

# Productivity and Competitiveness

Rt Hon Oliver Letwin MP

CONSERVATIVE  
*Mainstream*

*Winning from the Centre*

## **About Conservative Mainstream**

Conservative Mainstream seeks to extend the appeal of the Conservative Party so that it commands the ground occupied by the broad mass of the British people. It acts as an umbrella grouping, with affiliates including the Tory Reform Group, the Conservative Group of Europe, and Parliamentary Mainstream.

Mainstream believes that the Conservative Party is at its best and most successful when it addresses the practical problems the British people face in their daily lives, and extends opportunity throughout society. Its publications and meetings are designed to help the formation of thoughtful and attractive Conservative policies.

## **Rt Hon Oliver Letwin MP**

Oliver Letwin was born on 19 May, 1956. He was educated at Trinity College, Cambridge and London Business School and was elected a Member of Parliament for West Dorset in 1997. He was a Director of NM Rothschild & Sons Ltd (Director 1991-2003). He was a member of the Prime Minister's Policy Unit from 1983-1986, after being Special Adviser to Secretary of State for Education and Science (1982-1983) and Fellow of Darwin College, Cambridge (1981-1983).

He was appointed Frontbench Spokesman for Constitutional Affairs in June 1998. In September 2000, he became Shadow Chief Secretary to the Treasury. In September 2001, he was appointed Shadow Secretary of State for Home Affairs. In June 2002, he was made a member of the Privy Council. In November 2003, he became Shadow Secretary of State for Economic Affairs & Shadow Chancellor of the Exchequer.

His political interests include agriculture, European Community affairs, education, international affairs and international development, social security, trade and industry.

His publications include: *Ethics, Emotion and the Unity of Self*; *Privatising the World*; *Drift to Union*; *Aims of Schooling*; and numerous articles in learned journals and popular press.

## FOREWORD

In the long term, nothing will work properly in this country unless we maintain a strong economy. In turn, that economy will only keep performing if we improve our productivity and competitiveness.

So Oliver Letwin's thoughts on these two key economic issues are centrally important both to the development of Conservative economic policy and to the future prosperity of individuals, firms, and public services in Britain. His explanation of why productivity has failed to improve under Gordon Brown, and how we can do better, is one of the big political battlegrounds for the months ahead.

Conservative Mainstream is delighted to provide an opportunity for Oliver Letwin to expound his views, as part of our "Winning from the Centre" programme, designed to help the Conservative Party come to the next Election with a set of political ideas which will win the support of those whose political loyalty is not tribal.

Damian Green

Chairman, Parliamentary Mainstream.

## **Productivity and Competitiveness**

### **Rt Hon Oliver Letwin MP**

Do you recall how often the Chancellor used to talk about the crucial importance of the competitiveness and productivity of the UK economy? He used to talk about it all the time. For reasons I'll come onto, he doesn't mention it so much anymore. Like some minor character in a soap opera, it now comes back into the script only at moments when the plot is a little thin.

An awful lot depends on the competitiveness and productivity of the British economy. How productive we all are, and how competitive our companies are in international markets, is the main determinant of how wealthy we are as a nation. Get that right, and we can share the benefits of growth between the improvements in public services and the gradual reductions in the tax burden that we all want. Get it wrong, and everything starts to fall apart.

Gordon Brown knows that, which is why he made such a fuss about productivity seven years ago when he first took up residency at Number 11. As a politician myself, I hesitate to drag up old speeches and quote them back to their luckless authors. I know I'm setting a precedent that I'll almost certainly live to regret. But, Gordon Brown telling us all about the productivity miracle we were going to witness under this Labour Government was no single, off-the-cuff remark. Indeed, if we were just measuring the output of productivity pledges, we'd have seen an unbelievable increase in the national output.

At a speech to the CBI in May 1997, just shortly after coming to power, Gordon Brown made this pledge:

“We will identify the barriers to growth and productivity, and then we will relentlessly work to remove them. Whether the problem is a lack of research, or difficulty in applying what we know; whether the constraint is the available technology, or if what is needed is help for exporters and small businesses – we want to help now.”

The next month, he was off again in his Mansion House speech, pledging “a long term commitment to higher levels of investment both in people and in business to provide the capacity for strong and stable growth for the long term.” By the time he spoke to the CBI again in November 1997, the Chancellor was so pleased with what he'd done in the first few months, he sounded as if

he felt all the problems of low investment and poor productivity had already been solved. From now on, all our problems would be behind us:

“When I spoke to you last year we were – all of us – agreed that rising levels of investment were the key to future prosperity. The 2 per cent cut in corporation tax to its lowest level ever, the reduction to 21 per cent of small business corporation tax, and the new investment incentives for small and medium sized companies not only reflect a Government that listened to the CBI’s proposals, but are the first stage in raising from too low levels, the quality and quantity of investment in the future of Britain.” Except, of course it wasn’t that simple.

We’re all used to Labour targets not being met by now. And we know, not least from the Prime Minister himself, that delivery is a lot trickier than they ever imagined. So nobody will be too surprised to learn that the growth rate of productivity has not improved under Labour. But they might be surprised to hear something else: it’s got a lot worse. A Chancellor who came into office pledging to improve the rate of growth of productivity in the UK economy has completely failed to do so.

In the five years to 1997, productivity growth in the UK averaged 2.5%, which was faster than productivity growth in either the US or Eurozone. That was the record Gordon Brown was going to improve on. What happened? Although productivity continued to grow rapidly in some industries, productivity growth across the economy as a whole slipped to an average annual growth rate of just 1.6% during the first 6½ years of Labour Government, compared to 2.8% in the previous 6½ years.

And the productivity gap Gordon Brown was going to close? How did we do on that measure? In 1997, the Americans and the French were significantly more productive than we were. The Office for National Statistics put out fresh figures only last week, showing that British performance relative to other countries has been better than it previously thought. British productivity on this latest measure matches that of Germany – but let’s remember that German productivity suffered terribly when it integrated with the old East Germany.

Among our major competitors, France and the U.S. still have far higher productivity than we do. The average GDP per worker across the whole of the G7 for 2002 was 12% higher than in the UK. The difference between what they produce in an hour’s work and what we produce in an hour’s

work, is still very wide – which is one reason why we in Britain have to keep on putting in more and more hours just to stay where we are. It’s odd that Gordon Brown doesn’t mention this in one of his many lectures on how superior the record of the UK economy under Labour is.

It could be argued that I am being unfair. It might be that Gordon Brown’s policies haven’t had time to work yet. After all, new factories take time to build. New management techniques take time to implement. Research and development takes time to turn into new products – and the economic cycle has been working against him recently.

Perhaps the productivity miracle we were all promised is just around the corner. Except it isn’t, as Gordon Brown has given up himself. His own budget forecasts predict no increase in the current dismal rate of productivity growth. He’s not even trying any more.

Anyone who wants to know the truth should look at page 176 of the pre-Budget report, published by the Treasury last December. “Actual growth in output per hour since 2002 has averaged less than 2%,” it says. Its forecast going out to 2006 shows no pick-up in productivity. We have to think seriously about how we can improve our productivity and competitiveness. We have to do this if we are to create a more prosperous nation. And we have to begin by thinking about why the UK’s relative position is not getting substantially better.

I want to start with a few general observations. Let’s start with red tape. There has been an explosion of rules and regulations. All of them are well-intentioned. All of them are trying to redress some wrong, or to create better working conditions, but taken together they are proving deadly.

The Institute of Directors estimates the total cost of new regulations introduced since 1997 at over £20 billion. The British Chambers of Commerce, in its own survey, came up with almost exactly the same figure. That is a large cost to the British economy. Businesses are in no doubt about how this impacts on productivity. The British Chambers of Commerce say: “British business has a clear consensus on how the Government could improve productivity in the UK: Simplify tax and regulation.”

Individual regulations may not cost much to implement, but they divert attention from the main task of businessmen and entrepreneurs – running their companies more effectively. The morning spent grappling with a new

set of paternity leave rules is a morning not spent trying to understand a new piece of software. And that new piece of software might have allowed your office to double the amount of business it handled with the same number of staff. The day spent on a training course learning about new environmental rules was a day not spent on a training course learning about new distribution systems. And yet that new distribution system might have allowed your drivers to deliver 20% more stuff in 10% less time – and that would have been a real productivity gain. Little by little, red tape and regulation chips away at our ability to deliver higher productivity growth. Like a governmental black hole, it sucks up the energy around it.

I know that every politician promises less regulation or, under the present Government, “better regulation”. We’re all against red tape. Even Gordon Brown doesn’t stride into the Treasury every morning snapping his fingers, muttering, “I want two dozen pointless, meddling, intrusive regulations – and I want them before we break for mid-morning coffee and biscuits.” At least, I have no proof that he does.

I accept that it is going to be hard to cut back on red tape, at least in the short-term, but what really matters is the rate of change. Every new rule and regulation takes time to understand. It takes time to implement. Rule books have to be re-written. Forms re-formatted. Staff retrained. Energy and money and time are consumed at every point.

If you staunch the flow of new regulations, then you immediately start to lift the burden placed upon companies. They might still have a thousand and one regulations to deal with – but at least it’s the same one thousand and one it was a few weeks ago. It’s when you add another five new rules to the load every week that the real damage is done. Just by slowing down the rate at which new red tape is created, we can immediately free up time to allow companies to start working on improving their productivity. We can start to close down the regulatory black hole. We can stop it sucking up so much energy. And when we’ve done that, we can go further. Conservatives want the total regulatory burden imposed by each Whitehall department to fall year-by-year. We want sunset clauses for some new regulations – so they would automatically lapse after a period of time unless explicitly reaffirmed.

Then there are taxes. Again, we all know that Gordon Brown has increased the tax burden on business – just as he has increased the tax burden on all of us. The CBI calculates that extra taxes on business since 1997 are running at

£6 billion a year, or a total of £54 billion by the time of the next election. The percentage of GDP business pays in tax is now very similar to the rest of Europe – 9.9% in the UK, compared with 10.1% in Germany, 9.7% in the Netherlands and 7.2% in Ireland. Let’s be clear. Money paid out in tax is money that is not left over for investing in new products, in training, or in new ways of working. I last week announced a Medium Term Expenditure Strategy which should give us room to do something about this.

However, my issue with tax is not just its level. Just as with regulation, it is the complexity of the tax system that is making life so much harder for business. There can be no question that the tax system has become too complex. Take a look at that bible of the tax accountant, Tolley’s Yellow tax handbook. It now runs to 7,344 pages, spread across four volumes. I cannot quantify the effect. But I am certain that a significant part of this Chancellor’s failure to close the productivity gap with our main competitors is because of the damage done by the complexity of the tax system in particular, to the owners of small and medium-sized businesses.

Those managers can’t afford to create vast legal and accounting departments to fight their way through Gordon Brown’s avalanche of tax breaks, rules and credits. Even if they can, think of the time and energy that is being diverted from running their business. Instead of making their business more efficient, they make it more tax-efficient. That’s a difference of just one word, but a huge gulf in performance.

An efficient business is set up for the convenience of the customer. A tax-efficient business is set up to inconvenience the Inland Revenue. We are fast becoming a nation of tax-planners, not a nation of business-planners. Does anyone seriously suppose for a moment that this is helping us become more productive or competitive? By creating a fairer, more neutral, and more stable tax system we can give people more time to run their companies. We can move back from tax-planning to business planning.

What else – apart from reducing the flow of new regulation and reducing the complexity and opacity of the tax system – should we be doing differently? Can we take positive steps to improve productivity? I am not going to give any simple or glib answers. The low-productivity of the British economy has been an issue for almost a hundred years. We’re not going to fix it overnight.

Gordon Brown, as I have explained, came into office with lots of promises of quick results. As we have seen, that doesn't work. We need to make sure we don't repeat that mistake. We need to be honest about the timescales.

As any factory manager will tell you, quick fixes aren't the way to improve productivity. Quite often, you have to build a whole new factory. You certainly have to think about re-organising the way you operate. These things take time. The sad paradox is that the desire for fast results in this area produces no useful results whatsoever. Until we admit that our progress will be slow, we won't make any progress on tackling this issue.

Government can make a difference. If – as well as accepting the long timescales – it distinguishes intelligently between what it can do and what it cannot do. Let me illustrate the nature of this distinction by comparing the two changes that are most likely to increase the productivity of British business: improvement in the skills and training of British employees, and increased amounts of efficient investment.

The reason why both these changes matter so much is simple. The equipment that you have and the skill with which you use it are what determines how productive you are. However, it does not follow that the Government should think itself capable of dealing with both of these issues directly.

Let's start with vocational training. The academic literature suggests that most employees and most employers place a distressingly low value on NVQII qualifications at present. Contrast that to Germany. In Germany the apprentice system delivers definable economic benefits. Get one, and your employer will pay you a better wage. Why? Because the customer, in turn, will pay more to have the work carried out by a craftsman they know has the right skills. Overall, the levels of skills among the British workforce are not high enough. The Learning and Skills Council has this month published the results of a survey that covered 72,000 employers around the country. It found that severe skill shortages were holding back companies from growing.

The statistics are shocking – particularly for a Government that has made education one of the standards upon which it wants its success or failure to be judged:

- One in ten of the English workforce – that's 2.4 million people – don't have the skills necessary to do their job.

- A lack of basic skills is costing the average medium-sized business, employing 50 people, £165,000 a year.
- A fifth of all employers – 22% – reported that there were skill gaps within their organization.

It's easy to get lost in the statistics, but what that means in practice is this: companies are not bothering to invest in new machinery or set up new divisions because they don't think they can find the staff. Some individuals are being over-worked because they are working alongside people who haven't been given the training to do their jobs. Meanwhile, many others can't get jobs. They either don't have the skills, or alternatively they can't get a better-paid job because they aren't qualified, and this happens too often, they have the miserable experience of trying to do a job that they haven't been properly trained for. It's a dire predicament for everybody.

We need to learn from abroad. We need vocational qualifications that have real weight in the marketplace. We need young people to be able to say that their qualification is worth having because it will help them earn more money. We need employers to offer higher wages to a person with qualifications because they know that he or she will earn more for the company.

Is this – alongside the improvement of our schools, to provide higher levels of literacy, numeracy and other basic skills – something with which a Government needs to concern itself? Abundantly, yes. The solutions do not need to be – indeed, should not be – big state solutions. On the contrary, they should involve giving parents, professionals and businesses more control and bureaucracies less power to run people's lives. But the government does, nevertheless, need to establish the structures and provide much of the funding from general taxation.

The position in relation to investment is altogether different. The latest statistics show that business investment has fallen over the last year. Gordon Brown has made great play of his R&D tax credit. After a disappointing start, he has made some progress. There has been some take-up by companies. Who knows, maybe it has created some R&D that might otherwise not have taken place.

But I draw your attention to a survey from Ernst & Young this month. It found that many companies were either unaware of the tax credit, or felt the benefit was not worth the trouble of filling in all the forms. Of the companies that did make a claim, one third said they found it harder than they expected

to identify qualifying R&D activities. In addition 40% of the companies that did claim were subjected to inquiries by the Inland Revenue.

That illuminates a general point about fiddling, and micro-management. As a rule, it hasn't worked. If it had, we would now be seeing an increase in investment, rather than the decline we have actually witnessed. The reason being that once again, you create incentives for companies to plan their tax bill, not their business.

What counts as R&D? Aren't companies just going to re-classify departments under 'research'? Was that trip sales or research? Those new computers in the marketing office? Don't they count as research as well? The Inland Revenue has in fact published a definition of what R&D is. It comes to six thousand and twelve words – and must have consumed a vast amount of civil service time and energy in the drafting and re-drafting of those words.

What I might think of as R&D and what the Revenue thinks of as R&D doesn't quite match. Apparently, just creating a fabulous new product doesn't count. "Novelty, innovation or uniqueness in the product or process are not sufficient to demonstrate technological or scientific advancement," it says. "It is how such attributes arise that is important." The Chancellor is trying to try to use the tax system to raise productivity, but "novelty, innovation or uniqueness" don't count.

The truth is, as anyone in business will tell you, that creating new products is very hard. There isn't any prescribed way of doing it. There are lots of things that companies do that lead to new products or new ways of working but which don't come under the label of 'research'. It's not just men in white coats with test tubes and Bunsen burners who create new products. It's creative, talented people being alive to a world buzzing with new opportunities and markets.

They don't need Gordon Brown leaning over their shoulder, jabbing his finger, and saying this is research, and this isn't: I'll give you a tax credit for this but not for that. In reality government can't hope to capture the diversity of the modern global economy. We can't hope to know which sectors will grow or which won't, and we shouldn't try.

The point I want to make is that this issue of productivity and competitiveness is a good illustration of what divides the political parties at the beginning of the 21<sup>st</sup> century. Old Labour was not interested in productivity. That

was something the bosses did. Labour was in the business of handing out the cookies, not thinking about how to make them. I acknowledge that they've changed. I don't doubt that Tony Blair and Gordon Brown are sincere when they say they want business to succeed. They genuinely wanted to improve productivity. I am sure they are troubled that it hasn't happened, but they just don't know how to do it. They think that task forces, committees, initiatives and targets can make factories and offices produce more, but they are wrong. Who knows, maybe in the next few years we'll get a productivity czar.

Governments don't improve productivity. Governments don't deliver greater competitiveness. Individuals and companies do. However, that isn't to say government can do nothing.

Government has to make sure that everyone is getting a good education. People who don't have the right skills are not going to be very productive. It has to make sure we have an infrastructure which works. People stuck on late trains, or in traffic jams, are not going to be producing anything. Government needs to make sure planning laws are comprehensible and stable. Nobody can expand their business if they can't find the space for a factory or an office or a warehouse – or if it costs too much or takes too long to build. Government also has to make sure that crime is low, that taxes are low and that schools and hospitals are of high enough quality, so that this is an attractive country in which businesses can base themselves.

I repeat: governments don't create productivity improvements, individuals and companies do. For example, probably the most impressive new sector of the British economy in the past seven years of Gordon Brown's Chancellorship has been the mobile telecoms industry. Vodafone is the clear leader of its industry globally, and, now one of Britain's biggest companies. That's quite an achievement. How much help did it have from the government? Absolutely none.

Government doesn't create business success. It doesn't know which industries will grow, or how they will grow. It's hard enough for the people within the companies to know that. A bureaucrat sitting in the Treasury has no chance. If we stand back, we can make a difference. If we provide excellent education and training, staunch the flow of rules and regulations, make the tax system less complex, and get our infrastructure working, gradually our productivity will start to improve.

Our position is very different from Gordon Brown's. We don't believe companies need to be cajoled, persuaded, or pushed into higher productivity and they don't need to be bullied. Both individuals and companies want to become more productive. Individuals know that developing new and more valuable skills is the way that they become richer. Companies know that getting more output from a factory or an office is the way that they become more profitable.

The ideas and the innovation are all there. The British have always had a genius for creating new products, chasing new markets, and for inventing new ways of doing things. All we have to do is lay down the right foundations, enable people to acquire the skills they need, and then get out of the way.

In the long term, nothing will work properly in this country unless we maintain a strong economy. In turn, that economy will only keep performing if we improve our productivity and competitiveness.

So Oliver Letwin's thoughts on these two key economic issues are centrally important both to the development of Conservative economic policy and to the future prosperity of individuals, firms, and public services in Britain. His explanation of why productivity has failed to improve under Gordon Brown, and how we can do better, is one of the big political battlegrounds for the months ahead.

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