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Could Britain work harder?

The economy is shrinking yet there are more people in work. Should we be worried that our productivity is declining?

Kathryn Cooper, Economics Correspondent Published: 19 August 2012

When Stephen Avila, a solicitor, was given notice of redundancy three years ago, he, like thousands of workers hit by Britain's double-dip recession, decided to set up on his own.

Birkett Long, the firm where he had worked for seven years, advised mostly medium-sized manufacturing companies around Chelmsford, Essex, and legal work was one of the first things the businesses cut when the downturn struck.

Avila, 36, was already designing websites in his spare time and decided to try to earn a living from it. With the help of Freelancer.com, an outsourcing website, he set up Surge Digital, an agency that helps small local firms with their online marketing.

"The first year was very tough and there were many times I questioned whether I had made the right

decision," he said. "We had only a handful of clients and were running at a loss.

"By the end of the year, however, I realised I might be able to make a career out of it. We now have nine staff and offices in Farnborough as well as Colchester, and turnover was up 300% last year."

Workers like Avila are critical elements of the riddle that is perplexing economists and which the Bank of England has called a "genuine puzzle". Employment is rising — more than 200,000 people joined the workforce between April and June — but the economy is shrinking, with output down 0.7% over the same period.

That means productivity — the output each British employee produces for every hour worked — dropped by 1.2% in the second quarter and is now 2.5% below its level when the economy peaked in the first quarter of 2008.

So is Britain not working as hard as it was before the credit crunch? Or, as so often is the case in this recession, are the official figures misrepresenting the economy?

Part of the answer lies with workers such as Avila, who have left full-time employment and returned to the labour market on lower pay and are now producing less than they did before the crisis — initially at least.

The percentage of permanent employees in the workforce has fallen from 58.8% in the first quarter of 2008 to a record low of 54.6% in the second quarter of this year, according to Citigroup, the investment bank.

Economists increasingly fear that there has been a deeper structural shift in the British economy and that output may never get back to the heady levels achieved before the financial crisis.

Simon Wells, chief UK economist at HSBC, said: "We are three years into the recession and by this stage you would expect output and productivity to be picking up quite strongly, but they are not.

"The Bank of England is now wrestling with the issue of whether this weakness reflects a permanent change in the capacity of the British economy to supply goods and services.

"Are workers who have had to move into other industries not quite as productive as they were? And does a lack of investment by firms mean that capital — computers, machines — is not as productive as it was? Unfortunately, nobody is sure."

The answers to these questions will have big implications for the government. Last November, the Office for Budget Responsibility (OBR), the fiscal watchdog, assumed that productivity growth would rise to 2.1% in 2014 and 2.2% beyond that.

That is in line with productivity growth in the boom years before the credit crunch and recession, but if it turns out to be too optimistic, the coalition's plans to reduce the deficit could take far longer to work than expected. This will heap further pressure on George Osborne, the chancellor, to come up with a plan B.

"Understanding this productivity puzzle is of increasing importance for policymakers," said Wells.

DAN DALEY could have picked a better time to buy the franchise for the Folkestone branch of Miles & Barr, an estate agency in Kent. At the peak of the housing market in 2007, the branch sold about 20 properties a month; two years later, this had slumped to five or six.

When Daley, 40, took over the branch in 2010, he had to decide whether to keep on its seven staff: five agents, a mortgage broker and an assistant. Rather than make anyone redundant, he offered them all the chance to stay — but on a self-employed basis rather than as staff.

"I offered them all the choice, and they took the self-employed route because they could see it offered them more flexibility," he said.

Daley has since taken on two more people to meet demand from buy-to-let investors and sales are up to 10 or 12 properties a month. Scores of firms — and their workers — have had to make tough choices such as this during the recession.

The latest labour market outlook from the Chartered Institute of Personnel and Development (CIPD) found that almost a third (31%) of private sector firms had maintained staff levels higher than required by their level of output over the past year — largely to retain their skills.

This could be one of the reasons employment has remained high and productivity particularly weak. Firms have hoarded labour throughout the recession to avoid the cost of hiring and firing, but the employees they retain have less work to do.

Gerwyn Davies, labour market adviser at the CIPD, said: "The tenacity with which employers are hanging on to skilled labour is a reflection of the high value they place on it and the damage they fear will be done to their businesses if they are forced to start making more redundancies.

"But there is only so long they can hold out for growth. The labour market is approaching a game-changing phase — one that could shape Britain's capacity to compete for a generation. Private sector firms should be using any spare capacity they have to train, to innovate, or to focus staff in areas such as business development to help drive the medium-term prospects of their firm and the UK economy."

Ultra-low interest rates and leniency by lenders have also meant far fewer companies have gone bust in this recession than in the early 1990s, despite the fact that the downturn has been deeper. The business insolvency rate in the last quarter of 2009, at the end of the recession, was only 0.3% compared with 0.8% in the final quarter of 1992. Again, this has kept employment up but pushed productivity down.

Companies have also been able to retain more staff than in previous recessions because wage growth has been extremely weak, which has kept a lid on labour costs. Total pay (including bonuses) rose by only 1.6% in April to June compared with the previous year, according to the Office for National Statistics — but inflation is running at 2.6%.

In America, where inflation during the crisis was much lower than in the UK, and therefore real labour costs were higher, firms had more incentive to lay off workers. The US unemployment rate rose far more sharply in the downturn — from about 5% in 2008 to 10% in 2010 — but has fallen just as sharply in the recent recovery. The rate in the UK has fluctuated between 7.5% and 8.5%.

All this points to British companies with a large amount of spare capacity — underworked staff who can raise their game once the economy picks up, which will lead to a rise in productivity.

An alternative — and more worrying — explanation is that many firms are already at full capacity and the lack of productivity is a more permanent feature. The last quarterly survey from the British Chambers of Commerce found that the percentage of manufacturing firms operating at full capacity rose by three points to 39% in this year's second quarter, while in services it edged up one point to 36% — the strongest level since the second quarter of 2011.

Lord Desai, one of the signatories to the 2010 letter (Francesco Guidicini)

"Tight credit conditions may have prevented new and productive start-up companies entering the market and stifled investment opportunities. The investment recovery has been particularly weak, meaning workers have less [or older] capital, making them less productive," said Wells.

In this scenario, the Bank of England's attempts to pump money into the economy through quantitative easing and the Funding for Lending scheme will push up inflation again, because firms operating at full capacity will raise prices.

HOWEVER, John Philpott, formerly with the CIPD and now an independent labour market economist, offers a more benign view. He suggests the weakness in productivity could be just a "statistical illusion" caused by improvements in the labour market.

He points out that despite the big increase in private-sector employment in the past year, there has been barely any increase in the level of vacancies. Indeed, vacancies are still down on their mid-2010 levels. This suggests the labour market has become more effective at filling posts.

"To stay unemployed is much more difficult now because there is a penalty for remaining out of work for a long period of time, so people move back into the jobs market fairly quickly. This is a structural improvement in the labour market rather than anything to do with output, so you get almost a statistical illusion on productivity," Philpott said.

Michael Saunders, economist at Citigroup, agrees that weak productivity is in fact a positive sign. "The current mix of weakness in real pay and weakness in productivity is a major supply-side success, in our view.

"Some people who have lost jobs as full-time employees are re-entering the labour market via self-employment, part-time work or temporary jobs. Such jobs may have lower pay and lower productivity than their previous jobs, but are preferable to unemployment — both for the individual and the country as a whole," he said.

The final — and simplest — explanation is that GDP figures misrepresent the health of the economy and that productivity will improve as output picks up. Economists expect GDP in the second quarter to be revised up, while growth in the current quarter could be as high as 1.7% on some forecasts as the economy bounces back from its early summer lull.

This is a common pattern in recessions. Official data at the end of 1992 showed that the peak-to-trough fall in output was just over 4%, whereas data now show a much shallower 2.5% decline from the peak.

Most economists agree that output must pick up soon, otherwise either unemployment will rise or productivity will remain exceptionally weak. Howard Archer of IHS Global Insight, the analysis firm, said: "Unless the economy starts showing sustained decent underlying improvement, pressure will increase on firms to release some of the workers they have been holding on to.

"We suspect that the number of unemployed will reach a peak of 2.8m in 2013, which would see the unemployment rate reach 8.7%."

What economists really think of Osborne

In February 2010, 20 senior economists wrote a letter to this newspaper backing the Conservative party's deficit reduction strategy, in what would become a turning point in the run-up to the general election in May 2010.

The letter, signed by eminent figures such as Sir Howard Davies, a former deputy governor of the Bank of England, called on the Labour government of the time to act more quickly to cut the budget deficit than in plans set out by chancellor Alistair Darling.

Shadow chancellor George Osborne promptly claimed that Labour's "argument on the deficit had collapsed".

Last week, the debate emerged again when the New Statesman magazine claimed that the letter's original signatories had turned against Osborne. But had they really?

First, half the economists either refused to talk to the magazine or were on holiday. And had the other 10 really changed their minds?

In the original letter, the economists wrote: "In order to be credible, the government's goal should be to eliminate the structural current budget deficit over the course of a parliament, and there is a compelling case, all else being equal, for the first measures beginning to take effect in the 2010-11 fiscal year."

None of the economists quoted in the article said he or she had undergone a change of mind on this particular point. Even if they had, Osborne has too. In his original deficit reduction plan, the structural current deficit was to be eliminated in 2014-15, but this target has since been set back until after this parliament.

What the economists did say is that capital spending — as opposed to current spending — should increase to boost the economy, but that is not a reversal of the position in their original letter.

Roger Bootle, managing director of Capital Economics, told the New Statesman: "If I were chancellor at this point, I would alter the plan, I would stop the cuts to public investment and I might even seek to increase it. The key thing is to try and get the private sector to spend its money and that may require a bit of government spending to prime the pump."

The original letter gave the chancellor considerable flexibility anyway. "The exact timing of measures

should be sensitive to developments in the economy, particularly the fragility of the recovery," it said.

The other signatories of the letter included Tim Besley, Charles Goodhart, Albert Marcet and Christopher Pissarides of the London School of Economics; Lord Meghnad Desai of the House of Lords; Ken Rogoff of Harvard University; and Anne Sibert of Birkbeck College, University of London.