

[Britain's productivity conundrum](#) [1]

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UK [unemployment is falling](#) [3], hours worked are increasing, while output is still stagnant (or even [decreasing](#) [4]). What does all this mean? How can the private sector create more jobs, while the total output it produces is still stagnating or even decreasing? Some economists seem puzzled by this saying that one set of data in this case is [wrong](#) [5]. Even though this might be true as one of the two parameters is misleading, there are deeper explanations for this prevalent occurrence in the past few months.

It is not surprising that the first reaction on the market is a decrease in productivity (see graph below) as more people employed are actually producing less. This can partially be explained by an increase of hiring due to the Olympic Games, since none of these people are creating value or output growth for the economy, but nonetheless have paying jobs.

Source: ONS, [Labour Market Statistics](#) [6], July 2012, pg. 8

Lower wage growth would suggest that unit labour costs are decreasing which is making workers cheaper and more likely to find work. However, looking at the graph this doesn't seem to be the case. But the question still remains: what is driving productivity down?

If we turn to statistics, we can blame the faulty data reporting and faulty measures of economic activity such as the GDP, or the way we define employment. However, we always use this data and if it serves as a sort of a benchmark in good times, there is no reason why not use it in bad times. The efficiency and precision of the indicators is a debate for itself, but I leave this for another time.

As for employment, personally I would always rather look at the employment-population ratio, an indicator that paints a much more precise picture of economic activity since it takes into account people leaving the workforce, which usually biases the unemployment figures downwards. In that perspective, the labour market isn't improving, it's still in [distress](#) [7].

The second explanation for a temporary drive in employment compiled with a stagnating output can be

seen in the manifestation of the government's job policies. While the British government is going head over heels to try and bring more people into work, their programs of incentivising employers to hire more workers are an example of a severe labour market distortion. No wonder productivity is rapidly falling. Employers hire people only to get the government benefit. There is no economic incentive for an employer, apart from the government subsidy he receives. The additional worker won't create new value; his or her marginal product is very likely to be diminishing.

And since these programs are only at their beginning stages, productivity is likely to become even worse in the years to come. So what's the point of the policy? Simple, it shows good numbers and thus relaxes the pressure on the government. The fact is that this is just another 'Potemkin village' designed to skew the public opinion into showing that the government is actually doing something to help the economy. But here's the catch - whatever it does, it only hurts the chances of recovery.

The public is bemused into thinking that the government must address the market failures created by reckless bankers or the finance industry. That wasn't the issue at all; market failures were in that particular case created by a series of government initiated policies. Ranging from the distortions on the housing market, the credit market, the banking risk, the overall systemic risk and even the European contagion - all these areas were cramped by excessive risk taking which was supported by the regulatory environment and policy decisions.

The market (i.e. the people engaged in interactions and decision-making) simply reacted to the vastly distorted signals sent to them. So the proper way of fixing this can only lie in the market itself, as long as its recovery signals aren't being distorted. Having the government subsidize employers to hire more people simply to increase head count, or having the government force banks to reach [lending targets to SMEs](#) [8] or pre-determined 'winners', are exactly the type of wrong and distorted signals that are preventing the recovery.

One is leading to rapidly declining productivity, and the other is making banks lend money to businesses which already have enough of it, thereby completely excluding the ones that actually need it to expand their productive activities. To paraphrase Arnold Kling and Nick Schultz from their excellent book *From Poverty to Prosperity: 'markets often fail, that's why we need markets.'*

There is only [one way](#) [9] of resolving the issue of declining productivity and competitiveness, and it's not an employment subsidy, it's a labour market reform.

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[4] <http://www.tradingeconomics.com/united-kingdom/gdp-growth>

[5] <http://blogs.wsj.com/source/2012/07/18/unemployment-statistics-are-the-odd-one-out/>

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