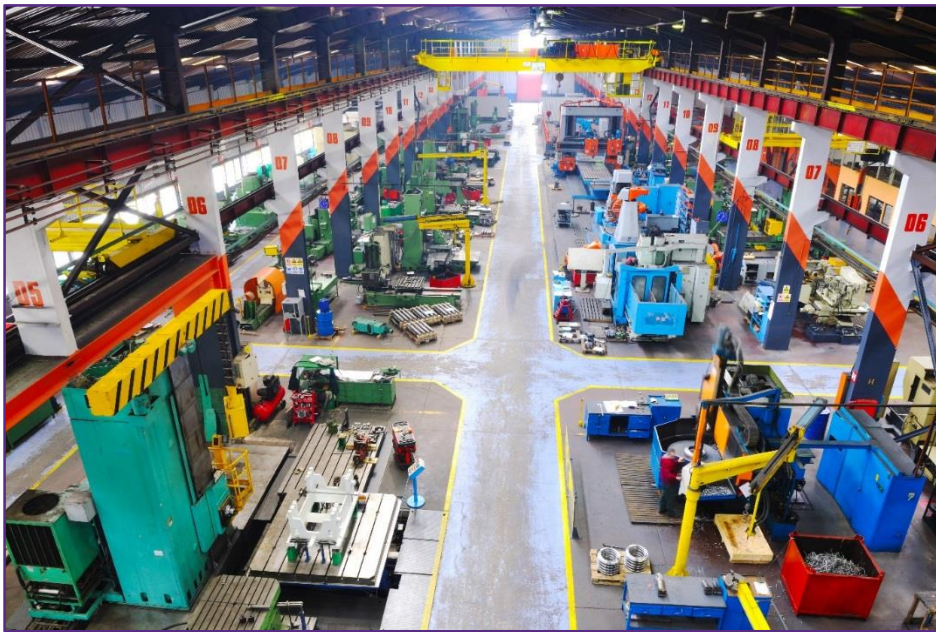




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## **Britain's disappointing productivity performance: causes and potential solutions**



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**Making a difference to policy outcomes locally, nationally and globally**

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# Britain's (and Scotland's) disappointing productivity performance: causes and potential solutions

Jeremy Peat, International Public Policy Institute

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## I Britain's and Scotland's productivity performance

The past was consistent. For decade after decade, with no more than minor and very short-term interruptions, productivity – output per unit of input – in the UK grew by a steady 1½% to 2% per annum. In recessions during the 20<sup>th</sup> century productivity growth did decelerate, but not for long. The norm was for productivity to accelerate from relatively early in the upswing.

Clearly this mattered, both because increasing productivity was the main factor generating growth of GDP and income per head; and because this also was the major contributor to the UK's continuing competitiveness in international markets. Growth of productivity at a rate lower than our key trading partners and competitors would mean competitiveness problems and over time a decline in growth and a lower exchange rate – possibly coupled with marginally higher interest rates to keep inflation under control.

To explain a little further, in simplified terms, growth in the output of an economy, as measured by GDP and other indicators, will be due to some combination of population growth leading to a greater supply of labour (more inputs) and increased productivity. A greater supply of labour may increase output, but not necessarily output per head or indeed income per head and economic welfare. Increased productivity should lead to both higher output<sup>1</sup> and higher output per head, both directly and via enhanced competitiveness. Increasing productivity, especially relative to key competitors, is both a recipe for and a symbol of economic success and potential for greater affluence. It matters for the economy as a whole but also for households and enterprises.

This stable and predictable state of affairs regarding productivity growth came to an end at the time of the 2008 banking sector-induced recession – or possibly somewhat earlier. Since then

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<sup>1</sup> The increase in output is not necessarily in terms of quantity. Increased output via improved productivity can be via quality changes resulting in an output of higher unit value. Likewise investment to achieve increased productivity can be in skills, etc. as well as in physical equipment.

UK productivity growth, and probably to a slightly lesser extent Scotland's, has stagnated – and deteriorated as compared to most other major economies.<sup>2</sup>

Most forecasting models still include something akin to a 'reversion to the norm' so far as productivity is concerned. They assume that the rate of productivity growth will return to the long-term trend. The only question, as so often in economic forecasts, appears to be on the timing of a move; when the reversion will take place. Even in their latest Inflation Reports the Bank of England economists justify their forecast of a pick-up in growth into 2016 and beyond on the basis of productivity growth reverting to the norm.

Unfortunately nobody has produced a convincing analysis as to why productivity growth has stayed so low for so long; and failing such analysis it is remarkably difficult to explain convincingly why and when any reversion should happen. That is not to say that a reversion will not happen, rather that we cannot readily explain why this should be the case if we do not know how to explain the productivity story over the past 8 years or so. Indeed if we do not better understand what has been going on over this period and if a 'reversion to the norm' does transpire, then we will not know why, will not be able to understand its implications and will not know how best to ensure that higher productivity growth is continued. And if it does not transpire then we will have no idea as to what policies should be prioritised to achieve what ends.

## II Possible Causes

If you google UK productivity these days you will find numerous references to the 'conundrum' or 'puzzle' of why productivity growth did not recover as the UK emerged from recession – albeit into a slow and limited recovery. A wide variety of theories have been posited with some more convincing than others. The remainder of this IPPI Policy Brief considers and assesses some of the theories, before I set out my own analysis.

### 1. *Is it just a blip?*

This argument is becoming increasingly difficult to sustain. The 'blip' has been long lasting. This is not just one of those anomalies that we can ignore and pass by on the other side – especially as the downturn (or at least growth below long term trend) is still with us.

### 2. *The problem is the data*

There are some grounds for believing that adjustments to key data sets have, at the least, made calculations between past and present productivity more complex. More generally economic

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<sup>2</sup> For more very helpful detail on and analysis of Scotland's productivity performance please see 'Scotland's Productivity Performance: Latest data and insights' by Kenny Richmond and Jennifer Turnbull of Scottish Enterprise as published in the Fraser of Allander Institute Commentary Volume 39 Number 2; November 2015.

data are always subject to change. Many economists over the years have written doctoral theses on how key economic data have changed and how such changes have resulted in substantially different interpretation of events – and consequently the scope for sub-optimal policies based on what has later turned out to be an incorrect view of (at that time) very recent economic history.

### 3. *All explained by structural change?*

At its simplest the argument here is that a high share of productivity growth comes from manufacturing. The re-structuring and down-sizing of manufacturing alongside the continuing increase in the share of services in the UK economy has limited the scope for ‘old fashioned’ productivity growth. This is less the case in Germany, for example, which has maintained a much higher share of manufacturing in its economy and managed significantly higher productivity growth post-recession. In some ways this argument links to the data point above. Productivity change in manufacturing is much easier to measure than in the service sector. The data sets which we have do not readily pick out the changes in many elements of the service sector, including *especially* changes in quality, which equate to productivity growth<sup>3</sup>. In principle productivity growth should be a key aspiration for services as much as for manufacturing.

### 4. *Not just a UK phenomenon?*

It is correct that productivity trends globally do vary markedly. However, the UK – and Scotland’s – weak performance does stand out as compared to our peer group, including our key competitors. Even if the problem is to some extent shared with some other countries that does not mean that we do not need to better understand its causation.

### 5. *Down to availability of cheap labour?*

This line of argument appears to have significant merits – as a partial explanation. In recent years we have seen a very welcome rise in employment, resulting in much lower levels of unemployment through and post-recession than was anticipated. Concurrently, for several years, average earnings declined in real terms. A combination of an unexpected degree of increase in the domestic labour supply (more people entering the labour force and people working more hours) and the increased level of UK in-migration did result in a ready availability of low cost, albeit to some extent relatively low skilled, labour. Companies seeking to expand output in uncertain times may have preferred to add to their pool of labour rather than taking steps to invest in new equipment. In the UK labour can be relatively easily hired and fired (at least at the margin)<sup>4</sup> while much investment in equipment is both lumpy and of significant scale – and has only a limited resale value. However, given constraints on the labour supply in the

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<sup>3</sup> See footnote 2 above.

<sup>4</sup> Not to mention zero hours contracts giving employers great flexibility within their existing labour force.

short to medium term, this may now mean that production via extra labour may no longer be such a cheap option – as the ‘surplus’ of labour is largely utilised.<sup>5</sup>

6. *Risk aversion is rife – and justifiable?*

This theory works alongside the availability of cheap labour. Perceived risks in the business environment, domestically and internationally, were very high during and post-recession. The Great Recession was a trauma the like of which had not been experienced before. Nobody was at all sure as to how the domestic and global economies would subsequently evolve. (Indeed we are still unsure – in many ways we have yet to revert to the economic norm.) This was/still is a time to be risk averse, waiting for more certainty to appear on the horizon before making significant investments. Survival was/is the watchword.

7. *The wrong type of management?*

Likewise it was a time when a sound financial manager at the helm was deemed safer than an entrepreneurial type. Senior recruitment executives have pointed out that a high percentage of top tier CEO jobs in Scotland in recent years have been filled by someone from the finance area – often the incumbent finance director. A safe pair of hands was preferred just to keep the show on the road, with the more entrepreneurial type of manager kept on ice until risks had receded. Innovation was not on the business agenda and remains a relatively low priority.

8. *Shortages of risk capital – blame the banks (again)?*

This view again reinforces the previous three arguments. Just as many companies will have been risk averse, so too the banks. Indeed given their experiences through the past decade they would not only be likely to be risk averse but for many years will have been capital constrained. However, the limited level of investment in the UK economy, the other side of the coin to strong growth of employment, has been due to both limited *demand* for funds for investment from corporate UK and (probably to a lesser extent) constraints on the *supply* of funds. Any constraint on the availability of capital, alongside an unwillingness to invest has simply overwhelmed the positive effect of ultra-low interest rates.

### **III But productivity really matters**

Should we simply rely upon faith that a norm reversion to the previous trend in productivity growth will just come along soon? Or should we not try to understand what has been going on and then consider what could and should be our response?!

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<sup>5</sup> One item of good news is that this may be leading to more emphasis on improving the quality of existing labour forces, i.e. via training, etc.

The importance of achieving renewed productivity growth was underlined a few months back (22<sup>nd</sup> June 2015) in a speech by the Deputy Governor of the Bank of England, Jon Cunliffe who noted that: -

“In the 10 years prior to the crisis [the 2008 recession], growth in the hours worked in the UK economy accounted for 23% of overall economic growth. The mainstay of economic growth, the other 77%, came from growth in productivity. Since 2013, only 9% of UK economic growth has come from productivity improvement. The remaining 91% has come from the increase in the total hours worked.”

He went on to note that a gradual pick up in productivity is central to the MPC's then current forecast. However, “it may never be possible to explain fully what has happened to UK productivity since the crisis – the “productivity puzzle”.”

As noted above, in my view it is important to attempt to develop a reasoned hypothesis as to the cause of slow productivity growth; and from this base to consider how the tide might be turned; and thence to address possible policy solutions.

#### **IV A reasonable hypothesis**

Slow productivity growth in the UK and Scotland in recent years can plausibly be ascribed to a combination of factors 5 to 8 listed above (i.e. cheap labour, risk aversion, cautious management and risk capital constraints). The starting point would have been risk aversion in the corporate sector. Interest rates may have been as low as was feasible, but the priority was to survive not borrow or invest. The proportion of loss-making firms in our economy remains way above the long-run average. Nevertheless liquidations have not shot up. Companies are hanging on – we have what Cunliffe has described as ‘more than a hint of ‘zombiness’ in the corporate sector’.

In these circumstances the finance director holds sway and caution and short-termism are the watchwords. Fortunately, as capacity became constrained and there was a desire to increase production, then a low risk option was at hand. Low cost labour was readily available and flexible – via short-term contracts, part-time employment and zero hour contracts, etc. This flexible and low cost labour could be deployed as that short-term option while the balance sheet was being gradually moved out of intensive care. This will have suited the troubled relationship and risk managers at the banks as well as directors, institutional investors and shareholders.

This hypothesis is consistent with developments in the UK economy; namely low investment, higher than projected employment – but with an emphasis on short-term and part-time, certainly



flexible arrangements – and (until recently) declining real wages. At the same time international competitiveness appears to have suffered and the UK trade deficit has grown and grown. A higher than normal share of growth of GDP has come from consumption<sup>6</sup>, on the back of high employment, declining consumer prices and cheap and readily-accessible credit, and all this despite declining real wages.

## **V How to turn the tide?**

The view from the Bank of England appears to be that factors are already at play which will lead to trend reversal; and a return to productivity growth as usual. Again to quote Cunliffe: - “As the economy grows, spare capacity is used up. The real cost of labour increases relative to the cost of investment. Firms have a greater incentive to find efficiency gains and to switch away from more labour-intensive forms of production. This should boost productivity.”

Certainly there is some logic to this theory and also evidence that real wages are rising once more. Indeed the latest quarter’s productivity data are mildly encouraging. However, the trends in business investment remain deeply disappointing. Similarly there is little evidence of any marked increase in bank lending or indeed demand for credit from the corporate sector. The incentives may have switched somewhat – from labour to capital – but risk aversion remains and innovation is scarce.<sup>7</sup>

The domestic and external environments will be key factors in the risk equation. The eurozone is the key market for many UK and Scottish companies. The continuing problems with Greece, and the perceived risks across the eurozone flowing from the Greek crisis<sup>8</sup>, are constant headlines in the media. More attention is now being paid to deceleration in the Chinese economy and greater risks elsewhere amongst the BRIC nations – Brazil and Russia to be precise. The decline in commodity prices and the lower level of oil prices are all indicative of more global economic uncertainty. The expectation of the FAI, Bank of England and others is that global growth will gently slow, with the majority of growth coming from the emerging markets, although growth there is also expected to decelerate. Within this context the continuing strength of sterling, against the euro in particular, is having an adverse effect on exports.

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<sup>6</sup> And in Scotland from publicly funded construction.

<sup>7</sup> In their November Inflation Report the Bank of England states that: - “The MPC judges that productivity growth is likely to slow a little in the near term before picking up modestly over the next few years, as the factors weighing on it wane further. Although there is substantial uncertainty around this judgement” [In other words it is still unclear what will happen and when.]

<sup>8</sup> And now uncertainties regarding UK’s place in Europe coupled with concerns about immigrant flows.



My view is that there should be a gentle pick up in investment, innovation, productivity and hence competitiveness; but that this will be markedly slower and is far less secure in probability terms than assumed in many macro models. This in turn will imply slower growth of GDP than estimated. Hence we should consider carefully how a pick-up in innovation and investment more generally can be encouraged to boost the UK and Scotland's productivity performance.

If we achieve a return to growth in average earnings at historic rates *without* an increase in productivity then the result will be higher inflation and, consequently, higher interest rates and a lower growth of GDP and economic welfare.

## **VI Policy options: a 'Productivity Commission' for Scotland?**

There is no 'productivity plan' in place in Scotland, or indeed at the UK level<sup>9</sup>. The Chancellor has suggested that improved housing options would assist – to allow greater flexibility and mobility of labour. He has also pointed to improved infrastructure, particularly for the 'Northern Powerhouse', as an encouragement to corporate expansion – including movement into new markets – and investment. These policies are of themselves perfectly sensible but cannot be seen as tackling the root causes of the UK's low productivity growth.

Clearly the answer must lie in enhanced innovation, increased investment, better utilisation of (and of course availability of) key skills, better understanding of markets (domestic and especially international), sensible risk-taking by informed and dynamic management and a continuing focus upon higher value-added and enhanced quality to increase competitiveness. How these outcomes can be achieved, what might be appropriate interventions to best help incentivise such favourable outcomes is a moot point.

One final thought; could a short term **'Productivity Commission' for Scotland** help to set out a way forward for businesses, Government and other interested parties to improve Scotland's productivity performance and thereby increase the opportunity to increase economic welfare in Scotland?

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<sup>9</sup> Although the UK Government did publish in July 2015 "Fixing the foundations: Creating a more prosperous nation" Cm 9098

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**Jeremy Peat OBE** is a Visiting Professor at the International Public Policy Institute at the University of Strathclyde. He has a distinguished career as an economist and economic commentator and was Group Chief Economist at the RBS (Royal Bank of Scotland) from 1993 to 2005. He is a member of the Board of Scottish Enterprise, Chair of the Royal Zoological Society of Scotland and was a long-standing Director of the David Hume Institute (2004-14). He is a fellow of the Royal Society of Edinburgh, of the Chartered Institute of Bankers and the Royal Society of Arts. He is a regular commentator on economic and wider public policy issues and writes a monthly column for the Herald newspaper.

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