Summer budget: High hopes for the productivity plan – is enough being done?

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*In the 2015 summer budget, George Osborne at last identified the UK's productivity performance as an important issue that needs to be tackled. Here, **Anna Valero** reviews some of the measures ahead of further detail on the government's productivity plan due out tomorrow.*

The issue of productivity was left out of the March budget and somewhat ignored during the general election campaign – much to the dismay of economists, for whom weak productivity performance since the financial crisis is the number one problem facing the UK economy. Therefore, Osborne's post-election announcement that dealing with weak productivity would be a priority in this parliament was welcome news.

A productivity plan is to be published on Friday, but the budget announcement gave a snapshot of some key policies in this area. Overall, there are some positive steps – but it is unlikely that such measures are enough to get productivity growing at the rate required to catch up with our international peers like the US, France and Germany who are currently 30 per cent more productive than us in terms of output per hour.

Summer budget productivity measures

Osborne kicked off the discussion around productivity with transport. All areas of our transport system need investment to be on a par with our international peers, but the focus of the speech was on the road network. A new fund for roads will be created, financed through increases in vehicle excise duty. But rail was not discussed, and this is of concern given the delays in key projects like the electrification of the Trans-Pennine Express. Other elements of the infrastructure system were not discussed. In light of concerns around security of supply in energy, one would have hoped for some more focus on measures to increase UK generating capacity.

Next were skills. Dealing with technical and vocational skill gaps is key to improving our productivity performance and the announcement of an apprenticeship levy on large businesses is likely to be an effective way to raise the quantity and quality of apprenticeships (if businesses have to bear some cost of such schemes anyway, they may as well make them effective). The plan to convert student maintenance grants into loans however, is likely to have a negative impact on university applications from poorer students, which would be bad for productivity and social mobility.

The Chancellor then turned to the issue of balancing economic activity across the UK. Planning restrictions have been identified as a key constraint to growth by the LSE Growth Commission, and further granting of powers to more local levels (e.g. via the Northern Powerhouse and other similar schemes) may help to ease these. But the extent to which this is possible is unclear and will depend on the local political economy.

Low investment in capital and innovation is a key problem in the UK. Distortions in the housing market contribute to this. Continuing excess demand for housing, especially in London, and the ensuing endless rises in house prices is a problem for productivity since it implies that investing in property is far more attractive for anyone with some cash to spare than investing in a risky start up. The Chancellor announced a reduction in the tax relief on mortgage interest for buy to let investors (so that tax relief will be at the basic rate of tax, even for higher rate taxpayers) but this is likely to have a marginal impact while the capital gains and rents on properties continue to soar. Demand side policies such as help to buy and right to buy only make these problems worse. The adjustment to inheritance tax also serves to make property investment an even more attractive choice, and is of course bad for social mobility.

Increases in the Annual Investment Allowance are a useful measure for small businesses, but a key constraint for small businesses seeking to invest is access to finance – for which more competition in banking and incentives for different types of finance (such as an allowance for corporate equity) would be needed.

Businesses will certainly be cheering the further reductions in the corporate tax rate (from 20 per cent currently to 19 per cent in 2017 and 18 per cent in 2020), but even at 20 per cent we had the lowest rate in the G7, and some international business leaders have even described the UK as a tax haven. It is unclear that these further reductions were really necessary – especially given the brutal cuts to welfare announced in the same budget.

Another key challenge for the UK is to more effectively use the skills of women. Many of the most productive members of our workforce simply don't find it worthwhile to be in employment (even if they would like to work) given the high costs of childcare and lack of flexibility in many workplaces. The increase in free childcare to 30 hours, as outlined in the Conservative manifesto is certainly a step in the right direction, but does little to address the fundamental obstacles for women since additional childcare is still required. What is needed is more of a cultural change, and we may be able to learn from other countries (such as Scandinavia) in this regard.

The last headline policy announced was the "Living Wage". This may be good news for the lower paid individuals, but they are simultaneously seeing cuts in their benefits so for some the net effect will be negative. In terms of the productivity effect of this policy, the OBR estimates it could have a small impact but only via a change in the composition of the workforce (companies are likely to lay off less skilled workers who are now more expensive). If we were able to find a sustainable solution on productivity, wages would rise organically and this should be the priority.

More needs to be done

An area not focused on in the Chancellor's speech, where we will hope for more on Friday is innovation policy. Our science budget has been falling in real terms as a proportion of GDP, and is lower than our peers. Government financed research and development is important in its own right, and via spillovers into the private sector. We should do better in this area.

We need bold measures to tackle our productivity problem, an issue which is becoming more concerning by the day (the OBR has just lowered its forecasts of productivity growth). Creating more of a climate of long-termism amongst business and policy makers is required to address a challenge of this scale, particularly because the payoffs of policies implemented today may take years to be realised. Let's hope Friday's plan reflects this.

About the Author

Anna Valero is in her fourth year of the LSE MRes/PhD in Economics, and works on the Productivity and Innovation programme. Her work is focused on firm organisation and workforce skills, and their effects on productivity and innovation.