

Why Productivity Growth Is Good For a Healthier Labor Market

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Why are we creating so few jobs in the United States? In fact ... we are not. Since the 2008/09 recession, when lost 8.7 million jobs, we recovered as many as 5.7 million. It definitely has been a bumpy path, as attested to by the latest job report for March. However, we are now back at an aggregate number of 135 million jobs, which is only three million behind the pre-recession peak. In some industries, such as mining and professional and business services we now even have more jobs than before the recession. Currently we are probably on a trend of about 180,000 jobs per month, which from a historical perspective isn't bad at all.

The reason why there is nevertheless not much of a feel-good factor about the job market is because the unemployment rate has remained stubbornly high. This is only partly because employment hasn't returned to pre-recession levels, but also because the working age population has continued to rise, at least until now. While participation has declined, the delaying retirement of older workers may add to the difficulty of younger workers to find a job. Another key problem is that government jobs don't recover as a result of subsequent spending cuts over the past 2-3 years.

But there is another big problem with the labor market today, which has largely gone unnoticed: ***today's jobs aren't getting any more productive***. Many argue not to worry about productivity now. The economy is still below the potential output level (perhaps even below the potential output growth), so more jobs is better whatever job it is. Also, in the short term productivity growth only kills jobs, so maybe slow productivity growth even provides a bit of support to job creation. But is slow productivity growth really a good model for future creation of jobs, and when do we need to start to worry about it? We would argue: sooner rather than later!

The reason for the need to accelerate productivity is simple: you cannot grow an economy for very long on the basis of jobs only. Even if labor compensation growth remains stagnant, without productivity growth there wouldn't be much left for new investment. Productivity growth provides the economy with the additional firepower to invest in new machinery and equipment, people's skills and other intangible assets, such as R&D and innovation. Without productivity growth, the average return on a job falls, jobs get cheaper and reduce the incentives for employers and employees to invest in training and education. Low productivity also means low wages, which won't help consumption. Less government austerity, or rather more government spending, would help counter the slow growth in GDP, and make some new investment possible, but not much help can be expected from there in the short term. In other words, with zero productivity growth rate diminishing returns kick in rapidly and growth eventually comes to a halt.

Indeed the latest numbers show that the productivity performance of the U.S. economy is dismal. Before the recession output per hour in the non-farm business was on average 2.6 percent during the peak-to-peak period from 2000-Q4 to 2007-Q4. During the recession, labor productivity surged in a very unusual way to almost 6 percent year-over-year by the end of 2009. “Unusual”, because productivity typically behaves in a pro-cyclical manner and slows during recessions rather than accelerates. We all know what happened: companies panicked in late 2008 and laid off many more people than necessary, with little damage done to their business processes as they had the technologies from previous years available to do more with less. Once the recovery began in late 2009, many but jobs came back and productivity began to drop, again in an untypical anti-cyclical manner. But the latter was nothing more than a correction to what happened during the recession.

The productivity story has become more puzzling as of 2011. By now we had arrived in the “structural” phase of the recovery, characterized by slow GDP growth as demand remained low, a slowing global economy and – although contestable, and certainly not telling the full story – some persistent structural issues in the labor market itself, such as skill and geographic mismatches, etc.. Labor productivity growth in the non-farm business sector slowed to almost zero by 2011 and remained very low at 0.7 percent for 2012 as a whole. Manufacturing, the stronghold of productivity growth has been somewhat better at 2.2 percent in 2012, but nothing like the average of the 2000s which was in the range of 3-4 percent. Even from an international comparative perspective, U.S. productivity growth has been extraordinary low. In 2012, output per hour in the U.S. increased at only 0.2 percent, which was lower than in Europe (where it was 0.6 percent) or the OECD as a whole (about 1 percent). In fact, there are only two years in U.S. post WW-II history that productivity growth was even slower, which was 1974 (-1 percent) and 1982 (-0.8 percent).

So what’s going on here? There are a few possible explanations for this slow productivity performance in recent years:

1. Slow growth in equipment – In a typical year U.S. businesses increase the capital services obtained from equipment and software by around 3-4 percent. In contrast, capital services in 2009-2012 have been roughly only half of that, and the pace of improvement is very slow. Without an acceleration in investment it is difficult to raise labor productivity quickly, as most of it would come down to total factor productivity growth only, which is the growth in output after accounting for the growth of all inputs, including machinery and software.
2. Relaxing a little – As they fought for survival, many companies were stretched too thin in recent years, and now that profits are higher, they are adding new workers, which reduce productivity growth.

3. Cheap labor and low productivity – Taking advantage of very low compensation levels, on the margin, many companies are incentivized to add more workers rather than invest in new equipment and technology. As a result, output per worker will slow down.

4. A long tail of less productive small and medium sized enterprises – Many SMEs who survived the worst of the recession, may have decided to hang in there until times get better, keep there (often local) people on the payroll at even lower wages, taking the solid productivity growth of large businesses down.

5. The “new normal” for productivity growth is only around 1% - Productivity already slowed since 2004, but the hardship many companies experienced during the Great Recession forced them to exhaust all the potential for technological and organizational improvements. Now they are left with fewer opportunities to improve efficiency. And, moving forward, there isn’t enough technological progress out there to drive strong productivity growth.

It’s hard to single out any one of those explanations as most important as all may be part of the story. But while the first four are more transitory issues, the last explanation may be the most worrisome as slow technological change and innovation could be a longer term concern. Indeed when looking at the total factor productivity (TFP) growth estimates, as published by the San Francisco Federal Reserve, and adjusted for cyclical factors, not only labor productivity but also the TFP growth trend has been clearly slowed down since the mid-2000s.

The debate about technological change and its impact on the skill distribution and the job market has become very contentious in the past year. Pessimists like Tyler Cowen and Bob Gordon would argue that there is little new technology around right now that will help accelerate the long term productivity trend. However, neither of them would argue that less technology would be of much help to job creation. Others, notably Brynjolfsson and McAfee, are arguing that the latest developments in IT will significantly reduce the job multiplier (the number of additional jobs created for one tech job), if not make it negative. Others argue that, at least historically, the number of “unanticipated” growth opportunities that arise from technology booms are so large, that one really cannot tell what’s around the corner, and some optimism seems justifiable.

Technology and total factor productivity are not just enemies of jobs. While it’s not difficult to imagine that robots can substitute for jobs, they can also be very helpful in making jobs much more productive, and freeing up the resources for new jobs that don’t get done right now. The impact of new technology may stretch far beyond the manufacturing sector to other parts of the economy, including the health care and education sectors, where we likely need more rather than less help from technology. And, as labor force participation will be coming down even further as our population ages, we need the additional help down the road.

Whatever the relationship between technology and jobs, as slow as it currently is, TFP growth doesn't seem the biggest threat to job creation. For now, more productive jobs create the best opportunity to push GDP growth beyond the dismal 2 percent trend we are currently on. While much faster economy-wide TFP growth may slow job creation, nobody can really predict by how much, as we don't know what new opportunities are around the corner. What we can predict, however, taking history as a guide, is that by not having sufficient productivity growth, the current pace of job growth will be unsustainable as GDP growth will get too slow to carry it. Without productivity growth we can also expect wage growth to slow across the board with few exceptions, and reduce incentives for firms to invest in training their people. Productivity growth also creates room to strengthen the tax base, raise revenue, reduce debt and create room for more government investment.

One of America's traditional economic strengths has been its ability to grow productivity. There have been times that one could get worried about "jobless growth" at times when productivity accelerated rapidly. But that's not the case time around. America now needs its productivity engine reignited to keep the labor market on a healthy growth path.