Britain needs a new approach to fix its shameful productivity record

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VIEWPOINT

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Britain needs more examples of high productivity, which Amazon, *pictured*, is known for

Virtually all chancellors aspire to improve Britain's shamefully poor productivity record. Few succeed. Can Philip Hammond, who at last week's Conservative Party conference identified productivity as one of the key challenges for his Chancellorship, hope to do any better?

For Britain to succeed and prosper in the post-Brexit world, it is vital that he does. Productivity growth – more output for less input – is the magic ingredient which delivers higher living standards. It's why real wages rise over time, and it's why, at least in the modern age, each generation has been significantly better off than the last one. Without it, living standards stagnate or decline and, as we are seeing, political and social tensions rise.

Poor productivity growth, or rather the absence of it, is therefore an urgent cause for concern.

The phenomenon is by no means confined to Britain. Since the financial crisis, it has been common to virtually all Western economies. Yet for Britain, there is at least the opportunity to play catch up, for we have a much longer-term issue with poor productivity than some of our main rivals. It's not just the US and Germany that the UK lags, but France, the Netherlands, Sweden and even Italy.

Even narrowing the margin just a little would pay big dividends. If Britain could raise its productivity rate of growth by just one percentage point a year, Hammond points out, we would, within a decade, add £250bn to the size of the economy, or £9,000 for every household in Britain.

At its best, the UK is as productive as anywhere, yet such examples of world-beating performance are patchy and highly concentrated geographically. Basically, London and the South East are fine. It's the rest of the country we need to worry about. If rates of productivity seen in London could be applied nationally, even the US would be left trailing.

Yet it is the wider, worldwide problem of poor productivity growth I want primarily to address here. By now, we are all able to list some of the bigger, macroeconomic causes of this sickness – from ageing populations, poor rates of labour force participation, inadequate investment, a broken banking system and a decline in the number of new company formations.

Yet at its heart is a paradox which has so far gone largely unexplained; on the one hand we see apparently transformational technological progress and, what with the prospect of driverless cars, breakthroughs in medical diagnostics and cures and even colonies on Mars, the promise of lots more to come. On all kinds of fronts, from LED light bulbs to factory automation, the world is becoming massively more efficient in its use of both resources and labour.

So much so, that the main worry among policymakers is not so much that of insufficient innovation but rather "technological unemployment" – the fear that automation will put us all out of a job. Yet if this is indeed what's happening, it's not yet apparent in the productivity figures.

Some of this seeming mystery can be explained by faulty statistics that fail adequately to capture the dynamics of the new economy. Measuring the transition from an economy based on tangible production to one centred more around ideas and knowhow is proving troublesome.

But these deficiencies cannot be the whole story. A new paper by economists at the OECD provides what I think may well be a large part of the remaining answer. The world, they suggest, is divided between a relatively small number of "frontier companies", where technological take-up is high, and a great hinterland of laggards which, despite its inefficiencies nevertheless manages to scrape by and survive.

Frontier companies are typically three to four times more productive than the laggards, tend to be big multinationals, and pay well. Their higher productivity also means they have significantly higher mark-ups. These differences apply in equal measure to service and manufacturing sectors.

It has obviously always been the case that some companies are swifter to adopt and exploit new technologies than others. What's changed is the process of diffusion by which new, productivity-enhancing technologies are more widely adopted throughout the economy. One way or another, it has become broken. Productivity growth is therefore becoming increasingly dispersed. New technologies are spreading rapidly across and between countries, but their diffusion to all firms within individual economies is slower and slower. It is small wonder that so many in the West find themselves left behind by globalisation. Many of its fruits are simply not being plucked.

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Markets, it seems, are becoming ever more prone to "winner takes all" dynamics, with a small number of large firms able to manipulate standards and regulations to their own advantage. Today's new technologies tend to be costly and complex to introduce, and require high skills, which smaller players struggle to emulate. As a result, barriers to entry are getting higher, and markets less competitive. Virtually all advanced economies seem to have less competition in key sectors than they used to, with many industries becoming significantly more concentrated than they were.

Capital may also have become quite widely misallocated to asset rich but productivity poor companies during the financial crisis and the subsequent low interest rate environment. The process of "creative destruction", by which older, poorly performing companies are forced out of business by more innovative, competitive newcomers seems to have substantially ground to a halt. Productivity growth is becoming increasingly dispersed, there is less entrepreneurialism, and the laggards are not going out of business as they should.

Hammond is plainly right to focus on Britain's poor productivity record. And there is no doubt something to be said for the enhanced infrastructure spending and public investment in education and training he suggests as remedies. But the key takeaway from the OECD research is the urgent need for structural reform, including product and labour market deregulation, to get the broken diffusion machine going again.

Central banks can do nothing more to save capitalism from itself. There is also a limit to the effectiveness of further fiscal interventions. A different approach is called for.

Business

has seen its share price climb from 95.5p to 142.6p.

Share price

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