Productivity

Productivity is a measure of the **efficiency** of the labour force measured by **output per worker** or **output per worker hour**.

The advantages of higher productivity

Productivity is the main determinant of **living standards** – it quantifies how an economy uses the resources it has available, by relating the quantity of inputs to output. As the adage goes, productivity isn't everything, but in the long run it's almost everything.

Higher productivity can lead to:

(1) **Lower average costs**: These cost savings might be passed onto consumers in lower prices, encouraging higher demand, more output and an increase in employment.

(2) **Improved competitiveness and trade performance:** Productivity growth and lower unit costs are key determinants of the competitiveness of British firms in global markets.

(3) **Higher profits**: Efficiency gains are a source of larger profits for companies which might be re-invested to support the long term growth of the business.

(4) **Higher wages**: Businesses can afford higher wages when their workers are more efficient.

(5) **Economic growth:** If the British economy can raise the rate of growth of productivity then the trend growth of national output can pick up.

The productivity gap

The level of GDP per worker and GDP per hour worked in the UK is well below that of the United States, France and Germany. This is known as the **productivity gap**. Some progress has been made in closing the gap but there is still much work to do.

No one factor on its own is sufficient to explain the differences in efficiency.

(1) **Relatively low rates of capital investment** – i.e. the failure of the economy to invest and thereby to raise the stock of physical capital available to the workforce

(2) **Low rates of spending on research and development** – The UK now devotes much less of GDP to research spending than other nations and this impacts on the pace of innovation and the speed with which new technology is incorporated into production

(3) **Skills of the labour force** – there are long-standing concerns about the educational skills of the UK labour force including basic literacy and the quality of job specific training. Britain has one of the highest rates of **functional illiteracy** among adults, together with fewer workers with higher skills (at degree level or above) compared to the United States and fewer workers with intermediate and vocational skills compared to Germany and Japan.

(4) **Over-regulation of industry and commerce and a lack of competition** – the 1999 McKinsey Report highlighted a lack of competitive pressures in some industries (notably retailing) as a source of inefficiency and low productivity growth.

Skills gap and low profits contribute to poor productivity

A recent study from the Engineering Employers Federation finds that fewer firms in Britain take on apprentices, investment projects are often ditched by managers and skilled workers are in short supply. The EEF argues that UK firms need to invest in capital equipment and skills and innovation, as well as making the best of modern working practices such as lean manufacturing and high performance working. Part of the problem for manufacturers has been a lack of profits to invest.

Adapted from research published by the Engineering Employers Federation www.eef.org.uk

'Productivity in Britain continues to lag behind that of our main European competitors. One important reason is the large number of workers in Britain who have low skills and, consequently, low productivity and low pay. Many young people still fail to acquire any adequate level of skill. Young people with low skills on the UK labour market are faced with restricted employment opportunities, and the prospect of a poor quality job.'

Adapted from research published by House of Lords Economic Affairs Committee

Report into low UK productivity by economists at the London School of Economics

The persistent productivity gap between the UK and the two big continental European economies can mainly be 'explained' by the fact that they have more capital invested per worker and their workers are more skilled. Productivity growth is highest in industries with greater product market competition - where less productive firms contract and close while new more productive ones open and grow; and where competitive pressures force existing firms to improve.

If the UK could reach French productivity levels, we could award ourselves 20% higher wages or take a day off and still earn the same. Or we could spend the extra resources on schools and hospitals, greater benefits for the needy or lower taxes.

Capital investment plays an important role in productivity growth. But the UK has less physical capital per worker than the United States and considerably less than France and Germany. Many explanations have been offered for these shortfalls, including macroeconomic instability and business uncertainty.

Those industries with the most **up-to-date capital machinery**, together with **advanced managerial skills** and **highly qualified and well-trained workforces** tend to achieve much higher levels of productivity. The availability of **large-scale green-field, full-integrated production plants** and **good industrial relations** are also at the heart of achieving year on year improvements in output per person employed.

The **strength of demand also affects productivity**. When demand is high and production plants are running close to full capacity, then output per worker employed is likely to be rising because factor resources including labour and capital are being used to their full extent. In contrast, during a recession or a slowdown in demand, the utilisation of labour and capital falls. Productivity growth often slows down in a recession.