

The knowns and unknowns of productivity

What explains the long-standing productivity gap between the UK economy and the other big OECD economies and what policies might be effective in helping to close it? **Romesh Vaitilingam** quizzes **John Van Reenen**, director of the Centre for Economic Performance (CEP), on the latest research evidence.

RV: Why should we worry about productivity?

JVR: First, let's define what we're talking about. Productivity is the amount of output produced for inputs used – where output could be cars, steel sheets, insurance policies or haircuts; and inputs could be workers, capital equipment or energy. The most commonly cited measure is one of the productivity of workers: output per hour worked.

For economists, labour productivity is the key indicator of economic health. Over the long haul, real income growth and hence living standards must follow labour productivity growth. And if productivity growth drives incomes, then it is clearly crucial for the sustainability of the public finances.

RV: So what's the story on UK productivity?

JVR: There is an infamous and long-standing productivity gap between the UK economy and the other big OECD economies. The most reliable data

is from what we call the 'market economy', which excludes those sectors like health and public administration where output is very hard to measure. In the latest market sector data, UK output per hour worked is about 30 per cent below that in the United States. While the gap has narrowed to some degree since 1979, it seems to have been stable or even widened since 1995. And the productivity gap is particularly evident in key service sectors, including wholesale and retailing, hotels and restaurants and financial services.

The gap with major European economies is also striking. Despite some improvement since the early 1990s, UK output per hour worked is around 20 per cent below that of France and Germany. The UK is in the middle range of European Union countries. ▶



RV: We seem to have been hearing about a productivity gap for years. So is it bigger or smaller than it used to be?

JVR: It's worth distinguishing between three periods over the past 60 years. First, after 1945, the UK and other Western European countries enjoyed a 'golden age' of economic growth. Europeans were successfully chasing the US productivity frontier. Economists think that a lot of this catching up was driven by the spread of new ideas from the United States to the rest of what now constitutes the OECD. Because catching up is easier than innovating at the technological frontier, US productivity growth was generally slower than in Europe. But the catch up process was much slower for the UK than for France and Germany and the country slipped down the productivity rankings.

The second period, from around 1973, is more of a mixed picture. Following the oil shocks of the mid-1970s, both US and European productivity rates slowed significantly, though by 1990, France and Germany had caught up with the United States. From about 1980, productivity began to rise in the UK, especially in manufacturing as large numbers of jobs were shed and the power of trade unions, which sometimes militated against change, was reduced. A great deal of CEP research has been on industrial relations: we've found evidence that the weakening of unions has helped productivity growth, although this may have been at the cost of greater wage inequality.

Most recently, there seems to have been a structural shift in US productivity growth in the mid-1990s. It went from about 1.2 per cent a year between 1977 and 1995 to 2.2 per cent a year between 1995 and 2001. And the latest projections from the New York Fed suggest a prospective annual growth rate of 2.6 per cent in the next decade.

RV: So what explains the UK's persistent productivity gap?

JVR: At different periods in history, the UK's productivity gap has been attributed to a wide range of more or less likely causes that cre-

ate disadvantage compared with other countries. No single factor provides a complete explanation but there are essentially four big issues: competition, capital investment, innovation and skills.

First, competition: productivity growth is highest in industries that face greater product market competition – where less productive firms contract and close while new more productive ones open and grow; and where competitive pressures on existing firms force them to improve. The historic weakness of competitive intensity in many sectors of the UK economy is gradually being eroded through deregulation and through strengthened legislation against anti-competitive practices. This should improve productivity growth.

Second, capital investment plays an important role in productivity growth. But the UK has less physical capital per worker than the United States and considerably less than France and Germany.

The third driver of relatively slow UK productivity growth is a relatively low level of investment in research and development. Despite the high quality of UK science, there is a difficulty in translating scientific achievement into productivity, which is reflected in low levels of R&D expenditures and low levels of patenting and innovation.

Finally, skills have an important impact on productivity. The UK is behind France and Germany in terms of intermediate skills and behind the United States in graduate skills.

RV: What kind of skills are we talking about? Are we a nation of incompetent managers like David Brent in *The Office*?

JVR: There is a wealth of anecdotal evidence that management skills are part of the story behind the UK's productivity gap with the United States. Business leader Sir John Harvey-Jones once noted how general management skills are not as highly valued as skills in finance, accounting and consultancy: 'When I was chairman of ICI [then the UK's largest manufacturing company], all the advisers that we used – advisers mark you – were all paid more than I was, be they auditors, be they the merchant banks, be they the City solicitors. Now, I ask you, in realistic national terms, who is likely to have the biggest impact on the fate of the bloody country?'

While there is little hard research evidence on the failings of UK managers, CEP work in progress is looking at how different management practices influence productivity. The emerging results indicate that the UK does score badly on measures of management best practice, not just behind the United States but also, on many aspects, behind France and Germany.

RV: So what kinds of things can we do to improve the UK's productivity performance?

JVR: Improving management skills, perhaps via the pressure of increased competition, is certainly one avenue. But more broadly, the importance of skills for productivity growth confirms the continuing need for policy to focus on education and training across the board – from pre-school interventions like Sure Start to schemes seeking to tackle the lack of basic literacy and numeracy skills among far too many adults.

In the area of innovation, one potential policy response to stimulate greater business expenditure on R&D is tax subsidies. The United States has had an R&D tax credit since the 1980s and it seems to have been effective. The UK government has recently introduced two R&D tax credits, the impact of which CEP researchers are tracking.

And then there is the burgeoning area of research and policy interest in public sector productivity. Poor relative productivity performance in the public sector is likely to have a large impact on a country's aggregate productivity. The effects are not only direct but also indirect given the importance for private sector productivity of a well-educated and healthy population who can conduct business free of the fear of crime.

Another potential policy tool is public investment in transport, which has historically been low compared with other countries. CEP research shows that the impact of improved transport infrastructure on UK productivity could be dramatic. Analysis of regional productivity differences suggests that a 10 per cent reduction in average journey times throughout the country would raise productivity by 1.12 per cent and nearly twice this amount for areas whose access to cities is increased the most.

RV: But presumably many other countries are pursuing a productivity agenda. How do we fit in with the rest of the world?

JVR: It's certainly vital to take an international perspective on productivity. So, for example, competition should be encouraged as a driver of improved productivity growth not only at the national level, but also by openness to the international economy. Policies that encourage greater trade liberalisation are significant here, and 2005 is potentially a



milestone with the World Trade Organisation meeting in Hong Kong in December, which just might reach a deal to conclude the Doha round of trade talks.

This year is also the halfway point in the so-called Lisbon agenda, the EU's ambitious plan launched in 2000 to create 'the most competitive and dynamic knowledge-based economy in the world' by 2010. The new president of the European Commission Jose Manuel Barroso claims that this agenda and its potential for boosting EU jobs, productivity and growth is a high priority. One key way to promote it would be to push through the proposed 'services directive', designed to break down barriers to trade in services across the EU. This is exactly the kind of pro-competitive measure that could help boost European productivity and growth, and it is very disappointing that there are signs that the Commission appears to be willing to water down the directive.

RV: What can we learn from the most productive countries like the United States?

JVR: The big question is whether the UK and Europe will follow the US productivity growth acceleration since the mid-1990s, which has been associated with more effective use of information and communication technologies. One view says that there may be just a lagged effect in Europe. Another suggests that a lack of competition and too much regulation are impeding the necessary organisational changes.

This is another area where CEP has an active research programme, looking at detailed data on differences in the diffusion of the new technologies and productivity between industries and between firms, and on organisational behaviour within firms.

RV: In his book *Happiness* (see page 46), your predecessor as director of CEP, Richard Layard, argues that the happiness of society does not necessarily equate to its income. Isn't working harder ultimately going to make people unhappier?

JVR: People's happiness is certainly a fundamental issue. But Richard would never say that improved productivity necessarily means less life satisfaction. For example, if we measure labour productivity as output per worker rather than output per hour worked, we find that UK and German productivity are very

similar. What this means, of course, is that the Germans work fewer hours. Indeed, the average German employee has the equivalent of two months more holiday a year than the average UK worker and still manages to produce the same output. The old cliché is actually true: higher productivity comes from working smarter, not working harder.

There are similar potential confusions in the view that emphasising productivity means encouraging greater inequality. If we can achieve faster economic growth through productivity improvements, the fruits of this growth can be used in many different ways. There is nothing to prevent the additional growth being spent primarily on benefiting the worst off in our society through greater redistribution or on better public services. ■



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