

Employment Relations Comment

February 2015

The productivity challenge – and what the next government should do about it

Employment Relations Comment will be distributed free of charge via email. Copies can also be downloaded from www.acas.org.uk.

Employment Relations Comment will provide short accessible features on topical employment relations issues.

This article was written by Ian Brinkley, Chief Economist at the Work Foundation.

We welcome your comments. These should be sent to policypublications@acas.org.uk

The views expressed in **Employment Relations Comment** are those of the authors and not the Acas Council.

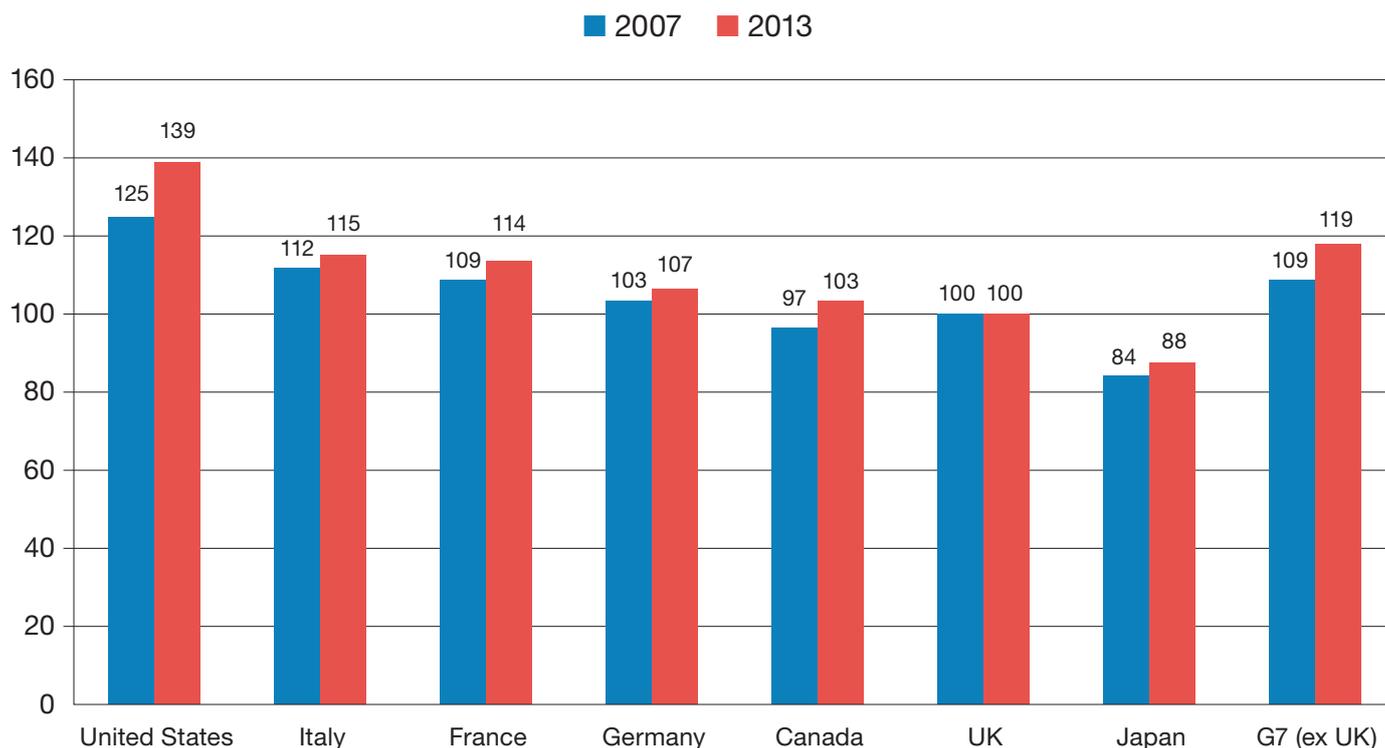
In 2008 the financial crash delivered a massive shock to the labour market. Many of its features were not unusual. Most job losses were concentrated in the production industries and amongst full time workers, and the young. The recovery has seen a rise in contingent insecure work, including temporary employees, self-employment, unpaid family workers, and people on government schemes, alongside the replacement of full time and permanent jobs lost in the recession. But in at least three important respects this has not been a normal recession or recovery.

Firstly, the crash was financial, and OECD research has indicated that recoveries from financial crashes are often more protracted than those caused by more conventional inflationary economic shocks. In terms of GDP growth this has been one of the slowest recoveries on record. Moreover, some of the consequences are still working their way through the financial system both here and across the EU.

Secondly, since 2008 wage growth has been exceptionally weak and employment growth has been exceptionally strong. In the recession many organisations imposed or negotiated wage freezes and cuts rather than lay people off. This is a change from previous downturns, when employment fell much more sharply. What is more puzzling is why employment continued to grow strongly in the recovery.

Thirdly, the combination of weak GDP growth and strong employment performance between 2008 and 2014 has seen low productivity. At the time of writing there is little sign that productivity is recovering – a source of frustration for the Office of Budget Responsibility (OBR) which keeps building productivity recoveries into its economic forecasts only to be confounded by the actual behaviour of the economy.

BRITAIN'S RELATIVE PRODUCTIVITY PERFORMANCE 2007 TO 2013 (UK=100)



Source: Office for National Statistics

The UK is not alone in experiencing a slowdown in productivity, but it does seem to have been exceptional compared with many other major economies. The latest estimates from the Office for National Statistics suggest that between 2007 and 2013 the UK's relative performance against the rest of the G7 deteriorated from 9 percentage points behind the average to 19 percentage points behind the average. This is shown in the chart above. Longer run OECD estimates suggest we are back to the same relative position as were in the early 1990s.

Many explanations have been put forward, some a little contradictory, and the more plausible are set out below:

- Miss-measurement:** as the economy has become more service based and business investment has switched from physical investment to investment in 'knowledge', it makes it difficult to measure productivity accurately and we may therefore be understating the rate of productivity growth in this recovery;
- Sector specific factors:** exceptionally large falls in output in the oil and gas sectors and the financial services industry have pushed output lower than employment for a period, while lower wage and lower productivity sectors now account for a higher share of GDP;
- Too many zombie firms:** financial institutions have held back from closing firms that owed them money, and banks may be excessively cautious in making loans to new and expanding businesses, so that the normal reallocation of resources from lower productivity activities to higher productivity activities has been inhibited;
- Innovation slowdown:** the pace of productivity enhancing innovation is slowing as we have completed all the easy wins from the previous big leaps in technology, leaving only incremental innovation in well-established areas. The next generation of radical technological changes are still decades from market;

- **Economic uncertainty:** the financial crash saw a simultaneous downturn across the OECD, a rare event, and six years on there are doubts about the sustainability of the recovery in the Eurozone and worries about slowing growth in emerging economies. Faced with unprecedented insecurity, firms have held back productivity enhancing investment programmes;
- **Labour is cheap and plentiful:** with real wages falling labour has become much cheaper than in previous recoveries, so firms have invested in more people rather than new technologies and new plant and offices;
- **Flexible wages:** the flexible labour market has seen wages for new entrants fall significantly compared with incumbents. Many more people are competing for work, especially in the bottom half of the labour market, as welfare to work policies bite, increased participation by older workers has increased and the share of the workforce whose wages are determined by collective bargaining has declined, implying less workplace bargaining power for some employees;
- **Labour hoarding:** in the top half of the labour market, firms are reluctant to let skilled labour go even though their output growth sits poorly with staffing levels. This choice amounts to a significant investment and will be hard to get back when the firm's fortunes improve.

What most analysts now agree is that while all of these reasons probably contribute something to the productivity puzzle, few think they constitute a full explanation.

The macro-economists have tortured just about every dataset they can get their hands on in just about every way possible. It is always possible that a new insight will provide the missing part of the explanation, but so far we are coming up short¹. We would normally expect a productivity recovery to follow an investment revival, and the revised investment figures in the Autumn Statement do show business investment growing since 2010.

The productivity puzzle is not just a short term issue. No one really knows whether we are looking at a temporary phenomena which will come to an end as the consequences of the financial crash work their way through; a more prolonged slowdown because of permanent damage to the economy between 2008 and 2010; or a more fundamental structural shift linked to a slowdown in the application of productivity enhancing new technologies. The worst case scenario would be the UK becoming locked in a low wage, low growth recovery, where low productivity growth prevents wages rising and low wage growth inhibits productivity improvements.

Perhaps this worst case scenario, while not impossible, is also unlikely. The fundamentals that drive productivity – business investment, levels of education and skills, and the quality of the infrastructure – have not changed much since 2008 and we now know that business investment seems to have been much less badly affected than we first thought. We have also benefited from the continued ability to recruit more skilled and younger workers from overseas to supplement the existing workforce. It also seems unlikely that the scope for technological innovation has taken a nose dive, notwithstanding the market failure of Google Glass. We are still a long way from fully exploiting the potential of existing technologies, even if some of the next wave of technologies is still some way off having a significant market impact.

However, even if the most likely future is a return towards the productivity growth rates that prevailed from 1997 onwards, we still have a productivity challenge. The relative performance of the UK would have to improve if there is to be any prospect of closing the gap against the G7 average and returning to the pre-recession position shown in the chart above.

The UK's relatively weak productivity performance has been a source of concern for successive governments, though there were signs that the relative gap against some other major economies was closing somewhat over the decade to 2008. A recent ONS analysis of long run drivers

of productivity noted that since 1997 the importance of improved labour quality – education and skills – had increased, but there has been little increase in the amount of capital behind each employee.

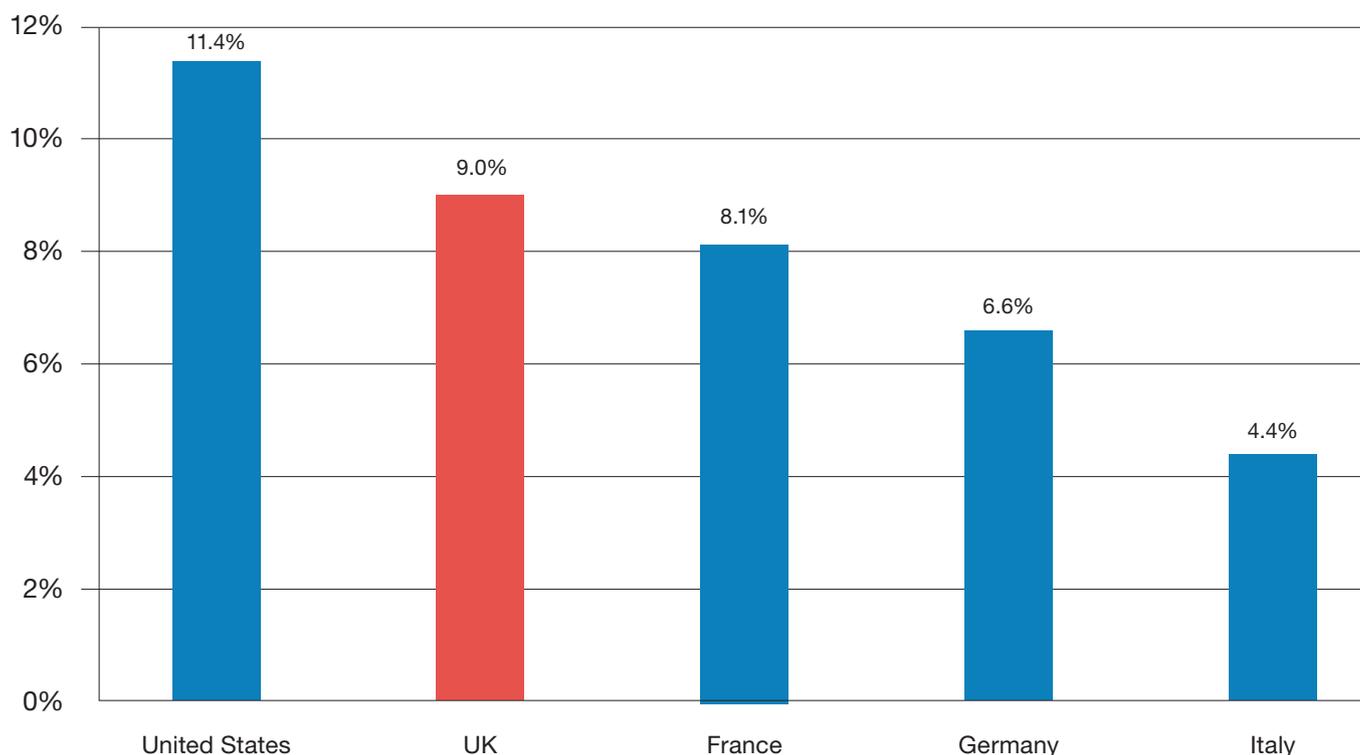
There is a growing consensus that the bit of the productivity puzzle we cannot easily explain is based on what is going on in the workplace – in other words, there is a significant part of the fall in productivity shortfall that is attributable to employment relations in its widest context.

One thing that is becoming increasingly clear is that there is a major discrepancy between what goes into workplaces and what comes out. For example, in modern service based economies, investment in knowledge based intangibles (that is, R&D, software, training,

design, organisational and intellectual capital) matters far more than physical investment – and as a share of GDP we have one of the highest rate of investment in the G7, only second to the United States². The comparison is a little flattering, as economies like Germany invest more in tangible assets, reflecting in part their much larger manufacturing sector. We have an above average share of well-educated people and an above average share of good quality jobs, at least compared with the rest of the EU³. Moreover, though we score less well on skills, behind Germany and Japan, we are doing better than France, Italy and the United States⁴. In other words, a lot is going into British workplaces, but there is a miss-match with what comes out.

BUSINESS INVESTMENT IN INTANGIBLE KNOWLEDGE BASED ASSETS IN 2010

Share of GDP



Source: Conference Board, TWF estimates, <http://www.intan-invest.net/>

A key focus on what is going on in British workplaces and how and why it impacts on productivity performance looks to be essential if we are ever going to have a satisfactory explanation of the productivity puzzle, let alone come up with sets of policies that improve the UK's mediocre long run productivity performance. In a previous Acas discussion paper, Professor Keith Sissons⁵ noted that the workplace and employment relations had been relatively neglected in policies focused on improving productivity performance in the UK. He is quite right. Acas can make a significant contribution in highlighting the issue given its experience and expertise in the workplace and the strategic view it is taking on the labour market. But transforming UK workplaces is too big a task for any one organisation to take on.

The next government should be looking to bring together a coalition of social partnership, representative, and expert bodies which have the necessary focus and expertise on the workplace to help develop a renewed focus on the productivity challenge and to mobilise their networks and influence in a common cause. There are a number of organisations that could be brought together such as Acas, the UKCES, the Low Pay Commission; representative bodies of capital and labour such as the CBI and the TUC; small business organisations such as the British Chambers of Commerce and the Federation of Small Businesses; professional organisations such as the CIPD and management institutes; and independent expert bodies such as Lancaster University's Work Foundation.

There is a shared agenda emerging between capital and labour. The concerns aired at Davos about the rise of inequality and how to address it might be dismissed as the usual hot air such international gatherings of business and governmental elites

typically generate. However, the CBI has acknowledged that more needs to be done to increase wages through workplace progress and sustained productivity improvements, a goal clearly shared by the TUC and others.

In a recent report on how to address the problem of low wage growth and low productivity the CBI has highlighted the value Australian businesses places on the Australian Productivity Commission in identifying both the challenges, especially at sectoral level, and in helping implement change.

All the opinion polls suggest we are heading towards another coalition government after May. It would provide an early sense of serious and long term purpose if one of the first acts of the new government was to create a Commission for Workplace Productivity aimed at bringing an institutional coalition of the willing together to focus on boosting productivity and wages through influencing workplace practice and progression.

References

1. <http://www.theworkfoundation.com/blog/1875/The-productivity-puzzle-real-or-imagined>
2. OECD 2014
3. Eurofound (2012) 'Trends in job quality in Europe'
4. OECD Skills Survey 2014
5. <http://www.acas.org.uk/media/pdf/o/8/The-UK-Productivity-Puzzle-is-employment-relations-the-missing-piece.pdf>