How to grow the UK’s dwindling productivity

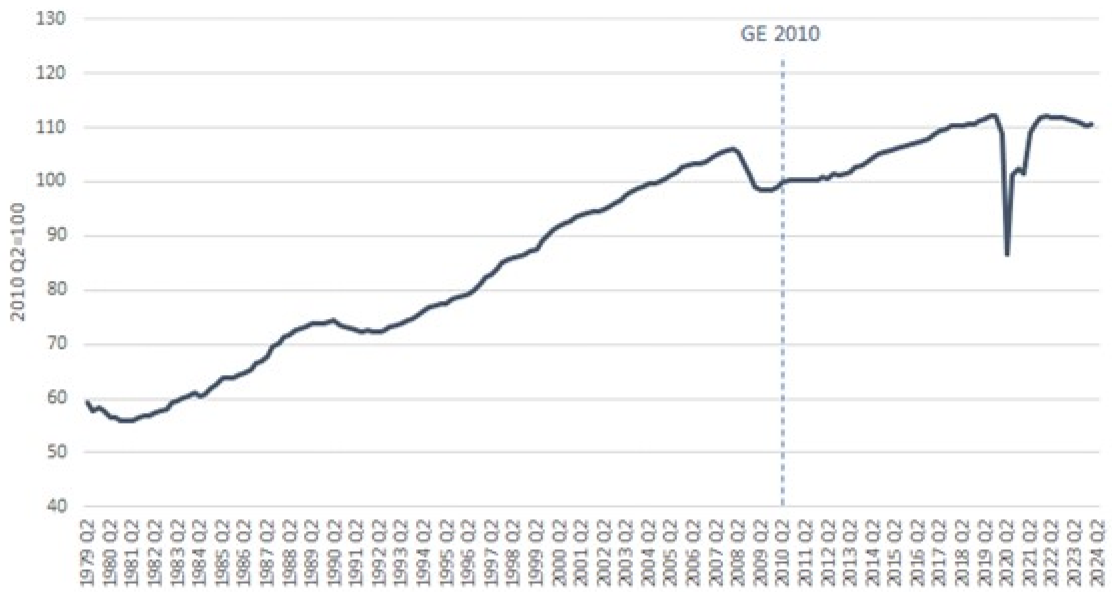
The UK economy is stuck. GDP growth per person has been anaemic over the last 14 years, and last year it actually fell. The cause behind these concerning figures is the collapse in the growth of productivity. If the next government is going to improve public services and living standards, it will first need to improve the economy’s productivity. ***Anna Valero*** *and* ***John Van Reenen*** *assess the Conservatives’ and Labour’s plans for doing that, and argue that a radical approach is needed.*

Improving the UK’s growth prospects is a key priority for both main parties in the run up to the general election. Britain had close to zero growth in national income (GDP) in 2023, and slipped into a recession in the second half of the year. While the recession was short-lived and the economy returned to growth in the first quarter of 2024, the outlook remains poor with the IMF forecasting 0.7 per cent GDP growth for 2024.

The UK’s growth record since 2010

How does this recent experience compare to the bigger picture? Average annual GDP growth between 2010 and 2023 was 1.6 per cent, slower than its average of 2 per cent between 1997 and 2010. But GDP growth is heavily influenced by population trends, so a much better measure of a country’s material wellbeing is the growth of GDP *per person*. On this measure (plotted in Figure 1) post-2010 growth was only 0.9 per cent, about a third lower than the average during 1997-2010, which was 1.4 per cent. Remarkably, GDP per capita was only back to its 2019 level in 2022, and actually *fell* in 2023.

Figure 1: GDP per capita, 1979 Q2-2024 Q1



Gross domestic product (Average) per head, CVM market prices: SA, Series based in 2010Q2 at 100, Series IHXW, release date: 10 May 2024. Source: ONS

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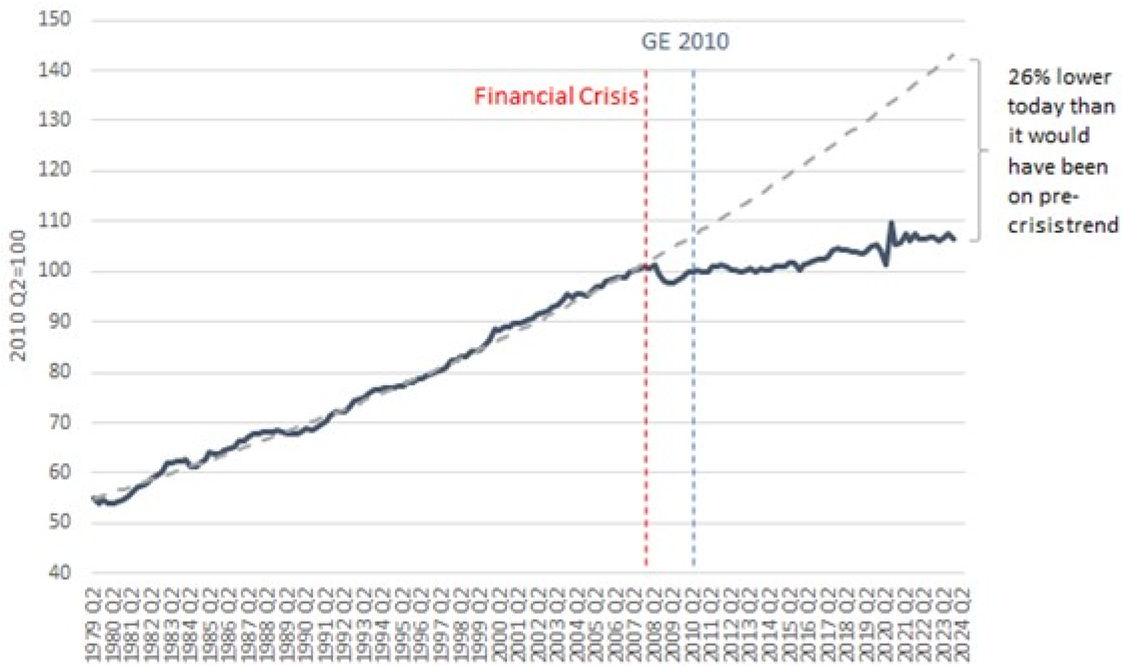
The slowdown in GDP per head growth has come despite increases in the fraction of working age people in jobs. The underlying cause of low GDP per capita growth is the collapse in the growth of *productivity* (GDP per hour, shown in Figure 2). Between 2010 and 2023, average annual productivity growth was 0.5 per cent whereas the 1997-2010 average was over three times higher at 1.6 per cent. And looking at the whole period since the financial crisis shows that productivity is 26 per cent lower today than it would have been on pre-crisis trends. Productivity growth is the driver of improvements in economic performance. The fact it has been so anaemic is the fundamental reason for the problems we face today, from squeezed public services to a stagnation in living standards.

Figure 2: GDP per hour (labour productivity), 1979Q2-2023Q4



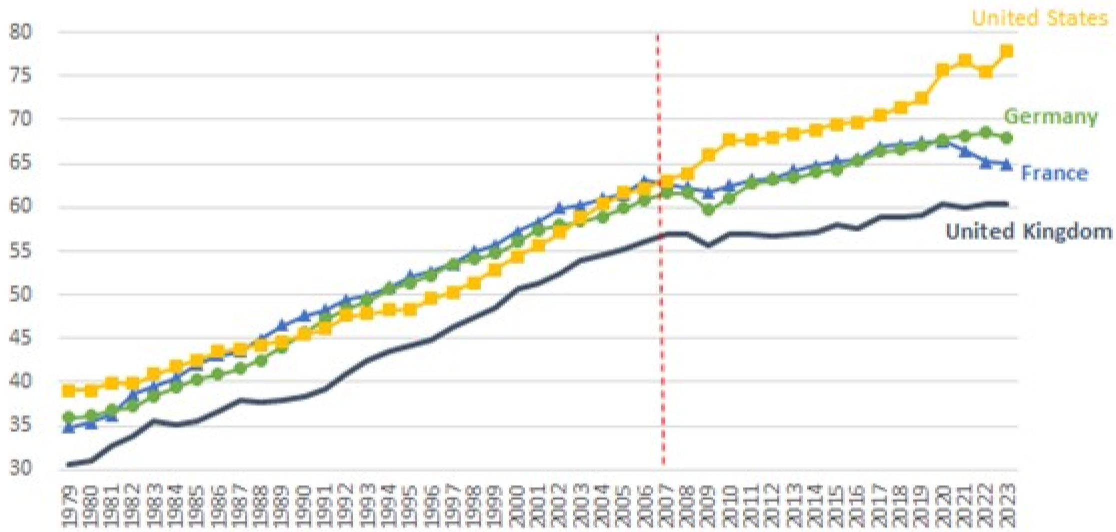
UK Whole Economy Output per hour worked SA, Series based in 2010Q2 at 100, Series: LZVB, release date: 14 May 2024. Source: ONS

International comparisons

Events such as the global financial crisis, the Covid pandemic and the energy crisis were largely outside of the influence of UK policymakers. One way to assess the importance of UK specific factors comparing ourselves to other countries. Figure 3 plots GDP per hour for the UK versus core comparators: France, Germany and the United States. This shows two things. First, that the UK's productivity level has been lower than its main peers consistently over the past four decades. And second, that the UK's post financial crisis productivity growth has been relatively poor – certainly flatter than these comparators until the pandemic.

A decomposition of the slowdown in the UK and its comparators reveals that there have been slower efficiency improvements ("TFP") after the financial crisis in all countries, but that the slowdown in capital accumulation ("Investment") has been particularly large in the UK.

Figure 3: GDP per hour in the UK compared to France, Germany and the US



Source: OECD, Real gross value added per hour (US dollar PPP), data extracted 23 May 2024. Note UK 2023 data were not yet in OECD dataset, so for this year we used growth rate from ONS Output per hour worked series LZVB (release date: 14 May 2024).

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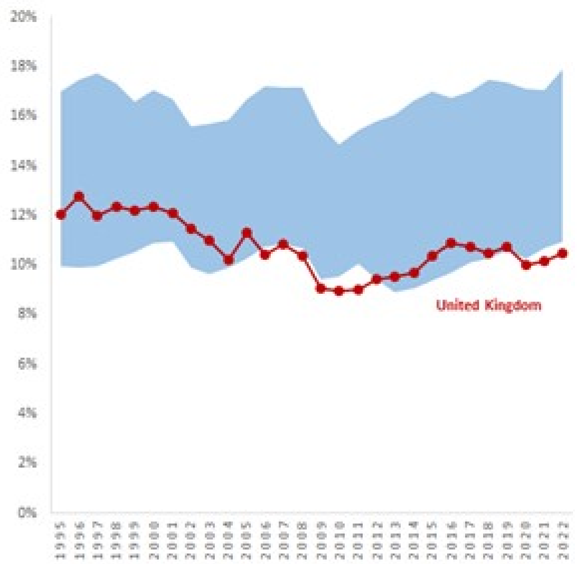
Longer term underinvestment

The economic slowdown has occurred against the backdrop of persistently low levels of UK investment relative to other advanced economies (Figure 4) in both the private and public sectors. The trends differ, however. Private sector investment began falling in the late 1990s, dipped during the financial crisis and then started to recover before stagnating again following the Brexit referendum. The reasons for this are complex and differ over time, but one of the reasons for the recent underperformance is policy uncertainty.

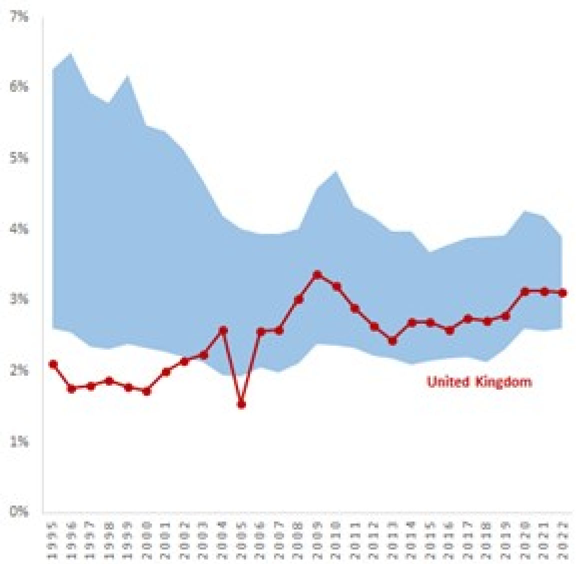
Public sector investment on the other hand was rising during the 1990s and until the financial crisis, suffered during the austerity of the early 2010s, and then recovered slightly between 2014 and 2022. Based on current plans set out in the Spring Budget of 2024, public sector gross fixed capital formation is set to fall as a share of GDP.

Figure 4: Capital Investment (gross fixed capital formation) as a share of GDP, UK and G7 countries

A. Private Sector Investment over GDP



B. Public Sector Investment over GDP



Notes: Sourced from OECD Data Explorer, Data accessed: 28 May 2024. Series: Annual investment by asset and institutional sector: General government and Total Corporations; Annual GDP and components – output approach. All series in national currency, current prices.

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Policies to improve growth

Both main parties have put the economy at the centre of their campaigns. There are a number of welcome shared policy priorities on business investment – such as the need for pension reforms to unlock finance for UK investments, and addressing planning barriers that hold back infrastructure projects and housebuilding. But planning reforms are politically hard and the current government has made very limited progress – the Labour party seems willing to be more radical.

Labour also differentiates itself with an emphasis on stability including via a more explicit and lasting industrial strategy, linking this also to its mission to decarbonise the UK energy system by 2030 in its Green Prosperity Plan. In order to provide more policy certainty and consistency, Labour have committed to bringing back the Industrial Strategy Council, and placing it on a statutory footing.

A key issue relates to financing public sector investment for productivity and net zero. Labour plan additional public sector investment of around £4.7 billion per year as part of its Green Prosperity Plan, and have set out some changes to fiscal frameworks that might be more permissive of higher public investment, but plan to keep to the government's rule of a falling debt to GDP ratio between years four and five of a forecast horizon. This will likely be the binding constraint on investment spending in the next few years.

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The need for a radical approach

While the Conservatives have made some progress on long-term reforms to increase business investment, the party seems still to be focused on tax cuts which will do little to address long-term productivity growth, and which would have to be funded by further unspecified cuts to public services or investment. Labour appears willing to take a more explicitly strategic approach, with a welcome emphasis on net zero in its growth strategy, although it is clearly constrained in terms of what can be committed in terms of resources. The reforms being outlined should be consistent with promoting stability, and more focus on long-term value creation within the fiscal framework. Overall, it is clear that the next government will inherit a challenging economic position and a radical approach is likely to be needed.

This blogpost is based on the CEP election analysis: growth and productivity.

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