



BOOK REVIEW

THE POWER OF PRODUCTIVITY: WEALTH, POVERTY, AND THREAT TO GLOBAL STABILITY

By William W. Lewis, Chicago: The Chicago University Press, 2004, ISBN: 0-226-47676-6, 339 pp. (excluding i-xxxi)

It is interesting to note that 14 years before Lipton (1977) highlights the issue of “Why Poor People Stay Poor”, Solow (1963) has already introduced the concept and method to measure growth, which was then widely applied to appraise a nation’s poorness. The model, later named after Solow, argues that apart from capital stock and workforce, another attribute of growth is technological change or efficiency or productivity. The third attribute is so crucial to the extent that it is used to gauge whether a country’s development is sustainable or not. Thousands of papers on the Solow model, mainly empirical, covering all sectors of the global economy, have been published in journals, books, reports and proceedings. In these works the productivity of countries is measured and compared, and then ranked.

Together with the model came many other concepts and theories: catching-up, convergence and divergence, efficiency, and input-driven theories, among others. In fact, the model provides an impetus to large improvements on how productivity growth is measured. Specifically, productivity growth is broken down into many components ranging from technical change, economies of scale, factor substitution to innovation. Furthermore, the production function used to measure productivity growth over the 40-year period has withstood a series of evolution. Depending upon the nature of the economy and availability of data, the function varies from the standard Cobb-Douglas production function to other functions like cost and profit functions.

So far, with very few exceptions, studies conducted to measure productivity rely on aggregate data. Though useful for a ‘bird’s-eye

view' analysis, studies based on aggregate data are insufficient to make a definitive and conclusive inference concerning the productivity performance at the industry level. Moreover, large variations in relative labor productivity across industries show that aggregate productivity gives a somewhat incomplete picture of the technological and productivity characteristics across countries (Ark, 1993).

Having said this, the book by Lewis, entitled, "The Power of Productivity: Wealth, Poverty, and Threat to Global Stability", is very unique. First, all the elements that make up a productivity study as described above are rigorously reviewed. Second, the presentation is simplified in such a way that even a layman with little knowledge of economics, let alone algebra, would be able to understand the analysis and arguments put forward by the author without much difficulty. Lewis, at the very outset, clarifies that the contents of the book are not about which production function is best to measure productivity. Rather, it is about charting the poor nations' future based on their strengths, weaknesses, opportunities and threats in order to attain high productivity.

The book takes off by putting before the readers the world economic conditions after the Second World War and the measures taken to overcome them. Recession was the buzz word after that war, and a vast array of international and national institutions such as the United Nations, the World Bank, the International Monetary Fund, and a host of non-government and government aid organizations were instituted with the 'holistic objective' of extending a helping hand to poor nations to enable them overcome poverty in the years ahead (p.3). Conventionally, it was thought that improvements in infrastructure, technology, capital markets, education, and health care were the answer to eliminating the stark development and growth imbalances between the rich and poor nations. After sixty years passed and with billions of dollars spent, the conventional thinking has been proven wrong. The imbalances or disparities have, in fact, not only widened but also become more severe.

In the early 1990s, the conventional thinking gained a new momentum when the Soviet Union (USSR) was 'dissolved'. It was believed that by addressing the issues of macroeconomic policies, such as flexible exchange rates, low inflation, and government solvency together with microeconomic elements such as price deregulation,

privatization, and good corporate governance, capitalism would certainly make a new inroad into the Eastern Bloc. At almost the same time, market reform swept through every corner of the world, including countries as diverse as Argentina, Brazil, India, Mexico, Nigeria, Poland, and China. Most of these countries did virtually everything needed to spark rapid growth but the results were once again disappointing. Obviously, the 1997/98 financial crisis was partly to blame. By the end of the 1990s, practically all of these and other poor countries' growth rates had returned to their low levels and the profile of the global economic landscape had hardly changed. Now, even after 60 years, more than 80 percent of the world's population still earn less than a quarter of the average income of rich countries. The only consolation lies in a handful of countries that have succeeded in their attempt to move out of dire poverty into the middle ground and enjoy a real prospect of joining the rich ones.

If the status quo is perpetuated, it is worrisome. It means that today's poor countries will likely remain poor even in 20 years to come because economic development is a slow process. Even if poor countries grew at the extraordinary rate of 7 percent a year, it would take them 50 years to catch up with the rich countries. At current rates of less than 3 percent a year, a couple of centuries would be needed to catch up, if they ever do. The gap between the rich and poor, according to Lewis, is a major threat to global stability.

In this respect, conventional solutions have failed because they do not address the real causes of persistent poverty. In economics, it is necessary to understand why individual firms operate as they do, since they are the ultimate sources of growth and job creation. Most economists cannot afford the time and resources needed to look in detail at the way an entire country's economy works. They rely instead on broad national data sets and complex econometric tools that yield qualified and 'statistically significant' answers at best.

The strength of this book is that it neither relies on broad national data sets nor complex econometric tools. Instead, it has the luxury of studying the dynamics and evolution of a representative group of industries in 13 countries: the United States, the United Kingdom, Sweden, South Korea, Russia, Poland, the Netherlands, Japan, India, Germany, France, Brazil, and Australia. In each country, it analyzes the

performance of 6 to 13 industries (auto, retail, construction, steel, ICT, foods and beverages, health, banking, power, among others), beginning from 1990, and compares it with the performance of the same industries in other countries. The work is thus micro-based with detailed studies of individual businesses, from state-of-the-art auto plants to black-market street vendors over a period of one decade. It builds an understanding of the economy from the bottom up, not the top down; a grassroots rather than a bird's-eye view (p.7).

This book has also brought forth a new and incomparable understanding of the persistence of income disparities among nations. Specifically, it argues that economic progress depends on increasing productivity and undistorted competition. When government policies limit competition, even unintentionally, more efficient companies cannot replace less efficient ones. Productivity slows lead to economic growth slows and nations remain poor. To understand what makes countries rich or poor, it is argued that economists must understand what causes productivity to be higher or lower. This understanding is best achieved by evaluating the performance of individual industries, since a country's productivity is the weighted average of productivities of all industries. Such a micro approach reveals the important fact that the productivity of industries also varies widely from country to country.

By taking this approach, this book has actually revealed two crucial insights. First, to understand why some countries are entangled in poverty, it is necessary to look beyond broad macroeconomic policies, such as interest rates and budget deficits. The myriad zoning laws, investment regulations, tariffs, and tax code must also be considered since they hold back the productivity of industries and thus a nation's prosperity. Undoubtedly, macroeconomic stability is necessary but not a sufficient condition for prosperity. In the same vein, a stable economy alone is not enough to make countries prosper and grow. Japan, for example, has had a stable economy for decades but suffered from years of stagnation.

The second insight is the realization that the income level of a country is determined, above all, by the productivity of its largest industries. High productivity in the unglamorous 'old-economy' sectors such as retailing, wholesaling and construction, is most important, since more people work in these sectors rather than in high-tech enclaves and financial markets. The study on the rapid US productivity growth

in the 1990s was found to be due to six industries, including retailing and wholesaling, and not by the crow about the 'new economy'. IT investments played a modest role. In India, the fast-growing IT industry has elevated the living standards of no more than a minuscule part of the population.

Differences in productivity also explain the persistence of disparities in wealth among rich nations. Twenty-five years ago, the economies of the United States, Europe, and Japan were generally expected to converge because technology, capital, and business practices flowed freely among them and their workforces were healthy and well-educated. However, significant disparities in wealth remain among these rich countries. Many economists have mistakenly attributed the differences in productivity of the countries to differences in their technology and capital markets. Indeed, this was not the case. Lewis's research found that these two factors explain only a small part of the differences in the countries' economic performance.

Now, if differences in technology and capital markets do not count, what does? On-the-job training was cited as one of the causal factors. In the early 1990s, Germany and Japan seemed to surpass the United States in economic performance. Since then, Japan's carmakers have built factories in the U.S. that achieve 95 percent of the productivity these companies enjoy at home. It was found that differences in the education system between US and Japan do not contribute much to productivity achievements in the auto industry. Rather, on-the-job training clearly compensates for the difference. This truth holds for poor countries as well. Some of Brazil's private retail banks are as efficient as any in the world. South Korea's POSCO, the successor to Pohang Iron & Steel, has the highest productivity of any integrated steel producer. Poor education systems have not hindered these companies to register high output per worker.

Perhaps one good lesson that poor countries can learn from these findings is that capital, technology, and education are not the prerequisites for attaining high productivity. Poor countries have the potential to grow much faster than what most people think. They can rely on labor productivity, which can be increased dramatically without additional capital. However, this can only be accomplished if the poor countries get their economic policies right (p.251). The Indian case is the best example cited by Lewis. About 20 percent of the people work in

companies that are structured somewhat like those in the developed world, but their average labor productivity is only 15 percent of what their US counterparts achieve. It was calculated that these companies could increase their productivity to about 40 percent of the US average without any additional capital investment, just by reorganizing the way they conduct work. In 1983, the high-performing Japanese auto company Suzuki Motor invested in a joint venture to make cars in India. Suzuki, which had the operational control, built plants like the ones in Japan, organized the work as it is organized in Japan, and trained employees to work (including the on-the-job training) as they do in Japan. As a result, the productivity of these facilities is 55 percent of the US auto industry average.

All this points to one conclusion, that is, poor nations do not have to wait to accumulate huge capital investment and to adopt a capital-intensive technology to be on par with rich nations in terms of productivity. In addition, they do not need to wait for more development aid from rich countries. If local businesses followed the proven approaches for organizing production and managing a workforce, poor countries could actually grow much faster.

Apart from on-the-job training, another factor that Lewis identifies to have significantly contributed to high productivity is competition in product markets. In each of the 13 country studies, it is found¹ that competition is the mechanism that helps more productive and efficient companies expand and increase their market share. Less-productive companies either have to go out of business or become more efficient (p.71). Either way consumers benefit as companies offer better goods at lower prices, and this has, in turn, unleashed a burst of new demand.

But government policies sometimes hinder competition and prevent innovation from spreading. Specifically, in economies in which the market mechanism is not in place, some resources may have been used to protect against diversion rather than to produce output. For example, capital is used for security systems and fences rather than for factories and machinery. In much of Europe, zoning laws prevent large retailers from expanding as fast as they could and, therefore, from replacing less efficient small retailers. Because retailing is one of the largest sectors in most economies, it has important ramifications for a nation's standard of living. For instance, Tesco, the United Kingdom's largest food retailer, has failed to obtain planning permission to build a modern

supermarket on the site of an abandoned hospital near central London because the building is over 100 years old. The result of such a failure is lower productivity for the UK economy and higher food prices for consumers. In Japan, a combination of zoning laws, tax policies, and government subsidies has allowed the smallest, most inefficient retailers (also called mom-and-pop industry) to flourish. Today they account for slightly half of all retailing employment, compared with less than 20 percent in the United States. Even the United States is not spared policies that limit competition. The 2002 steel tariffs, which have since been declared illegal by the World Trade Organization and withdrawn, protected US steel producers from lower-cost foreign competitors. The recent increase in US agricultural subsidies does the same.

The book proves that in poor countries, Russia included, many policies that distort competition have created major barriers to growth (pp.185-86). Examples are countless. After the USSR collapsed, a flurry of new business activities took place in Russia. It was assumed that more productive companies would replace the unproductive Soviet ones and that Russia would rapidly become rich. But it turned out to be the opposite. The new Russian companies were no more productive than their Soviet predecessors. This is because some of the productive companies enter the market and fail while others do not bother to try. For instance, Carrefour, perhaps the best French international retailer, concludes that it could not make money in Russia due to the competition coming from the open-air markets and the *gastronomes* (Soviet food retailing stores). The latter have a decisive tax edge over Carrefour since many of them neither pay rent nor tax.

A similar situation exists in Brazil. About 50 percent of its workers are not registered with the government. Although many of these people are poor and would not be taxed heavily, the total revenue forgone is substantial because of the number of workers involved. As a result, the Brazilian government must collect twice as much as the United States does in profit, employment, value-added, and sales taxes from corporations to finance its government. When taxes are included, it costs more for the productive companies to do business relative to the less productive, informal ones, which do not pay taxes. Modern, productive enterprises cannot easily reduce the market share of their unproductive counterparts, and thus the economy's natural evolution is stymied. Similarly in India, competition among housing developers and

construction firms is based not on cost and productivity advantages but on gaining control of scarce parcels of land without clear ownership titles. Over 90 percent of land titles in India are subject to dispute, and thus no one will invest in land someone else might claim.

Despite all these, dismantling barriers to economic growth can be difficult. Regardless, some firms must be allowed to go out of business even though it will force workers to find new jobs. Industries must be opened to foreign competition, and the enforcement of tax codes and other regulations must be strengthened. And governments must stand up to special interests. How can countries mobilize the political will to do all these things? The answer lies in focusing on consumers, not producers. Many people think that production itself creates economic value, an idea that sometimes makes governments protect businesses regardless of their poor performance. This approach, according to Lewis, is a mistake. Such people and governments fail to understand the link between production and consumption. Goods have value only if consumers want them. Otherwise sheer production does little to raise the standard of living.

In essence, the major findings of the book can be summarized by the following points: (i) many of the predictions of growth theory can be favorably considered in a cross-section context if the investigation is industry level-based (i.e., micro approach), but not economy wide-based (i.e., macro approach); (ii) differences in physical capital, technological advancement, and educational attainment only partially explained the large variation in labor productivity or output per worker across countries; (iii) differences in the levels of market openness cause large differences in productivity achievements and, therefore, large differences in income across countries; and (iv) the extent to which different countries have adopted a consumer-centered economy in place of the producer-centered economy is partially related to the extent to which they have made the economies free from rent-seeking, corruption, and other predatory behaviors.

All countries' long-run productivity performance is determined primarily by the institutions and government policies that make up the economic environment within which consumers and firms interact harmoniously and transparently. If policy makers in poor countries and the many development experts who advise them can furnish the most effective 'medicine' to this frequently overlooked disease, those countries

can experience rapid growth. Only then will the shape of the global economic landscape begin to change for the better, and the pernicious threats from the deprived-cum-poor countries be avoided.

ENDNOTES

1. In another study, Hall and Jones (1999) have treated social infrastructure, which is in many ways similar to the competition mechanism, as another determinant of growth. By social infrastructure they mean the institutions and government policies that provide the incentives for individuals and firms in an economy. Those incentives can encourage productive activities such as the accumulation of skills or the development of new goods and production techniques (p.95).

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