THE CONFERENCE BOARD

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## The Conference Board Report Finds Low Wages Not Always Key Success Factor for Overseas Investment

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The comparative cost advantage of taking your business to low-wage countries such as China or India, where unit labor costs in manufacturing are 20 percent lower than in the U.S., are often not the bargain they seem when wages are adjusted for low productivity, according to a report released today by The Conference Board.

This is also true of decisions to locate in Mexico, Central and Eastern Europe rather than in North America and Western Europe.

"One critical lesson for businesses that benefit from one-time labor cost benefits when investing in 'low wage' countries is that productivity gains from new technology and innovation have to keep pace with often fast rising wages of skilled and semi-skilled workers or the 'cost advantage' begins to erode," says Bart van Ark, Director of The Conference Board international economic research program and co-author of the report with The Conference Board Director of Global Demographics, Judith Banister, and Economist Catherine Guillemineau, formerly of The Conference Board.

**UNIT LABOR COST COMBINES COMPENSATION AND PRODUCTIVITY**

Unit labor cost (ULC) is defined as the average labor compensation per unit of output and is measured as the ratio of labor compensation per employed person (or per hour worked) relative to output per employed person (or per hour worked) for the aggregate manufacturing sector in six major emerging economies (China, India, Turkey, Mexico, Czech Republic, Hungary and Poland) as well as the old European Union-15 countries and Japan.

With the release of this new dataset, The Conference Board is the first non-governmental organization to provide such data on a regular basis. International data on the growth rate of unit labor costs are widely available, but comparisons of levels are very rare due to the unavailability of comparable production measures in a common currency. This report also marks the first attempt to estimate the level of unit labor costs in China and India in comparable U.S. dollar purchasing power parity.

**WHERE UNIT LABOR COSTS ARE LOWEST**

The report finds when adjusting for productivity gaps, the cost competitiveness of emerging economies is not as strong as suggested by wage differences. This is because their lower wage cost goes together with lower productivity. Hence emerging economies still retain a competitive advantage because in most cases the productivity gap is smaller than the wage gap. This is because companies can benefit from better use of technologies due to their exposure to international competition.

There are large differences in unit labor cost between emerging economies. Among a group of six major emerging economies, the variation in unit labor costs in manufacturing ranges from 20 percent of the U.S. level for China and India, to almost equal the U.S. level for Mexico.

"These differences underscore the challenge that even very low wage countries have in fostering productivity growth that keeps pace with or exceeds rising wage levels to preserve their relative global competitive position," says van Ark. "The key for emerging economies is to promote productivity through technological change and innovation to match wage increases which will undoubtedly happen in a rapidly growing economy."

**PRODUCTIVITY GAINS ADD TO U.S. ADVANTAGE**

During the past 12 years, the U.S. has widened its unit labor cost advantage over Europe, thanks not to lower wages but to continued higher productivity gains. Japan has succeeded in restoring its competitiveness by bringing down its manufacturing wage costs below the EU-15 in 2004, which helps boost international competitiveness but has done little to spur domestic markets.

The report shows that the balance between wage and productivity gains is not just a challenge for emerging economies, but for all countries.

Says van Ark: "For advanced countries, the issue is to keep labor compensation in check with productivity. This raises issues about the balance between net and gross pay, the tax base, and the cost structure of firms. But it also forces government and business to focus on exploiting knowledge creation as a means to stay at the productivity frontier and avoid a race to the bottom in terms of cost competition."

COMPENSATION IN EMERGING COUNTRIES LESS THAN 15 PERCENT OF U.S. LEVELS

The level of labor compensation in manufacturing in emerging economies is extremely low relative to advanced economies. On average, the manufacturing sector in Central and Eastern Europe and Mexico pay between 10 percent and 15 percent of compensation paid in the U.S. In Turkey, the level is around 5 percent. The manufacturing sector in India and China only pays between 2 percent and 3 percent of the U.S. compensation level on average. But these are average compensation levels for all manufacturing companies. Global companies are likely to operate at smaller wage margins among their plants in different countries, paying wages at much higher levels than domestically owned plants in emerging economies.

As the gap in labor productivity between emerging economies and the U.S. and other advanced countries is generally smaller than the wage gap, the emerging economies retain a labor cost advantage. But there are important differences. For example, China and India manufacturing industries have been most successful in keeping labor compensation at the lowest possible levels, namely 2.5 percent to 3 percent of the U.S. level in 2002. Labor productivity was also far below the U.S. level at 12 percent to 13 percent. But productivity levels exceeded compensation levels by a considerable margin. As a consequence, unit labor costs in China and India are on average 20 percent lower than unit labor costs in the U.S. So China and India are by far the most competitive manufacturing nations in The Conference Board sample. At the other extreme among the emerging economies is Mexico, which had labor costs of 11 percent of U.S. levels in 2002. But this was matched by a similarly large productivity gap. As a result, unit labor costs in manufacturing were almost equal to those in the U.S.

**THE U.S. UNIT LABOR COST ADVANTAGE OVER EUROPE**

During most of the 1990s, the U.S. unit labor cost advantage over Europe was supported by higher U.S. productivity, more than by higher wage levels. But unit labor costs can change rapidly, particularly when price levels change. Relative to the U.S. in 2005, unit labor cost in the EU-15 was significantly higher than in 2002, namely 30 percent higher in 2005 versus about equal in 2002. By 2005, none of the EU-15 countries, except Finland and Ireland, had manufacturing unit labor cost below the U.S. level.

The increase in unit labor cost between 2002 and 2005 is, in part, related to the rapid appreciation of the euro relative to the U.S. dollar which caused a significant increase in relative labor compensation. However, relative unit labor cost between the U.S. and the EU-15 reflected not only short-term exchange rate variations, but also a drop-off in labor productivity in Western Europe.

During the past 12 years, the U.S. has shown continued higher productivity gains. Until 2002, this effect was offset by increasing labor compensation in the U.S. due to the dollar appreciation, but since then the double effect of declining labor cost and rising productivity has led to a rapid improvement in U.S. manufacturing labor cost over the European Union.

**JAPAN IS STILL COMPETITIVE**

Unit labor cost in Japan today is higher than in the U.S., as the relative high level labor compensation levels of past years are not supported by equally high productivity levels. Presently, Japanese manufacturing does signal a further improvement in productivity levels strengthening its cost competitiveness, even though it has done little to spur domestic markets.

**ABOUT THIS REPORT**

This report is the first in a series of studies by The Conference Board on competitive performance among advanced and emerging economies. Future reports will address the performance of individual industries, and the role of technology, innovation, and knowledge.

Source: *Competitive Advantage of "Low Wage" Countries Often Exaggerated*
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