Why rising productivity is cause for worry

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The numbers may indicate that companies are shedding professionals—and that can undercut growth in the long term.

Here's a little puzzle for you. We're in the middle of the worst financial crisis since the Great Depression. Yet a key economic statistic—productivity, defined as output per worker hour—seems to be sailing along without a worry. According to the latest government data, nonfarm business productivity rose by a decent 1.8% over the past year. Looking over the past two years, since early 2007, output per hour grew at a strong 2.6% annual pace, far faster than the 25-year average gain of 2%.

History tells us that strong productivity numbers like these should bring a happy-face economic boom. When businesses are able to produce more with fewer workers, profits and wages generally go up, living standards rise, and inflation stays low. In fact, during the New Economy boom years of the late 1990s productivity growth averaged about 2.5% to 3% a year, and we were ecstatic. As Nobel Prize winner Paul Krugman once said: "Productivity isn't everything, but in the long run it is almost everything."

But history also tells us something else: Massive economic disruptions are typically accompanied by weak or negative productivity growth, because businesses have trouble raising money and operating efficiently. Output per hour stagnated in the two deepest postwar recessions, 1974-75 and 1981-82. During the worst of the Great Depression, 1929 to 1933, productivity plunged.

So why, today, are we blessed with the unlikely combination of deep recession and rising productivity? The optimistic explanation is that American businesses have gotten religion and are aggressively squeezing out waste and boosting efficiency. If that's true—and to some degree it surely is—then businesses can survive the recession and even increase profits without raising prices. And that, in turn, helps Fed Chairman Ben Bernanke keep interest rates at near-zero without worrying unduly about inflation.

But there may be another, less benign, reason for rising productivity. In past downturns, educated professionals have escaped mainly unscathed. This time businesses are relentlessly hacking at their professional workforce—a tactic that boosts short-term productivity while hurting long-term growth. Rising productivity may be a sign of weakness, not strength.

White-collar woes

Over the past year the number of employed professionals has fallen by 0.7%, a rare decline. Outside of the still-growing education and health-care occupations, the number of employed professionals has dropped by a dramatic 3.6%.

The slide started in earnest after the Lehman debacle. Since August 2008, employment in engineering and architecture occupations is down 10.3%, computer and mathematical occupations are down 9.3%, and natural and social science occupations are down 2.3%. And the broad class of "creative" professionals, including designers, artists, and performers, is down 11.5% Together these four occupational groups have lost 1 million jobs since August. (For more details, see my blog Economics Unbound.)

In the short term, when a company cuts professionals, output per hour goes up. A pharmaceutical company could, in theory, ax its entire research operation without affecting current sales. And an automaker that laid off its new car designers could still churn out the same number of vehicles, and productivity would rise.

The danger: If the economy is stuck in a slow-growth recovery, companies may not be quick to rehire their professionals—and that would be a disaster. Professionals are the people who do the research, the new-product development, the information-gathering, the training, and even the marketing which moves the economy forward. They are the main source of the "intangible investments" necessary for innovation and future growth. In effect, we could be eating our seed corn to get through the financial crisis—and the official stats would not warn us.

With these sorts of job cuts, it isn't surprising that R&D spending at many companies is down compared with a year earlier. For example, in their latest quarterly reports, Cisco (CSCO) reported a 16% decline in R&D, Johnson & Johnson (JNJ) is down 11%, and 3M (MMM) is down 8%.

A postscript: The Bureau of Economic Analysis (BEA) is already in the slow process of revamping the gross domestic product statistics to incorporate business spending on R&D as an investment, just like spending on computers. That would fix part of the strong productivity puzzle, since reduced corporate spending on R&D would be reflected in slower growth in GDP and productivity, more accurately tracking the true state of the economy.

Because of budget cuts in 2008, the preliminary figures published by the BEA go only through 2004—no help today. The new budget just put out by the Obama Administration boosts the BEA's budget and specifically directs the agency to "produce new and expanded GDP-related statistics that uniquely measure the role of innovation." That would fund better statistics on R&D and other intangible investments. But given the mammoth federal deficits, it still is not clear whether this request for extra funds will survive the coming congressional debates.

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