UK Economic Performance since 1997

How bad was Labour?
And what are the implications for restoring growth?

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Introduction

• Getting back to growth the major challenge:
  – Dealing with public debt and deficit
  – Productivity growth main cause of material wellbeing

• Our approach: data driven
  – What happened 1997-2010? (vs previous governments, vs other countries, implications for current government)
    – Provisional, especially in post 2008 Great Recession
    – We need better quantitative policy evaluation
Our story

• UK did surprisingly well 1997-2010
  – Fastest GDP per capita growth in G6 nations
  – Not a “bubble” in finance (or public sector, property or oil)
  – Continuation of improvement beginning under Mrs. Thatcher: reverses 100 years of UK decline

• Labour’s policies likely played a part

• Since pre-2007 productivity improvements real, output gap may be larger than supply side pessimists think
  – Implies room for Plan B, slowing fiscal consolidation

• Long-run growth strategy
  – Relentless focus on removing barriers in sectors with strong global growth & where UK has comparative advantage
Outline

1 UK Relative Economic Performance since 1997: Growth, productivity and jobs
2 Other measures of business performance
3 Was the UK’s strong post 1997 Performance anything to do with Labour’s Policies?
4 The Great Recession and Beyond
5 Policies for Growth
1 UK Relative Economic Performance since 1997: Growth, productivity and jobs

2 Other measures of business performance

3 Was the UK’s strong post 1997 Performance anything to do with Labour’s Policies?

4 The Great Recession and Beyond

5 Policies for Growth
UK growth in GDP per capita faster than every other G6 country

Annual average growth GDP per capita, 1997-2010

Notes: OECD data GDP is US$, constant prices, constant PPPs, (OECD based year: 2005).
UK growth in GDP per capita faster than every other G6 country

Annual average growth GDP per capita & GDP per adult, 1997-2010

Another way to represent growth performance since 1997

Trends in GDP per capita relative to 1997

UK GDP per capita growth performance was strong in both the pre and post 1997 periods

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Trends in GDP per capita relative to 1997

Growth decomposition 1

Basic “welfare” measure

\[
\frac{GDP \text{ Capita}}{Capita} = \frac{GDP \text{ employee}}{employee} \times \frac{Employees \text{ population}}{population}
\]

Labour productivity  Employment Rate
Growth decomposition 1: workers

GDP per worker relative to 1997

Growth decomposition 1: workers

Employment per capita relative to 1997

Growth decomposition 2

Basic “welfare” measure

\[
\frac{GDP}{\text{Capita}} = \frac{GDP}{\text{hours}} \times \frac{\text{hours}}{\text{population}}
\]

Labour productivity

Hours per capita

Or

Hours per worker \times workers per capita
Growth decomposition 2: hours

GDP per hour relative to 1997

Growth decomposition 2: hours

Hours per capita relative to 1997

Productivity decomposition

• We’ve seen that UK productivity growth performance overall was strong
• What are the sources of this?
• Two key ways to decompose
  – Contributions of sectors
  – Contributions of production inputs
• We look at the boom years, up to 2007. Two reasons
  – This was the period of productivity growth, what was driving it?
  – Data constraints! EU KLEMS currently only available up to 2007
• We look at the better measured “Market Economy”
The sources of productivity growth by sector: It wasn’t all finance in the 1997-2007 boom!

Sector contributions to market economy productivity growth (1979-2007)

Notes: Analysis based on EU KLEMS data. Average sectoral growth rates for the periods 1979-1997 and 1997-2007 are weighted by each sector’s average share in market economy nominal GVA (GDP less taxes, plus subsidies) over the relevant period. Reallocation effect refers to the labour productivity effects of reallocations of labour between sectors that have different productivity.
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**Sector contributions to market economy productivity growth (1979-2007)**

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Sources of productivity growth: Skills and ICT became more important post 1997

Sources of market economy productivity growth (1979-2007)

Notes: Analysis based on EU KLEMS data. EU represents all EU-15 countries for which growth accounting could be performed, i.e. AUT, BEL, DNK, ESP, FIN, FRA, GER, ITA, NLD & UK. Data for France and EU are available from 1981 onwards.
UK still lags behind in total economy productivity levels

GDP per hour levels (UK=100)

Notes: Analysis based on OECD data GDP is US$, constant prices, constant PPPs, Figures for 1979 West Germany only.
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5. Policies for Growth
Other measures of business performance

• Focus on productivity because it’s key measure of long-run performance for economists
• But also look at
  – Investment (overall and FDI)
  – Innovation
  – Education and skills
  – Management
  – Entrepreneurship
  – Profits
  – Trade
  – Regional Inequality
• Overall, more of a mixed bag. Positive trends but still problems in levels
The UK has been successful at attracting FDI, with inward FDI higher than comparators

Inward Foreign Direct Investment Flows (% GDP)

Notes: Analysis based on OECD data
R&D has increased slightly as a proportion of GDP between 1997 and 2007 after falling since late 1970s

Gross Domestic Expenditure on R&D (GERD), as a % of GDP

Notes: OECD MSTI June 2010 (data not available on a consistent basis prior to 1981)
Proportion of workers with a college degree has risen faster in UK than other countries

Percentage of 25-64 year old population by educational level

<table>
<thead>
<tr>
<th>Year</th>
<th>Tertiary Education</th>
<th>Upper Secondary and Post-secondary Non-tertiary</th>
<th>Below Upper Secondary</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>UK</td>
<td>23</td>
<td>37</td>
<td>41</td>
</tr>
<tr>
<td>2008</td>
<td>33</td>
<td>37</td>
<td>48</td>
</tr>
<tr>
<td>US</td>
<td>34</td>
<td>52</td>
<td>11</td>
</tr>
<tr>
<td>1997</td>
<td>23</td>
<td>61</td>
<td>17</td>
</tr>
<tr>
<td>Germany</td>
<td>25</td>
<td>60</td>
<td>15</td>
</tr>
<tr>
<td>1997</td>
<td>20</td>
<td>39</td>
<td>41</td>
</tr>
<tr>
<td>2008</td>
<td>27</td>
<td>43</td>
<td>30</td>
</tr>
<tr>
<td>France</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Notes: Data from OECD Education at a Glance (2010)
Summary of UK performance 1997-2010

• An overall strong performance - GDP per capita grew faster than other countries in G6

• Continues Conservative trend (1979-1997): UK GDP/cap grew faster than both the US and France in Lab and Con periods

• Productivity growth was broad based – finance only a small contribution (business services and distribution matter more)

• Growth of efficiency (TFP) similar in both Lab and Con periods, but bigger contribution from skills and new technology post 1997

• Other indicators also show signs of improvement but level of productivity and other business indicators remains a problem
1  UK Relative Economic Performance since 1997: Growth, productivity and jobs
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3  Was the UK’s strong post 1997 Performance anything to do with Labour’s Policies?
4  The Great Recession and Beyond
5  Policies for Growth
UK performance 1997-2010 looks good.....

- But was any of this due to Labour policies?
  - Did Labour just reap dividends of Conservative radicalism on privatisation, anti-union laws, end “lame duck” subsidies, etc.
  - So can only claim credit for “not messing things up”

- But Conservative reforms were unlikely to cause *permanent* increase in the rate of productivity growth (e.g. unions).

- Likely that some Labour policies did contribute such as policies over: *Competition, Education, Innovation*
  - **Caveat:** Lack of proper evaluation of most UK policies means much guesswork
Competition Policy

• Strong evidence that increases in product market competition boost productivity

  – Stronger (e.g. Cartel punishments & whistle blowers)
  – Less politicised (e.g. Merger policy)
  – More autonomous & better resourced

• Utility Regulation (2003 Communication Act & Ofcom Strategic Review)
Innovation Policy

• **Growth theory** puts innovation at centre of productivity growth
  – “Spillovers” imply that too little R&D performed

• **Empirical evidence** shows that:
  – R&D boosts productivity growth

• UK R&D tax credit for small firms introduced in 2001 & extended to large firms in 2003

• Increases to the science budget (Haskel et al, 2010)

• R&D/GDP falling since ‘70s, but stabilised from mid-2000s
Education Policy

• Increases in human capital increase productivity via higher average labour quality but also through “spillovers” (e.g. Innovations).

• **Quantity of education increased through**
  – Expansion of Higher Education
  – Higher staying on rates (e.g. EMA, see Dearden et al. 2009)

• **Quality of Education?**
  – City Academies (Machin and Venoit, 2011)
  – Teaching interventions like Literacy & Numeracy Hours (McNally, 2010)
  – More qualifications, but concern over grade inflation
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UK Productivity in the Great Recession

Real Output Per Hour, Index=100 in 2008, 2001Q1-2011Q2


- EU KLEMS data is not available beyond 2007, and therefore it is not possible to carry out the cross-country sectoral productivity analysis.
Did the Great Recession change everything?

• Were 1997-2007 productivity improvements an illusion?
  – No, not just “bubble”.

• Was the Great Recession due to Labour’s policies?

• Did Labour do the wrong things after the crash occurred?

• Did Labour’s policies leave the UK more vulnerable to the effects of the downturn than other countries?
  – Financial Market regulation
  – Public debt/deficits
The Great Recession and beyond

- What are the effects of Great Recession on potential output
  - How much output permanently lost?
  - Is economy on a lower productivity growth trend?

- “Output Gap” is difference between potential & current output
  - If economy near full capacity output gap is close to zero, so if demand increases (e.g. Expansionary monetary and fiscal policies translate into higher inflation)
  - Supply side pessimists view that output gap is small/zero
The Output Gap Debate

GDP at market prices (£ million)

Notes: ONS Q2 2011 Quarterly National Accounts, GDP in £ million, in real terms at market prices (seasonally adjusted)
Notes: ONS Q2 2011 Quarterly National Accounts

- **Strong optimists**: No permanent reduction in the level of output or slower growth rate
- **Strong pessimists**: Permanent loss of output and lower growth trend
“In Between” Views (e.g. Growth rate not affected)

Notes: Analysis based on ONS Q2 2011 Quarterly National Accounts
Estimating the Output Gap ("educated guesses")

1. Statistical Filters
   - Transparent, but depends on period over which one "smooths"

2. Production functions (OECD, EC, NIESR)
   - Based on economic model, but sensitive to judgements, measurement and data revisions

3. Cyclical Indicators (Office Budget Responsibility)
   - Uses wider range of timely information, but survey measurement issues & needs scaling to another method

4. Semi-structural approaches (IMF- Global Projection Model)
   - More rigorous but very sensitive to econometric specification
Estimating the Output Gap ("educated guesses")

- Most estimates find significant output gap, but seems to be shrinking (last week’s EC report)

<table>
<thead>
<tr>
<th>Source</th>
<th>Methodology</th>
<th>Output gap</th>
<th>Year</th>
<th>Trend GDP growth rate assumed</th>
</tr>
</thead>
<tbody>
<tr>
<td>MPC, Adam Posen, 2010</td>
<td>Not specified</td>
<td>3-over 4%</td>
<td>2010</td>
<td>suggests that it is largely unchanged</td>
</tr>
<tr>
<td>MPC, Martin Weale, Nov 2010</td>
<td>Not specified</td>
<td>4-6.5%</td>
<td>2010</td>
<td>&quot;trend growth has probably fallen a little&quot;</td>
</tr>
<tr>
<td>European Commission, Autumn Forecast, 2010</td>
<td>Production function</td>
<td>just over 5%</td>
<td>2010</td>
<td>n/a</td>
</tr>
<tr>
<td>IMF, World Economic Outlook, October, 2010</td>
<td>Semi-structural approach</td>
<td>2.6%</td>
<td>2010</td>
<td>n/a</td>
</tr>
<tr>
<td>NIESR, January Economic Review, January 2011</td>
<td>Production function</td>
<td>4% or more</td>
<td>2010</td>
<td>&quot;not much greater than 2%&quot;</td>
</tr>
<tr>
<td>OECD, Economic Survey of the United Kingdom, March 2011</td>
<td>Production function</td>
<td>4.6%</td>
<td>2010</td>
<td>n/a</td>
</tr>
<tr>
<td>OBR, Economic and Fiscal Outlook, March 2011</td>
<td>Cyclical indicators</td>
<td>3%</td>
<td>2010</td>
<td>2.35% to end 2013, 2.10% after</td>
</tr>
<tr>
<td>IMF, World Economic Outlook, October, 2011</td>
<td>Semi-structural approach</td>
<td>2.9%</td>
<td>2011</td>
<td>n/a</td>
</tr>
<tr>
<td>Chris Giles, FT, September 2011</td>
<td>Cyclical indicators</td>
<td>2.6%</td>
<td>2011</td>
<td>n/a</td>
</tr>
</tbody>
</table>
Pessimists: banking crisis reason for permanent damage

• Why are banking crises so bad for output?

• **Direct effect**: banking a high productivity sector & shift of workers into other industries dampens aggregate productivity
  
  – But in long-term a better allocation of UK talent to sectors which create more positive spillovers (e.g. High tech manufacturing & ICT)
  
  – Evidence on direct effect suggests only small (e.g. Martin, 2011; BoE, 2011). Productivity fell a lot in finance, but large falls were witnessed in others sectors too.

• **Indirect effects of banking crisis**
  
  – Less efficient allocation of capital
  
  – Reduction in investment due to increased cost of finance
  
  – Fewer new company formations, capital scrapping or liquidations
  
  – The value of a UK “core competency” has fallen
Indirect Evidence for Pessimists

• Recent poor growth performance
  – Global demand low. Real improvements pre-2007

• Oil Producing Sector in decline
  – Long trend, oil not big contribution to productivity 1997-2007

• High inflation shows we have little spare capacity
  – Mainly “imported” inflation – domestic wages inflation very low

• Hiring in 2010-11 evidence for little spare capacity
  – Increases low given big jobs fall 2008-2009. Real wage cuts

• Trade performance
  – Puzzle, some J-curve effect?
A more optimistic view?

- Revisions to GDP upwards? (Dale/MPC, 2011)
- Employment holds up because of real wage flexibility & better Employment service
- Pessimism could be a self fulfilling prophecy?
  - A long recession causes potential output to fall
- Even if there is an significant output gap is it better to stick to Plan A of fiscal austerity? And most importantly what about the long-term growth strategy?
  - Over to Dan
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We need the right short run macro and longer term micro policies to secure long-term growth

• The period since 1997 has been better than is commonly thought. What does all this mean for growth policies?

• **To promote long term growth we need to:**
  
  – Expand the potential of the economy via supply side policies
  
  – Run the right macro policies: currently that means helping recovery from recession by running at current potential

• Many important factors are outside direct influence of UK economic policy

• **Nevertheless, UK domestic policy does matter**
Growth policies need a Plan B for macro stance

- UK growth has been anaemic, far worse than expected when 2010 Budget set
- There is an output gap
- We reject the idea that even if there is a significant output gap is it better to stick to Plan A
- The alternative is more back-loaded austerity, “Plan B”; monetary policy can’t do it all
- There are spending options that are not permanent and tax cuts which can be temporary
- Confidence in the bond markets needs to be watched but should not be a reason for not moving at all
  - July 2010 Budget got it wrong, and we can amend policy
  - Public investment less likely to spook markets
In designing long term supply side policies, key points are:

- **Listen to what Growth theory tells us**: Importance of innovation, human capital, creative destruction, competition, city regions, good governance, patient capital, venture capital

- **Learn from UK experience**: Importance of product market competition, the accumulation of human capital, balanced regulation, and innovation policies

- **Admit our “collective ignorance”**: There is no single “magic bullet” to growth – need to experiment, evaluate and learn

- **Appreciate the complementarities or trade-offs between policies**: “laundry lists” are not enough (though we will give one in a minute!)
“Plan V” strategies involve the right environment for growth, and some targeted enabling policy

• Economists rightly wary of too interventionist a stance
• Despite this most governments do have a *de facto* industrial policies (e.g. towards exports and FDI)
• Policies should be focused on the intersection between the areas of global growth and local comparative advantage.
  – Areas like: bio-pharmaceuticals, financial and business services, creative industries and some areas of ICT (e.g. Autonomy and ARM)
  – Look at barriers and useful pro-active policies
Some specific “Plan V” policies which we will briefly run through...

• Competition
• Education and skills
• Infrastructure
• Financial markets
• Higher education
• Immigration
• Public sector productivity
• Regulation and planning
• Taxation
Long-run growth policies: some thoughts

- Competition
  - Education and skills
  - Infrastructure
  - Financial markets
  - Higher education
  - Immigration
  - Public sector productivity
  - Regulation and planning
  - Taxation

- Merger of OFT and CC could be a distraction
- Stalling of greater international market integration
- Dangers of trade protection
Long-run growth policies: some thoughts

- Competition
- **Education and skills**
  - Literacy and numeracy rates
  - Education leaving age
  - Apprenticeships for under 19 year olds
- Infrastructure
- Financial markets
- Higher education
- Immigration
- Public sector productivity
- Regulation and planning
- Taxation
Long-run growth policies: some thoughts

- Competition
- Education and skills
- **Infrastructure**
- Financial markets
- Higher education
- Immigration
- Public sector productivity
- Regulation and planning
- Taxation

- Public investment (at a time of low interest rates) unlikely to “spook” markets
- Many smaller projects – larger and less risky returns than “grand projet”
Long-run growth policies: some thoughts

- Competition
- Education and skills
- Infrastructure
- **Financial markets**
  - Higher education
  - Immigration
  - Public sector productivity
  - Regulation and planning
  - Taxation

- Higher capital requirements, living wills
- Vickers agenda – plus?
- SME access to finance (KfW style bank?)
Long-run growth policies: some thoughts

- Competition
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- Infrastructure
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- Higher education
- Immigration
- Public sector productivity
- Regulation and planning
- Taxation

- Human capital, scientific innovation and an export industry
- Risks of tougher immigration policy for highly skilled
Long-run growth policies: some thoughts

- Competition
- Education and skills
- Infrastructure
- Financial markets
- Higher education
- Immigration
- Public sector productivity
- Regulation and planning
- Taxation

- Direct role on GDP
- Productivity effects of immigration in general unclear
- Free movement of highly skilled workers, including scientists a “no brainer”
Long-run growth policies: some thoughts

• Competition
• Education and skills
• Infrastructure
• Financial markets
• Higher education
• Immigration

• Public sector productivity
• Regulation and planning
• Taxation

• Competition, information and choice
• Care must be taken with implementing quasi markets
• Some geographical variation in public sector pay – but no race to the bottom
Long-run growth policies: some thoughts

- Competition
- Education and skills
- Infrastructure
- Financial markets
- Higher education
- Immigration
- Public sector productivity
- Regulation and planning
- Taxation

- Getting balance right
- Energy market concerns
- Labour markets – despite increased regulation, no evidence of fall in productivity.
- Land – planning and retail productivity, high tech clusters
Long-run growth policies: some thoughts

- Competition
- Education and skills
- Infrastructure
- Financial markets
- Higher education
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- Public sector productivity
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- Taxation

- Agree with thrust of Mirrlees
- Real issues with complexity and instability rather than marginal rates
- Removal of special deductions (e.g. IHT and family firms), removing corporate tax bias towards debt
Conclusions and discussion

- So Labour record pretty good
- Continued trend from 1979 but at least some due to its policies (competition, education & innovation)
- In presence of significant output gap room for action
- Long term policies need coordinated plan that draws on lessons from past