Where should low-wage sectors feature in an industrial strategy?

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At a fundamental level, a nation’s living standards are determined by three factors: the share of the population in work (employment), the value of goods and services produced by these workers (productivity) and how the economic rewards from producing these goods and services are shared among the population as a whole (the income distribution). Whilst the UK economy fares very well in terms of employment (ONS, 2017a) and has shown some small reductions in income inequality of late (ONS, 2017b), its recent productivity performance has been lamentable.

The government’s industrial strategy white paper (HM Government, 2017) aims to address a two-fold challenge in this area. First, it seeks to restore the UK to a path of positive productivity growth, after a decade in which the level of output per worker in the UK has barely improved (ONS, 2017c). Second, it seeks to close the productivity gap between the UK and our major competitors – countries such as France and Germany, where output per hour is around 30 per cent higher than it is in the UK (ONS, 2017d). When seeking to find levers to improve productivity, it is common to consider the relative merits of efforts to improve skills, boost capital investment, intensify market competition or foster innovation (e.g. HM Treasury, 2015). Such considerations reflect an acknowledgement that one cannot do everything all of the time. However, governments and other stakeholders also have choices about where they focus their attention. Emerging, high-value sectors are often signalled, including in the white paper itself.

However, the white paper also recognises that some of the biggest opportunities for raising productivity come from low-wage, high-employment sectors, such as retail and hospitality. This echoes another theme of the industrial strategy, which is to improve employees’ earning power and to make the economy work for all. In this chapter, we evaluate the case for giving special attention to low-wage sectors and discuss different ways in which that might be done.

Productivity in low-wage sectors

In recent work for the Joseph Rowntree Foundation (Forth and Rincon-Aznar, 2018), we undertook a comprehensive analysis of the productivity performance of the UK’s low-wage sectors, with a particular focus on the role that they play in the UK’s productivity gap with other countries. We focused on the ten industry sectors where at least one-quarter of the UK workforce are low-paid (defined as having gross hourly earnings below two-thirds of the UK median wage). The largest of these is the retail sector, accounting for 5.6 per cent of UK value-added, 8.4 per cent of all hours worked and 21 per cent of all low-paid employees (see table 1). Other large low-paid sectors include administrative and support services (covering activities such as security and cleaning), hospitality (covering the activities of hotels and restaurants) and residential care and social work (covering the provision of adult and children’s social care). Together our ten chosen sectors account for almost one-quarter of all value-added in the UK, around two-fifths of all hours worked and around two-thirds of all low-paid employees.¹
Table 1: The UK’s low wage sectors (ordered by UK share of gross value added)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Sector share of total UK gross value-added (%)</th>
<th>Sector share of total UK hours worked (%)</th>
<th>Value-added per hour (UK = 100)</th>
<th>% of employees in the sector who are low-paid</th>
<th>Sector share of all UK low-paid employees (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail (Division 47)</td>
<td>5.6</td>
<td>8.4</td>
<td>75</td>
<td>46</td>
<td>21</td>
</tr>
<tr>
<td>Administrative and support services (Section N)</td>
<td>4.8</td>
<td>8.2</td>
<td>68</td>
<td>29</td>
<td>6</td>
</tr>
<tr>
<td>Hospitality (Section I)</td>
<td>3.0</td>
<td>5.7</td>
<td>61</td>
<td>59</td>
<td>16</td>
</tr>
<tr>
<td>Residential care and social work (Divisions 87-88)</td>
<td>2.0</td>
<td>4.9</td>
<td>46</td>
<td>31</td>
<td>10</td>
</tr>
<tr>
<td>Arts, entertainment and recreation (Section R)</td>
<td>1.4</td>
<td>2.4</td>
<td>68</td>
<td>30</td>
<td>3</td>
</tr>
<tr>
<td>Other service activities (Section S)</td>
<td>2.1</td>
<td>2.4</td>
<td>104</td>
<td>33</td>
<td>3</td>
</tr>
<tr>
<td>Sale and repair of motor vehicles (Division 45)</td>
<td>2.0</td>
<td>2.1</td>
<td>107</td>
<td>25</td>
<td>2</td>
</tr>
<tr>
<td>Agriculture, forestry and fishing (Section A)</td>
<td>0.7</td>
<td>1.7</td>
<td>43</td>
<td>38</td>
<td>1</td>
</tr>
<tr>
<td>Food processing (Divisions 10-12)</td>
<td>1.6</td>
<td>1.5</td>
<td>121</td>
<td>29</td>
<td>2</td>
</tr>
<tr>
<td>Textiles and clothing manufacturing (Divisions 13-15)</td>
<td>0.4</td>
<td>0.4</td>
<td>111</td>
<td>31</td>
<td>1</td>
</tr>
<tr>
<td>All 10 low-paid sectors combined</td>
<td><strong>23</strong></td>
<td><strong>38</strong></td>
<td><strong>71</strong></td>
<td><strong>39</strong></td>
<td><strong>65</strong></td>
</tr>
</tbody>
</table>

Source: Forth and Rincón-Aznar (2018)

As one would expect, most of these sectors have levels of productivity that are either at or below the level of productivity in the UK as a whole (see table 1, column 3). The larger sectors among them also play a key role in determining the trajectory of productivity growth at the national level: retail alone accounts for one-tenth of the national slowdown in productivity since the financial crisis (Riley et al, 2018). However, the primary interest of our research was in the performance of these low-paid sectors relative to the same sectors in other major economies, and their contribution to the UK's overall productivity gap with those countries.

How do levels of productivity in the UK’s low-wage sectors compare with other countries?

When the ten sectors are grouped together, aggregate productivity in this low-paid part of the UK economy is 30 per cent below that found in the same sectors in Germany, France and the Netherlands, and 20 per cent below that found in the US. If we look beyond these nations to other major European economies such as Austria, Denmark, Spain, Finland, Italy and Sweden, only Italy among this group has a level of value-added per hour below that of the UK (see chart 1).
As chart 1 clearly shows, the UK’s productivity problem is not restricted to low-wage sectors. In fact, we find that the UK’s relative position is slightly better, on average, in the low-wage portion of the economy than it is among higher-wage industries. But closing the UK’s productivity gap with its competitors in low-wage sectors would make a substantial contribution towards overcoming the national productivity problem, to an extent that is perhaps not often recognised. Our analysis indicates that raising productivity in low-wage sectors to the levels found in the United States would reduce the UK’s productivity gap with the United States by around 12 per cent. It would close between a fifth and a quarter (21-23 per cent) of our national productivity gap with France, Germany or the Netherlands.²

This overall picture hides a considerable degree of sectoral variation. For instance, the level of productivity in the UK retail sector lags the US by around 40 per cent but sits broadly on a par with levels of retail productivity in France and the Netherlands, and above that found in Germany. In the hospitality sector, however, productivity is around 10 per cent higher in the United States and Germany than it is in the UK and around 45 per cent higher in France. Each individual sector’s contribution to the UK productivity gap therefore varies, depending on which country the UK is being compared against (see chart 2). In the comparison with Germany, where the overall level of value-added per hour is 39 per cent higher than in the UK, the differential rate of productivity in administrative and support services is key, accounting for around one sixth (16 per cent) of the total gap. Arts and recreation account for a further 4 per cent. In the comparison with France, administrative and support services and arts and recreation are again prominent, along with accommodation and food service. For the Netherlands, food processing plays a fairly prominent role, whilst in the comparison with the United States, retail is the leading contributor.
How do rates of productivity growth in the UK’s low-wage sectors compare with other countries?

Of course, the gaps in productivity levels only tell part of the story. Rates of productivity growth provide the other dimension, but are no less encouraging, as they do not tend to indicate any prevailing pattern of catch-up for the UK (see chart 3). While rates of UK productivity growth in sectors such as agriculture and sale or repair of motor vehicles appear to be outstripping those seen in the four countries we have chosen as our main comparators, UK growth rates in sectors such as retail, accommodation and food service, administrative and support services and arts and recreation are either below par, or sit within a closely-bunched pack.
How can the UK close the gap with the productivity leaders?

To understand the reasons for the UK’s productivity gap in low-wage sectors more fully, one can use a standard productivity-accounting approach to decompose the gap in each sector into the contributions from cross-country differences in capital intensity, labour quality and total factor productivity (TFP). Whilst the relative contribution of these three components varies by sector and country, the general finding from such an analysis is that any weakness in productivity in the UK’s low-wage sectors is primarily due to differences in TFP, followed by differences in labour quality, with differences in capital intensity playing a more minor role. Three industry-by-country comparisons serve to illustrate this general point (see chart 4).
These TFP differences could be influenced by a range of factors, but our analysis across a range of sectors and countries indicates that what happens within firms could be particularly important. When we looked at the UK’s relative TFP position across a wide range of sectors, we found that countries were more likely to have a TFP lead over the UK in cases where they had a higher proportion of workers in training, more extensive use of management practices such as performance-related pay, a higher share of employees using ICT and a lower share of employees on temporary contracts. The organisation and management of low-paid work thus appear to be critical areas for future attention.3

There are two main points to take away from this analysis overall. Firstly, productivity in most of the UK’s low-wage sectors lags that found in the same sectors in other countries. Secondly, because a number of these sectors account for sizeable shares of national value-added, raising productivity in these industries would go some considerable way to raising national levels of productivity. They thus have the potential to help the UK address its current productivity challenge, alongside the higher-value sectors that often gain most attention. In addition, because many of these sectors are also large employers, and are necessarily characterised by low wages, there is also a broader inclusivity argument for giving them particular attention.

**So what should we do?**

The main implication of the above analysis is that low-wage sectors deserve a place in the government’s industrial strategy. The government’s main offer for specific sectors so far has been through sector deals. Twelve deals have been announced, or are being actively discussed, but only one is for a low-wage sector: tourism, which overlaps closely with the hospitality sector. There has so far been no sector deal for the two largest low-wage sectors, retail and administrative and support services. The government has set up a Retail Sector Council, but it is unclear how much of a role this will play in relation to the industrial strategy. Sector deals have been criticised for representing the interests of incumbent firms over potential entrants and innovators (Industrial Strategy Commission 2017). Nevertheless, the
government should outline the policy infrastructure it will provide to raise productivity in low-wage sectors.

Some new innovative examples show what support to improve productivity in low-wage sectors could look like. The Productivity Through People programme takes experts from highly productive companies, such as BAE systems, to provide advice to low productivity ones, and provides anecdotal evidence of success in raising productivity. This chimes with a lesson from the above analysis that improving productivity in low-wage sectors requires some influence on the internal operations of firms. Business support services that encourage firms to get more from their workforce through on the job training, improving management practices or providing better contracting could raise productivity.

The industrial strategy white paper recognised place as one of its five foundations. Place is important because the needs and opportunities for an industrial strategy differ greatly across the country. Nevertheless, several low-wage sectors – in particular retail, hospitality and social care – are pervasive across the country and so should be a priority for many places. Local industrial strategies, currently being designed and led by city-region mayors and Local Enterprise Partnerships, could be a fruitful testing ground for the experimentation required to create policies that are successful at raising productivity in these sectors. Local experimentation should be encouraged and evaluated so we can learn from policy success and failure.

If the industrial strategy is to be judged a success, it also needs to be successful at the second of the government’s aims: increasing earning power. However, recent studies have found only a relatively weak link between increasing firm or sector productivity and wages (Ciarli et al., 2018; Card et al., 2018). Efforts to raise productivity will therefore need to be complemented by other policies to ensure that workers enjoy a fair share of any additional value added.

One direct lever that government could pull is the wage floor. The introduction of the National Living Wage (NLW) has been effective at raising low wages, and so far there is little evidence this has come at the cost of employment. Further rises in the NLW over the next couple of years could also help raise productivity. There is some evidence that increased labour costs arising from the NLW have ‘shocked’ managers into organisational improvements and lead to improved productivity (Riley and Rosazza-Bondibene, 2015; Green et al., 2018). However, raising the wage floor has also increased wage compression at the bottom of the distribution, and does little to help workers progress out of low pay (D’Arcy, 2018). It can only be part of the solution.

A second approach is to look for productivity improvements that also improve the quality of work, by promoting the concept that ‘good work is good for business’, as endorsed by the Taylor Review (2017). This approach also underlies recent steps to create a Good Employment Charter in Greater Manchester and Good Work Standard in London, again showing the benefit of local leadership. A third approach would be to look at policies that shift the balance of power in wage setting from employers to workers.

Low-wage sectors have not been the traditional focus of industrial strategies. But productivity differences between the UK and its competitors show it is possible to raise productivity in these sectors and contribute to closing the productivity gap. We do not yet know what policies would most effectively raise productivity and improve the quality of work in these sectors. We do know that these sectors will be vital to the government’s aim of creating ‘an economy that works for all’.

Notes
1. Over half of these (37 per cent of the total) are employed in retail and hospitality: two sectors which Sissons et al (2017) estimate to account for one-third of all workers in poverty in the UK.
2. Here we calculate the reduction in the aggregate productivity gap that would arise if productivity levels in the ten sectors in the UK were equalised with those found in the same sectors in the comparator country.
3. Other work has indicated the important role that management practices play in explaining productivity differences across firms and countries (see Bloom et al, 2012, 2016; Awano et al, 2018; Bryson and Forth, 2018).

References


