subsequently.

Zombie Companies

Another common explanation for poor productivity growth is the role of so-called 'zombie companies'. The argument is that low interest rates have allowed many more companies to survive the recession than would have otherwise been the case. Many of these companies, some argue, are able to meet interest payments but little else. They generate enough cash to service their debts but not enough to survive.

⁹ Budget Statement. March 2011

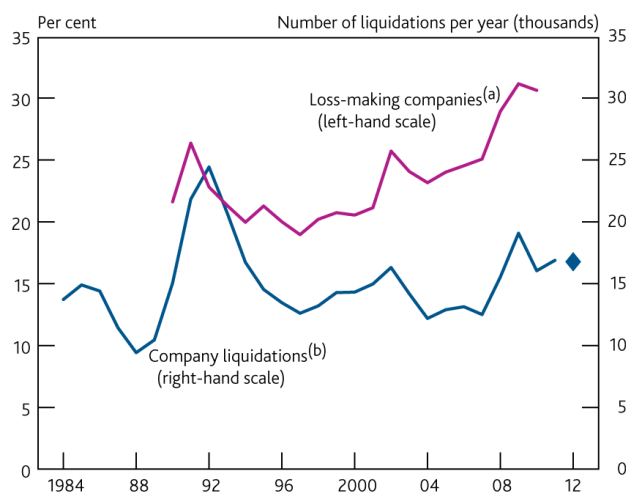
http://www.hm-treasury.gov.uk/2011budget_speech.htm

¹⁰ OECD Indicators of Employment Protection

<http://www.oecd.org/employment/employmentpoliciesanddata/oecdindicatorsofemploymentprotection.htm>

In effect they are ‘trapping’ workers in relatively unproductive jobs and using up resources that could be better (and more productively) used elsewhere in the economy. In an extreme form this argument states that artificially low interest rates have meant that not enough companies became insolvent during the crisis. These ‘zombie firms’ are now taking away resources that should be being used by more innovative start-ups.

This argument received a great deal of attention following the Bank of England’s Inflation Report of November 2012¹¹, which contained the following chart:



As can be seen whilst the proportion of companies making a loss rose sharply during the crisis, the rise in company liquidations was much smaller than during the early 1990s recession.

There are two potential problems with this line of analysis. First the data on loss-making companies only runs until 2010. More recent data from the ONS¹² (covering the net rate of return of non-financial companies in the UK in aggregate rather than the proportion which are loss making) suggests that the profitability of UK

companies has improved somewhat since 2010. This does not necessarily mean that proportion of firms making a loss has fallen since 2010, but it does suggest this may be the case. In other words some of the data used in constructing this argument may be outdated.

Secondly, and more importantly, the fall in the number of company liquidations may actually not reflect low interest rates and forbearance by banks but changes in the insolvency regime. The Enterprise Act of 2002 fundamentally changed the UK corporate insolvency landscape and so a comparison of insolvency rates in the early 1990s and late 2000s is far from straightforward¹³. The lower level of company liquidations may simply reflect a very different legal environment. Whilst there may well be some ‘zombie firms’ in the UK, the problem is unlikely to be as large as a casual glance at the chart above suggests.

Credit
Since the financial crisis, credit conditions for UK firms have been tight. This, as the Bank of England¹⁴ has argued, can have direct impact on productivity:

“The financial crisis has probably impeded underlying productivity growth: international evidence indicates that past financial crises have been associated with pronounced and persistent reductions in the level of productivity. Most directly, the tightening of credit conditions following the crisis increased the cost of working capital and reduced its availability. That may have prevented some companies from producing output, or reduced the efficiency of businesses’ production processes — for example if they have had to operate with smaller buffers of stocks.”

11 Inflation Report, Bank of England, November 2012.

<http://www.bankofengland.co.uk/publications/Pages/inflationreport/ir1204.aspx>

12 Profitability of UK Companies, Q3 2012

http://www.ons.gov.uk/ons/dcp171778_294545.pdf

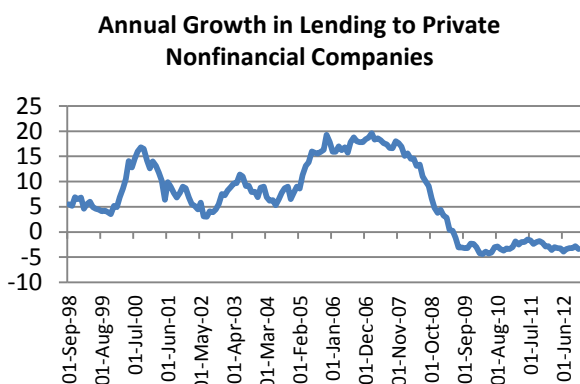
13 ‘No Insolvency Boom? Thank the ten-year-old Enterprise Act’, Accountancy Age, November 2012.

<http://www.accountancyage.com/aa/opinion/2223804/no-insolvency-boom-thank-the-ten-year-old-enterprise-act>

14 Inflation Report, Bank of England, November 2012.

<http://www.bankofengland.co.uk/publications/Pages/inflationreport/ir1204.aspx>

It is certainly the case that the growth of lending to UK non-financial business has been extremely weak since 2009¹⁵.



It is noteworthy that the contraction in credit provision to nonfinancial firms from mid 2009 onwards does coincide with the UK's fall in productivity. As the Bank argues a lack of access to finance may have constrained working capital and led to businesses either producing less output or operating less efficiently than would otherwise have been the case.

In addition lack of finance may have constrained investment by existing companies as well as holding back the expansion of new start-ups. It does seem likely that, as supply pessimists are prone to argue, tight credit conditions have contributed to a slowdown in productivity growth. However this also suggests that policies that raise the supply of finance to firms would have a positive impact on productivity growth in the future.

Weak real wages might also be indirectly reducing investment (and holding back productivity growth). If labour is very cheap then firms may have less incentive to increase their productivity through innovation and adding expensive capital equipment.

Sectoral Problems

Some have argued that the weakness in post-crisis productivity growth can be explained by a poor performance from some sectors since the

¹⁵Monthly 12 month growth rate of monetary financial institutions' sterling net lending excluding securitisations to private non-financial corporations (in percent) seasonally adjusted, Bank of England

recession. Simply put if the higher productivity sectors are growing at a faster rate than the lower productivity sectors then overall productivity will rise, and vice versa. The most commonly identified potential problems are the oil and gas sector and the financial industry. As a recent ONS report into the productivity puzzle noted¹⁶:

"In particular, oil and gas extraction – part of the mining and quarrying sector – has been falling for more than a decade. In addition, the maintenance requirements of ageing platforms have increased, taking them out of service for lengthy periods, while the explosion on the Elgin platform in March 2012 has also reduced output. This is a capital-intensive, and therefore high productivity, sector of the economy. A certain level of staffing is required to supervise the activities on North Sea installations, but the process of extraction is highly automated, and variations in output do not entail changes in employment on the same scale."

Any decline in oil and gas output would have the impact of lowering overall growth whilst not having a major impact on employment.

The other key sector identified is the financial sector, which recorded very strong productivity growth before the recession but has been much weaker subsequently. The Bank of England's Andrew Haldane has argued that¹⁷ much of the measured increase in financial sector productivity in the years before 2008 simply reflected banks gearing up their balance sheets and increasing leverage. Higher leverage allowed higher returns on equity for banks which was assumed to reflect higher productivity. Without excessive leverage measured productivity would have been much weaker. In the post-crisis era leverage is

¹⁶ "The Productivity Conundrum, Explanations and Preliminary Analysis", ONS, October 2012.

http://www.ons.gov.uk/ons/dcp171766_283259.pdf

¹⁷ The Contribution of the Financial Sector. Mirage or Miracle?, Andrew Haldane, 2010
<http://www.bankofengland.co.uk/publications/Documents/peeches/2010/speech442.pdf>

likely to be lower and hence productivity in the financial sector will not return to pre-2008 levels. There is no doubt some truth in the notion that problems in these sectors are having an impact on wider UK productivity. The decline in oil and gas output is a long run trend and financial sector productivity was boosted by excessive risk taking in the run up to the crash but problems in these sectors cannot explain the whole of the recent weakness in productivity.

As the ONS's own analysis found¹⁸ whereas there have been large falls in productivity in the financial sector there have also been falls across many other sectors. For example, compared to the pre-crisis decade, productivity growth has fallen in sectors as diverse as retail, transport, manufacturing and food services. Whilst the decline of the oil and gas sector and the lower productivity in financial services are having a negative impact on UK productivity they cannot explain all of the weakness.

Real Wages/Demand side problems

It may be the case that low productivity is actually a symptom of weak demand rather than a supply side problem. In an 2011 paper the economist Bill Martin¹⁹ noted that both the UK and the USA experienced similar crisis in 2008/09- a banking collapse, a contraction in bank lending, a rapid falling away of demand and a deep recession but the impact on their respective labour markets was very different. In the USA unemployed soared, whilst in the UK the adjustment came not from a huge increase in unemployment (although unemployment did rise considerably, it was less than could be expected given the scale of the recession) but rather from a collapse in real wages.

This fall in real wages maintained employment at

18 "The Productivity Conundrum, Explanations and Preliminary Analysis", ONS, October 2012.

http://www.ons.gov.uk/ons/dcp171766_283259.pdf

19 "Is the British Economy Supply Constrained? A Critique of Productivity Pessimism.", Bill Martin, Centre for Business Research, Cambridge University.

http://www.cbr.cam.ac.uk/pdf/BM_Report.pdf

a higher level than it otherwise would have done and also supported corporate profits. But – given weak demand, higher employment means (all things being equal) lower output per worker. As Martin explained:

"America's demand deficiency is registered in a high unemployment rate coupled with high productivity. In the UK, greater real wage moderation averted the large increase in unemployment. Demand deficiency was instead registered in the post 2007 productivity shortfall."

In other words, via the connection of real wages, the UK's weak productivity growth may be a function of low demand rather a problem affecting the supply side of the economy.

If demand were to increase then firms would see rising sales and as output rose so would output per employee and hence measured productivity. This argument has been echoed by the ONS²⁰:

"In some areas – for instance retailing, and estate agents - the behaviour of productivity may be partly dictated by the need to maintain a certain level of service even if demand has fallen. This is especially true of small outlets, where indivisibilities in staffing make it difficult to cut employee numbers in proportion to the reduction in business. In other cases, it is possible to reduce staffing levels with a lag – for instance if business shows no sign of picking up, then firms may reduce their opening hours. This will also show up initially as weak productivity... These sectors could see a relatively large reduction in productivity during the recession, although much of it should be reversible as demand growth resumes."

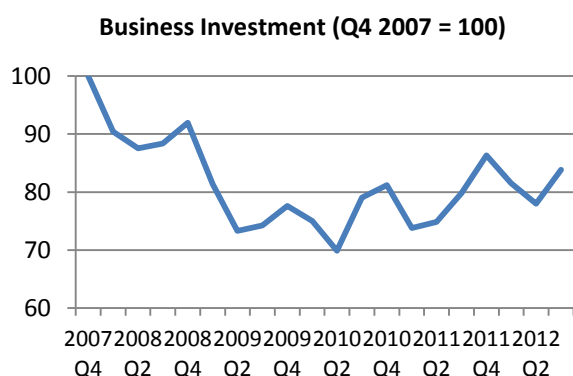
There is certainly a strong case that much of the current weakness in productivity is actually reflecting demand side rather than supply side factors.

20 "The Productivity Conundrum, Explanations and Preliminary Analysis", ONS, October 2012.

http://www.ons.gov.uk/ons/dcp171766_283259.pdf

Weak Investment

Since the financial crisis investment in the UK's capital stock has been very weak. Business investment, despite a recovery from its 2010 lows remains some 16% below its level of 5 years ago.²¹



Weaker business investment implies a slower growth in productive capacity than would otherwise be the case. All things being equal faster business investment growth would imply a higher capital stock and higher potential output. The question then becomes – what is holding back business investment? Whilst it may be that there is simply a lack of good investment opportunities it is perhaps more likely that uncertainty over future demand and a lack of access to finance are constraining investment. Firms after all are unlikely to wish to add to capacity at a time when demand is weak.

This suggests that whilst weak investment has held back productivity growth since 2008/09 that higher demand and/or easier credit conditions could boost investment spending and hence increase productivity.

The UK has a longer running problem with weak investment compared to its international peers²².

²¹ Business Investment, ONS, Q3 2012

<http://www.ons.gov.uk/ons/rel/bus-invest/business-investment/q3-2012-revised-results/bus-invest---stb-2012-q3-m3.html>

²² TUC Economic Report 2,

<http://www.tuc.org.uk/tucfiles/244/Economic%20Report%202.pdf>

One common explanation for this is excessive 'short-termism' from UK business which discourages long-term investment. Encouraging firms to take a more long-term approach should boost investment and hence ultimately productivity growth.

The Changing Labour Market

Related to both the real wage/demand side problems and sector specific issues is the idea that weak productivity growth reflects a wider change in the UK labour market post-recession. In a 2012 update to his 2010 paper Bill Martin argued (with Robert Rowthorn)²³ that the UK was becoming a 'demand-constrained, cheaper labour economy'.

Martin and Rowthorn argue that:

"major shocks abroad and at home depressed demand, as exports fell short and private saving rose, and increased people's willingness to accept low real wages as a means to preserve jobs. Output fell short but jobs much less so, implying widespread underutilisation of labour. On this view, low productivity is a symptom not of structural distress but of a demand constrained, cheaper labour economy."

Whilst this view, the lower real wages allowed firms to engage in labour hoarding, may prove a strong explanation for the weak productivity of 2009-2010 it is harder to square this with the growth in employment (and the fall in unemployment) that occurred in 2011-12. If existing workers were being under-utilised in 2012, why would firms take on more staff?

Martin and Rowthorn address this by arguing that there is an important distinction between 'overhead' and 'variable' labour:

"...variable labour, hired and fired as output goes up and down, and overhead labour, required in order to keep a business going. Examples of

²³ "Is the British Economy Supply Constrained II? A Renewed Critique of Productivity Pessimism", Martin & Rowthorn, Centre for Business Research, Cambridge University, 2012
http://www.cbr.cam.ac.uk/pdf/BM_Report3.pdf

variable labour may include assembly line workers and telesales staff. Examples of overhead labour may include senior management, key administrators and staff required to maintain brand image or safety standards. Overhead labour is a minimum quantity of labour that remains employed until a firm goes out of business."

The authors then considered the place of overhead and variable labour in high and low productivity firms:

"Both have overhead and variable labour. But the incentive to hoard variable labour is likely to be greater in the high productivity sector, granted similar prospects for recovery and real wages. Although needs vary, high productivity sector firms tend to be more reliant on people with advanced skills, and would therefore tend to face rehiring costs larger than those faced by firms in the low productivity sector. If strong, these incentives would incline high productivity sector firms more so than low productivity sector firms to hoard labour in recession. By the same token, the low productivity sector would need to rehire during recovery."

In other words high productivity firms were more likely to hoard variable labour during the downturn and this showed up in the official data as lower productivity. But after labour costs fell it was low productivity firms (that tend to be more labour intense) that had the greater propensity to hire variable labour.

They argue that this explanation fits the UK data:

"The economy recovered in 2010 but disappointed in 2011. In those two years, around 550 thousand jobs were created in relatively low productivity, low paid largely private service activities that had less incentive than other activities to hoard labour during the preceding contraction and more to gain from the availability of cheaper labour. This expansion of jobs is another feature of a demand constrained, lower wage economy."

In effect this provides a two stage explanation of weak UK productivity since the recession. During the recession lower real wages encouraged labour hoarding in high productivity firms and

this lead to a fall in measured productivity, then during the initial recovery, lower cost labour encouraged hiring from lower productivity sectors. As Martin and Rowthorn argue, "low real wages helped to promote labour intensive expansion in a variety of already low productivity service trades."

Such an explanation also fits with the actual pattern of the 'recovery' in the labour market to date. The most recent data²⁴ show that over the past five years the number of people in full-time positions is actually down by 331,000 whilst there has been a rise of 660,000 people in part-time work.

In addition there has been a large rise in self-employment. Analysis by the CIPD suggests that many of those declaring themselves self-employment since the recession possess lower skill levels than self employed people before the crash. They conclude that, "the recent rise in self-employment is due to weak demand in the jobs market rather than a sign of resilience or emerging strength in the economy".

The pattern of rising part-time and self-employment are consistent with a move into lower productivity activities.

The end result is that falling real wages related to weak demand may explain not only much of the fall in productivity during the recession but also some of the changing sectoral composition of the UK since.

Skill Shortages

Some have argued that poor productivity can be explained by a lack of skills in the workforce. For example a recent report from the EEF warned of a skills shortage in manufacturing²⁵. Skills

²⁴ Labour Market Statistics, January 2013, ONS.

http://www.ons.gov.uk/ons/dcp171778_292911.pdf

²⁵ Skills for Growth, EEF, 2012.

<http://www.eef.org.uk/publications/reports/Skills-for-Growth-a-more-productive-and-flexible-labour-force.htm>

shortages would make it harder for firms to expand output and could help explain the paradox of rising employment with flat output if more workers were required to produce the same level of goods and services.

Such an argument can only provide a partial explanation for weak productivity performance - it is difficult to see how a skills shortage could have rapidly developed post 2008. It may be the case however that the UK has faced a significant skills shortage for some time but the symptoms of this shortage were disguised before 2008 by other factors – for example an increase in measured productivity in the financial services sector.

Firm level data²⁶ from the ONS provides some evidence that this may be the case. A recent study suggests that in the years before 2009 there was wide variation in productivity levels between firms. One explanation is that some firms were under investing in both physical and human capital, as long as other sectors and firms were outperforming this was less of an issue for the wider economy.

Conclusions

An accurate assessment of the causes of the UK's weak productivity performance since 2009 is vital if policy-makers are going to make the right decisions about macroeconomic policy in the years ahead.

Over-regulation can be relatively easily dismissed as the culprit for poor productivity growth and hence the government's emphasis on deregulation will not be succeeding in boosting growth. The much debated idea of 'zombie firms' appears to be over-stated and even if it were not, calling for an increase in interest rates and insolvencies would seem a perverse policy choice given the wider negative impacts there

²⁶ Micro-data perspectives on the UK productivity conundrum, ONS, January 2013.

<http://www.ons.gov.uk/ons/rel/icp/microdata-perspectives-on-the-uk-productivity-conundrum/january-2013/micro-data-perspectives-on-the-uk-productivity-conundrum.html>

would be across the economy.

It is striking how many of the supposed 'supply side problems' currently afflicting the UK economy can actually be explained by a lack of demand. An increase in demand would almost certainly lead to higher business investment, adding to the UK's potential output. An increase in demand would also add to firms' output, potentially leading to a relatively rapid recovery in measured productivity.

Understanding the 'productivity paradox' means looking closely at what has happened to real wages in the UK since 2009. Both labour hoarding in 2009/10 and the growth in low-wage, low-productivity sectors since 2010 are very likely explanations for weak measured productivity. All things being equal an increase in demand should boost real wages and secure growth in higher productivity jobs.

This is not to say that the UK economy does not face supply side problems, they are just not supply side problems that can be dealt with through the traditional tool of deregulation. Improving the functioning of the UK's banking sector (to start with through the establishment of large scale state investment bank) so that it better supports the real economy is necessary. It is also likely that the returns in the financial sector pre-2008 were unsustainable and will not be repeated in the near future. There is also evidence that some sectors of the UK economy have faced productivity problems for a longer timeframe – possibly due to skills shortages and a lack of investment. These sectors may be expanding due to cheaper labour costs and, given weaker productivity growth in financial services, this may become more of a pressing issue for policy makers.

The UK in effect faces both demand and supply side problems. An immediate boost to demand would lead to an increase in productivity and is a necessary step to get the economy moving again but it is not sufficient. Reform of the banking system, changes to corporate governance that increase 'long-termism' and lead to more investment and a modern industrial policy that helps sectors other than finance to develop are all required. Equally important is a new skills policy that encourages employer investment in

skills, gives apprentices the right to level three qualifications and is consistent with the aims of a modern industrial policy.

If these two steps are not followed (demand stimulus short term and reform in the medium term) then the UK risks continuing down the path of being a demand constrained, cheap labour economy – one marked by lower real wages, lower productivity and ultimately lower living standards in the future. The UK economy requires not just a short term stimulus to demand to boost growth but also wider reforms in banking, skills and industrial policy that ensure we get the 'right' kind of growth. And the stakes are high, as the longer we stay on this course the more economic damage will be done, and the smaller the output gap will become – potentially significantly limiting growth prospects in the future.