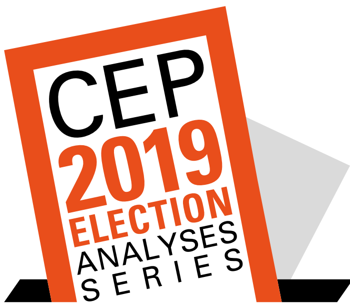

CENTRE *for* ECONOMIC PERFORMANCE

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A series of background briefings on the policy issues in the December 2019 UK General Election

The UK Economy

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#GE2019Economists

Paper EA049

CENTRE *for* ECONOMIC PERFORMANCE

The UK Economy: Policies for Investment and Productivity Growth

CEP ELECTION ANALYSIS

Anna Valero and John Van Reenen

November 2019

Summary

- The UK has suffered a 'lost decade' of near zero productivity growth. If productivity had grown on its pre-2010 trend (from the previous 30 years), it would be 17% higher today – around £5,000 per person.

- Woeful productivity is reflected in pitiful wage growth. Average earnings (after inflation) are about the same level as they were just before the financial crisis – the longest pay stagnation for centuries.

- The positive side of low wages is that there are plenty of jobs: the proportion of prime-age adults with jobs is 76%. Higher than historical peaks of 73% after previous recoveries from recessions. But underlying the strong aggregate performance, there has been a considerable compositional change, with a significant rise in the share of poor quality jobs.

- Boris Johnson's Brexit deal would be likely to reduce national income per person by more than 6% over the next decade relative to the Liberal Democrats' policy of remaining in the EU. If Labour were to preside over a soft Brexit, this would reduce rather than eliminate the economic damage.

- One of the reasons for the UK's longstanding weak productivity is low investment in long-term assets in infrastructure, innovation and skills. Current investment is depressed by uncertainty over the form of Brexit, which will not be resolved until a comprehensive deal with the EU is reached, which will take many years. But the main damage to domestic and overseas investment is due to what will undoubtedly be the negative effects of Brexit on the size of the UK economy. 'Resolving' the uncertainty with a hard Brexit will make this loss of investment even worse than it currently is.

- The willingness of the main parties to borrow more to invest is welcome. But public borrowing for current spending is not sustainable, especially in the event of a negative Brexit shock. All parties would need to raise taxes to pay for spending if an inflationary spiral is to be avoided.

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Introduction

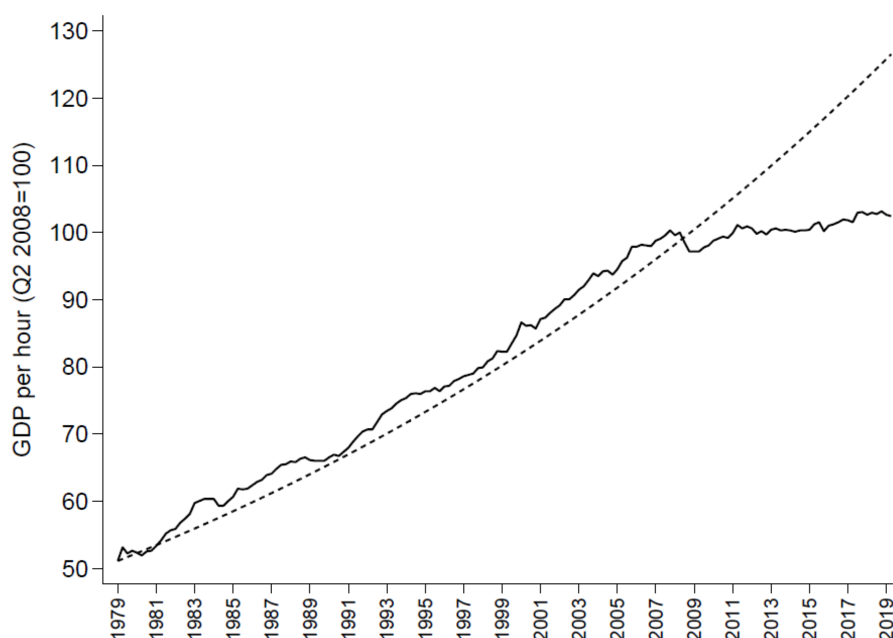
Since the global financial crisis, the UK has been grappling with persistent poor productivity performance. While a number of factors have been at play, reduced investment due to austerity harmed growth in the early years, and more recently, policy uncertainty surrounding Brexit has held back investment.

While Brexit has dominated UK politics and economic policy since the referendum on EU membership in 2016, the UK government has been developing an industrial strategy in recent years, and has also made a commitment to achieving net zero carbon emissions by 2050. These two elements of policy must be consistent and long-term to enable the UK to meet its commitments, while realising the growth opportunities associated with innovation in the low carbon transition. While institutions around industrial strategy have been strengthened, there is a risk that the volatile political climate could prevent its objectives from being achieved.

UK economic performance since the financial crisis

The most recent estimates of national income growth (GDP) were only 0.3% in the third quarter of 2019. Figure 1 shows the level of productivity (GDP per hour worked) since 1979. Had we followed the three-decade trend prior to the global financial crisis of 2008/09, productivity would have been 24% higher today. This is a truly abysmal performance.

Figure 1: GDP per hour worked in the UK



Notes: Whole Economy GDP per hour worked, seasonally adjusted. ONS Statistical bulletin, Labour Productivity Q2 2019, release date 8 October 2019 (Q2 2008=100). Note: predicted value after Q2 2008 is the dashed line calculated assuming a historical average growth rate of 2.2%.

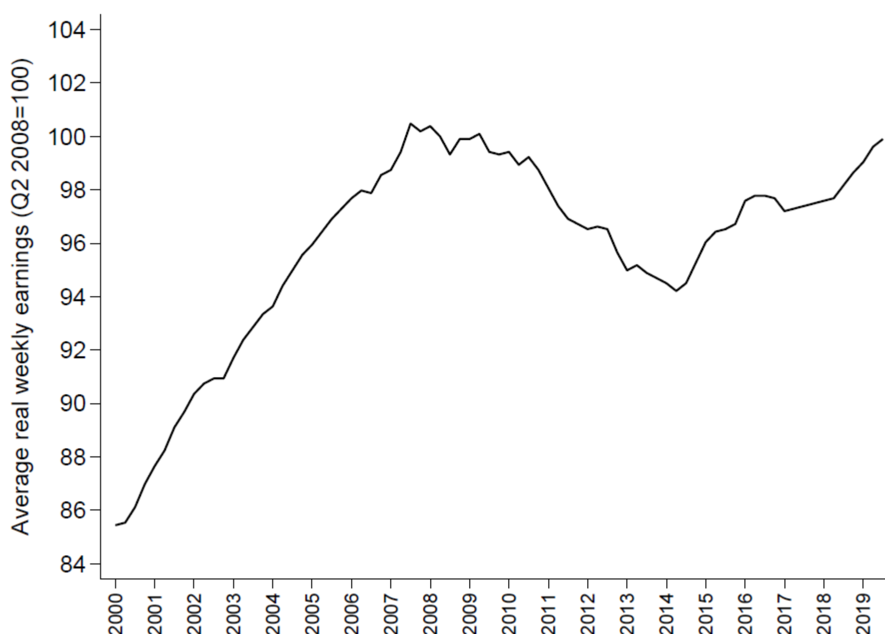
Even if we take the average annual growth rate in productivity from 1979 to 2010 (allowing for the immediate aftermath of the financial crisis), and apply this to the level of productivity at the time of the 2010 general election, productivity today would have been 17% higher, representing over £5,000 in GDP per capita.

Although the recovery has been weak across the developed world, UK productivity stands out for being particularly poor by international standards. This has resulted in a widening of the longstanding gap with its main peers.[1]

Moreover, behind the aggregate picture lie significant and persistent regional disparities, which, by some measures, have widened since the financial crisis (see, for example, the CEP's Atlas of British Industry, Bernick et al, 2018). The CEP Election Analysis on the UK's economic geography contains detailed discussion on the drivers of these trends (Overman, 2019).

When workers are more productive they get paid more. Figure 2 shows how average real wages also took a hit following the financial crisis and they have still not fully recovered. This stagnation of wages is worse than the Great Depression – one has to go back to the nineteenth century for such periods of poor prolonged real wage growth.

Figure 2: Average real weekly earnings in the UK



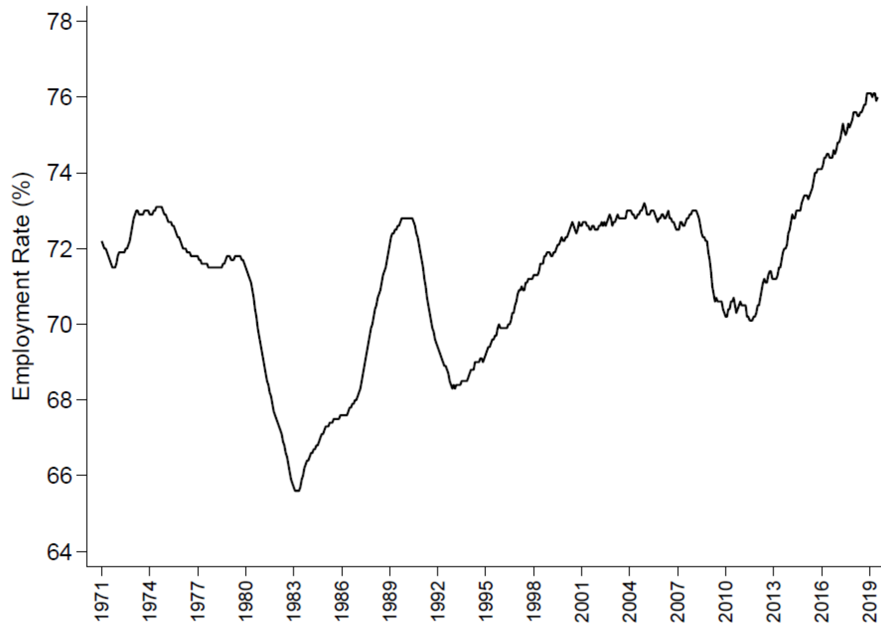
Notes: Average Weekly Earnings, seasonally adjusted regular pay, real terms index, ONS. Release date 12 Nov 2019 (Q2 2008=100).

Given the fact that labour has been cheaper, employment rates have been strong in the post-crisis period, hitting a record high of 76% in early 2019. Figure 3 shows that this is higher than the earlier peaks at the height of booms in the mid-2000s and the late 1980s, when it reached around 73%.

But this aggregate performance hides changes in the composition of the workforce: labour market slack is higher with falling hours and associated increases in under-employment. There has also been an increase in the share of poor quality jobs, often with little employment protection. See the CEP Election Analysis on the UK's labour market for more discussion (Costa and Machin, 2019).

[1] Recent analysis by the OECD which seeks to produce harmonised measures of hours worked between countries puts the gap in productivity levels between the UK and US at 16.4% (based on 2016 data), see OECD (2018). The gap with Germany is slightly smaller at 14.4%, and with France it is 11.4%. While these gaps are smaller than those in previous estimates, they are substantial. Moreover, the UK's comparatively weaker performance in recent years implies that gaps have widened over time.

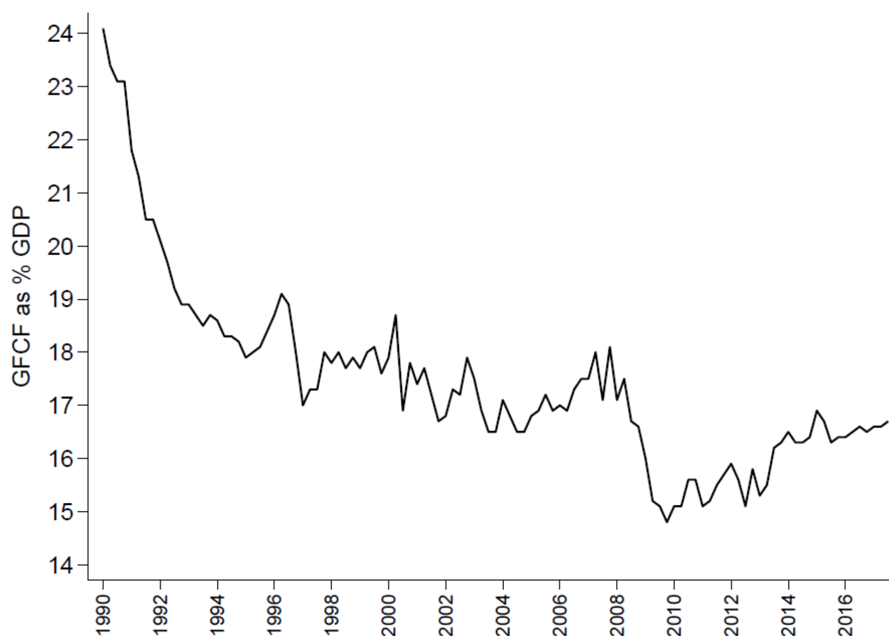
Figure 3: The UK's employment rate



Notes: Fraction of UK population aged 16-64 in employment, Seasonally Adjusted, ONS (release 12 Nov 2019)

The backdrop to this election is Brexit. The Conservatives have promised to deliver Boris Johnson's hard Brexit deal, which would mean that GDP would be about 6.4% lower over the next decade or so (CEP and UK in a Changing Europe, 2019). Optimistic estimates put the loss at 3%; pessimists at more than 9% (Dhingra et al, 2017), but there is a consensus that the supply side of the economy will contract significantly due to Brexit. The CEP 2019 Election Analysis on Brexit Economics sets out estimates of the long-run economic impacts of Brexit under different scenarios, and the effects on investment, output and living standards since the Brexit vote (Dhingra and Sampson, 2019).

Figure 4: Investment as a share of GDP



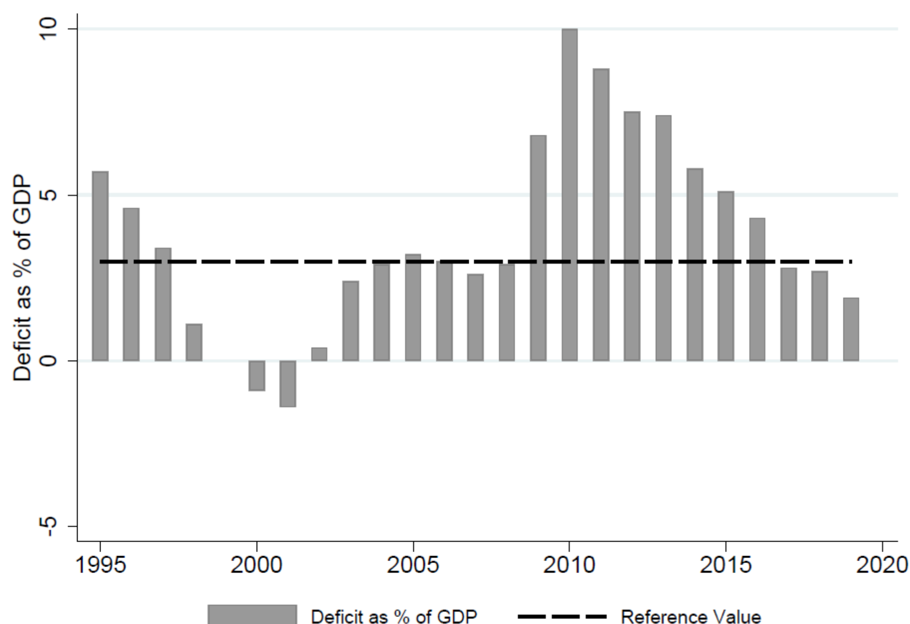
Notes: Gross Fixed Capital Formation as a percentage of GDP, ONS, 'An analysis of investment expenditure in the UK and other OECD nations', release: 3 May 2018

One factor causing the UK's weak productivity performance since the financial crisis is investment (see Figure 4). Part of the explanation for currently low investment is uncertainty over the form that Brexit will take (Bloom et al, 2018). But it is a mistake to believe that 'getting Brexit done' will improve things. First, there will be years of negotiation over what form the UK's future trading relationship with Europe will actually look like.

Second, a hard Brexit is a *certain* bad economic outcome compared with remaining in the EU. The UK will be a relatively smaller market with higher trade costs with our closest neighbours, so a less attractive place for investment. In this sense, the Liberal Democrats' policy of remaining in the EU would produce a double dividend: a 'Remain bonus' from reducing uncertainty in the short run and a long-run boost from making the UK a more attractive place than it would be outside the EU.

Austerity contributed to the gradual reduction of the deficit as a share of GDP (see Figure 5). In retrospect, the sharp cuts to public investment in infrastructure in 2010-12 were clearly a mistake given the low interest rate environment and large multipliers (see, for example, Blanchard and Leigh, 2013).

Figure 5: The public sector deficit as a percentage of GDP



Notes: UK government debt and deficit, June 2019, ONS. Release 18 October 2019. The dashed line shows the Maastricht deficit to GDP reference value of 3.0% set out in the protocol on the excessive deficit procedure

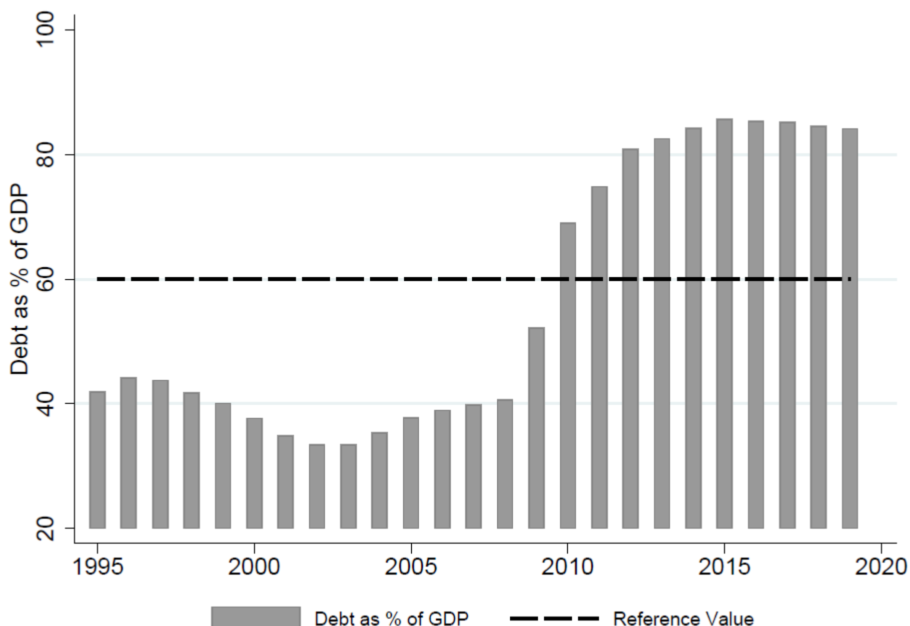
It is welcome that the main parties are promising increases in spending to finance public investment, so long as such investments are based on solid evidence rather than political gimmicks and ministerial whims. But public spending requires tax increases; otherwise the deficit will be unsustainable, especially in the event of a negative Brexit shock. While debt as a percentage of GDP has fallen in recent years, it is still high by historical standards (see Figure 6).

Investment for growth

Investment in fixed capital (including infrastructure) and research and development (R&D) in the UK have been consistently lower than the main comparator countries, and there has also been inadequate investment in skills, in particular at intermediate levels. Figure 7 shows that UK R&D

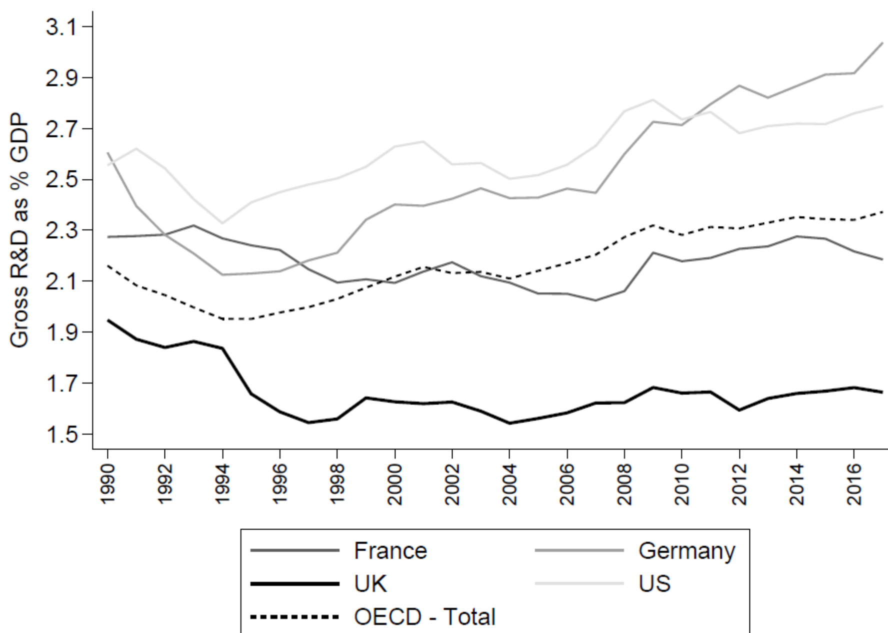
expenditure has been below its main peers as a share of GDP for some time, and the same pattern applies when considering business or government expenditure on R&D separately.[2]

Figure 6: Debt as a percentage of GDP



Notes: UK government debt and deficit, June 2019, ONS. Release 18 October 2019. The dashed line shows the Maastricht deficit to GDP reference value of 60% set out in the protocol on the excessive deficit procedure.

Figure 7: Gross R&D as a percentage of GDP



Notes: Gross Domestic Expenditure on R&D (GERD) as a percentage of GDP, OECD MSTI, data extracted 13 Nov 2019.

[2] Similar analysis using OECD data shows that gross fixed capital formation as a share of GDP is also lower in the UK than in France, Germany and the United States.

Chronic underinvestment in innovation, infrastructure and skills is discussed in the LSE Growth Commission's 2013 and 2017 reports. Increasing investment in these areas is key to solving the UK's productivity puzzle, closing the productivity gap with its main comparator countries, and achieving growth that is more inclusive.

This includes improving the performance of lagging regions – where skills and infrastructure in particular are key issues – see the CEP Election Analysis on the UK's economic geography (Overman, 2019). Investment is also crucial for enabling the UK to meet its commitment to net zero carbon emissions by 2050 and moving the economy onto a sustainable growth path (Rydge et al, 2018).

Increases in both public and private investment are needed, accompanied by a long-term but dynamic industrial policy that will help to prioritise government investment and 'crowd-in' private sector investment into the future. Strong institutions, collaboration with businesses, evaluating[3] and adjusting policies based on evidence will all be key for success (Rodrik, 2004), together with co-ordination across areas of government policy.

To achieve this, industrial strategy should be put on an even footing with other areas of economic policy, such as competition, fiscal or monetary policy, so that it can be truly long-term and independent from political cycles. In this context, the establishment of the Industrial Strategy Council – a body made up of a range of key stakeholders from business, policy and research with a remit of developing success metrics and assessing progress – is welcome. But under current structures there is still a real risk that a new business secretary or government could change or cancel promising programmes, as has often happened in the past.

Final words

The UK's poor productivity performance since the financial crisis puts the economy in a fragile position as it deals with prolonged Brexit-induced uncertainty, and faces the potential for a *certain* negative outcome if a hard Brexit is pursued by the next government.

The UK needs its next government to pursue policies that generate investment for long-run, sustainable and inclusive growth. While the increased public investment being promised by the major political parties is welcome, it must be fully costed, taking account of the negative impacts on public finances that would result from Brexit, and priorities must be set based on evidence of what works.

[3] There is a general lack of robust evidence on the effectiveness of business support policies (see, for example, Roland and Valero, 2015; What Works 2014a, b). More policy experimentation and evaluation is needed, and the BEIS 'Business Basics programme' is a good example of this type of initiative, aimed at learning how the performance of the 'long tail' of underperforming businesses can be improved.

Further reading

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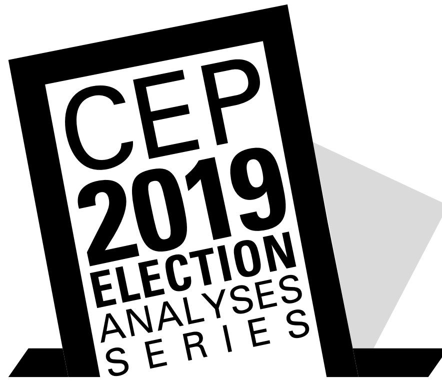
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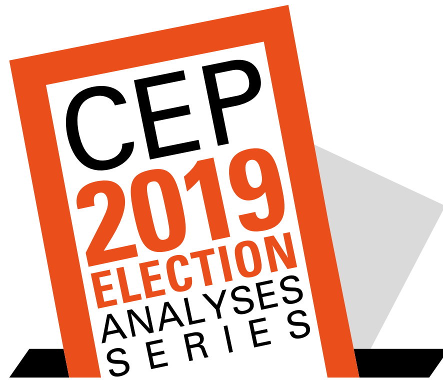
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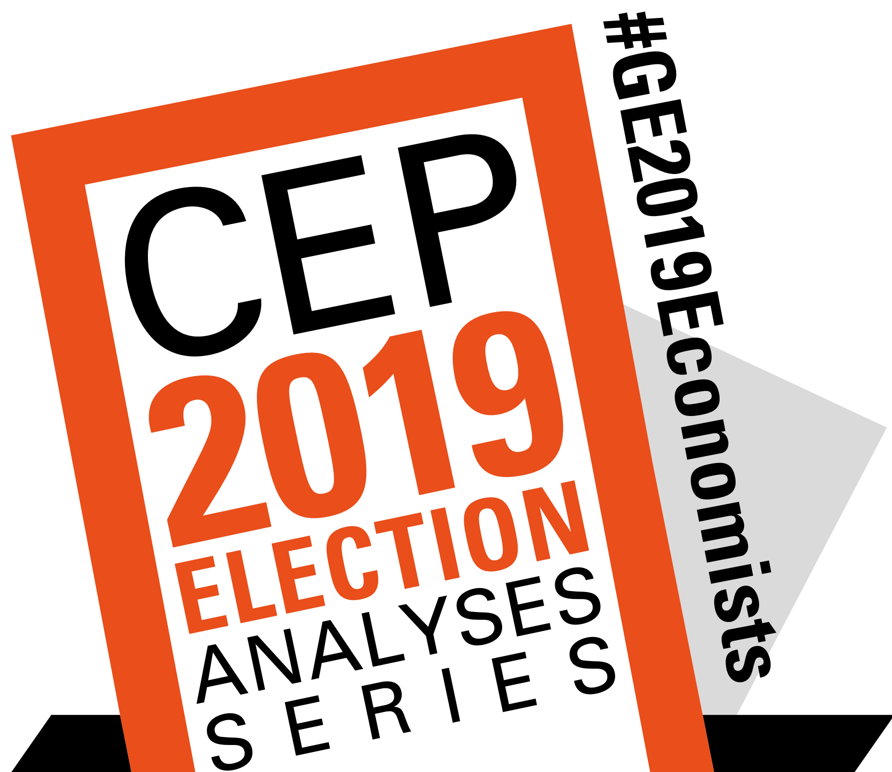
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