# ‘The UK’s productivity puzzle’

Brexit is not the reason for Britain’s poor productivity record according to Professor Graham Gudgin in an article for *Briefings for Britain* which we publish in full below.

Through a process of deduction and elimination, he concludes that the UK’s addiction to mass migrant labour may be the principal cause of the flat-lining we have seen in the fifteen years since the Global Financial Crisis in 2008.  Even with interest rates at historically low levels there was no incentive to innovate.  Much easier to get an extra body in to do the job.

Now that interest rates are rising again to pre-2008 levels, companies will have to work smarter as well as harder to compensate for the extra borrowing costs they are now facing. But the millions who were invited over to fill those vacancies in the first place are still here.

The implications are obvious.

“Unless output starts to grow much faster, we will end up sharing a fixed economic cake among a larger population.”

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## The Great Stagnation. Brexit not to blame.

### By Graham Gudgin

The virtual cessation of growth in productivity since 2008 is the largest economic problem of our age since living standards are unable to rise without higher productivity. This includes standards of public service provision which have come under severe pressure as government revenues have also stagnated. This stagnation is poorly understood but is more a consequence of faster employment growth than slower growth in output.

A major conference in Cambridge this week brought together hundreds of 'policy wonks' to discuss 'The Great Stagnation'. This term refers to the largest economic problem facing the UK, and indeed to much of the West. This is the fact that after many decades and indeed centuries of growth, productivity has virtually stopped expanding.

## *Identifying the problem*

The American Nobel-Prize winning economist Paul Krugman is famous for saying in reference to living standards that "*productivity isn't everything, but in the long-run it is almost everything*". It is perhaps a comment on the outlook of the British elite that the Conference, organised by CivicFuture, led by the estimable Munira Mirza, said little about the direct causes or even consequences of the stagnation and instead mostly talked around the issue.

The slowdown is however hugely important and needs to be understood. It not only means that our living standards have not risen for a decade and a half, but nor has public spending which explains a lot about the state of the NHS and much of the rest of our public services. If productivity growth had not ground to a virtual halt the Government would now have 25% more to spend on everything from health and education to prisons and would not be under pressure to raise taxes to record levels.

### *Taxation levels*

Policy-makers have a poor understanding of what has gone wrong but they are not really to blame, since the international economics profession is in disarray over the problem which it calls the ‘productivity puzzle’.  Liz Truss and Kwazi Kwarteng reflect the views of right-wing economists in believing that we are over-taxed and that tax-cuts will restore growth in productivity.

### *Idleness & Austerity*

However there is not much evidence that high tax countries experience slower growth. Truss, with Conservative colleagues also described the British as the ‘worst idlers in the world’.  More generally, economists tend to blame austerity in resulting low investment including low public investment in infrastructure, and also insufficient labour skills. The most popular remedies are improved education and skills and increased entrepreneurship. Those on the right blame over-regulation and in particular wish to dismantle the planning system set up under the 1948 Town and Country Planning Act.

We have to be careful here to see which problem is being explained. In the British context there is a confusion between low productivity relative to major comparative economies, including the USA, and a slowdown in productivity. To repeat, the slowdown has occurred across most OECD economies although it has been more marked in the UK than in most other countries.

### *Shrinking manufacturing sector*

At the Great Stagnation conference, Lord David Sainsbury, a former science minister, blamed deindustrialisation and the rise of China, leading to the UK falling a long way behind

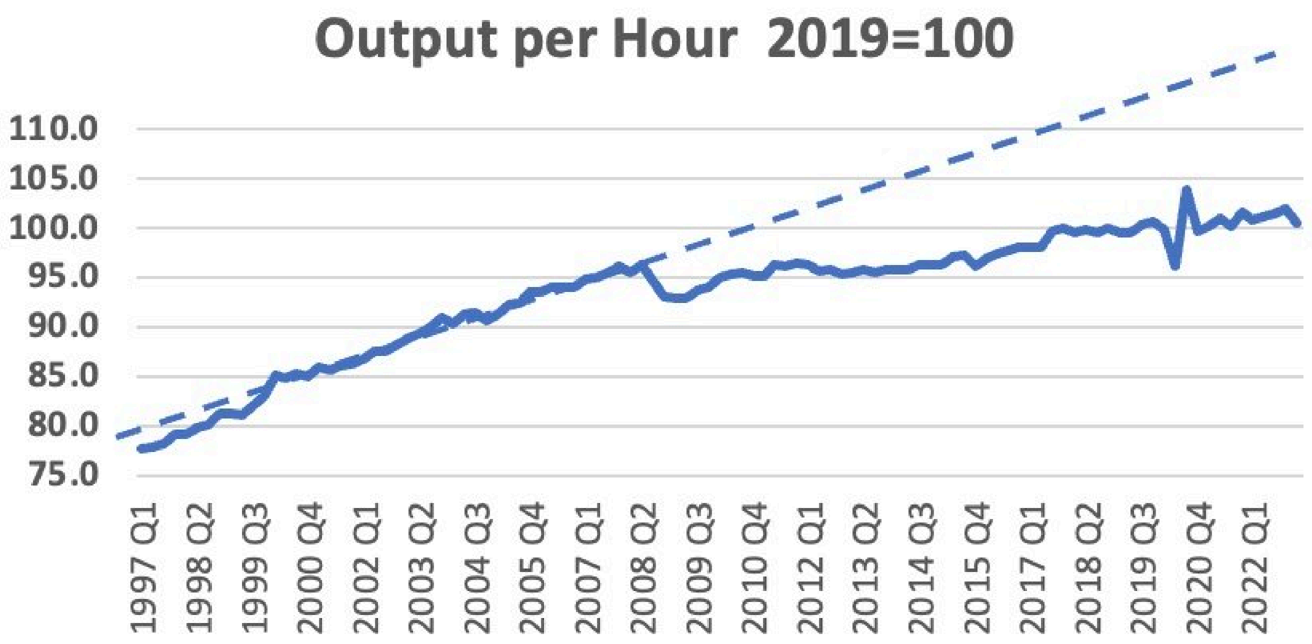
South Korea, Japan and Germany in developing a modern manufacturing sector. Sainsbury was however talking about a longer slowdown in productivity growth, dating back to 1990 and his focus on modern manufacturing fails to fit the facts of growth. Neither in Germany nor Japan have their economies grown faster than in the UK throughout the current century.

Clearly, strengths in manufacturing do not guarantee rapid economic growth.  What was refreshing about the conference was that no-one blamed Brexit and this is wise since the showdown clearly predated even the Brexit referendum never mind actually leaving the EU.

It is true that current UK productivity is lower than some major competitors but this is generally an old rather than new phenomenon. Sainsbury talked about a widening gap with the USA, but per capita GDP at purchasing price parity in the UK has been around 75% of the US level since World War II. The US pulled ahead during that war when its huge resources and economies of scale were fully utilised in such things as aircraft production while a war-bankrupted Britain struggled to modernise for decades.

## *Current conundrum*

The productivity slowdown of current concern is much more specific and has a precise start-date in the first quarter of 2008 as can be seen in the chart below. Output per hour which had grown reasonably consistently throughout the postwar period suddenly slumped in 2008 and has struggled to expand ever since. Productivity growth was a little slower in the post-1980 Thatcher era (free-marketeers should note) than previously but nothing like the current slowdown has been seen since  records began three-quarters of a century ago.

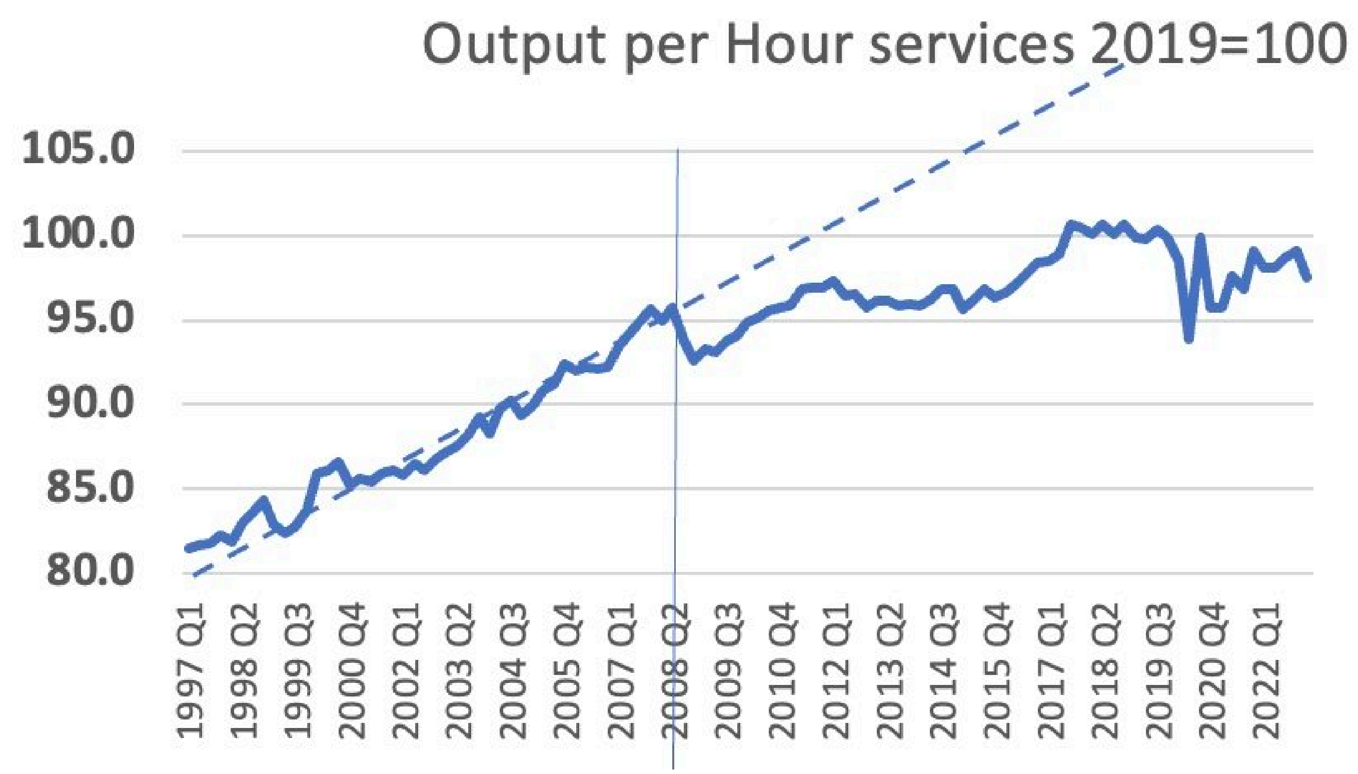



Source of data: ONS

The slowdown has been experienced right across the economy and the following two charts show that it has occurred in the service sectors as well as in manufacturing. One unremarked feature in manufacturing has been a dramatic recovery in productivity during the pandemic lockdowns of 2020 when output per hour worked soared by 25%. It seems that output continued to be generated even while a significant part of the workforce was furloughed, This reflected the fact that around half of employees in manufacturing are in administrative, clerical and managerial occupations rather than in


Source of data: ONS

direct production. This somewhat artificial boost to productivity was unlikely to be fully sustained but may lead to a permanent rise in productivity as firms discover that they can do without part of their labour force. No equivalent pandemic-related boost to productivity is evident in the service sector (see chart below).



Source of data: ONS

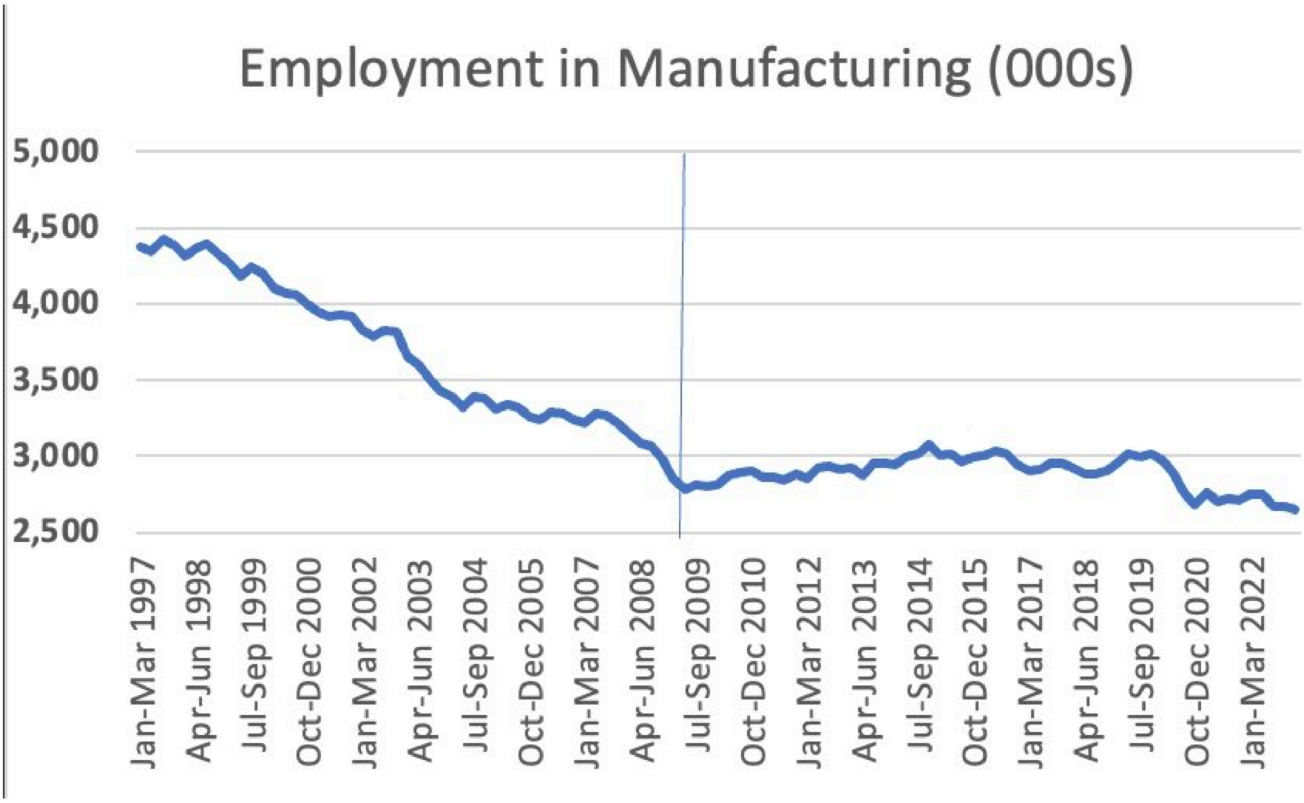
## *The 2008 Financial Crash*

We thus have a precise event to explain. The question is why productivity suddenly stopped growing in early 2008 and why has it struggled to expand ever since. Those who note that austerity began soon afterwards, in 2010, have a point. A huge government financial deficit opened up during the banking crisis, as tax revenues plunged and bailout and unemployment costs soared with the Coalition Government struggling to manage the public finances.

Austerity means that the recovery from recession was somewhat muted, but growth in GDP in the decade from the trough of recession in 2009, was 2% per annum. This is below the long-term trend of 2.5% per annum, but not that far below. Nor does it follow that productivity growth should have slowed much, or at all, even if the economy was growing a little slower.

## *An Employment Enigma rather than a productivity puzzle*

What happened instead was that employment began to expand faster than at any time since the late 1980’s despite the slower growth in output. In manufacturing, the long decline in jobs since 1973 suddenly came to an end (see chart below for the period since 1997) and firms started taking on labour despite hardly any growth in output.




Source of data: Labour Force Survey

The obvious implication is that ultra-low interest rates from late 2008 changed the relationship between output and employment. We can estimate that around 3 million more jobs were created than would have been the case if productivity had continued to grow at its pre-2008 trend (and interest rates remained close to their pre-banking-crisis levels). Firms have been willing to employ more people at any given level of output than was previously the case.

With rock-bottom interest rates, economic theory would suggest that firms would invest more, leading to higher productivity, but the opposite has happened. Investment has been generally low. With less capital than might have been expected, firms needed more employees than they otherwise would have.

Over the period since 2008 the number of new small businesses formed each year increased by 100,000 above the previous annual average. Even though some of these did not survive long, the stock of businesses can be estimated to have been 350,000 higher over a decade than would otherwise have been the case.

If these businesses employed as few as 5 people each this would have raised employment by almost 2 million in a decade, accounting for the majority of the estimated extra jobs since 2008. Other firms may have faced less pressure to meet profit targets when interest rates were very low and as a result failed to prune labour forces as much as would have been the case under a higher interest rate regime.

## *Jobs, immigration and housing*

One feature of the period since 2008 is that 80% of the extra jobs were taken by people not born in the UK. Many of these people were from Eastern Europe and working in jobs at close to the minimum wage. It is possible that many firms found it cheaper to employ immigrant labour than to invest in labour-saving equipment even at low interest rates. With an extra 3 million jobs employing an additional 2.4 million people not born in the UK (and assuming that most of these were new immigrants), then this would have necessitated around one million additional dwellings over a decade, or an extra 100,000 each year.

Since the stock of dwellings rose by an average of 200,000 a year over the decade after 2009, this level of immigration might have required the equivalent of half of the new houses built.  These dwellings would have been mostly bought by buy-to-let landlords and rented to new immigrants. Assuming the same number of houses would have been built in the absence of additional immigration, then the implication is that fewer dwellings were available for the indigenous population. It is possible that fewer dwellings would have been built in the absence of the extra immigration, but the extremely high level of house prices compared to average wages suggests this was not a major factor.

## *Conclusion*

If this explanation of the great stagnation is correct then the implication is that now that interest rates have returned to the levels typical of the pre-banking-crisis era, employment will begin to fall or least to increase slowly. Numbers of new small businesses will fall back to earlier lower levels and so-called ‘zombie’ companies will fail due to their inability to make a profit at higher interest rates. Productivity will then begin to rise once more as marginal firms drop out of the economy and other firms come under greater cost pressures from higher interest rates to cut employment costs.

Has the great stagnation been a real economic problem? If the main cause was higher levels of formation of companies in low productivity activities, then in itself that may not have been such a bad thing. More cafes, Deliveroo riders or Uber taxis might not have been strictly necessary but were nevertheless useful and were used.

The main long-term issue is maybe that it was immigrants who largely filled the jobs, and most of these will remain even if the jobs now disappear.  Unless output starts to grow much faster, we will end up sharing a fixed economic cake among a larger population. The new Britons will also continue to need dwellings in a country which strongly resists any relaxation of planning controls to accelerate new building.

This is of course all less than ideal. It also stems from the banking crisis which resulted in interest rates falling below 2% for the first time in the 300-year history of the Bank of England. The financial deregulation of the Thatcher era has a lot to answer for.

By Dr Graham Gudgin, for *Briefings for Britain, 27/07/23*

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