THE NEW YORKER

THE FINANCIAL PAGE

WHAT AILS US

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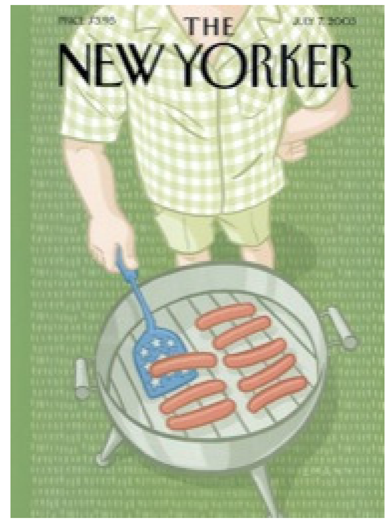
JULY 7, 2003



Forgive American consumers if they feel a bit perplexed. Policymakers and pundits have been warning them about the prospect of deflation (a prolonged and widespread decline in prices), but there's no sign of any decline in many of the prices that people pay every day. Car-insurance premiums jumped more than nine per cent last year. Health-insurance costs are soaring, to say nothing of the cost of a haircut. Cable-TV prices have risen sixteen per cent since 2000. And then there's college: tuitions at private colleges have jumped 5.6 per cent annually over the past three years, according to the College Board, and public colleges are even worse. In times like these, it's hard to get worked up about deflation.

Why the divergence? It may have something to do with Mozart. When Mozart composed his String Quintet in G Minor (K. 516), in 1787, you needed five people to perform it—two violinists, two violists, and a cellist. Today, you still need five people, and, unless they play really fast, they take about as long to perform it as musicians did two centuries ago. So much for progress.

An economist would say that the productivity of classical musicians has not improved over time, and in this regard the musicians aren't alone. In a number of industries, workers produce about as much per hour as they did a decade or two ago. The average college professor can't grade papers or give lectures any faster today than he did in the early nineties. It takes a waiter just as long to serve a meal, and a car-repair guy just as long to fix a radiator hose.

The rest of the American economy functions differently. In most businesses, workers are continually getting more productive and can produce a lot more per hour than they could ten or twenty years ago. In 1979, workers at G.M. needed forty-one hours to assemble a car. Today, they need just twenty-four. In the nineties, according to the consulting firm McKinsey & Company, retailers boosted their sales per hour by sixty per cent, and that was nothing compared with computer makers, whose productivity since 1995 has gone up sixty per cent each year. Because companies are producing more for less, they can hold down costs, and when times are good they can raise wages without hiking prices. So, in the late nineties, as productivity rose, wages did, too, though inflation lay dormant.

Generally, productivity growth is a boon, but it creates problems for non-productive enterprises like classical music, education, and car repair: to keep luring talent, they have to increase wages, or else people eventually migrate to businesses that pay better. Instead of becoming nurses or mechanics, they become telecom engineers or machinists. That's why teachers are getting paid a lot more than they were twenty years ago. (The average salary for an associate college professor has risen almost seventy per cent since the early eighties, and that's if you adjust for inflation.) To pay those wages, schools and hospitals have to raise prices. The result is that in industries where productivity is flat costs and prices keep going up. Economists call this phenomenon "Baumol's cost disease," after William Baumol, the N.Y.U. economist who first made the diagnosis, using the Mozart analogy, in the sixties. As anyone with kids knows, cost disease is alive and well. A recent study by the economists Jack Triplett and Barry Bosworth demonstrates that among the service businesses that have been least productive in recent years you'll find education, insurance, health care, and entertainment. These are the ones that have seen steep price hikes.

There are really two American economies: one that's getting more productive and one that's not. In the first—the economy of Dell, Toyota, and Wal-Mart—consumers have grown accustomed to paying less for more. In the second—the economy of Harvard, the Yankees, and Bob's Body Shop—they pay more for the same. The first economy has policymakers worried about deflation. The second has consumers worried about paying their bills.

Cost disease isn't anyone's fault. (That's why it's called a disease.) It's just endemic to businesses that are labor-intensive. Colleges, for example, could do many things more efficiently, but, since their biggest expense is labor, the only way to reduce costs is either to increase the number of students each professor teaches or to outsource the work to poorly paid adjuncts. The same goes for health care: you can control drug costs and limit expensive new procedures, but, when it comes to, say, hospital care and doctor visits, the only way to improve productivity is to shrink the size of the staff and have doctors spend less time with patients (or treat several patients at once). Thus the Hobson's choice: to lower prices you have to lower quality.

Once upon a time, economists worried that cost disease would wreck the economy, as services started to eat up more and more of people's budgets. But the evidence now suggests that it can be contained. As long as the productive industries keep growing quickly enough to offset the sluggards, the economy as a whole can stay in good shape. The most significant consequence of Baumol's cost disease, in fact, may be political, rather than economic. Some of the most important services that the government provides—education, law enforcement, health care—are the hardest to make more productive. To keep providing the same quality of services, then, government has to get more expensive. People pay more in taxes and don't get more in return, which makes it look as though the public sector, at least compared with the private sector, is inept and bloated. But it could be that the government is merely stuck in inherently low-productivity-growth businesses. It's not inefficient. It's just got a bad case of Baumol's.