PRESS RELEASE

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Falling Real Wages and the UK’s Flexible Labour Market Help Explain the Productivity and Employment Puzzle

UK real wages declined by about 8% since the start of the downturn in 2008, a much worse experience from all previous postwar recessions. According to new research by John Van Reenen director of the Centre for Economic Performance published today, wage falls help explain two connected puzzles: why unemployment has not risen by more since 2008; and why labour productivity (national output per worker) has been so low. On past trends, labour productivity should be about 10% higher than it is today.

The solution to the puzzles lies in the country’s flexible labour market, which has made real wages much more sensitive to falls in demand. This is likely to be due to policy changes over the last 30 years, especially the weakened power of unions and welfare reforms that have meant those on benefits search harder for work than in previous downturns.

Professor Van Reenen, director of the CEP at the London School of Economics, says:

“Although very tough for employees, some pay is better than no pay. Keeping a lid on unemployment is important to stop people losing their skills, motivation and connections with the world of work.”

Falling wages have led to “capital shallowing” because faced with lower labour costs compared to machinery and buildings, firms have been cutting capital used for every worker, and this has depressed productivity as measured by output per worker. Investment has also been kept down by demand uncertainty, banks’ reluctance to lend as they rebuild balance sheets and a huge fall in public investment.

Back-of-the-envelope calculations show that falls in capital investment account for over two-thirds of the drop in output per worker, with the fall in average hours worked also accounting for around another quarter of the productivity drop.

Once greater labour market flexibility is taken into account, the fall in UK core productivity (what economists call efficiency or “TFP”) looks similar to other severe postwar recessions: a bit worse than the 1980s, but a bit better than the 1970s (see Figure 1). TFP is generally flat in recessions due to under-used capacity as firms are hoping for demand to pick up again.

Professor Van Reenen comments:

“Supply-side pessimists have said that the UK’s level and trend productivity potential has suffered very large and permanent cuts so that any fiscal and monetary stimulus would just lead to more inflation. Our analysis suggests that this is exaggerated.
Low capital and hours are generating low GDP per worker and these are likely to be due to low demand filtered through our flexible labour market.

UK potential growth recovered after earlier severe recessions and there is no reason why this should not happen again. The economy needs greater long-run investments as recently recommended by both the IMF and the LSE Growth Commission."

Figure 1: Productivity trends (after controlling for capital and hours) in years following recessions (start of recessions indexed at 100)

Note: “1970s” recession dated 1973-1977 (so year 1 = 1973, year 2 = 1974, etc); “1980s” recession dated 1979-1983 (so year 1 = 1979, year 2 = 1980, etc); “Current” is dated 2008-2012 (so year 1 = 2008, year 2 = 2009, etc.). These are estimates of Total Factor Productivity (TFP), i.e. core productivity/efficiency controlling for inputs like capital and hours. 1970s and 1980s TFP taken from EU KLEMS and current TFP from ONS data as estimated by Pessoa and Van Reenen (2013)*. Whole economy estimates.

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