Four theories to explain the UK’s productivity woes

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“Productivity isn’t everything, but in the long run it is almost everything,” said Paul Krugman, the Nobel Prize-winning economist, in 1994.

This statement is as valid today as it was then. Productivity — or output per hour by workers — is the key driver of economic growth.

For the UK, this issue is critical. Productivity is no higher now than it was just before the 2008 financial crisis, in stark contrast to the average annual growth of 2.1 per cent recorded during the decade before the crash. Had the pre-crisis trend persisted, productivity would now be 20 per cent higher.

After seven years of forecasting that productivity growth would return to pre-crisis levels and repeatedly being disappointed, the UK fiscal watchdog said this month it was poised to downgrade its assumptions.

This move by the Office for Budget Responsibility will hit its forecasts for economic growth and tax revenues and create a challenge for chancellor Philip Hammond because it risks undermining his goal of balancing the government’s books by the mid 2020s. He is expected to make measures to boost productivity a central theme of his Budget on November 22.

Productivity stagnation since the crisis has been concentrated in a small number of industries: finance, telecoms, energy and management consulting. Over the past 18 months this issue has been accentuated by there having been a pick-up in employment in less productive service sectors.

There is much debate and little agreement about the reasons for the UK’s productivity woes. Below the Financial Times reviews the main theories.

1. Companies have invested too little

New machines and other technology make workers more productive, but business investment has been growing relatively slowly since the crisis.

Companies’ capital spending is only 5 per cent above its pre-crisis peak, compared with a 60 per cent increase over the decade after the 1980s recession and 30 per cent following the 1990s slowdown.

“The fall in business investment during the financial crisis — in both intellectual property and physical assets — has . . . depressed productivity growth,” said Robert Chote, chair of the OBR, this month.

But extra capital spending will boost productivity only if it allows workers to do something new, or an existing activity more efficiently. Some experts, including Robert Gordon, professor of social sciences at Northwestern University, argue recent technological developments have less ability to transform productivity than earlier inventions.

FT verdict

In the immediate aftermath of the crisis, business investment was constrained by some companies’ inability to borrow money as banks shored up their balance sheets. This is less of an issue now most banks have recapitalised.

Other factors, such as a lack of worthwhile investments, or uncertainty about the economic outlook, must now be playing a greater role in deterring companies from more capital spending.

2. Productivity is being measured in the wrong way

Productivity is calculated by dividing gross domestic product by the number of hours of work. But there are known difficulties in measuring GDP and these could result in a misleading picture of productivity.

In the past arguably more than today, GDP was boosted by activities that were costly in the long run, notably high-risk practices in the financial services industry before the crisis, and the extraction of oil from the North Sea during its boom years. Profits generated in these areas were counted towards GDP but the long-term costs were not factored in, which may have served to overstate productivity before the crisis.

Today, there are difficulties in measuring the contribution to GDP of new digital technologies, and this may therefore be understating productivity in this area.

“Many in the technology sector argue that conventional GDP statistics understate the importance of the digital revolution,” said Diane Coyle, professor of economics at Manchester University, last year.

FT verdict

Bank of England researchers concluded in 2014 that these sorts of issue could explain about a quarter of the shortfall in productivity growth since the crisis. This is obviously significant, but many of these issues have been emerging gradually for some time and so they cannot account entirely for productivity stagnation since 2008-09.

3. Low rates have sustained zombie companies

Record-low interest rates have cut companies’ borrowing costs, allowing some highly unproductive companies — so-called zombies — to avoid going bust. This appears to be borne out by how the rise in the number of companies going into administration was much less dramatic during the past recession than before.

Monetary policy was very different in the most recent big economic slowdown compared with the previous one. The BoE cut interest rates to 0.5 per cent, making it easier for companies to finance their loans. By contrast, interest rates were held above 10 per cent during the recession of the early 1990s.

However, it is not only unproductive companies that have high levels of debt relative to their profits — leverage that puts them at risk of becoming insolvent when monetary policy tightens. “Both high-productivity and low-productivity companies [have] high debt ratios. Higher interest rates hit both types of company,” said Andy Haldane, BoE chief economist, in March.

FT verdict

Low interest rates explain part but not all of the productivity stagnation. Analysis by the BoE in March suggested it could explain at most 3 percentage points of the 20 per cent shortfall in productivity.

4. Businesses have held on to unproductive workers

Unlike in previous recessions, companies did not make large numbers of workers redundant when the crisis hit.

Unemployment peaked at just 8.5 per cent of the workforce after the 2008-09 recession compared with 10.7 per cent reported in the 1990s. Keeping hold of workers was costly in the short term and hit productivity as demand fell but employment held up.

“[The number of people willing to work] has been more robust than in previous recessions,” said Helen Miller of the Institute for Fiscal Studies think-tank. “Changes to state pensions and benefits are likely to have contributed to this. To the extent this has held down real wages, it has played a part in allowing firms to continue to employ workers even if they are producing less.”

FT verdict

Labour hoarding partially explained weak productivity growth immediately after the crisis. But the creation of 3.5m jobs since 2009 suggests companies are no longer simply holding on to under-utilised workers.

An increase in the number of people looking for work, which has helped to hold down wage demands, and uncertainty about the economic outlook since the Brexit vote, may have encouraged companies to hire more staff — even if some of them are relatively unproductive — rather than investing in machines.