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Employ America Research Report

# The Dream of the 90’s is Alive in 2024: How Policy can Revive Productivity Growth

## *Executive Summary*

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The last time the US economy saw high and sustained productivity growth was the 1990s. That strong productivity growth was the result of three key dynamics: full employment, a fixed investment boom, and a stable supply-side. Today, we have the opportunity today to design policy that recreates these dynamics and secures the strongest productivity growth in three decades for years to come. To do this, policymakers must use the levers of fiscal, monetary, and industrial policy to provide smart support to the economy. The benefits to ensuring that all three conditions are met once again stand to be very significant.

### The Three-legged Productivity Stool

The strong productivity growth of the late 1990s was historically unique, and made possible by three key factors. All recoveries see these three factors to some degree, but strong productivity growth requires all three to be firing on all cylinders. In the late 1990s, the U.S. economy assembled the benefits of all of the following:

1. **A mature labor market**, where employment growth transitions to wage growth and continues to support consumer demand.

2. **A fixed investment boom** where strong demand and accommodative financing incentivize businesses to invest in productivity and capacity enhancing equipment.

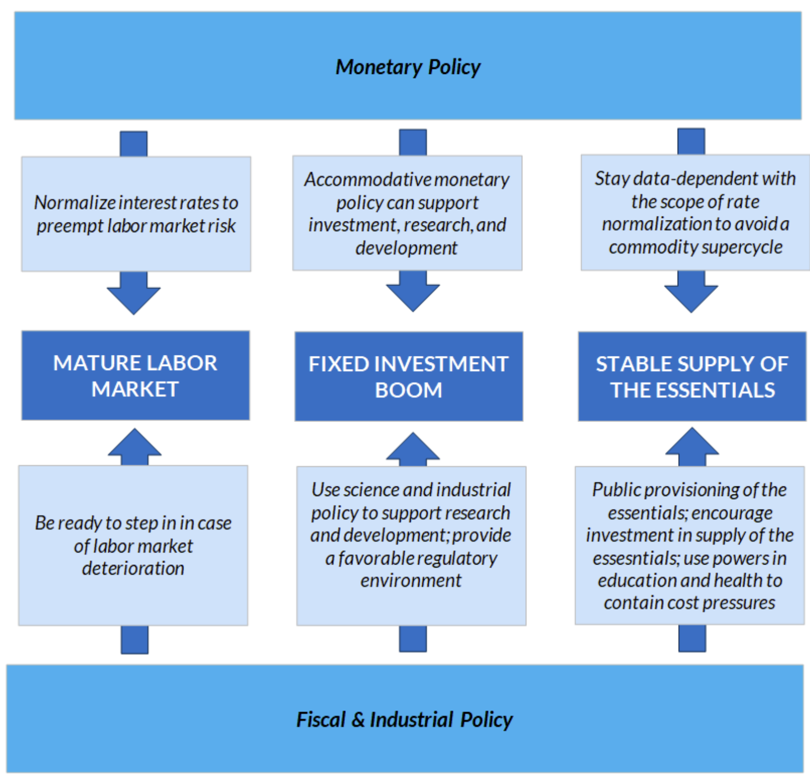
3. **A stable supply of “the essentials”** of food, housing, energy, and healthcare—without this, increased consumer demand is at risk of being wasted on rising inflation.

These three dynamics are like the three legs of a stool, and all support one another, and together support stronger productivity growth. Full employment provides sustainable growth in labor income and consumer demand. This growth of demand, in turn, justifies the investments in productivity-improving technology made by companies. These investments then deepen the capital stock—the factories and equipment in the economy—which in turn boosts labor productivity and minimizes any inflationary consequences of wage growth.

While luck played a major role in the 1990s, we have the opportunity to rely on policy strategy today instead. In the 1990s, the US economy was fortunate to avoid significant energy and food shocks and even benefited from low commodity prices during the Asian financial crisis. But even then, policy still played an important role, particularly in supporting research into microchip development and allowing the labor market to remain strong after the early-1990s recession.

Today, we should not simply rely on luck to bring back productivity growth. Instead, policy must be proactive and provide support to the economy by helping build three strong legs for the productivity growth stool. We have the opportunity to recreate the positive productivity dynamics of the 1990s, as long as fiscal, monetary, and industrial-level policies provide smart support to the economy. **Strong productivity growth is not simply an outcome to hope for; it is a goal for policymakers to actively aim for.**

## How Policy can Support Productivity Today



**Maintain Full Employment.** Full employment and labor scarcity provide a stimulus to firms to make investments in productivity-enhancing equipment. Thanks to the strength of the post-pandemic recovery—itself a product of strong fiscal and monetary support throughout the pandemic—many measures of employment are making multi-decade highs. As job-switching and labor market churn slow down with the end of the recovery, workers can develop experience and build efficiencies in their current jobs. Over time, a mature labor market will likely continue to support higher productivity as we move past the “early innings” of the recovery.

Now that the labor market is beginning to mature, policymakers face a novel challenge: maintaining tight labor markets. In our view, the best way to do so is for policymakers to preempt any downside labor market risks. The biggest risk to the labor market today is a labor market recession. In order to maintain the hard-won policy victory of tight labor markets, **the Federal Reserve must be willing to normalize interest rates and preempt risks to the labor market.** Labor markets look tight today, but we know for a fact that when they begin to deteriorate significantly, problems can quickly snowball.

**Encourage Investment and Innovation.** The recovery in fixed investment has been weaker than the labor market recovery. However, this also means that there is further runway for this dynamic to continue growing. Tight monetary policy appears to be slowing fixed investment, but fiscal supports are keeping energy and manufacturing construction investment on a firmer trajectory.

For a real investment and innovation boom to get started, firms need to feel as though expected demand justifies making further investments to enhance productivity or capacity. Maintaining consumer demand by ensuring a baseline growth rate of labor income should be considered a macroprudential priority from an investment perspective.

Once a boom starts, policymakers will need to prevent the tight financial conditions that straitjacketed fixed investment in structures and equipment in the 1980s. Back then, high interest rates meant investment goods were more expensive to finance, which helped incentivize firms to focus on financial maneuvering over increased investment. If the Fed is generous in its approach to interest rate normalization, a boom in fixed investment may well be possible.

**Build a resilient supply of the essentials.** The biggest lesson of the pandemic has been that economists and policymakers cannot take orderly supply chains for granted. In order to prevent the supply-side from locking-up, policy needs to promote a resilient supply chain in essential sectors such as energy, food, housing, and medical services. Decarbonization will require substantial increases in fixed investment, as will controlling rental inflation. It is up to the Fed to ensure that the monetary policy environment remains sufficiently conducive to bring forth the appropriate volume of fixed investment. Elsewhere on the supply side, industrial policy should be undertaken with a macroprudential view to help stabilize inflation. Finally, the government can also control costs directly, without altering supply in sectors where it has significant sway over pricing, such as medical services and education. Doing so helps ensure that the sectors making productivity gains do not see the benefits of those gains eroded by rising prices elsewhere.

**If policymakers decline to take these straightforward moves, they should be clear that that decision means abandoning strong growth, a more resilient economy, and a better deal for workers.** With the pandemic recovery largely complete, we are at a crossroads for the 2020s economy. Whether or not we see a continued productivity boom is ultimately a question of policy, not merely a question of fate. If policymakers successfully support these three core productivity drivers—**a mature labor market, a fixed investment boom, and a stable supply of the essentials**—strong and sustained productivity growth is likely to follow.