Advanced economies remain in the doldrums. People's incomes are rising at a very low pace, especially in the lower half of the distribution. Two global trends—the slowdown in productivity and the rise in inequality—reflect the state of policy, and point to the challenges policymakers face to change prospects for their citizens and the global economy.

Economies become more prosperous when output per worker rises. Since the early 2000s, however, productivity growth has declined in many advanced countries. The slowdown in productivity—the OECD average slid from 2.0% in the 1990s to 1.4% in the 2000s—has been particularly pronounced since the global financial crisis struck in 2007. In fact, productivity growth has been lower in the last decade than at any time during the past 60 years. This deceleration pulls down the scope for stronger income gains.

Rising inequality reflects dampened income growth of many workers. Since 1990, the income of the top 10% has grown 1.2% per year. Contrast this with an annual income growth of 0.6% for the bottom 40% and an even more dismal 0.3% for the bottom 10%. The fruits of economic activity have been concentrated among
higher earners, and flowed far less to median and lower earners. Redistribution through taxes and transfers offset some of the rise in labour income inequality in the 1990s, but not in the 2000s. Little wonder ordinary people have protested so loudly and in so many countries!

What explains these two global trends? Start with the productivity slowdown. The deceleration of productivity has been sharpest since the global financial crisis, when demand and investment have been very weak. For several economies, however, the productivity slowdown goes back to the early 2000s, and corresponds with other long-term trends of fewer start-ups, declining business dynamism, sluggish investment in knowledge-based capital, and a widening dispersion in productivity growth between the most innovative firms and the rest. What underpins rising inequality? On the high-income end, policies that inhibit competition and delay exit may have benefited employees in some lucrative firms, in finance and technology for instance. Technological progress has probably pushed up the earnings of very skilled workers in particular. At the other end of the income spectrum, sluggish employment growth, along with reduced bargaining power, have curbed income growth of low-skilled workers.

Frontier firms forge ahead on productivity

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A closer look reveals that the slowdown in productivity and the rise in inequality have a third relation: a growing gap between the robust productivity growth of dynamic, frontier firms, who can pay more to their workers, and a much more
lacklustre productivity performance among regular, traditional firms, who can afford to pay relatively less. We are still testing the precise nature of the three outcomes, including the extent to which there are common policy foundations.

How might public policy respond? The policy choices—on monetary policy, fiscal policy and structural policies—affect both productivity and inequality. If coordinated and enacted coherently, they could act as levers to tackle the productivity slowdown and the rise in inequality together.

Aggressive demand management, through monetary and fiscal actions, can lift output, investment, and through those channels, productivity too. In many countries, the sluggish recovery in investment since the crisis has depressed productivity as well as undermined employment growth. Since low-income, low-skilled workers often are the first to lose their job, slow growth exacerbates poverty and income disparities. Slow growth also sends the signal to firms to reduce investments in finding new markets and developing new products, tempering productivity diffusion.

Public investment—in infrastructure, research, education—is a powerful policy lever and a pillar of economic progress. Not only do these expenditures expand demand and create jobs today, but they can, by catalysing private activity, supporting innovation and improving skills, raise the long-term ability of the economy to grow and provide for the long-term needs of the citizens. Since the crisis, many governments have reduced public investment, in part because their focus was on immediate fiscal consolidation. The very weak recovery and already strong reliance on monetary accommodation demands a renewed focus on fiscal policy and public investment. Interest rates for sovereign debt obligations are now very low, so governments can borrow for public investments at unprecedentedly low rates. Further, infrastructure is in a poor state in many countries, while the need for new infrastructure, in low-carbon energy supply for instance, is crucial to meet the climate-change crisis.

Structural policies need to go hand-in-hand with demand side policies to tackle productivity and inequality. Many countries have, for instance, room to reallocate money to education, and indeed, our analysis indicates that increases in education spending, offset by savings elsewhere, are good for productivity and equality of income and opportunity. Another example is stronger R&D collaboration between firms and universities, which can improve the diffusion of productivity gains from leading to lagging firms.

Reforms of product market regulation and bankruptcy legislation that ease barriers to firm entry and exit raise innovation and productivity. Pro-competition reforms also tend to raise employment over time; although they can increase the
chance of a job loss for lower-income workers they also increase the chance of getting a new job. Lifelong learning, training and active labour market programmes have proven value in enabling people to skill up and find new jobs. Packaging product market reforms with greater efforts to provide training and job-search support bears the promise of promoting productivity and reducing inequality, too.

The banking and finance sector was a key conduit for the financial crisis. But it has also contributed to subsequent shortfalls in demand. In some markets, high financing costs have exacerbated the weakness in investment. Faster write-downs of non-performing loans, rationalising the banking markets and, in some situations, bank recapitalisations would help improve the transmission of monetary policy stimulus into credit demand and investment. Too-big-to-fail guarantees to large banks add to inequality. Financial sector employees enjoy a wage premium compared with workers in other sectors. In Europe, this financial wage premium is 25% of average earnings and reaches nearly 40% for top-paid workers.

Solving the productivity-inequality twin challenge requires coherent and comprehensive policy packages of demand and structural policies that take account of the existing institutional framework and policy settings that are unique to each country. Even as each package deploys monetary and fiscal policy, and levers from each of the suite of structural policies (innovation and market competition, labour skills and adaptation, financial system structure and performance), there is no one-size fits all.

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