After a century of decline in which UK productivity fell behind that of France, Germany and the United States, the last three decades have seen the country catching up. A CEP report by **Anna Valero** and colleagues focuses on performance during the Labour years 1997-2010 – and draws lessons for the current government's strategy for growth.

Growth and productivity:

UK economic performance since 1997

A common view is that the performance of the UK economy between 1997 and 2010 under Labour was very weak and that the country's current economic problems are a consequence of poor policies. In a recent report, we analyse the historical performance of the UK economy since 1997 compared with other major advanced economies and with performance prior to 1997, notably the years of Conservative government, 1979-97.

We focus on measures of business performance, especially productivity growth. This is a key economic indicator since in the long run, productivity determines material wellbeing – wages and consumption. Productivity determines the size of the 'economic pie' available to the citizens of a country. GDP per person is a function of productivity (say output per employee) and the jobs market (the percentage of the population employed).

The big picture

We conclude that relative to other major industrialised countries, the UK's performance was good after 1997. The growth of GDP per capita – 1.42% a year between 1997 and 2010 – was better than in any of the other 'G6' countries: Germany (1.26%), the United States (1.22%), France (1.04%), Japan (0.52%) and Italy (0.22%).

Figure 1 shows GDP per capita levels in four countries relative to 1997. The height of the line indicates the cumulative growth: in 2010, the UK had a level of GDP per capita 17% higher than in 1997; over the same period, US GDP per capita had grown by 14%.

The UK's high GDP per capita growth was driven by strong growth in productivity (output per hour), which was second only to the United States, and good performance in the jobs market (which was better than in the United States). The UK's relative economic performance appears even better in the years prior to 2008 before the Great Recession engulfed the developed world.

But wasn't it all a bubble?

The UK's impressive productivity performance relative to other countries was a continuation of the trends during the period of Conservative government from 1979. This broke a pattern of relative economic decline stretching back a century or more.

UK GDP per capita fell relative to France, Germany and the United States from 1870 to 1979, but over the next three decades this trend reversed. UK GDP per capita was 23% above the United States in 1870 whereas the United States was 43% ahead of the UK in 1979. By 2007, the UK still lagged behind the United States, but the gap had closed to 33%.

During the past 30 years, the UK has had a faster catch-up of GDP per capita with the United States under Labour than under the Conservatives, although there has been a slower rate of relative improvement when the UK is compared with France.

But surely the growth of productivity was all due to 'unsustainable bubbles' in sectors such as finance, property and oil?' Actually, the answer seems to be 'no'. The expansion of property and the public sector both actually held back aggregate productivity. The financial sector contributed only about 0.4% of the 2.8% annual growth in the UK market economy between 1997 and 2010.

Our analysis shows that the productivity increases were mainly in business services and distribution, and they were generated through the increased importance of skills and new technologies. It is difficult to see how all such activities could have been generated by an artificial financial or property bubble.

Analysis of other indicators of business performance – such as foreign direct investment, innovation, entrepreneurship and skills – supports our view that the gains in productivity were largely real rather than a statistical artefact.

This points to a more positive reading of the supply side of the economy than the current consensus. Although the UK still has some longstanding issues in terms of lower investment relative to other G6 economies (especially in R&D and vocational skills), things have improved.

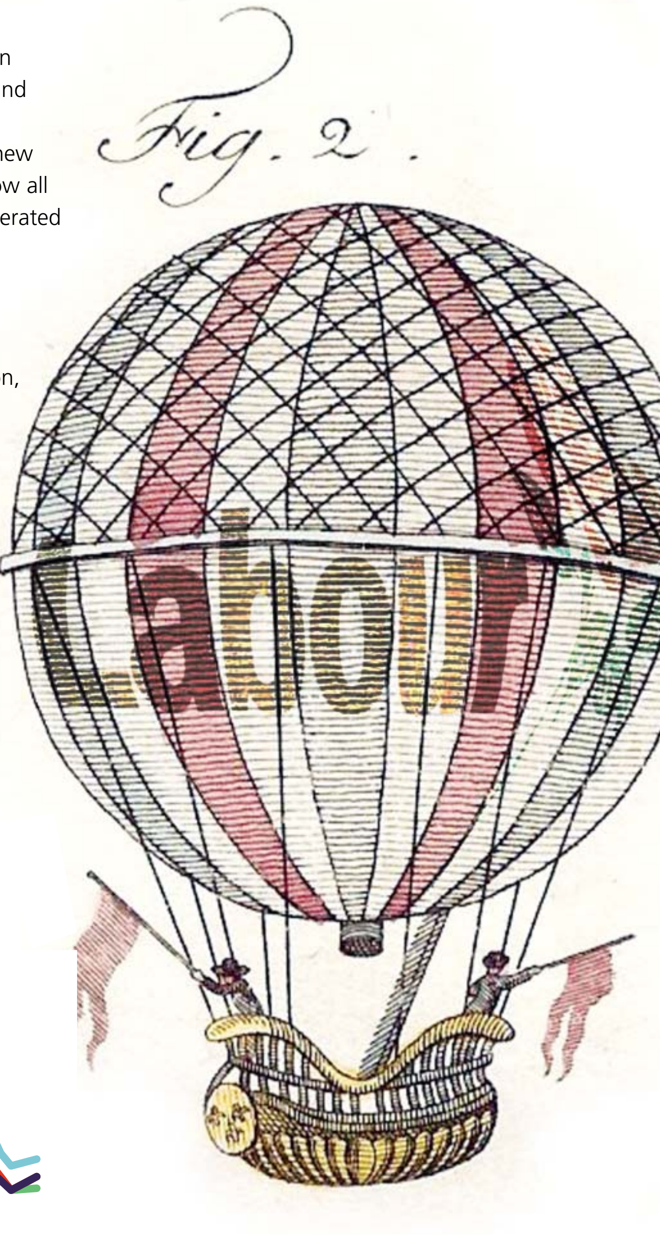
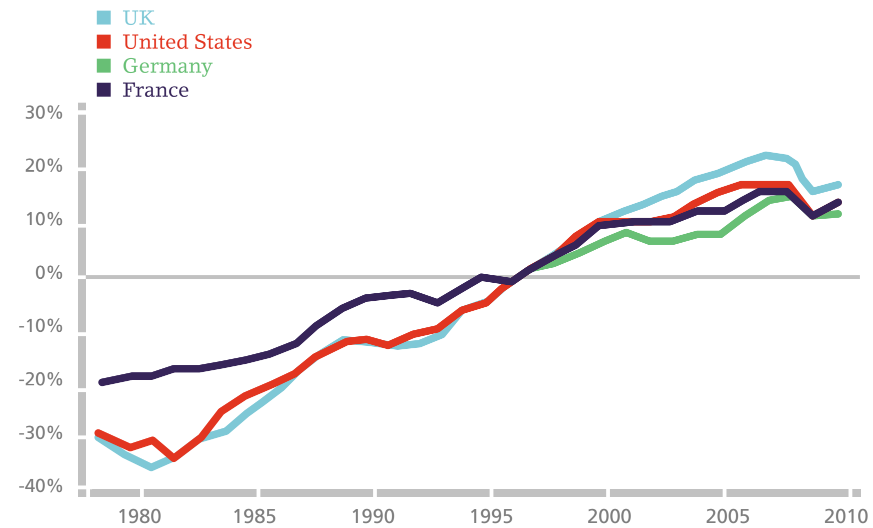


Figure 1:
Trends in GDP per capita 1979-2010 (relative to 1997)



Notes: The analysis is based on OECD data (with Germany dropped before 1997 due to reunification). GDP is measured in US dollars at constant prices and constant PPPs, using the OECD base year of 2005. The working age population data are from the US Bureau of Labor Force Statistics. For each country the logged series is set to zero in 1997, so the level of the line in any year indicates the cumulative growth rate (for example, a value of 0.1 in 2001 indicates that the series grew by exp(0.1)-1=11% between 1997 and 2001). The steeper the slope of the line, the faster growth was over that period.

UK economic performance under Labour continued the trend improvement under the previous Conservative government

Did Labour's policies have any positive influence?

Some have argued that Labour simply enjoyed a 'free ride' on the radicalism of Mrs Thatcher. Most analysis suggests that freeing up the labour market through breaking union militancy, removing subsidies for 'lame ducks' and implementing privatisation, lower marginal tax rates and cuts in benefits all boosted performance after 1979. On this line of argument, the best that could be said is that at least Labour did not return to the failed pro-union, anti-competitive policies of the 1970s.

But the 'at least Labour didn't mess it up' argument is not compelling. It is hard to believe that the Thatcher reforms permanently kept productivity growth higher for the next 15 years. The anti-union policies may have raised output, for example, but it stretches credulity to think that they kept the UK on a permanently better path of productivity growth.

We believe that it is more likely that some policies of the Labour government drove some of the productivity improvement. In particular, the strengthening of competition policy and utility regulation, the support for innovation and the expansion of university education played a positive role. It is possible that immigration may have also played a positive role.

Establishing the exact magnitude of the causal impact of these policies is difficult, and the need for proper quantitative policy evaluation remains as strong as ever. Unfortunately, Labour's rhetoric of 'evidence-based policy' often did not work out in practice. As with the present government, there was too much 'policy-based evidence'.

The policy area where Labour clearly failed was financial regulation. In addition, and more clearly with hindsight, public debt was allowed to rise higher than it should have done. Although these factors did not drive the boom and did not cause the global recession by themselves, the UK economy was more vulnerable to the recession than it should have been.

Does the Great Recession change everything?

Does the experience of the recession since 2008 show that the productivity improvements to the supply side since 1997 were illusory? We have argued 'no' as the 1997-2010 improvements were real and not due to the bubble sectors of finance, property and oil. But how much did the financial crisis permanently reduce the rate and level of productivity growth?

The extreme version of the 'supply-side pessimism' argument is that because the recession was caused by a banking crisis, the fall in potential output has been so severe that the UK's output gap (the difference between actual and potential GDP) is now close to zero and productivity growth will be permanently lower. Pessimists point to the 7% fall in GDP and slower growth from the trough of the 2009 recession.

It is likely that the recession has caused some permanent fall in output compared with what it would have been without a deep downturn. But there is huge uncertainty over the size of the output gap. An alternative explanation to a supply shock that has permanently reduced the level and growth rate of potential output is simply that global demand is muted.

Policies based on an excessively pessimistic view of potential output can lead to needlessly slow growth

Productivity increases under Labour were mainly in business services and distribution, not finance and property bubbles

Three considerations point in a more optimistic direction. First, the pre-2008 productivity growth rate suggests that the supply side made real improvements before the crisis.

Second, the fall in productivity between 2008 and 2011 is broad-based and not all due to specific sectors such as finance and oil (just as the 1997-2008 productivity growth rates were not dominated by these sectors).

Third, wage growth remains very low, consistent with substantial spare capacity in the economy.

We worry that policies based on an excessively pessimistic view of potential output can lead to needlessly slow economic growth. Indeed, pessimism over the state of the supply side can become self-fulfilling as ever-larger austerity programmes cause excess scrapping of human and physical capital.

Policies in the short to medium run: to Plan B or not to Plan B?

The current 'Plan A' for the UK economy is a period of very strong fiscal consolidation – spending cuts and tax rises to eliminate the structural public sector deficit in the life of this Parliament.

An alternative Plan B would be to slow down the pace of the fiscal consolidation. If the output gap were near zero, then Plan B would simply increase inflation, so the fact that we think there is a good chance of a substantial output gap implies the possibility of a Plan B.

The desirability of a Plan B would be muted if monetary policy was sufficient, if fiscal policy was ineffective in an open economy like the UK, if any increase in public spending or tax cuts was irreversible or if markets would panic at any retreat from Plan A.

Our report considers these problems, but does not find them overwhelming objections. We argue that we do indeed need a medium-term plan for debt reduction but this does not have to be done at the current speed when the advanced world economy is so fragile. Thus we need a short-term stimulus ('Plan B') and a long-term growth strategy ('Plan V').

A strategy for long-run growth

Whatever view is taken on shorter-term policies, all sides agree on the need to focus on longer-term growth. The report draws out some of the lessons from our analysis for how to restore longer-term growth.

The structural improvement in the UK's relative performance since 1979 contains the lesson that getting the market environment right is key: strong product market competition, openness to foreign investment, flexible labour markets, a welfare to work system and smart regulation are major factors in promoting growth. Government has a role in all of this, setting the rules, and it also needs to be pro-active in building human capital and infrastructure and supporting innovation.

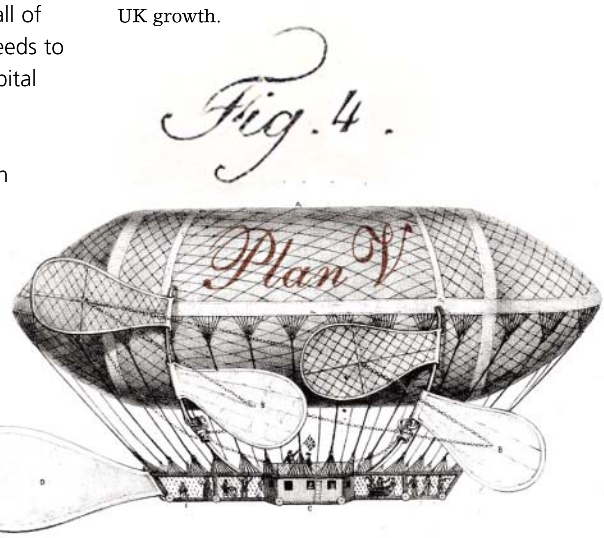
Our report argues that a growth strategy must go beyond the 'laundry list' approach as policies interact with each other and efforts must be focused. We sketch a plan for a 'V-shaped' recovery that requires the state and civil society to scan the global economy for potential growth in demand, and then focus on areas where the UK has actual or latent comparative advantage.

Within this space, there has to be relentless scrutiny of where the state is hindering and where it could help. A specific example is higher education, a globally growing sector in which the UK has comparative advantage as witnessed by the country's strong science base and high share of the market for overseas students (who count as service exports). Restricting immigration is hugely damaging to this sector.

More generally, growth policies could include supporting sector-specific skills, access to credit for small enterprises and innovation in key industries such as software and healthcare. We offer less of a blueprint for growth than a way of thinking about growth that could form the basis for economic revival.

This article summarises 'UK Economic Performance Since 1997: Growth, Productivity and Jobs' by Dan Corry, Anna Valero and John Van Reenen, CEP Special Paper No. 24 (http://cep.lse.ac.uk/pubs/download/special/cepsp24.pdf).

Dan Corry, chief executive of New Philanthropy Capital, was head of the Number 10 Policy Unit, 2007-10. **Anna Valero** is an occasional research assistant in CEP's productivity and innovation programme. **John Van Reenen** is director of CEP and co-chair with Tim Besley of the LSE Growth Commission, which will report at the end of the year on policies to boost sustainable UK growth.



Getting the market environment right is key for promoting long-run growth