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The Productivity Paradox

By STEPHEN S. ROACH

Despite the economy's stunning 8.2 percent surge in the third quarter, the staying power of this economic recovery remains a matter of debate. But there is one aspect of the economy on which agreement is nearly unanimous: America's miraculous productivity. In the third quarter, productivity grew by 8.1 percent in the nonfarm business sector — a figure likely to be revised upwards — and it has grown at an average rate of 5.4 percent in the last two years.

This surge is not simply a byproduct of the business cycle, even accounting for the usual uptick in productivity after a recession. In the first two years of the six most recent recoveries, productivity gains averaged only 3.5 percent. The favored explanation is that improved productivity is yet another benefit of the so-called New Economy. American business has reinvented itself. Manufacturing and services companies have figured out how to get more from less. By using information technologies, they can squeeze ever increasing value out of the average worker.

It's a great story, and if correct, it could lead to a new and lasting prosperity in the United States. But it may be wide of the mark.

First of all, productivity measurement is more art than science — especially in America's vast services sector, which employs fully 80 percent of the nation's private work force, according to the United States Bureau of Labor Statistics. Productivity is calculated as the ratio of output per unit of work time. How do we measure value added in the amorphous services sector?

Very poorly, is the answer. The numerator of the productivity equation, output, is hopelessly vague for services. For many years, government statisticians have used worker compensation to approximate output in many service industries, which makes little or no intuitive sense. The denominator of the productivity equation — units of work time — is even more spurious. Government data on work schedules are woefully out of touch with reality — especially in America's largest occupational group, the professional and managerial segments, which together account for 35 percent of the total work force.

For example, in financial services, the Labor Department tells us that the average workweek has been unchanged, at 35.5 hours, since 1988. That's patently absurd. Courtesy of a profusion of portable information appliances (laptops, cell phones, personal digital assistants, etc.), along with near ubiquitous connectivity (hard-wired and now increasingly wireless), most information workers can toil around the clock. The official data don't come close to capturing this cultural shift.

As a result, we are woefully underestimating the time actually spent on the job. It follows, therefore, that we are equally guilty of overestimating white-collar productivity. Productivity is not about working longer. It's about getting more value from each unit of work time. The official productivity numbers are, in effect, mistaking work time for leisure time.
This is not a sustainable outcome — for the American worker or the American economy. To the extent productivity miracles are driven more by perspiration than by inspiration, there are limits to gains in efficiency based on sheer physical effort.

The same is true for corporate America, where increased productivity is now showing up on the bottom line in the form of increased profits. When better earnings stem from cost cutting (and the jobless recovery that engenders), there are limits to future improvements in productivity. Strategies that rely primarily on cost cutting will lead eventually to "hollow" companies — businesses that have been stripped bare of once valuable labor. That's hardly the way to sustained prosperity.

Many economists say that strong productivity growth goes hand in hand with a jobless recovery. Nothing could be further from the truth. In the 1960's, both productivity and employment surged at an annual rate of close to 3 percent. In the latter half of the 1990's, accelerating productivity also coincided with rapid job creation.

In fact, there is no precedent for sustained productivity enhancement through downsizing. That would result in an increasingly barren economy that will ultimately lose market share in an ever-expanding world.

That underscores another aspect of America's recent productivity miracle: the growing use of overseas labor. While this may increase the profits of American business — help-desk employees or customer-service representatives in India earn a fraction of what their counterparts in the United States do — the American worker does not directly share the benefits. The result is a clash between the owners of capital and the providers of labor — a clash that has resulted in heightened trade frictions and growing protectionist risks. There's nothing sustainable about this plan for productivity enhancement, either.

In the end, America's productivity revival may be nothing more than a transition from one way of doing business to another — a change in operating systems, as it were. Aided by the stock market bubble and the Y2K frenzy, corporate America led the world in spending on new information technology and telecommunications in the latter half of the 1990's.

This resulted in an increase of the portion of gross domestic product that went to capital spending. With the share of capital going up, it follows that the share of labor went down. Thus national output was produced with less labor in relative terms — resulting in a windfall of higher productivity. Once the migration from the old technology to the new starts to peak, this transitional productivity dividend can then be expected to wane.

No one wants to see that. For all their wishful thinking, believers in the productivity miracle are right about one critical point: productivity is the key to prosperity.

Have we finally found the key? It's doubtful. Productivity growth is sustainable when driven by creativity, risk-taking, innovation and, yes, new technology. It is fleeting when it is driven simply by downsizing and longer hours. With cost cutting still the credo and workers starting to reach physical limits, America's so-called productivity renaissance may be over before Americans even have a chance to enjoy it.

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