Number 60
5 July 2015

Economic Bulletin

THE ESSENTIAL IMPORTANCE OF IMPROVED PRODUCTIVITY

- If productivity is very weak, the national debt will rise every year of this Parliament.
- UK productivity has performed poorly by historical and international comparisons.
- The performance of productivity has varied across different sectors.
- The Government must take an all-encompassing approach to tackle the problem.

Deficit reduction depends on productivity

If productivity fails to grow in the coming years, the Government will fail to achieve its deficit reduction targets. Alongside the planned £30 billion worth of discretionary measures to cut departmental spending, welfare spending and reduce tax avoidance, Government forecasts assume a rebound in productivity. Productivity is the ultimate determinant of real wage growth and rising living standards. In other words, without a recovery in productivity, tax revenues will fall short and demands on welfare spending will rise.

Scenario analysis conducted by the OBR in its Economic and Fiscal Outlook of December 2014 underlines this fact. In a strong productivity scenario of 4%, GDP will grow at almost double the rate under the central forecast. Furthermore, public sector net debt (PSND) would be 56.7% of GDP by 2019/20 compared to 72.8% in the central forecast.

However, in the weak productivity scenario of 0.5%, the average GDP growth rate will less than half of the growth rate in the central forecast. PSND will continue to rise every year to reach 86.6% and the Government will be running a budget deficit every year of this Parliament instead of achieving its planned budget surplus by 2018/19. Whilst the OBR's central forecast has been slightly updated, the difference in outcomes between strong and weak productivity scenarios will be virtually the same.

	GDP growth (%)				
	2015-16	**2016-17**	**2017-18**	**2018-19**	**2019-20**
Central Forecast	2.2	2.2	2.4	2.3	2.3
Weak Productivity	1.2	1.0	0.9	0.8	0.7
Strong Productivity	4.1	4.0	3.9	3.8	3.7

	Public Sector Net Debt (% GDP)				
	2015-16	**2016-17**	**2017-18**	**2018-19**	**2019-20**
Central Forecast	81.1	80.7	78.8	76.2	72.8
Weak Productivity	82.6	84.2	85.1	85.9	86.6
Strong Productivity	78.3	74.9	69.8	63.7	56.7

What has happened to productivity?

The poor performance of productivity in recent years gives little cause for comfort. Labour productivity on the output per hour basis fell by 0.2% in Q4 2014 compared with the previous quarter which means that it is still lower than the pre-crisis 2007 levels. Whilst manufacturing output per hour is 1.8% higher than in Q4 2013, services sector productivity is only 0.7% higher. At the end of 2014, productivity was still 16% below where it would be if it had grown at the pre-crisis rate. In addition, Total Factor Productivity (TFP), which is the growth of output which cannot be explained by the growth of labour and capital inputs, has seen three consecutive years of contraction. TFP fell by 1.5%, 0.4% and 0.1% between 2012 and 2014.

Since 2007, labour productivity has also performed poorly by international standards. On an output per hour basis, productivity in the UK in 2013 was 17 percentage points below the G7 average and 19 percentage points on an output per worker basis. This is the largest productivity gap with the rest of the G7 since 1992. Throughout 2013, productivity grew across the G7 by 1%, although in the UK it fell.

Whilst it has been weak across the economy, there is significant variation in productivity performance across different sectors. For example, wholesale and retail sector productivity is growing at a robust rate whereas, finance, professional services and ICT services remain key weaknesses. More broadly, investment as a share of GDP in the UK is lower than across other G7 or OECD countries and Research and Development spending as a proportion of GDP is also weaker. Impaired allocative efficiency, perhaps a by-product of ultra-loose monetary policy, seems also to have contributed.

In the May Inflation Report, the Bank of England downgraded its forecasts for productivity growth in 2015 from 0.75% to just 0.25% and in 2016 to just 1.25%. This is well below the pre-crisis average growth rate of output per hour of 2.25%. These downgrades in productivity growth have become a persistent feature in official forecasts.

Given the scale of the fiscal challenge which remains, the Government should use the Emergency Budget to recommit itself to eliminating the budget deficit over the course of this Parliament. However, to do this the Chancellor will have to implement a comprehensive programme of policies to generate stronger productivity growth.

The Chancellor is expected to release a Productivity Plan alongside the upcoming Emergency Budget. This is welcome as it is unlikely that the UK will be able to return to pre-crisis productivity growth rates without wide-ranging reforms. As an illustration of the wide-ranging nature of the productivity challenge, below are a collection of proposals covering the diverse fields of competition policy, tax policy, skills policy, deregulation, energy policy, intellectual property and the Sharing Economy.

Proposals

1. Liberalise bank licensing

Reducing the amount of capital required for certain loans would help to ease the process of entry for new, small banks. Allowing more flexibility in the risk weighting of loans could be done by allowing new banks to use averages of the bespoke weights used by big lenders. Challenger banks should also be allowed to share credit risk data which would help them to offer SME banking products. Local authorities should be allowed to use smaller banks, thereby opening a new market for Challengers.

2. Carry out wide ranging programme of tax simplification

The UK tax system is too complex: the length of legislation, the method of drafting, the hugely expanding compliance costs and the introduction of retrospective legislation combine to create commercial and personal uncertainty and cost. While the 2015 Conservative Manifesto pledge to "establish the Office of Tax Simplification on a permanent basis and expand its role and capacity" is welcome, it is not enough: the approach of the OTS has been to identify isolated areas of the tax system for simplification whereas what is needed is comprehensive reform of tax law. This could take the profits of the business as a starting point for tax calculation which could cut the tax code to about one tenth of its current length. For the simplest businesses a three-line account (income minus expenses = profit) would be all that is needed. The Government should also subject tax reliefs and exemptions to a five year review.

3. Simplify and consolidate planning laws

The Government should introduce "Pink Zones" in the planning system which will deliver lighter, streamlined planning regulation and cut through existing red tape. Pink Zones would bring together local residents, developers and councils to achieve consensus over new development and accelerate the development process. They would also increase competition, bypass many current planning regulations and improve design standards by employing a Special Purpose Vehicle as the delivery mechanism.

4. Reform fracking planning applications

The need to spend hundreds of thousands of pounds, and more than a year, to gain planning permission merely for exploratory projects is a barrier to the growth of fracking. The Government should reduce this barrier by placing a strict time limit for local councils to make their decision before it is passed on to Central Government. The Government should also examine treating shale gas fields a matter of national importance and thus a decision for Central Government.

5. Reform the North Sea fiscal regime

The Government should abolish the Supplementary Charge on profits from UK oil and gas production. By reducing the tax burden, the Government would help to revive production and investment in the sector and could well be done at no dynamic cost. In the longer term, the Government should consider incorporating changes in the oil price to mitigate risk. This could act as an automatic stabiliser, cutting the tax rate if market conditions deteriorate.

6. Include EU regulations in the One in Two Out rule

By including both domestic and EU regulation in the rule, the Government would be forced to be bolder in reducing burdensome regulation. By rolling back or at least offsetting the sharp rise in EU regulation, the Government would help to free capital for investment and to deliver longer term productivity gains. It would also encourage the Government to be more focussed on preventing the implementation of EU regulation in the first place.

7. Expand water industry competition

The Government should aim to have a faster introduction of retail sector competition in the water industry than the current April 2017 target. Water industry competition should also be extended to households by reforming the Water Supply Licence regime and reducing consumption thresholds. The Government should also end the "Forbidden to Fail" mantra for water companies and re-examine the case for retail market exit.

8. Increase competition in public sector procurement

The Government should reduce the cap on the size of IT projects and extend the use of two year term contracts. The Government should ensure that all firms involved in domestic procurement processes are fully aware of the expansion of EU wide public sector procurement. The Government should also push for a lower contract value above which EU public sector procurement will be subject to continent-wide competition.

9. Introduce National Apprenticeship Qualifications

The Government should introduce more sophisticated ways to measure how well an apprentice has performed throughout the programme. Also, a standardised grading system equivalent to a university degree classification should be introduced to create National Apprenticeship Qualifications. This will provide more information on the relative performance of different aspects of an apprenticeship which should drive up standards.

10. Expand information given by schools on league tables

Schools should publish information on the employment rates and average earnings of their alumni in school league tables. This would improve parental choice and help to break down the barriers between education and enterprise. Schools should also provide details on the study of ICT and modern foreign languages in league tables. This should be both on the proportion of pupils taking those subjects but also the performance of those pupils.

11. Abolish patent renewal fees, encourage licensing and establish new SME accelerated patents

Patent renewal fees are a poll tax on innovation which hurts start-ups and SMEs in particular. Abolishing patent renewal fees would send a powerful pro-enterprise signal and help to boost the commercialisation of intellectual property. The Government should also abolish the fee on patent licensing and further simplify the application process. The Government could pay for this by allowing the Intellectual Property Office to levy fines on IP infringers.

The Government should also give SMEs the right to request accelerated processing of their patent applications. A patent application can often take between three and four years to complete which is too long for too many. The IPO already carries out some accelerated procedures, such as the popular Green Channel which allows patent applicants to request accelerated processing. SME accelerated patents could be modelled in a similar way.

12. Unleash the Sharing Economy

Local authorities should join in the Space for Growth programme and advertise unused space. The registration process should be simplified for buildings where there is no need for onerous security vetting. The Government should also:

- publish guidance to end the uncertainty over the employment and tax status of Sharing Economy participants
- implement a Sharing Economy personal allowance to build on the current Rent-a-Room allowance
- allow Sharing Economy firms to access GOV.UK Verify;
- continue to oppose attempts to carry out a regulatory crack-down on the sector.

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