Regional Economic Development
Local Economy Briefing 19

Productivity and Industrial Strategy Revisited

Introduction

The government's proposals for a "Modern Industrial Strategy" (green paper January 2017) could contribute significantly to the breaking of the current, sub-optimal economic structure and performance of the UK economy. At the time of writing, however, it is unclear how far (breadth and depth) and how soon it will be developed. We have had some energy-related announcements on electric vehicle aspirations but still await a promised, full white paper "before the end of the year".

In July 2017, the new, independent Industrial Strategy Commission (born out of the Universities of Manchester and Sheffield) released "Laying the Foundations" which considers the need, objectives and foundations for a prospective 'fresh' strategic approach to economic development. This commission provides plenty of expertise and advice in framing a renewed development model, calling for strategic economic management to create the conditions for investment in productivity on the supply side and to do this across the regions through the promotion of innovation and skills.

The "Foundations" document lists desirable strategic goals as:

- decarbonisation of the energy economy,
- adequate investment in infrastructure,
- sustaining health and social care,
- unlocking long-term business investment,
- supporting high value exports and
- spreading growth across the country.

It seeks a better institutional framework, better place-based productivity, better science and research-led growth, better competition policies, better finance and investment linkages, better skills development and innovation, and better alignment between the state's purchasing and regulatory power and business innovation and growth.

We can only support these principles. Although UK regional policy has been inconsistent, with a lot of capacity building and real activity thrown away over the years because of political tribalism and short-termism, these ideas have been the foundation of much thinking about regional development for decades.

Against the current, uncertain, international and domestic background, however, the need for real, sustained action is now paramount. We await the government's promised white paper on a "Modern Industrial Strategy" with great interest.

Productivity & Growth: the 'holy grail' of regional development.

In the first quarter of 2017, UK output per hour actually fell by 0.5%, taking it back below the 2007 peak. Although we may not be measuring all aspects of productive change, no increase in recorded productivity for a decade is bad for all of us - now and in the future, especially in a world unsure about future UK trading relationships.

Why is productivity so important?

Simply, productivity is the **only source of sustained higher living standards** over time. The economy creates value by businesses (predominately) producing 'output' which generates 'incomes' that can be 'spent' on that output. There is a circle from production, through earnings to expenditure which we measure nationally, albeit imperfectly, by gross domestic product (or gross value added) in a given time period – usually a quarter or a year.

This circle is dynamic. Economic growth has the potential to expand the circumference of the circle, adding more value each year and distributing this to businesses and households (and governments) as money to spend or to accumulate assets/wealth. Essentially, aggregate growth determines the size of the 'cake' we have to share amongst ourselves. We are also concerned with the make-up (ingredients) of that 'cake' and how it is cooked - how good it tastes. Over time, economic growth raises current living standards by making a bigger and better cake to be shared out amongst the UK population[1].

[1] We could have a long debate about the true, net position given environmental conservation issues and other negative effects of growth that are not measured well by GDP – perhaps we can review that another time.

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Why can't we do without growth?

Sometimes, it is argued that economic growth is not the only aspect of the economy that we need to consider. There are three basic reasons, however, why it gets so much political, media and business attention.

- First, the **population is increasing**. If the economic 'cake' does not grow, on average, most/many of us will get poorer year-by-year. Growth has to, at least, match the growth in the population just for living standards to stand still. This part of growth can be driven largely by the size/scale, engagement and performance of the workforce. Over the last decade, UK growth has been mostly of this sort – i.e. employment driven. We have thrown more people at the economy (numbers in employment) and they have increased output (grown the cake) but, with output per worker barely changed (in real value terms), for many, average, real household incomes have not really budged (the cake does not taste any better).

- Second, over time, we tend to innovate by **learning how to do things better**. Learning means we can produce more output with the same inputs as we did before and/or the same output with less inputs. If the total 'cake' does not grow, this suggests we do not need as many workers – unemployment rises and the social gaps between those 'in' and those 'out' of the economy get bigger – a potential recipe for a nastier tasting cake. "Unfair" distribution of value can lead to social indigestion and disruption. Aspects of this were evident during the recent General Election and the BBC salary furore. More positively, *doing things better* (increasing productivity) releases resources which, in a growing economy, allow us to *do better things* (also increasing productivity). Productivity growth releases resources for allocation to further 'progress' and that means growth.

- Third, human beings have **aspirations.** We expect to earn more when we are 45 than when we are 25 and we hope our children will be better off than we are. If we are to earn more when we are older and the cake does not grow (i.e. a zero-sum game), we can only do so by making someone else worse off (the old, the young?). We can only earn more if we are producing more value. For the individual, experience and skills increase over time and he/she can, therefore, add more value and be paid more. This only works for all, however, if the overall cake is growing, especially when we consider the potential for changes in wealth between generations. I am “better off” than my father was and he was “better off” than my grandfather was because the UK economy experienced productivity-led growth through most of the twentieth century. Will the same be true for my son in the twenty first?

Living standards need growth and growth needs productivity

This is where productivity comes in to its own. Over time, growth has to come from producing more with the resources we have in order to grow the cake in a way that creates more and ‘better tasting’ value. Productivity drives profit in the widest sense and profit is what can be distributed around for ‘everyone’s’ benefit. The problem of the last decade is that this has not been the case. As a result, many people do not feel any better off than they did ten years ago.

The bottom line is we cannot pay ourselves higher wages if we are not adding more value and that means higher productivity. Moreover, the risk is that, without growth in productivity, some sections of society will raise incomes at the expense of others. This can lead (as now?) to economic and political disquiet between young and old, rich and poor, and capital and labour. Overall, the second half of the last century was a lesson in how growth through higher productivity raises living standards. So far, the current half century is a lesson in the opposite: low productivity seems to be undermining sustainable living standards. The Great Recession (2008/9) and its aftermath have shown that low productivity growth creates economic and political tensions.

The simple idea about higher productivity and growth is that we need to produce more and better than we did before with the resources we have and, if the resources we have are increasing, we can grow even faster.

A classic example is agriculture which used to take most of the UK workforce to feed (sometimes badly) a much smaller (than today’s) population, but now takes less than 2% of the workforce to produce more output and to feed (with imports) a huge population. Simplistically, the agrarian revolution in productivity and distribution released labour for industrialisation and, in time, wider growth in living standards.

In the last few decades, we have seen the same effect in manufacturing. Employment levels have dropped as more productive manufacturing industries have released resources for the burgeoning services sectors. In motor vehicles, for example, the UK now produces more and higher value goods with much less labour than it used to. Our remaining manufacturing capacity is excellent - the issue now is whether there is simply enough manufacturing left.

For this century, the question is whether the same productivity trick can be pulled with services, which now employ most of the workforce. The digital revolution is increasing productivity in many services, potentially raising growth and releasing people and other resources for other 'new' activities.

We do not know what the next phase of development will be. Just as people in the early nineteenth century could not forecast (and some were fearful of) where the industrial revolution was heading, we cannot predict where the digital revolution is taking us. But, if it boosts productivity permanently, there is no reason for the impact to be any less profound and, potentially positive for economic, environmental and social sustainability.

What drives productivity?

Back from utopia, there are a few key drivers of productivity to consider. Four of these are about improving the supply side of the economy and one about the demand side.

- **Investment**… Firms grow by creating and satisfying demand and do this by adding value. Over time, this means **increasing capacity** through investment in new plant and machinery. More broadly, it means investment in the wider infrastructure – e.g. transport, communications, housing and energy. In a modern, mixed economy, the latter is often heavily influenced by government.

- **Innovation**… Firms grow by creating new or better products and developing new and better processes. The **invention, application and dissemination of new technologies and techniques** builds productive value - maximising revenue whilst minimising costs. The 'cake' gets bigger and better, producing more reward (private and social profit) for distribution to wage earners and shareholders.

- **Skills**… Firms grow by having a **better workforce,** in both qualitative and quantitative terms, that can create the higher value. There is a role for business, educators and the state in increasing competencies (building productive potential) through education and training. Working together, this can help to replace current 'leavers', enhance the present workforce and anticipate future needs.

- **Entrepreneurship**… Firms grow by **being aspirational, generating new ideas and taking risks**. Entrepreneurship is a vital component of the 'growth through productivity' process because it develops leadership, creates new models of value and stimulates the process of creative destruction, driving dynamic business change.

- **Competitiveness**… Firms grow by selling more, which means being competitive. You can be entrepreneurial and innovative (have good ideas and techniques), invest in the right capacity, products and services, and technologies, and apply high skills but, in the end, you need to penetrate markets. All the evidence is that **businesses who are involved in more markets,** especially through overseas exports**, are more productive, add more value, employ more people, pay better wages, innovate more, and grow better and survive.**

Conclusion

In the last few pages, we have discussed productivity-led growth: why it is important and what drives it. It is vital to all our living standards but, over the last decade, it has been sadly lacking. Currently, the risk is that uncertainties about the UK's policy, trade and regulatory framework, raise new barriers to productivity. In response, the role of development activity coming out of any "Modern Industrial Strategy" is vital to mitigating, eroding and removing those barriers at all spatial and sector levels.

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