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THE UK'S PRODUCTIVITY PUZZLE?

WHAT BUSINESS REALLY THINKS

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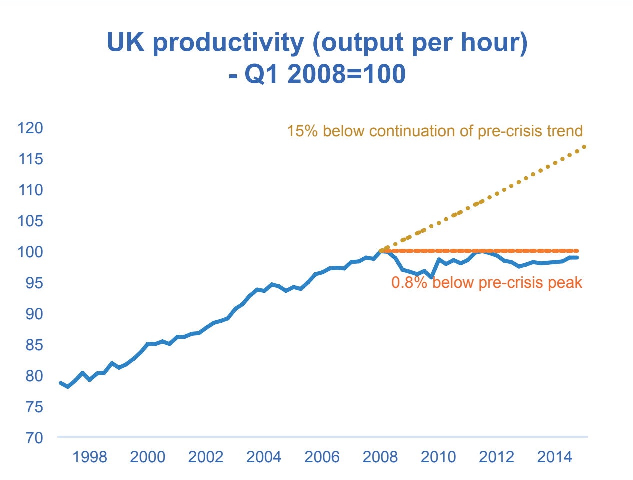
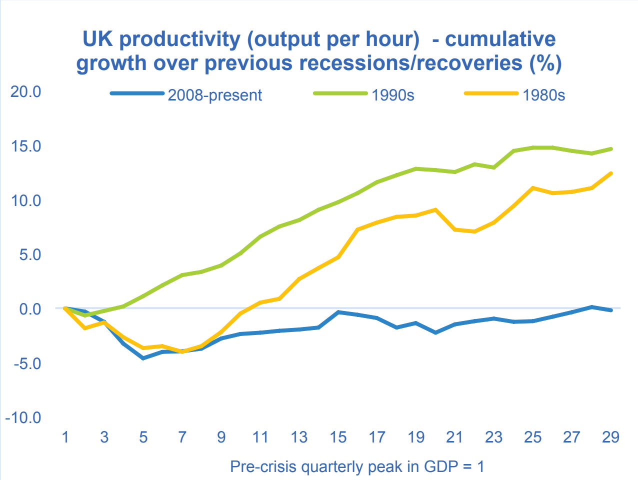
SEPTEMBER 2015

Policymakers and business leaders alike have been scratching their heads about the weakness in UK productivity growth. Since the financial crisis, we've been great at creating jobs, but economic growth hasn't quite kept pace. Consequently, wage growth has been disappointing and we worry about how sustainable UK growth is over the long-term. To get under the skin of the issue, we've been talking to our members about their productivity experiences. We've found a complex web of factors that have weighed on businesses as they adjust to a "new normal" business environment post-crisis: dealing with increased regulation; responding to competitive pressures and widespread skill shortages, to name a few.

The productivity puzzle?

The UK finally appears to be seeing the recovery that many dreamt of in the depths of the economic downturn: GDP has generally risen strongly since the beginning of 2013 and, across domestic demand at least, is relatively balanced. The recovery has also been good at creating jobs: the resilience of the labour market has led to more people in work and avoided some of the de-skilling that can happen when people are unemployed for longer periods of time. But the flip side has been weak productivity growth – the recovery has been jobs-rich but productivity poor, with growth in output per hour uncharacteristically weak compared to previous recoveries. Productivity is currently 0.8% below its pre-recession peak (in Q1 2008), and 16% below a continuation of its pre-crisis trend.





Source: ONS, CBI calculations

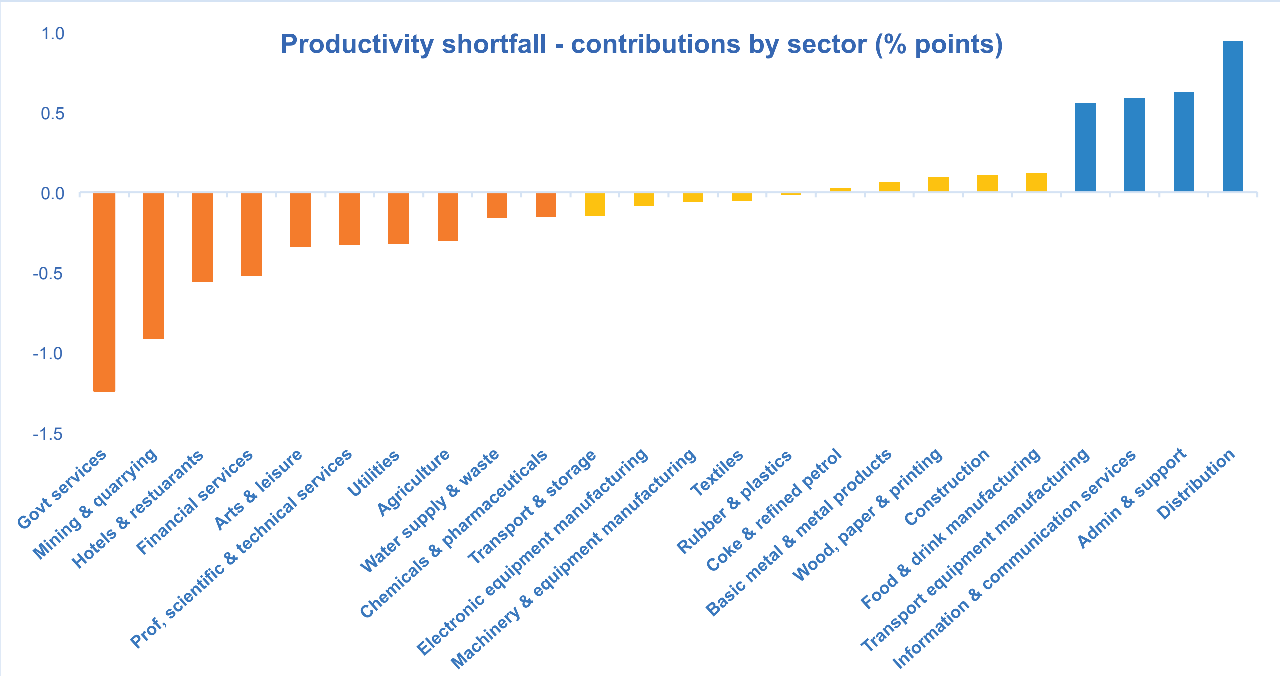
Why has productivity been so weak?

Given that productivity is a key driver of economic growth in the long-run, persistent weakness could have serious implications for the sustainability of UK economic growth. More immediately, weak productivity could lead to a deterioration in living standards by driving up unit labour costs, thus limiting the ability of businesses to pay their employees more. Higher unit labour costs could also damage the competitiveness of UK business abroad, hitting already weak export growth.

The potential reasons for stagnant productivity have been discussed at length. Some of it may be cyclical (i.e. related to the depth of the recession and a long, drawn-out recovery), which means that it will unwind as the economy continues to grow. However, a portion of it may reflect structural constraints, which means that productivity could struggle to return to its pre-crisis path.

Measurement issues in official data may also play a role: for example, there are issues with measuring true value added in certain sectors, where much of the output is "intangible" (e.g. in the digital sector). Analysts differ in the amount of weight that they assign to each of these explanations.

Another way of looking at the productivity challenge is by breaking it down by sector. The chart below illustrates the sectoral contributions to the shortfall in output per hour since the crisis – setting out which sectors account for the 0.8% shortfall in productivity relative to the peak in Q1 2008:



Source: ONS/CBI calculations

Four sectors exert the largest negative contributions – government services, mining & quarrying, hotels & restaurants and financial services. Together, they make up over a third of workforce jobs in the UK, 30% of GVA, but more than account for the entire productivity gap. But there is a long tail of "middling" sectors, which have also contributed to the underperformance, accounting for around half of the 0.8% shortfall since 2008. Meanwhile, a few sectors have actually registered positive contributions to productivity growth – for example, distribution and administration & support services.

The business take on the productivity challenge

To broaden our own understanding of the productivity challenge, the CBI has been talking to members in some of these sectors to try and unpick the story behind the trends. And the insights gleaned have enhanced our understanding significantly.

Government, financial services, mining & quarrying play a large role

Measurement issues affect government services

The issues in government services appear to be fairly well understood. Budgetary pressures brought on by fiscal consolidation have brought about changes in the mix of activity and employment which, contrary to expectations, have served to depress productivity. For example, greater use of teaching assistants in education (in place of hiring teachers, who would be more expensive) has raised headcount relative to output, thus reducing productivity. And the increased use of foster care in social work is a lower cost alternative to institutional care but would show up as a smaller rise in measured output[1], once again weighing on productivity. The sharp cuts to government departmental spending set out over the next Parliament could, all else being equal, eventually foster greater efficiency. However, gauging productivity in

[1] *The UK productivity puzzle – a sectoral perspective*, speech by Ian McCafferty (Bank of England), 19 June 2014

the public sector – both now and over the recent past – is hindered by the challenges in measuring value added effectively. For example, education sector output is linked to the number of pupils taught, which tends to rise in line with population growth, so may not be fully reflective of the true value added of the sector.

Mining & quarrying productivity in long-term decline

Mining and quarrying has been the other big drag on productivity, largely reflecting the impact of oil and gas extraction. Output per hour was already on a downward trend well before the recession, due to shrinking energy reserves and ageing equipment used in extraction. But despite these pressures, a minimum level of staff has had to be maintained, to operate equipment and handle maintenance of oil rigs [2].

Recent falls in oil prices look set to exacerbate this trend, as it undermines new investment. Corroborating this, our members cite a continued focus on decommissioning, in some cases at the expense of paring back headcount. This could point to a further decline in oil & gas productivity ahead.

Increased regulation has weighed on financial services

The drag from financial services productivity is perhaps unsurprising, given that the sector was at the epicentre of the financial crisis. The fall in output per hour reflects heightened risk aversion in a post-financial crisis world, causing the sector to focus on less risky (and less profitable) activities. These yield a lower return, which translates into lower measured output.

But our conversations with businesses also highlight the impact of increased regulation. Post-crisis, financial services firms have had to devote more resources towards compliance and risk management, which diverts resources away from more productive functions. The CBI's June 2015 *Financial Services Survey* found that devoting more resources to "non-productive" activities (such as regulation) was the most widely cited reason for a slump in productivity. The second most cited factor was a shift to less profitable products and services, chiming with the argument of greater risk aversion.

In addition to regulatory pressures, the sector is clearly undergoing a far-reaching transformation. The finance landscape is evolving, demonstrated by the rise of alternative finance providers such as "challenger banks". When starting out, such companies can struggle with getting the right operating systems in place, which acts as a drag on productivity until they're up and running. While likely a marginal influence on financial services productivity at present, this could become more of an issue as such firms increase in number.

But the sector is a prime example of where measurement issues cloud the true extent of the problem. In particular, the ONS only measures a part of FS output directly (using fees/commissions, etc.) and proxies a large proportion using interest rate spreads (working on the assumption that this is the implicit "price" of the service provided). This may overstate output during times of financial stress (when spreads tend to widen), and vice versa.

Using data from the CBI's *Financial Services Survey* on business volumes and employment growth, we have constructed an alternative estimate of financial services productivity going back to the early 1990s[3]. This measure implies that FS productivity was already *falling* in the run up to the financial crisis, in contrast to the stronger trend suggested by official data over the same period. This lends some support to the notion of measurement issues in the data, and casts doubt over the "productivity miracle" in financial services over the years running up to the crisis.

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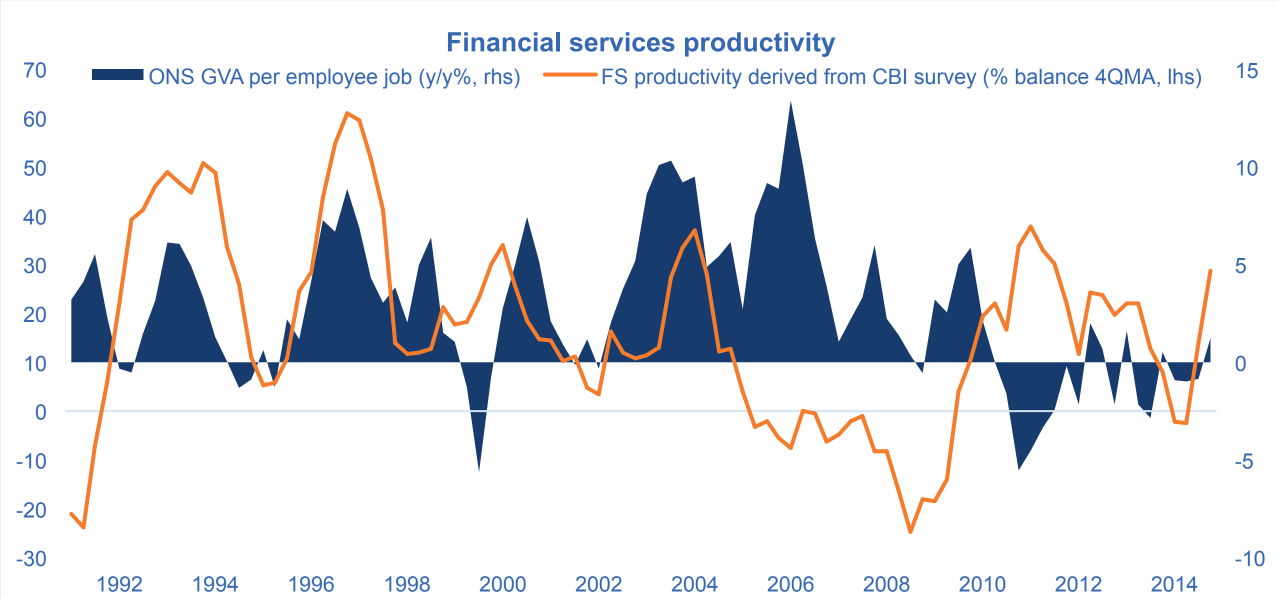
[2] Ibid

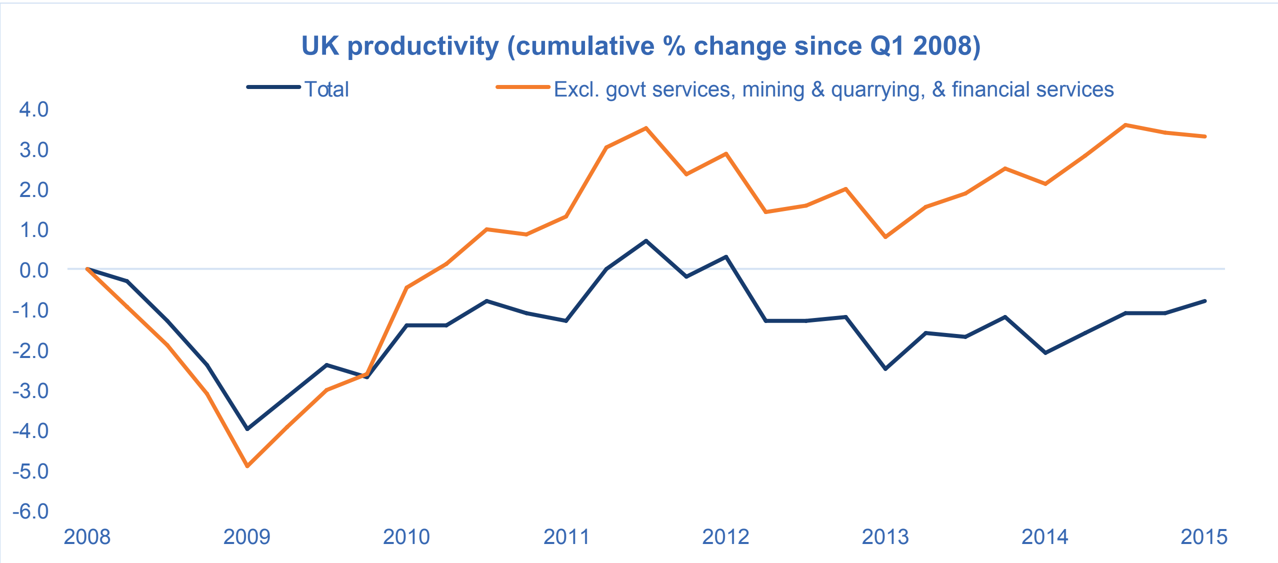
[3] *The Shape of Things to Come? 25 years of the Financial Services Survey*, CBI (forthcoming)



Source: ONS, CBI/PwC Financial Services Survey, CBI calculations

Emerging themes

Looking at the three big drags on sectoral productivity together, a different mix of cyclical and structural drivers emerges. Declining productivity in mining & quarrying is a longer-standing issue, pr e-dating the financial crisis. The public sector and financial services have been affected by exceptional factors – namely, measurement issues exacerbated by fiscal consolidation and increased regulation. Excluding these three sectors, the evolution of productivity in the UK has actually looked stronger since the crisis : output per hour stands over 3% *above* its pre-crisis peak, rather than 0.8 % below. However, it still rem ains a long way below a continuation of its pre-crisis trend (around 16% below).



Source: ONS, CBI calculations

Other sectors have also added to the UK's productivity challenge

Both global and domestic factors have held b ack agricultural productivity

Agriculture accounts for roughly half of the productivity gap, which is surprising given that it only makes up 0.6% of UK output. CBI members attribute this to greater exposure to global influences relative to the recent past, which has resulted in greater volatility in production. In particular, increasingly unpredictable weather patterns and scarce availability of land are hitting output. Pricing pressures are also squeezing margins, driven by subdued global commodity prices and heavy price discounting among customers in the retail sector. Margin pressures do not appear to have fed through to efficiency improvements as yet.

However, there are some glimmers of hope for the sector. A number of issues were cited as holding back investment, most prominently uncertainty over the permanence of the Annual Investment Allowance. This was made permanent in the government's Summer Budget at its £200,000 threshold, which should give smaller farmers the certainty needed for further capital spending. The Government's agri-tech strategy (as part of its broader industrial strategy) is also expected to go some way towards boosting innovation.

Transport & storage has been hit by a shortage of HGV drivers

Financial services isn't the only sector to have been hit by regulatory changes. Transport & storage – which falls under the category of a "middling" sector in terms of its productivity performance – has reported an adverse impact on productivity from a shortage of heavy goods vehicle (HGV) drivers. Changes to the regulation around employing HGV drivers mean they are now required to re-train to hold on to their licences. Given that many drivers were already close to retirement, a significant number have chosen to leave the profession instead.

To deal with the consequent shortage, our transport & storage members report having to employ a larger number of temporary drivers with a lower level of training. This is hitting their ability to conduct deliveries, hampering productivity growth. Furthermore, such drivers often require a higher salary, therefore driving up costs.

It is likely that the dearth of HGV drivers has hit productivity, and the ability to meet demand, in a number of other sectors. For example, it is an issue widely cited as a concern in the retail sector, where many large firms manage their own distribution networks.

Cocktail of issues weighed on construction productivity

Skill shortages were cited across several sectors as explaining weak productivity. This is corroborated by the CBI's business surveys, which show skill shortages becoming a more biting constraint on output and investment recently.

The impact on productivity is particularly stark in construction – another "middling" sector. Labour shortages affecting necessary functions, such as bricklaying, are limiting the capacity to deliver in several areas, notably in housebuilding. However, members also reported a broader shortage of managerial and engineering expertise, which is having a wider impact across the sector.

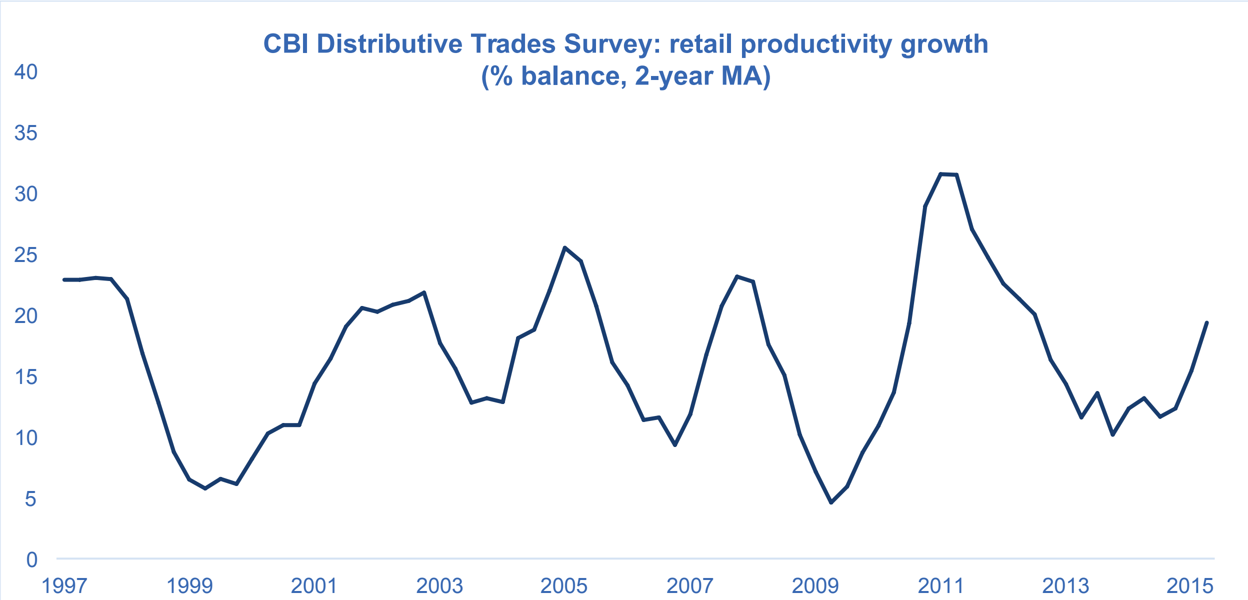
But while prominent, skill shortages are only one of a cocktail of issues depressing construction productivity. Lower-skilled labour was cited to be more widely available and relatively cheap, so hiring has been a preferable method of driving growth relative to investment (one of the widely debated reasons for weak productivity at the whole-economy level). Regulatory compliance, particularly in pension auto-enrolment and Real Time Information for PAYE, is also eating into available resources. And in a competitive environment, more efforts have been devoted towards winning contracts and tenders (an activity not necessarily recorded as measured output, playing into the measurement issues argument).

However, unlike agriculture, some construction firms cited heightened competitive pressure and compressed margins as having fostered improved efficiency. This could feed through to productivity ahead.

Competitive pressures have depressed retail sector productivity…

The impact of competitive pressures on productivity seems to vary across different sectors. Alongside the contrasting examples of agriculture and construction, the retail sector and food & drink manufacturing illustrate this.

Retail falls under the broader "distribution" sector, which has actually made a positive contribution to UK productivity growth since the crisis (+0.9ppts). However, this sector spans a wide range of activity, also including wholesale and motor trades alongside the retail sector. It is clear from conversations with members that productivity in the retail sector alone has been weaker. Indeed, an estimate of retail productivity growth constructed from the CBI's Distributive Trades Survey[4] (an official estimate is not readily available) lends support to this – after rising over the downturn, retail productivity growth has slowed considerably since, albeit showing some sign of turning around recently.



Source: CBI Distributive Trades Survey, CBI calculations

Our intelligence from members paints a picture of a sector that, like financial services, is undergoing structural shifts. This is particularly true of food and drink retail, where the entry of lower cost "discount" retailers has triggered heavy price competition. In such a tough trading environment, more resources have been deployed toward differentiation and maintaining a competitive edge. In some cases, in an effort to compete, many retailers have been taking on more people to provide a personalised customer service. This marks a reversal of previous investments in efficiency (e.g. rolling out automated check-outs), which were viewed less favourably by customers. As with many other sectors, skill shortages are also an issue, particularly for retailers with multiple business areas (such as IT and energy provision).

…but have led to efficiency improvements in food & drink manufacturing

The tough trading environment in the retail sector has clearly had a knock-on effect on productivity in other parts of the economy. The pressure on margins towards the beginning of its supply chain have been highlighted, hitting already volatile production in agriculture.

And yet it appears to be fostering efficiency in other parts of the supply chain. Food & drink manufacturing has seen a 4% rise in productivity since end-2013, and has registered a very small positive contribution to UK productivity since the downturn (+0.1ppts). Heavy retail price discounting has meant food & drink manufacturers have raised efficiency to win and deliver business at a low cost. In particular, there has been an increased focus on intelligent automation and smarter, leaner production, through enhanced capital spending and staff training.

But once again, growing skill shortages were flagged as a potential drag on further productivity improvements. Specifically, there are long-standing issues with getting new entrants into the food & drink sector to replace an ageing workforce. Some offset has also been cited from commodity price volatility and a lower focus on exporting (which would contribute to raising firm productivity), due to greater risk aversion.

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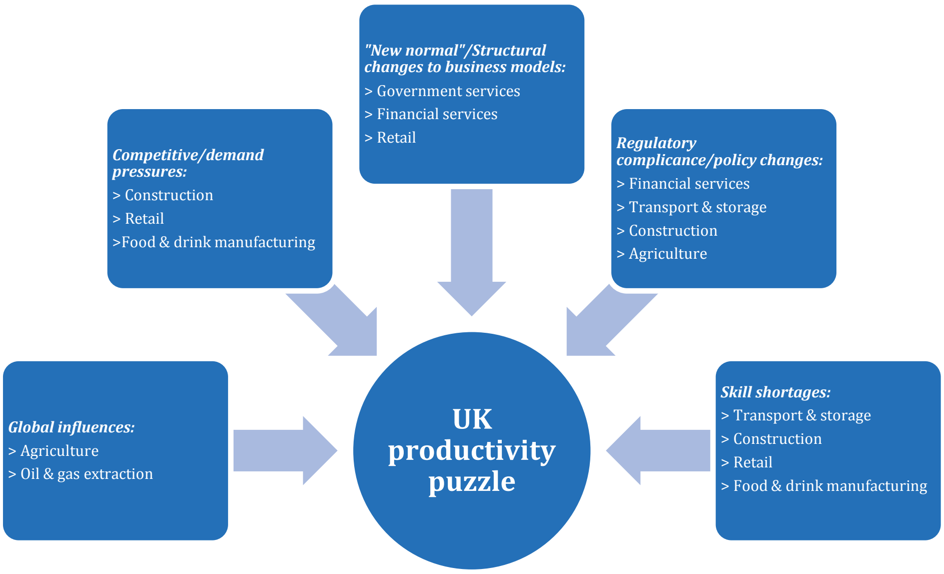
[4] The series is constructed by subtracting the quarterly survey balance for numbers employed from the balance for volume of sales (quarterly average).

What does this mean for the path of productivity ahead?

Our intelligence from members has highlighted a range of factors accounting for trends in productivity at the sectoral level. These issues can be grouped into a number of broad themes, summarised below.



It is clear that at least some of the shortfall in UK productivity since the crisis is structural – either resulting from the crisis, or pre-dating it. Our conversations with members indicate that exceptional structural factors (such as regulation) have played a prominent role in suppressing productivity – this is illustrated most starkly in the financial services sector. Productivity growth in such sectors may take longer to pick up, as businesses adjust to a different operating environment.

However, cyclical issues have played a prominent role too. Many sectors highlighted the impact of a tough trading environment and increased competition, and the retail sector is a good example of how this can permeate through the supply chain. Skill shortages are also widespread, stemming from both cyclical and structural constraints.

As some of these factors unwind, it is likely that we will see a more definitive pick up in productivity over the near term. The CBI's forecast is for modest productivity growth this year and in 2016, although at a rate well below the pre-crisis average.

However, it is clear that more can be done to boost productivity in the UK. In this respect, the enhanced focus of the government's recent productivity plan is encouraging. The greater focus on public sector productivity is welcome, given that it has exerted the greatest drag on growth since the downturn, as are measures to improve planning and digital infrastructure. However, it is unclear that a training levy for larger firms combined with a more restrictive approach to visa allocations will alleviate the constraint of skill shortages – particularly in the short-term.

But ultimately, our member intelligence re-affirms the notion that business needs to be the main force behind their own productivity (given the myriad of "within firm" issues cited), against the backdrop of the government continuing to facilitate the conditions for private sector growth. Only then will we see a sustainable recovery, shoring up the UK's growth prospects over the longer-term.

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