Statement to the Productivity Commission

by

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I am the author of a book on productivity in the UK (with Mary O'Mahony) and of some 60 articles in refereed journals. Many of these publications have been on productivity whether at the company, industry or country level. Others have been concerned with measurement issues (ICT, capital, and PPPs). I have recently written about the impact of the global financial crisis and on the UK's productivity puzzle.

After an academic career at Lancaster University I moved to the National Institute in 1987. I left in 1998 to go to the Bank of England where I became a Senior Economist. After retiring from there (though continuing as a consultant) I became associated with LSE in 2003 and also returned to the National Institute. I am currently also a Fellow at ESCOE and at the Office for National Statistics.

1. Introduction

The UK's productivity puzzle is of long standing. Yet it has provoked surprisingly little public discussion and debate. A search of the BBC's website is a disappointing experience. There is of course a considerable academic literature but by comparison for example with the size of the literature on (say) inflation targeting it is quite small. Now the government has adopted the Levelling-Up Agenda there is a chance that productivity and its discontents will become much more prominent. After all, levelling-up is really a synonym for raising productivity. The establishment of the Productivity Commission provides a huge opportunity for a fresh look at this vitally important issue. But it is very important that the Commission takes a fresh look at the arguments and evidence. There is a received wisdom here which one can read every day in the Financial Times and elsewhere which needs to be challenged.

In what follows I discuss the nature of the UK's productivity problem, some micro and macro factors which I believe to be important, and then conclude with a sketch of policies which I believe will be helpful.

2. What is the UK's productivity problem?

According to Paul Krugman (1994, chapter 1), "Productivity isn't everything, but in the long run it is almost everything. A country's ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker." UK data confirms Krugman's intuition. Table 1 shows UK productivity at the national level as measured by GDP per hour worked and living standards as measured by "median equivalised household disposable income". This is currently the best available measure of the material living standard of the typical British person. Note that median not mean income is the measure so this picks up the effect of changes in inequality.

Table 1 shows a worrying picture. The average growth rate of both living standards and productivity was highest in the earliest period, 1977-1990. Growth of living standards then slowed in the middle period, 1990-2007. But the period after 2007, the time of the global financial crisis and the Great Recession, has seen a collapse in growth. Productivity has been growing only at the pathetic level of 0.21% p.a. And this was before we were hit by the pandemic.

Table 1

Growth rates of the standard of living and of productivity, 1977-2019 (% p.a.)

	1977-1990	*1990-2007*	*2007-2019*
Standard of living	3.07	1.96	0.47
Productivity	2.35	2.34	0.21

Source: Office for National Statistics.

Note: Standard of living measured by (real) Median Equivalised Household Disposable Income, productivity by (real) GDP per hour worked.

The material living standard is not the only thing which matters to people of course. Other things like good health and longevity matter too. But we know that these are positively correlated with income. So I take it as axiomatic that material living standards matter to people. They should also matter to governments even though thinkers down the ages since at least Plato (usually benefiting themselves from a higher than average standard of living) have been highly critical of materialism.

What about international comparisons? Numerous studies have shown a productivity gap between the UK and the major economies with which we like to compare ourselves: France, Germany and the United States. The gap with the United States had opened up by the end of the nineteenth century. The UK remained ahead of France and Germany till after the second world war but was then surpassed by these countries in the early 1960s. But although remaining behind, up to 2007 the UK was actually closing the gap with our major competitors since we had one of the fastest rates of productivity growth amongst the advanced countries. In particular we were growing more rapidly than the United States (Oulton 2012). Based on the trends up till then, and particularly on the UK's excellent record of investment in ICT, I projected that the UK would continue to grow rapidly (again, Oulton 2012).

All this changed after 2007. The UK's productivity growth collapsed as we have seen. And instead of performing better than our competitors we now performed worse (Oulton 2019). Instead of France, Germany or the United States, a better comparator for the UK would now be Italy which has endured 20 years of productivity stagnation. Explaining this reversal of fortune is the major task of the Commission.

3. Micro explanations for the productivity puzzle

When firm-level data on productivity first became available it was immediately observed that there is a huge dispersion in productivity levels across companies. This is a general finding across countries which in the case of the UK was first documented by Oulton (1997). Also generally found is that large companies have higher productivity than smaller ones in the same industry.

Going beyond this, there is a widespread view that the UK is distinctive in having a particularly long tail of low productivity companies which drags down the overall average. This morphs into the view that large British companies are excellent but are let down by their smaller counterparts, unlike in competitor countries like Germany. But it won't do just to cite the great and the good on this point (e.g. Haldane 2017). It needs to be demonstrated. As far as I am aware the evidence on this is not in fact clear. So the Commission could do a great service by investigating this issue and hopefully settling it.

In fact, there are at least two pieces of evidence that go against this common view. First, Schneider (2018) found that the post-2007 productivity slowdown was concentrated in the upper tail of the productivity distribution. Here reallocation of labour away from high productivity firms reduced overall productivity. Low productivity firms continued much as before.

Second there is the fact, known for a long time, that foreign-owned firms operating in the UK have higher productivity than domestically-owned ones. We can be more precise than this. It is in fact US-owned companies which have a particularly strong advantage over UK-owned, or even European-owned, companies *in the same industry*. They are about 20% more productive (Oulton 2000). This is a real puzzle. Why should a US company, operating in the UK under UK law and institutions, and employing British workers, be able to achieve such high productivity? The proximate answer is that the US companies employ more human and physical capital but this still leaves the ultimate explanation unclear. The dismissive answer is that US companies are just good at snapping up excellent British companies so what we observe is just a selection effect. But I found that at the time they were acquired (when this could be traced) the British companies did not have particularly high productivity (Oulton 2000).

4. Macro explanations for the productivity puzzle

As we have seen everything changed after the global financial crisis and the Great Recession of 2008-2009. At the time of the crisis and for some time afterwards it was expected that the advanced economies would eventually get back to their previous growth path. There would be a permanent loss of output as a result of the recession but eventually GDP would return to its previous path so that future levels of productivity would be as expected prior to the crisis. Discussion focused on whether the recovery would be U-shaped or V-shaped. Unfortunately none of this came to pass. On the eve of the pandemic at the end of 2019 the level of productivity in the UK was no higher than it had been 12 years earlier just prior to the global financial crisis.

The now orthodox explanation for the slowdown is that it has little or nothing to do with the recession. After all, the recession was over by the end of 2009 but the slowdown has continued. The slowdown is instead explained by a decline in innovation (total factor productivity growth) which predates the crisis. This decline is partly exogenous, due to the fading effects of the ICT revolution. But it also partly endogenous, due to weaknesses in the competitive process, which again predate the recession. In other words, the explanation is to be found in purely micro factors, an increasing (and mysterious) malfunction in the competitive process. In my view this puts far too much emphasis on the experience of the United States. Productivity growth in the US may have been slowing prior to 2007 but it slowed down a lot more after 2007. In any case, what needs to be explained is why productivity slowed down more in the UK than elsewhere. Arguments about the importance of AI etc are irrelevant.

This raises the question: instead of looking to factors like poor British management or low UK skill levels (which were present both before and after 2007), should we be looking instead at more macro factors and to common trends across countries since 2007? Certainly banking crises unlike other types of recession seem to have long-lasting effects on at least the level of productivity (Oulton and Sebastiá-Barriel 2017). But to explain the UK's poor performance since 2007 we need to find factors which differentiate us from comparable countries, given that other commonly-advanced explanations seem lacking (Oulton 2016).

In a recent study of 22 Western economies since 2000 (Oulton 2019) I argue that our weak productivity performance is a macro phenomenon, mainly due to weakness in aggregate demand which in turn is due to constrained demand for each country's exports since 2007. The growth of export demand has fallen sharply in every one of the 22 countries. The variation across these countries in labour productivity performance since 2007 is due to differences in labour market institutions: for a given degree of constraint on export demand, countries with more flexible labour markets like the UK will experience better labour market results but worse productivity performance. If aggregate demand falls but labour input continues to grow the result must be a decline in labour productivity growth, even to zero. In most countries the growth rate of hours worked fell sharply after 2007 and even turned negative. By contrast in the UK hours worked rose at much the same quite rapid rate after the crisis as they did before it (2000-2007). This growth in labour input was due almost entirely to immigration, both from the EU and from the rest of the world. By contrast in an inflexible labour market migrants or young natives are unable to price themselves into jobs, which is the case in much of Europe. So the flip side of the UK's "jobs miracle" is the productivity disaster.[1]

5. Policies

Here are a few notes to suggest my own conclusions to date without any attempt to be comprehensive.

Migration

I believe the government has now got the right policy, at least on paper. Low skilled immigration is to be tightly controlled while high-skilled migrants are to be encouraged. In effect we are finally adopting the policy successfully pursued by countries like Canada and Australia (and the United States except that in their case they fail to enforce it). My only doubt is whether the government will stick to its guns in the face of endless whingeing from business.

Skills

The skills gap was first identified more than a century ago. Forty years of research at NIESR and elsewhere has amply documented its size and significance. The gap should be fixable but continued failure is likely if we try to rely on business to pay for it. Business has shown unwavering hostility to the modest apprenticeship levy. So government funding is essential.

[1] Congratulations to David Card on winning a half share in the 2021 Nobel Prize in economics. His seminal (though disputed) paper on the Mariel Boatlift is often taken to be supportive of a policy of open borders. It isn't.

Investment

There is a need for investment of all types to grow more rapidly for a lengthy period. How is this to be achieved? The cost of capital can be reduced by tax breaks. There is such a policy in place at the moment but unfortunately it is due to be abolished quite soon. More fundamentally the best way of boosting investment is a sustained period of more rapidly rising aggregate demand. But how is this to be achieved? Simply boosting private consumption via tax cuts or increasing public expenditure on consumption is not fiscally sustainable. Two other ways suggest themselves. First, a long term infrastructure plan which provides a high and rising level of public investment in roads, railways, broadband, R&D, etc, financed by borrowing. Provided that these investments are socially useful then they will spark additional private investment, driving up GDP and generating tax revenue sufficient to service the debt incurred. Second, faster growth of UK exports through trade deals. UK trade has been too concentrated on slow-growing regions. Germany has been far more successful than us in selling to fast growing countries like China. Until recently we sold more to Ireland than we did to China. A trade deal with China would be very advantageous. But here we run up against geopolitical constraints. The United States seems determined to stop the rise of China by one means or another and is doing its best to rope us into this (in my view extremely unwise) project. So far, with very little discussion, we have been inclined to take the US rather than the German view on China. I hope this will change.

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