Understanding value added per employee in six UK sectors: The insiders' view

Summary Report
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Summary report – Executive Summary

Editors:
Stephen Roper, Katherine Hathaway and Nigel Driffield

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About the Enterprise Research Centre (ERC)

The Enterprise Research Centre is an independent research centre which focusses on SME growth, innovation and productivity. ERC is a partnership between Warwick Business School, Aston Business School, Queen's University School of Management, Leeds University Business School and University College Cork. The Centre is funded by the Economic and Social Research Council (ESRC); Department for Business, Energy & Industrial Strategy (BEIS); Innovate UK, the British Business Bank and the Intellectual Property Office. The support of the funders is acknowledged. The views expressed in this report are those of the authors and do not necessarily represent those of the funders.

Executive Summary

Background

The UK's productivity puzzle has attracted much attention which has focused on the growing gap in productivity between the UK and its key international competitors. Often denominated in terms of 'value added per employee' or 'value added per hour worked' - both measures of labour productivity - the UK's productivity slowdown has been longstanding but has been particularly notable during the post-recession period

Statistical analyses have emphasised that 'the vast majority of labour productivity growth weakness arises due to changes in productivity growth within detailed industry groups.' These variations in sectoral productivity trends since the recession provide the starting point and rationale for this report. What are the origins of these diverse trends? Are these the consequence of intra-firm issues linked to leadership and management or technology? Or are they linked to sector specific factors such as regulatory regimes or market competition?

Our approach is primarily qualitative and draws on the experience and knowledge of 'industry insiders' in six sectors – business leaders, analysts, commentators and policy-makers. Detailed conversations were held with over 80 informants across six sectors between February and April 2019. This type of qualitative approach is of value to both reflect the wide range and variety of influences on value added and how these influences have changed and continue to evolve.

Understanding value added per employee

It is important to recognise that there are many measures of 'productivity' and that this term is often confused with measures of efficiency. However, the most common, and the typical focus of politicians and policy makers is labour productivity or value added per employee. Each of the insider interviews therefore started with a focus on value added per employee. In most cases, however, this concept was either unfamiliar or had little meaning in the context in which interviewees were operating. Instead, interviewees tended to equate the term 'productivity' with measures of operating efficiency often linked to physical outputs or throughput.

In some sectors - insurance, pharmaceuticals - the term 'productivity' itself had very little resonance and was dismissed as meaningless by some industry insiders. In other contexts - banking, beverages - complex supply chains and/or organisational structures created the potential for highly efficient and much weaker business units to co-exist limiting the value of generalised measures of 'productivity' or value added.

The lack of recognition and use of the term 'productivity' and - in many cases - the lack of understanding of the notion of value added per employee suggests a marked disconnect between policy dialogue and business practice. However, this should not be interpreted as a lack of interest or commitment to improving efficiency in most of the companies interviewed and this is reflected in diverse sets of performance metrics which are discussed in each section below.

In our interviews the lack of understanding and awareness of value added on the part of many interviewees often made it difficult to have a meaningful conversation about this specific measure of productivity. Instead discussions often defaulted to a focus on measures of operational efficiency with little reference to their contribution to overall value added.

Internal and external influences on 'productivity'

Across each of the sectors productivity - or more accurately - efficiency was influenced by a mix of internal and external influences:

- In ***Oil and Gas*** the oil price plays a dominant role in shaping both returns and value added per employee. Other factors highlighted by industry insiders included technology (innovation), management/leadership skills, regulation, geography and geology. As the industry consists primarily of international firms other UK-specific influences relate to geography (geology) and regulation both of which are seen as increasingly negative.

- In ***Beverages*** the highly competitive nature of the sector means that there has been a long-term focus on operational efficiency. The added complexity of premiumisation makes further efficiency gains difficult. Regulation and regulatory changes (e.g. sugar tax, reduction of plastic packaging, deposit return) are seen as raising costs and potentially impacting on margins and productivity as are changes to employment legislation (e.g. pension contributions).

- In ***Pharmaceuticals*** notions of productivity (efficiency) are seen as relevant only to the manufacturing and logistics element of the supply chain with little concern for value added. Financial indicators of corporate outcomes combine with operational measures to define performance. Challenging technological and market activities define the opportunities for profit, while tax and regulatory policies shape the global distribution of pharma activity and shape the sector's contributions to national economies. Leadership and management quality is generally perceived as high with evidence of a strong industry culture of continuous improvement.

- In ***Transport Equipment*** notions of productivity differ between sub-sectors although in none of our discussions was this understood in terms of value added per employee. Market structures and volatility, contract length and supply chain relationships limit efficiency gains. Across the transport equipment sector recruitment and retainment of skilled staff was seen as a barrier to productivity improvement, an effect exacerbated by volatile demand. Business leaders with an engineering specialism and leadership capabilities are also in short supply.

- In ***Banking*** our insider interviews suggested little concern with value added. Competition and the innovation that accompanies it was seen as one of the most important drivers of operational efficiency. Competition is driving automation and digital adoption. Maintaining customer experience and satisfaction is also seen as important driving both cultural and technological change. Better training of staff alongside promotion was also seen as a potentially important influence on productivity. Tighter regulation - including increased capital requirements and personal liability - discourages innovation.

- In **Insurance,** competition from incumbents and new entrants was emphasised as a major spur to operational improvements in the sector. However, complacency and conservatism in the sector and firms' leadership were emphasised by respondents as a barrier to innovation and productivity improvement. Regulation was also seen as a key barrier to productivity improvement both through its direct impact on costs and compliance costs as well as its indirect effect through increased conservatism. Conversely, technology was seen by respondents as a positive driver of productivity although some firms were hampered by legacy systems which are incompatible with the needs of data analytics.

There was a general perception, with the exception of the Pharmaceuticals sector, that management and leadership capabilities were often limited, and that innovation was constrained by conservatism. In some sectors - most notably insurance - this conservatism was linked to the regulatory burden. Leadership and management training was seen as an important area for future development.

Technology was generally seen as an enabler of efficiency and growth although firms' willingness and ability to adopt new technologies could be limited both by funding difficulties where margins are low (Beverages), incompatible legacy systems (Banking, Insurance) and market and supply chain structures (Transport Equipment).

Competition was seen as intensive in most of the sectors considered and interpreted primarily as a driver of innovation. The benefits of innovation were quickly eroded, however, where 'me too' products were developed by competitors (Pharmaceuticals), innovations were copied reducing margins, or customers demanded related price changes (Beverages). The changing nature of competition - the hollowing out of markets - was also evident in a number of consumer-facing sectors (Pharmaceuticals, Beverages, Insurance) with an increasing distinction between low value products/services and more personalised, premium offerings. This 'premiumisation' was seen as having negative productivity effects.

Regulation was also frequently cited as having significant costs. Costs of compliance were reportedly high, particularly where regulation changes repeatedly. Indirect effects - such as increased conservatism - may also result where firms face regulatory risk and/or managers face personal liability.

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Enterprise Research Centre
Centre Manager
Warwick Business School
Coventry, CV4 7AL
CentreManager@enterpriseresearch.ac.uk

Enterprise Research Centre
Centre Manager
Aston Business School
Birmingham, B1 7ET
CentreManager@enterpriseresearch.ac.uk

About the Centre for Progressive Policy

The Centre for Progressive Policy is a think tank committed to making inclusive economic growth a reality. By working with national and local partners, our aim is to devise effective, pragmatic policy solutions to drive productivity and shared prosperity in the UK.

Inclusive growth is one of the most urgent questions facing advanced economies where stagnant real wages are squeezing living standards and wealth is increasingly concentrated. The Centre believes that a new approach to growth is needed, harnessing the best of central and local government to shape the national economic environment and build on the assets and opportunities of place.

Centre for Progressive Policy
27 Great Peter Street
London SW1P 3LN

+44 (0)20 7070 3360
www.progressive-policy.net

Centre Manager
Enterprise Research Centre
Aston Business School
Birmingham, B1 7ET
CentreManager@enterpriseresearch.ac.uk