National Institute of Economic and Social Research

BUSINESS CONDITIONS FORUM

12 – 01 – 2022

Productivity and Levelling Up

The NIESR Business Conditions Forum is funded by an ESRC Impact Acceleration Account

UKRI Economic and Social Research Council

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Welcome from Rory Macqueen *(NIESR)*

Presentations and Discussion

- Josh Martin (Office for National Statistics): What the latest official statistics tell us about the UK's past and current productivity
- Bart van Ark (The Productivity Institute): Getting on the path towards a high productivity economy
- Guilherme Rodrigues (Centre for Cities): The link between economic complexity and productivity

Polls

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CHATHAM HOUSE RULES

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If you would like to take part in the forum but do not wish to be recorded, you can post any comments and questions in the chat and these will be read out by the Chair.

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Latest NIESR GDP tracker

Q4 nowcast: 1.0% growth. Q1 first tracker forecast out Friday

Latest NIESR wage tracker

Adjusting for base effects we estimate annual earnings growth of 4.4%.

This is expected to fall to 4.1% in Oct-Dec as base effect dissipates.

Latest NIESR CPI tracker

Underlying inflation – excluding extreme price changes – rose in November from 2.1% to 3.4%.

London has highest rate of underlying inflation at 4.3% with Northern Ireland at 2.4%.

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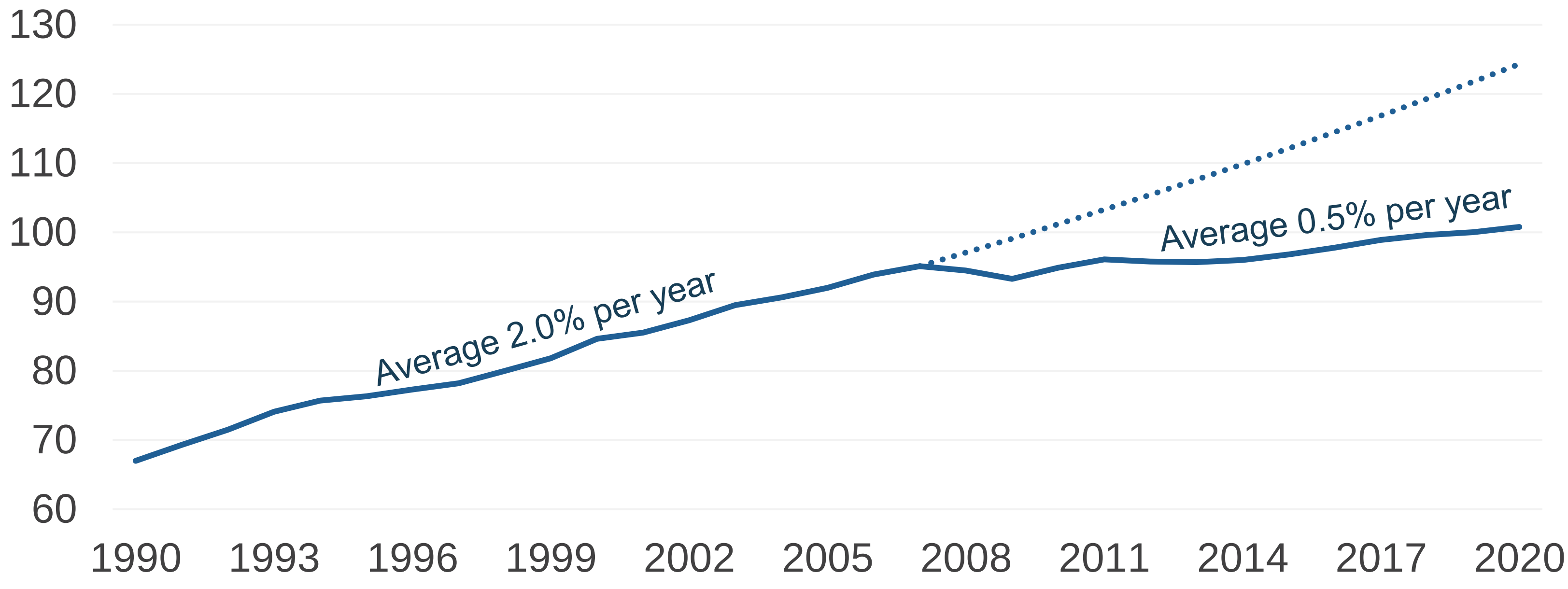
The UK’s productivity landscape

NIESR Business Conditions Forum

Josh Martin
Head of Productivity, ONS
Josh.Martin@ons.gov.uk; Productivity@ons.gov.uk
Twitter: @JoshMartin_ONS

Productivity growth has been slow since the 2008 downturn, and would be 20% higher today had it stayed on trend

Output per hour worked (£), index 2019 = 100, outturn and trend, UK, 1990 to 2020

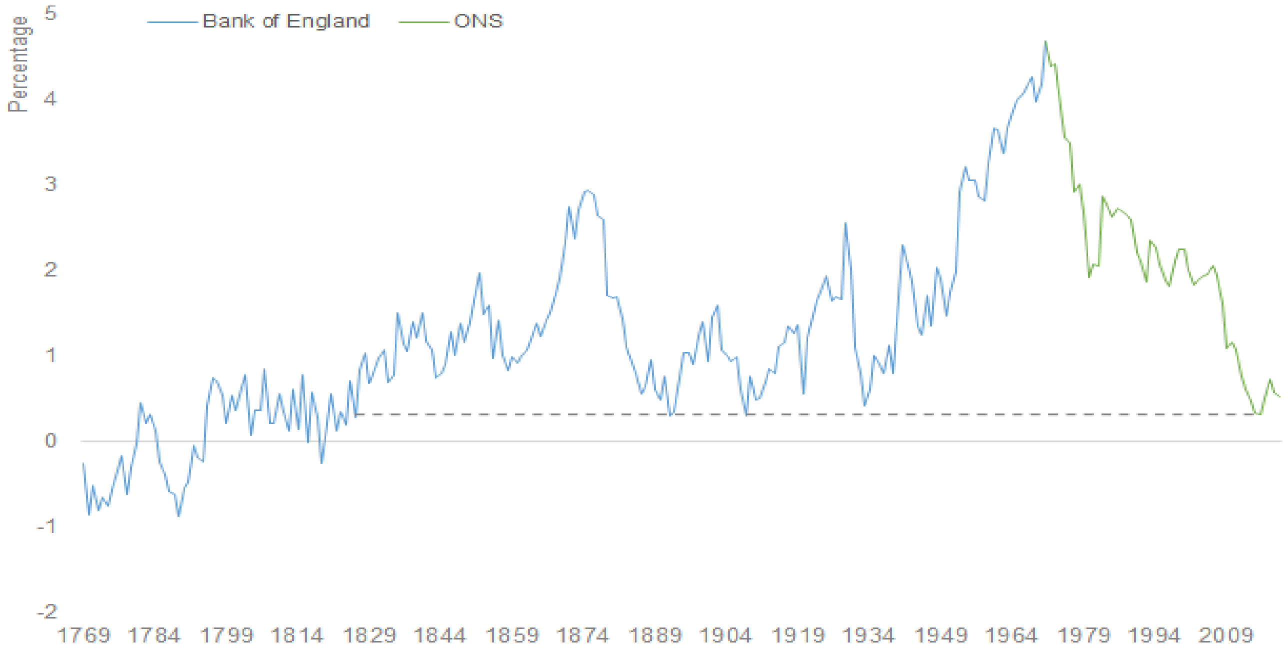


Source: ONS – Labour productivity

Office for National Statistics

Productivity growth has not been sustained so weak since the Napoleonic era

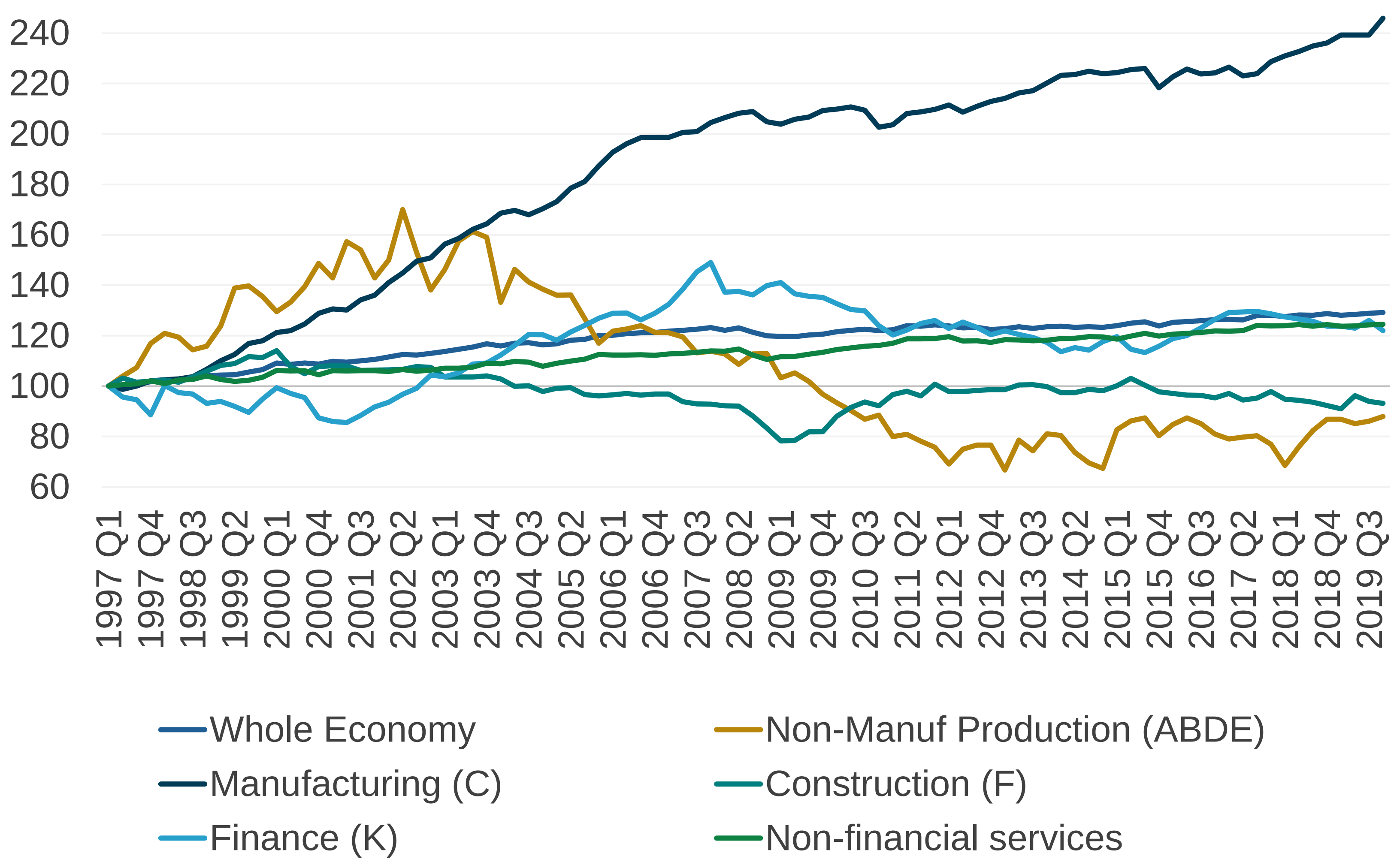
Rolling 10-year growth rate of output per hour worked, UK



Source: ONS Written Evidence to Productivity Commission (2021), using data from ONS – labour productivity, and Bank of England – millennium of macroeconomic data

Office for National Statistics

Output per hour worked, high-level industries, index 1997 Q1 = 100



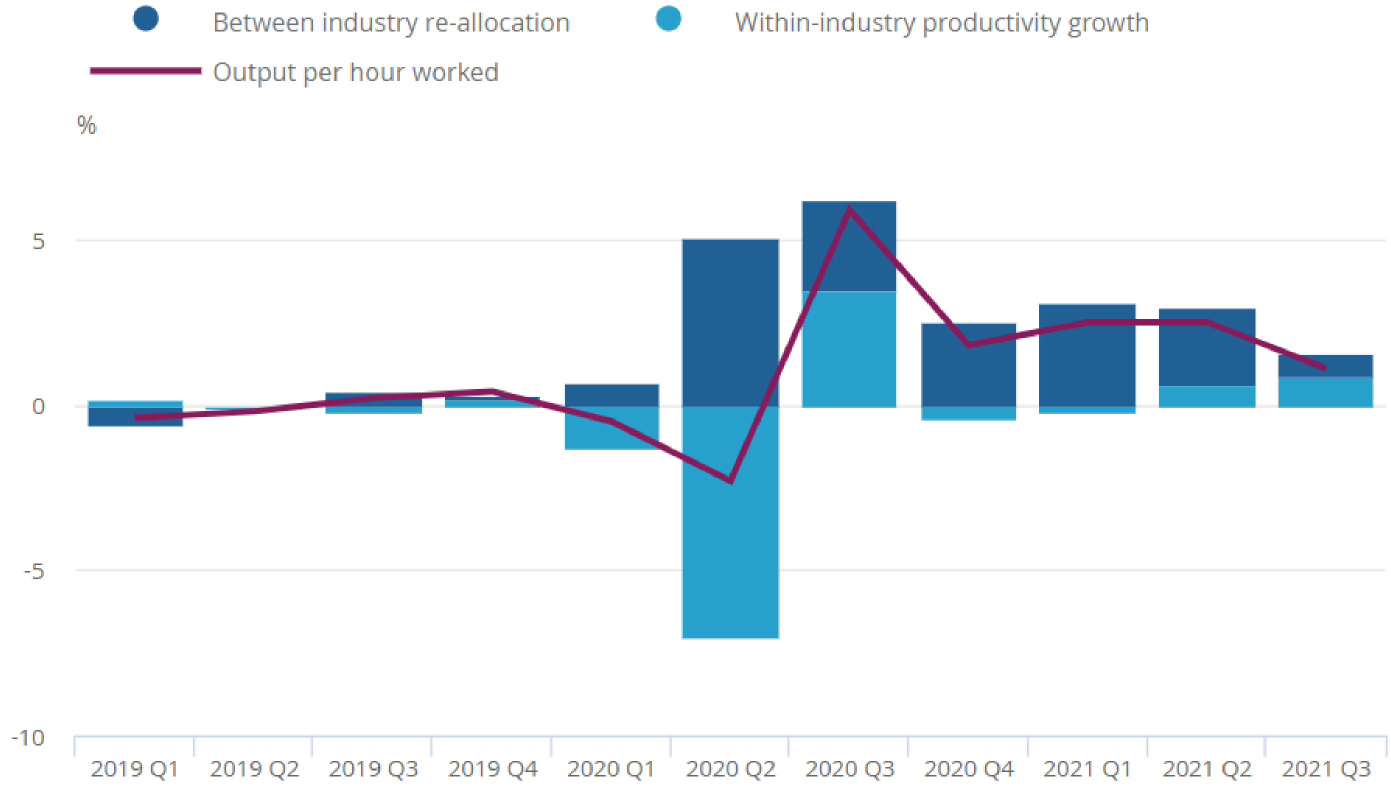
Office for National Statistics

Productivity during the pandemic

In Quarter 3 (July to September) 2021…

Output per hour worked	↑ 1.1% since 2019	↓ 1.4% since Q2 2021
Output per worker	↓ 0.6% since 2019	↑ 0.3% since Q2 2021
Output per job excluding furloughed workers	↑ 3.7% since 2019	↓ 4.2% since Q2 2021

Re-allocation effects during the pandemic

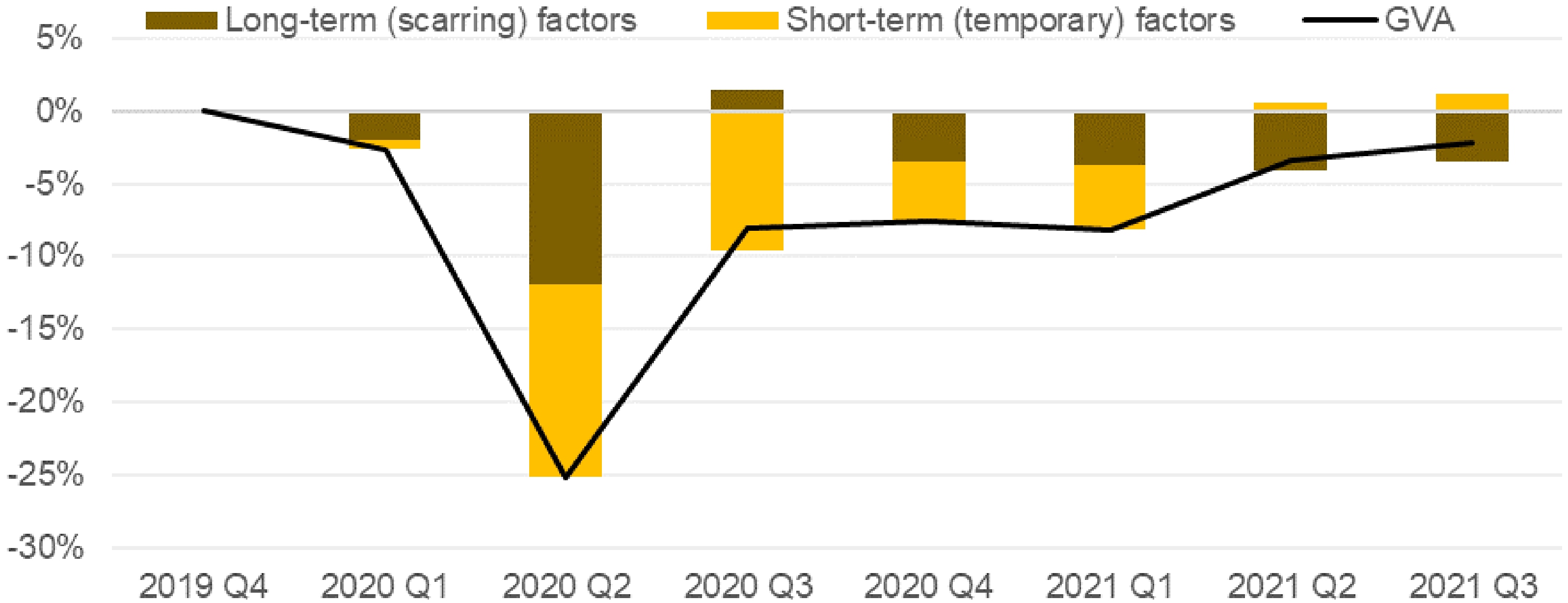


Source: ONS – Productivity overview, UK, for Quarter 3 (July to September) 2021, published 11 Jan 2022

Office for National Statistics

Decomposing the fall in market sector GVA into short-term and long-term factors

Cumulative changes, market sector, UK



Source: Office for National Statistics - multi-factor productivity estimates; @JoshMartin_ONS calcs
Notes: short-term factors are average hours worked, capital utilisation, labour composition, and between-industry MFP. Long-term factors are employment, potential capital services, and within-industry MFP.

Office for National Statistics

Productivity after the pandemic

<u>Upsides</u>

- Homeworking – hybrid workers more likely to get bonuses, more productive?
- Online retail – big boost in retail industry productivity during pandemic
- Focus – new research, findings and attention

<u>Downsides</u>

- Reduced potential – lower business investment and disrupted education
- Labour shortages – early retirements, outward migration, hysteresis?
- Homeworking – need for management skills, potential for lost opportunities

Thank you for listening!

Josh Martin

Head of Productivity, ONS

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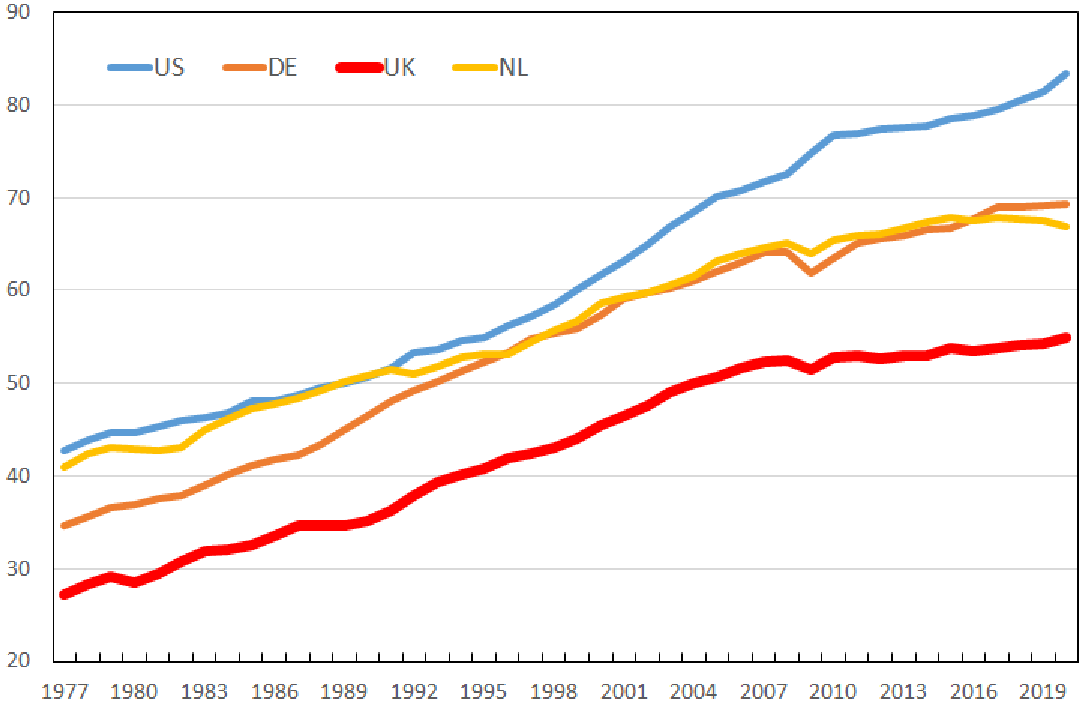
Widespread slowdown in productivity growth in western countries, but most strongly in UK

GDP per hour worked in US$ - using industry-specific purchasing power parities (2017)



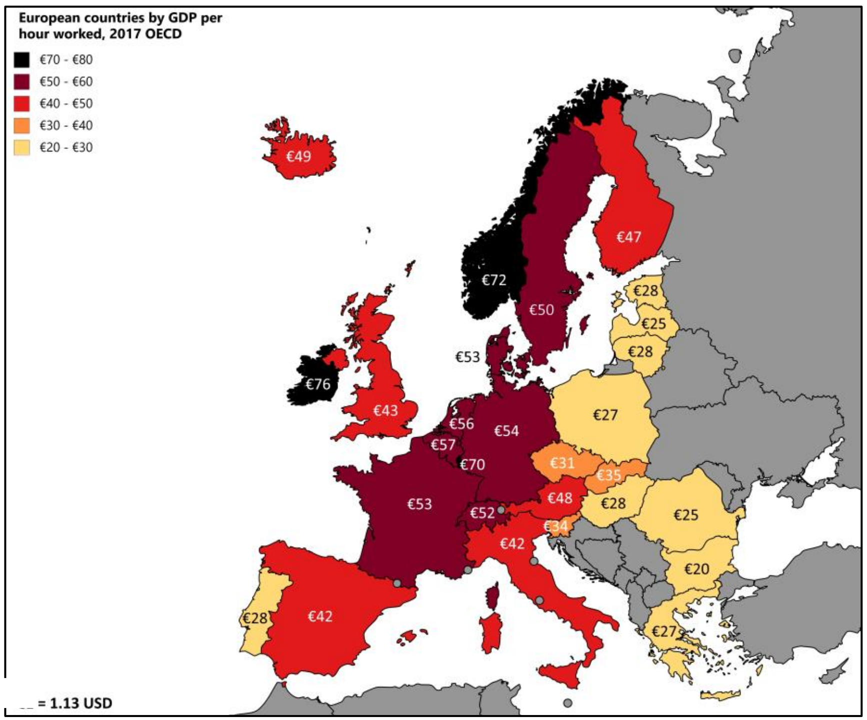
Key stylized facts on UK productivity slowdown:

- Systemic underinvestment in key components of intangible capital
- Proportionally large numbers of low skilled and low productive jobs
- Long tail of low productive firms across industries
- Unusual pattern of regional diversity in productivity, especially weak performance of 2nd tier cities

Note: converted at GDP PPPs
Source: The Conference Board Total Economy Database, August 2021

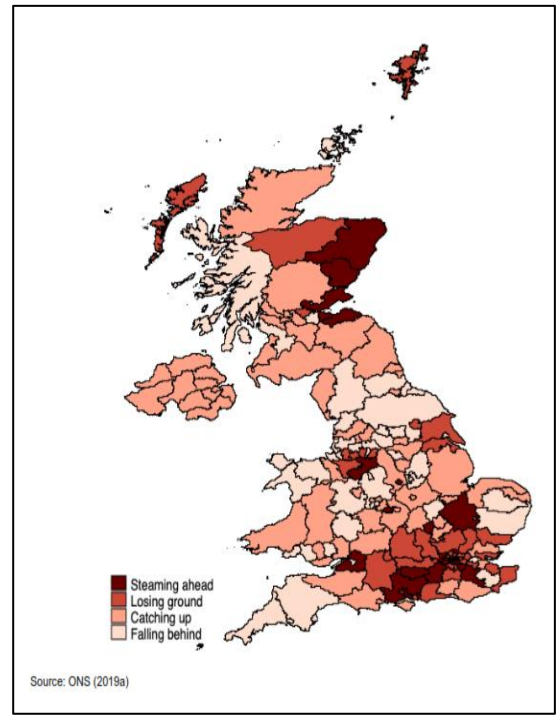
Low productivity level and large differences between and within regions

Low productivity levels relative to European economies



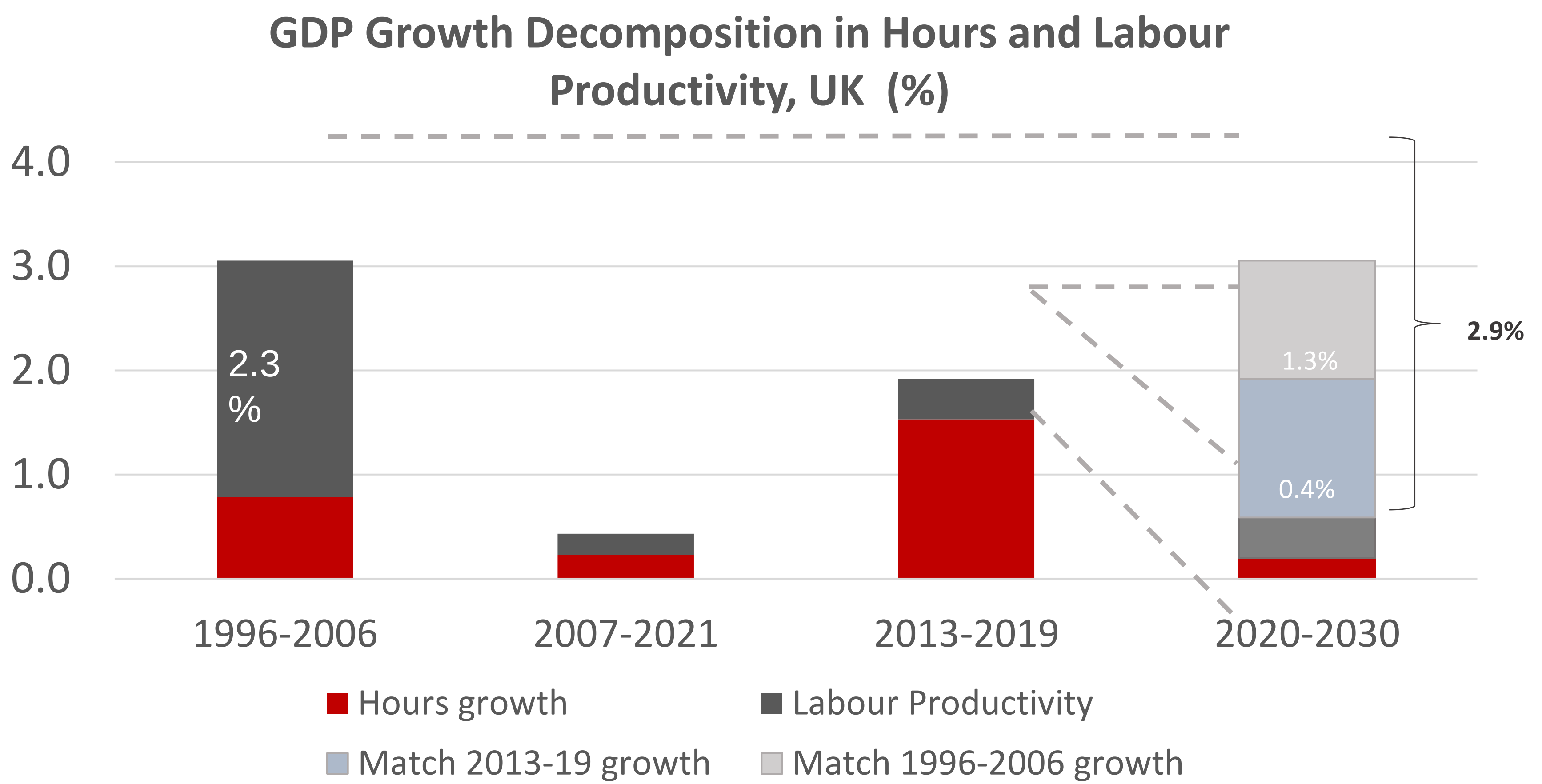
Source: OECD

Large gaps in opportunity between regions



Source: Industry Strategy Council (2020)

How to not miss the productivity revival again?



Key game changers for a productivity revival in the next decade

- ***Digital transformation***
  - New frontier technologies
  - Diffusion between firms
  - Absorption within firms

- ***Skill formation***
  - World class science
  - Further education
  - Apprenticeships
  - Non-technical skills

- ***Institutional reform***
  - Industrial policy
  - Regional and local governance reform
  - Fiscal reform

- ***Net zero***
  - Adaptation
  - Mitigation
  - Green jobs

Three new TPI papers on Productivity and Levelling Up

UK's Industrial Policy: Learning from the past?

Diane Coyle, Adam Muhtar (2021)

As a result of the institutional inability to learn from experience, British industrial policy suffers from policy inconsistency and coordination failures.

Policy recommendations

- UK needs to develop an institutional framework that supports evidence-based, forward-thinking and long-termist policymaking
- A statutory, independent oversight body should be set up to evaluate industrial policies and provide actionable information to Parliament
- A special purpose vehicle such as a sovereign wealh fund should be established to mobilise industrial policy initiatives -incorporating long-term horizons into strategic planning and investment decisions

Key insights

- The UK's industrial policy since the 1970s has been characterised by frequent policy reversals and announcements. This has been driven by political cycles, while multiple uncoordinated public bodies, departments and levels of government are responsible for delivery
- While the ambitions of British industrial policies may match the German, Japanese, French and Chinese counterparts, the UK does not compare well when it comes to the coordination of policies
- At the policmaking level, analysis and decisions in the UK are disjointed across ministries and agencies. Policy is largely generated from a 'top down' approach and the institutional structure for collaboration and coordination is inherently absent
- The authors find that a consequence of the policy inconsistency and poor coordination is that UK industrial policy lacks adequate information feedback channels from outcomes to the policy process; there is a failure to learn or to build on successes.
- To produce a policymaking practice that is forward-looking and long termist, the UK needs to develop better policy processes, requiring an instiutional framework that would enable an effective capability for infor-mation gathering and analysis and a learning mechanism to ensure that information gathered and evaluation of outcomes is the primary force shaping industrial policymaking (as opposed to political lobbying)
- The UK also needs an independent oversight body to evaluate the efficacy of its industrial policies. The provi-sion of independent scrutiny would deliver credible and actionable information to Parliament and guidance for futue policies. Conferring statutory status would be crucial to provide instiutional longevity.
- The UK should consider a special purpose vehicle to mobilise long-term industrial policy initiative. Here, the state typically utilises arms-length investment institutions (such as a sovereign wealth fund or a venture fund) to mobilise industrial policy initiatives that work alongside competitive market forces to ensure financial dis-cipline in its interventions. The developmental mandate forces these institutions to incorporate a long-term horizon into their strategic planning and investment decisions and a key outcome would be more competitive and productive companies plus investment in infrastructure, regional and human capital development

Levelling Up, Local Growth & Productivity in England

A. Westwood, M. Sensier and N. Pike (Nov 2021)

Ahead of the publication of the Government's 'Levelling Up' white paper, The Productivity Institute reviews the current role of institutions and governance structures across English regions in tackling spatial inequality and low productivity.

Policy recommendations

1. A stable institutional landscape is critical to productivity – this has been missing for decades in England
2. A clear devolution and decentralisation strategy based on coherent city region economic geographies at a scale that make a difference
3. Coordination between institutions at all levels (and different functions – transport & infrastructure, education, business support, research and development) is vital for this to work and succeed

Key insights

Despite a devolution of political powers to Northern Ireland, Scotland and Wales as well as several city-regions in England, Britain remains a unitary state that is overcentralised compared to other countries. At the same time Britain's institutional ecology at national as well as at the local and regional level can be weak, fragmented or poorly co-ordinated.

The three policy areas most important for boosting productivity and reducing disparities across regions are also subject to continuous chopping and changing including regional policy, industrial strategy and vocational education

There is a lack of spatial consistency and continuous churning within and between government reforms. For example, in England and Wales there were 19 Training and Enterprise Councils (TECs) created in 1990 looking after various economic and training schemes. These were replaced by nine Regional Development Agencies and 47 local Learning and Skills Councils. By 2010 both sets of organisations were abolished and replaced with 39 Local Enterprise Partnerships. Alongside there was the creation of several Combined Authorities (now 9 in England) as well as the 'Northern Powerhouse' and 'Midlands Engine' brands. Very few follow the same geographical boundaries or follow a consistent or coherent geographical or spatial framework. This is not a way to encourage private investment.

Successive British governments also have a poor track record of effective cross-departmental coordination, as highlighted not just during the Covid-19 emergency but also in relation to the repeated failure to put in place a robust industrial policy. For example, new Whitehall departments have been created and renamed, and industrial strategy recalibrated with every new incumbent in No 10.

Reducing high levels of regional inequality requires a more optimal balance between local and national fiscal powers, with more flowing to the former. However, it is likely that achieving this will require a period of strengthening capacity in local and regional institutions and of continuing fiscal transfer as gaps remain wide.

The Fiscal Implications of 'Levelling Up' and UK Governance Devolution

Philip McCann (Nov 2021)

When we set the UK in the context of other OECD economies, the UK does not have a fiscal equalisation system which is strongly related to the UK inequalities Nor does the international evidence imply that devolution or decentralisation per se will help to reduce the UK's interregional inequalities. It depends on the particular design and features of the devolution process .

As such, reforming the UK's interregional fiscal system in a manner which will help with 'Levelling Up' is complicated by the fact that it is in many ways such a strange system by international standards. As well as being a governance system in which local and regional government has amongst the least authority and autonomy in the industrialised world, it is also a system in which the control and accountability systems are almost unique, and there are 9 aspects to this. These 9 features mean that the UK displays a unique sub-central government fiscal and decision-making system in comparison to all other industrialised countries. Moreover, the long-run combination of only mediocre economic growth allied with very high interregional inequalities suggests that this over-centralised system has poorly served the UK.

There is currently widespread enthusiasm for devolution and decentralisation as part of a broader Levelling Up agenda. However, any devolution or decentralisation needs to be undertaken very carefully because if poorly implemented, UK devolution and decentralisation could easily worsen the already-high interregional imbalances. Therefore, any movements towards some forms of greater devolution and decentralisation under the banner of 'Levelling Up' must be well thought-out in advance and implemented within a clear long-term strategy which takes on board and constructively builds on the likely impacts of each of the individual governance reforms.

The 9 features

1. The UK increasingly has more of a cost-based than a revenue-based interregional fiscal equaliser system, and cost-based systems tend to provide much weaker fiscal stabilisation underpinnings than do revenue-based systems
2. The levels of UK sub-central government revenue, expenditure and investment which are decentralised are very low by international standards, as are the levels of sub-central government autonomy and authority
3. The UK distribution of sub-central government liabilities is unusual, in that the only other OECD country with a similar composition of liabilities close to that of the UK is Australia although the sub-central governance systems of the two countries are profoundly different.
4. The shares of UK sub-central government debt which are securitised are amongst the lowest of any OECD country, and are the lowest amongst any large OECD country. As such, the UK is not only unlike federal countries, but also unlike most other unitary countries, especially large unitary countries.
5. The UK central government exerts direct controls on almost all aspects of UK sub-central government, thereby creating distortions in policy objectives and limiting local policy-making discretion.
6. In the UK all sub-central government powers and responsibilities derive from central legislation, leading to a system of very strict rules and regulations. In many other countries, the relevant legislation is local or regional. The UK also differs from most other countries in that its shift to performance budgeting at the sub-central government level, combined with high-powered grant-seeking incentives, tends to skew local decision-making towards meeting the priorities of central government
7. In the UK, one of the most significant obstacles to devolution or decentralisation is the issue of constitutional checks and balances, and this inherently concerns the nature of parliamentary sovereignty and public accountability in the British constitutional worldview
8. The legal changes in Scotland following the recommendations of the Calman & Smith Commissions and in Wales (following the Silk Commission) mean that the UK is now rapidly becoming a quasi-federal state with highly unequal national governance components, each with very different sub-central governance arrangements, and an unclear definition of the centre of government
9. The over-centralised UK governance system militates against both central government learning and local government institutional capacity-building. The reason for this is that the extreme pyramidal nature of the UK governance system, combined with a lack of any meaningful meso-level governance tiers outside of the three devolved administrations or London, automatically disincentivises citizen engagement with government, especially in the weaker parts of the country. At the same time, this strange governance architecture curiously incentivises both short-termism in policy-making and large-scale interventions.

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What is productivity and why does it matter?

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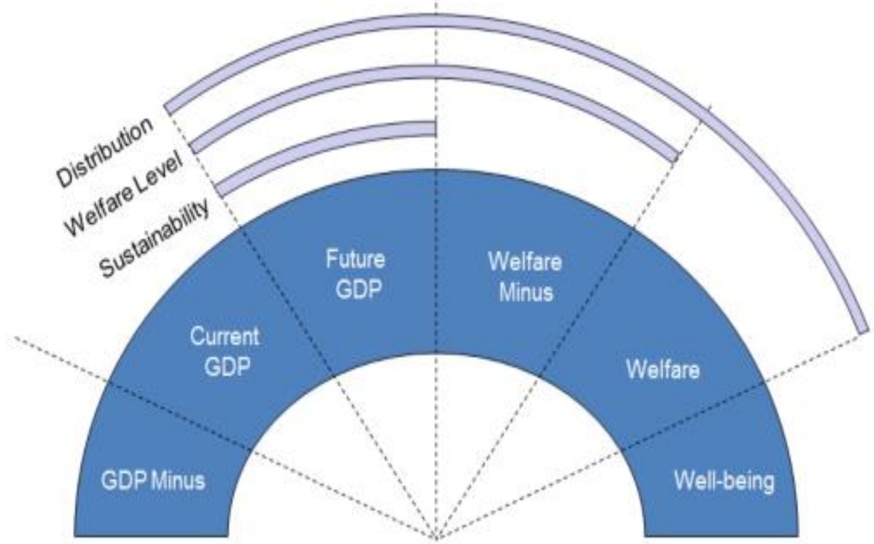
Output / Input = Economic Productivity

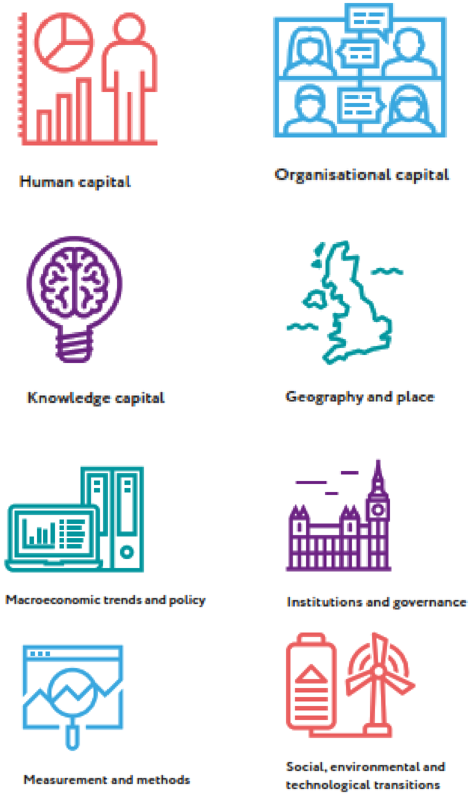


Source: Heys, Martin and Mkandawire, GDP and Welfare: A spectrum of opportunity , ESCoE Discussion Paper 2019-16

Outcome / Resources = Societal Productivity

The Productivity Institute

www.productivty.ac.uk



What levelling up really means: Economic Complexity in British cities

January 2022

Centre for Cities

Guilherme Rodrigues

Summary

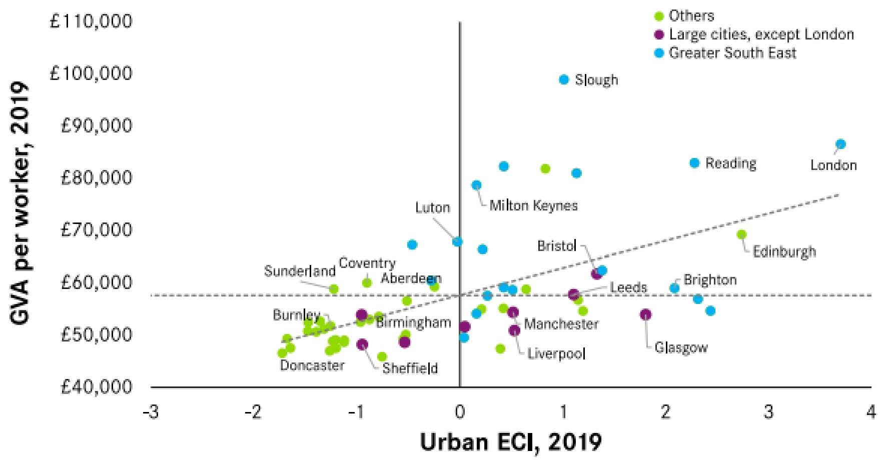
What does economic complexity tells us about cities productivity?

- Economic complexity highly correlates with productivity levels for the UK's cities, as the international literature suggests.
- The cities that were more complex in 1981 are more likely be complex and productive nowadays.
- The cities that **became relatively less complex typically remained specialised in the same activities** between 1981 and 2019. **Complex cities were able to move to new sectors.**
- Cities that improved its relative position, typically large cities, are still lagging in terms of productivity. Their complex sectors are still comparatively small.
- British large cities, despite recent gains, still underperform their French and German peers.

Analysis

Highly complex economies are more productive

Productivity and ECI at the urban level, 2019

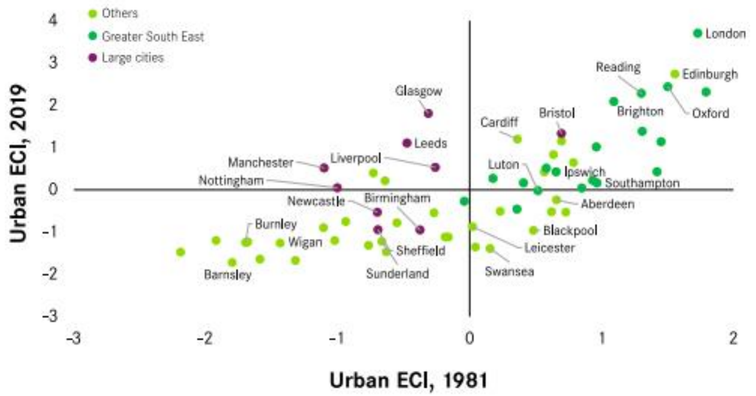


Source: ONS. Centre for Cities' calculations.

- There is a strong relationship between economic complexity and productivity.
- Cities that are both complex and **productive tend to be located in the Greater South East; while cities in the North and Midlands tend to be low productivity-complexity.**
  - **Complex activities tend to be knowledge-intensive services and low complexity mining and some types of manufacturing.**
- Large cities are the major exception (bottom right quadrant): we know that they are lag in terms of productivity but they are quite complex.
  - This goes in line with previous CfC's research that these cities are the ones with **the largest productivity gap**.
- Productive cities with low complexity are typically economies focused on a single sector like Luton, Aberdeen and Sunderland.

Past capabilities help explain the current situation

Most Greater South East cities remained complex between 1981 and 2019, while big cities became more complex



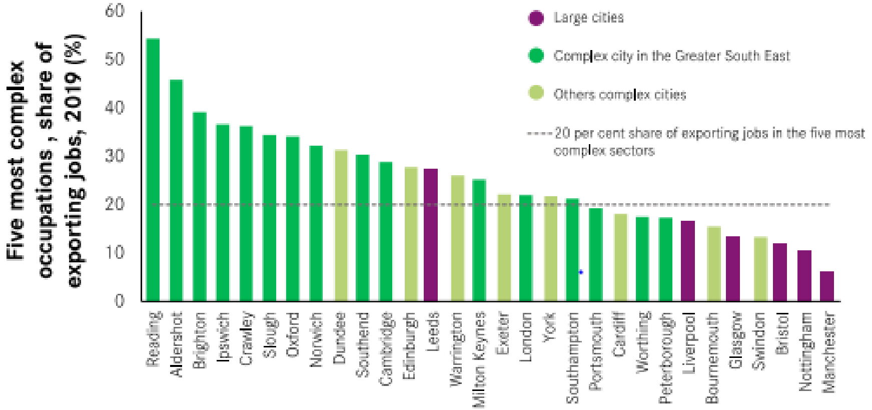
Source: ONS; Census, 1981. Centre for Cities' calculations.

- The large cities that still lag in terms of productivity were not complex in 1981 (top left quadrant).
- The Great South East has been a region of high complexity in the last four decades.
- Cities that lost complexity in relatively terms are geographically disperse but they have some similarities.

Large cities still need to growth their number of complex jobs

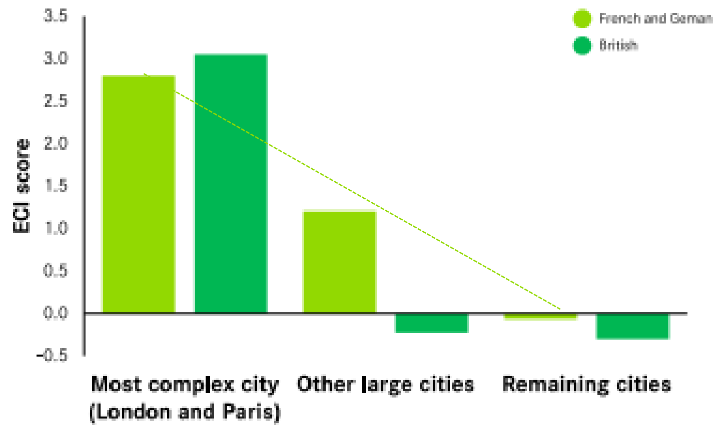
Complex cities with lower productivity tend to have a low complex base

Complex cities: size of most complex sectors in the economy, 2019



Source: ONS; Centre for Cities' calculations. Complex cities defined by places with ECI above zero.

Urban ECI: British, German and French cities



Source: ONS, INSEE and Destatis.

- Despite recent progress, large cities tend to **have fewer complex jobs than the other complex economies**.
  - **The most complex job account for less than 10 per cent of exporting jobs in cities like Manchester and Nottingham.**
- This **may explain the observed productivity gap** in the UK's largest cities. This is supported by international comparisons. The difference between the UK and France/German is mostly driven by the largest cities outside London.

‘Build on their strengths’ unlikely to make a city complex

Those places that continued to specialise in the same industries became less complex

PUA	1981	2019	Complexity (1981-2019)
Edinburgh	Radio/electronic capital goods (8.2%)	Computer programming, consultancy and related activities (19.0%)	Remained high
London	Banking/bill-discounting (8.4%)	Computer programming, consultancy and related activities (16.8%)	Remained high
Reading	Electronic data processing equipment (4.8%)	Computer programming, consultancy and related activities (37.4%)	Remained high
Aberdeen	Extraction: mineral oil/natural gas (24.5%)	Extraction: mineral oil/natural gas (28.3%)	Deteriorated
Blackpool	Aerospace manufacture/repairing (20.6%)	Aerospace manufacture/repairing (26.7%)	Deteriorated
Swansea	Iron and Steel industry (12.1%)	Manufacture of basic iron and steel and of ferro-alloys (13.6%)	Deteriorated

Source: ONS; Census, 1981.

- **To remain complex, highly productive cities have been able to change their specialisms.**
  - Banking is still very relevant for London’s economy but IT-related activities have emerged.

Meanwhile, a large portion of cities than became **relatively less complex have the same specialism they had four decades ago**, despite shifts in the global economy (e.g. international trade and rise of the information economy).

- Aberdeen has not moved beyond oil. Blackpool continues to specialise in aerospace manufacture. And steel still dominates in Swansea.

Conclusions

Conclusions

- Levelling up the economy must focus on the geography of knowledge.
  - Levelling up will only be achieved if it increases the amount of highly skilled exporting work in the private sector outside of the Greater South East.
- Big cities are the most promising places for levelling up.
  - Centre for Cities has calculated it would generate £48 billion per year in the national economy, which would be in reach of city residents and of people living in towns and rural areas nearby.
- Calls for places to ‘build on their strengths’ should be received with caution.
  - The aim of policymakers, especially local leaders, should therefore be to change the nature of these inherent benefits where they have the ability to do so, such as improving the skills of workers, to help them to reinvent their economies rather than further replicating what they already have.

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Thank you