Employment and productivity and their contribution to economic growth

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PURPOSE : to present a Commission staff working paper on employment and productivity and their contribution to economic growth.

CONTENT : this paper is in response to the request of the Secretary-General, in the framework of the Industrial Policy Steering Group, for an "'analysis of the analyses', i.e. to go further than normally in identifying the differences between the analyses of the individual services and address particularly also the underlying factors for such differences". It is a joint product of DGs Economic and financial affairs, Employment and social affairs and Enterprise. It focuses on the relationship between the two components of economic growth: employment growth and productivity growth.

The paper shows that EU employment and productivity growth patterns have diverged sharply over recent years. Compared with the first half of the 1990s, the period 1996-2002 has witnessed a significant increase in the contribution of labour to EU GDP growth but unfortunately this has been offset by a reduction in the contribution from labour productivity.

The paper looks at possible explanations for the growing divergence in the underlying performances of the EU and US economies and at how the EU could perform better on both the productivity and the employment fronts. It also addresses the question of whether the problem lies with the basic policy framework or with a failure, on the part of the Member States, to enact the necessary reforms to turn rhetoric into reality.

The paper concludes by stating that both economic theory and the experience of EU Member States and the US suggest that there is no call for an exclusive focus on either employment growth or productivity growth. GDP per capita – a measure of standards of living – depends on both GDP per person employed and the employment rate. From a policy perspective, the key objective must be to raise productivity levels using all the available instruments to stimulate growth of total factor productivity, whilst at the same time encouraging the labour-intensive growth pattern over the medium term that is needed to move towards full employment. Pressing ahead with the necessary labour market reforms may entail a period of productivity growth below full potential, but this should not be regarded as a trade-off in any sense. A higher employment rate implies an unambiguous increase in GDP per capita with no negative implications for the long-run productivity growth of the existing workforce. Furthermore, progress on labour market reforms does nothing to impede efforts to stimulate investment and technical progress. Thus, there is no reason why policy makers cannot act on both fronts simultaneously.

The EU's policy framework is designed to do precisely this. Moreover, a small number of Member States, which tend to be the ones that are more advanced in the implementation of reforms, have performed strongly on both employment and productivity, equalling or even surpassing growth rates in the US. Timely and thorough implementation of reform measures would therefore appear to be the real Achilles' heel of the Lisbon strategy. This short note has shown that the reasons why Europe has fallen behind the US in productivity growth in recent years are complex, with part of the explanation undoubtedly due to the extent to which information and communication technologies have penetrated the respective economies and part due to the relatively labour-intensive pattern of growth in the EU since the mid-1990s. However, a large residual element is left unexplained which is almost certainly related to the more fundamental factors driving growth.

These factors include, to mention some of the most important, education and training, investment in R&D, transport and communications infrastructure, the entrepreneurial culture, workplace organisation, the efficiency of the public sector and the way in which markets - the labour market, financial markets and product markets - are functioning. The EU's comprehensive reform strategy - outlined in some detail in this paper - aims for improvements in precisely these areas.

Nevertheless, in moving forward over the coming months and years on the policy agenda laid out in this paper, governments will inevitably face hard policy choices as to the optimal path to follow in order to realise the specific Lisbon objectives. The fact that they can pursue both employment- and productivity-enhancing reforms does not remove the obligation on policy makers to set clear priorities and to identify the areas of most urgent action. Moreover, the policy making function itself will be further complicated by the ongoing public finance constraints which will undoubtedly apply. Hard choices will therefore have to be made in terms of new public spending commitments with regard to both the overall balance to be achieved between productivity- or employment-enhancing measures and to the weight to be attached to specific initiatives. In addition, given the inevitable pressures on new spending commitments, governments will increasingly have to question existing public programmes in order to elicit greater efficiencies and higher levels of overall performance.