The UK's productivity challenge takes different shapes across sectors

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Productivity has been the hot topic in economic circles in the UK for a considerable period and the factors that have held back productivity since the crisis are fairly well rehearsed. The supply of labour has been growing strongly, fuelled by migration, benefit reform and increased labour market participation by older people and this has helped hold down labour costs. At the same time, the cost of capital has risen and capital availability has declined, reducing the attractiveness of investment. Heightened uncertainty and depressed demand has also reduced business appetite for investment and R&D. The low level of interest rates and bank forebearance are likely to have led to capital being tied up in lower productivity firms. And there are some sector-specific developments which will have held back aggregate productivity performance, such as the role that regulatory developments will have played in weakening financial sector productivity.

The outlook for productivity is at the core of forecasting the economic outlook and its recent performance throws up two particular questions:

- **The speed at which productivity returns to trend**: This recession and recovery are unusual in that they follow a global financial crisis, which is a relatively rare occurrence. Consequently, there is quite limited experience to draw on when trying to forecast the rate at which the economy will return to its usual operating capacity.
- **The level of trend**: The other complicating factor is the extent to which elements of the productive capacity of the economy were "destroyed" during the financial crisis. Some areas of the economy – such as financial services – are expected to have permanently lower productivity compared with pre-crisis. But the CBI's surveys also suggest that the economy's productive capacity has been hit across a broader range of sectors.

Post-crisis productivity: the business experience

CBI measures of spare capacity

The CBI's surveys provide some indication of the more longstanding impacts of the financial crisis on different sectors. Our surveys contain questions designed to gauge the degree of spare capacity in firms, which provides an indication of the degree to which output can rise without generating inflationary pressure. In the immediate aftermath of the financial crisis, these measures showed an increase in the quantity of spare capacity, which is what we'd expect following a recession. However, by 2011, measures of spare capacity had returned to "normal" levels, even though it wasn't until 2013 that GDP moved back above its pre-crisis peak.

There are a few reasons for the capacity measures to have returned to pre-crisis norms quickly. One is that productive capacity has been lost. Our regular Answering Practices Surveys (APSs) ask our respondents what they consider when answering the capacity questions, and the 2013 APS results suggest that firms' measures are varied and flexible, along such dimensions as what type of capacity is considered (physical, labour and so on), what proportion of capacity operation is considered satisfactory, and the timescales involved in increasing output. The issue then becomes: to what extent are changes in firms' estimates of their productive capacity temporary or permanent? If permanent, then the level of trend output has fallen, but if temporary, then it could recover under the right conditions.

The sector story

To drill down into what's been going on within businesses since the crisis and to help understand the scope for productivity to recover, the CBI consulted some of our members to try and get a real-world understanding of what factors were holding back labour productivity.

Financial sector

The fall in output per hour experienced in this sector likely 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.

Meanwhile, the finance landscape is evolving, with the emergence of "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.

Transport & storage

Financial services isn't the only sector to have been hit by regulatory changes. Transport & storage is suffering from a shortage of heavy goods vehicle (HGV) drivers following changes to the regulation around employing HGV drivers. 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.

Construction

The impact of skill shortages on productivity is particularly stark in construction. 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.

Hiring has been a preferable method of driving growth relative to investment following strong growth in labour supply. 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).

So what's the solution?

Some of the factors holding back productivity should dissipate naturally over time, such as credit cost and availability and the impact of uncertainty. Labour supply growth should cool over time as older people's participation in the labour market approaches its natural maximum. As interest rates start to rise, we may see more balance sheet repair by banks which may support a capital shift to more productive investment.

The role of increased financial regulation will have a more longstanding impact on the financial sector. A greater proportion of the financial sector will be employed in regulation and fewer in high risk/reward sectors, which in the near-term will suppress productivity.

But there are longstanding features of the UK economic landscape which may be holding the UK's productivity performance back relative to its peers. The quality of UK infrastructure, planning regulations, workforce skills, investment, innovation and R&D are all areas in which the UK tends to compare poorly when considered alongside our international peers. Activity in these areas will be crucial to delivering a fundamental improvement in productivity and living standards in the UK.

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Notes:

- *This post gives the views of its author, and not the position of LSE Business Review or the London School of Economics.*
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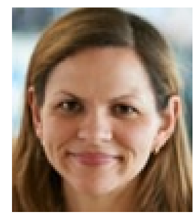

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