



## Press Release

### Piecing together the productivity puzzle

Since 2008 employment levels in the UK have been remarkably robust, and the unemployment rate, while too high, has remained mercifully low given the sharp falls in national income. The contrast with the recessions of the early 1980s and 1990s is dramatic.

The other side of this coin, though, is that productivity has slumped. More of us are working but, on average, we are producing 2.6% less output for every hour worked than we were at the start of 2008. More starkly we are producing 12.8% less than we would have been had the pre-recession growth in labour productivity continued.

In another reversal of long term trends, and in contrast to the slump in overall labour productivity, measured public sector labour productivity has risen.

In a new paper published today, IFS researchers address these *Productivity Puzzles*. There are many factors affecting productivity. We find little evidence that the overall fall has been caused by labour hoarding, the demise of financial services or changes in workforce composition. Instead, we conclude that the key contributing factors are likely to be low real wages, low business investment and a misallocation of capital.

This paper is a pre-released chapter from the February 2013 IFS Green Budget, funded by the Nuffield Foundation and to be launched on Wednesday 6<sup>th</sup> February.

#### Explanations for falling private sector productivity

**A more flexible labour market and responsive benefit system.** Real wages have fallen. Lower real wages have played a part in reducing aggregate labour productivity by allowing firms to employ more workers than they would otherwise have done.

We conclude that **low real wages** have been encouraged by more robust labour supply than in previous recessions, in part due to negative wealth shocks and pensions reform. In contrast to the 1980s and 1990s, economic inactivity has not increased. A benefit system with tighter job search requirements may have encouraged some groups to seek work. The labour market itself has likely been more flexible with “insiders” exercising less power to protect wages at the expense of jobs.

**A sharp fall in business investment.** Business investment remains 16% below the pre-recession high. The fall has been sharper and more persistent than in previous recessions, likely aided by high levels of uncertainty. If workers have less, and less good, capital to work with they will produce less.

**Misallocation of capital** is also likely to be reducing productivity. An impaired financial sector that is extending forbearance to low productivity firms while being more risk averse in funding new projects seems to be reducing firm entry and exit. And firm turnover is a key driver of aggregate productivity increases.

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### **Factors that can't explain the size of the productivity fall:**

**Labour hoarding.** The evidence that firms are employing more workers than they need for their current output levels is weak. Employment is growing not static. Quarterly flows of people into new jobs are higher than before 2008. The majority of firms will have adjusted their labour inputs by now.

**The demise of financial services.** The fall in aggregate labour productivity is not the result of a change in the industrial composition of the economy. Instead, the aggregate fall in productivity has resulted *entirely* from falls in productivity within industries. While a fall in the productivity of the financial sector has played a role in overall levels of productivity, there has been no shift in the workforce away from the financial sector.

**Changing workforce composition.** There are now more part-time workers and more self employed workers than prior to the crisis. They may be less productive than full time employees. But on average workers are also higher educated, more experienced and longer-tenured. We conclude that the effect of compositional changes to the workforce is much less important than falls in the average productivity of all workers.

### **Public sector bucks the trend with an increase in measured productivity**

In contrast to the private sector, public sector employment has contracted sharply – a 6% fall since the end of 2009 has almost completely reversed the increase in public sector employment over the previous decade. At the same time public sector output, as measured in the national accounts, has slightly increased. This suggests an increase in productivity in the public sector.

This turnaround relative to the private sector is particularly surprising given that historically, measured public sector productivity growth has been close to zero. In addition a large part of public sector output is measured based on the volume of inputs (largely employment).

An increase in productivity may suggest that there were unexploited productivity gains in the public service before the recession. However, the long run effects of lower employment on service quality remain to be seen

Helen Miller, a Senior Research Economist at IFS, said: “Given the scale and persistence of falls in output since 2008 it is remarkable that there are more people in work today in the UK than there were before the recession. The result though is a dramatic fall in labour productivity. The scale of the productivity fall, and the degree to which it is permanent, matters for policy prescriptions.”

“The labour market seems to have become much more flexible. And successive governments appear to have learnt from some of the great mistakes of the 1980s. Two decades of reforms have ensured that the benefit system is doing a much better job of ensuring that people remain in touch with the labour market.”

Wenchao Jin, a Research Economist at IFS, said: “The fall in labour productivity seems to have been driven by low real wages and low firm investment. Productivity slowdown has happened right across the economy. They have not been driven by a change in the composition of the economy nor by a change in the composition of the workforce”.

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*We are delighted to have produced this year's Green Budget in collaboration with Oxford Economics and are very grateful to the Nuffield Foundation for providing funding. We are also grateful to the Economic and Social Research Council for funding much of the day-to-day research at IFS that underpins the analysis in this report.*

Notes to Editors:

1. This research is published in 'Productivity Puzzles', Disney, R., Jin, W. and Miller, H., in *The IFS Green Budget 2013 (forthcoming)*, Emmerson, C., Johnson, P. and Miller, H. (eds), IFS, February 2013: London. The authors are Richard Disney ([richard\\_d@ifs.org.uk](mailto:richard_d@ifs.org.uk)), Wenchao Jin ([wenchao\\_j@ifs.org.uk](mailto:wenchao_j@ifs.org.uk)) and Helen Miller ([helen\\_m@ifs.org.uk](mailto:helen_m@ifs.org.uk)).
2. The Green Budget 2013, edited by Carl Emmerson, Paul Johnson and Helen Miller, will be launched at 10am on Wednesday 6<sup>th</sup> February 2013 at Senate House, London (<http://www.ifs.org.uk/events/863>). To reserve your place please contact Bonnie Brimstone at [bonnie\\_b@ifs.org.uk](mailto:bonnie_b@ifs.org.uk);
3. For embargoed copies of this specific chapter or other queries, contact: Bonnie Brimstone at IFS: 020 7291 4818 / 07730 667013, [bonnie\\_b@ifs.org.uk](mailto:bonnie_b@ifs.org.uk);
4. Previous editions of the Green Budget, can be found at: <http://www.ifs.org.uk/budgets>;
5. The Nuffield Foundation is an endowed charitable trust that aims to improve social well-being in the widest sense. It funds research and innovation in education and social policy and also works to build capacity in education, science and social science research. The Nuffield Foundation has funded this project, but the views expressed are those of the authors and not necessarily those of the Foundation. More information is available at [www.nuffieldfoundation.org](http://www.nuffieldfoundation.org).

