# What's Happening to Productivity Growth?

Over the past several years, monetary policymakers have been gradually raising the target federal funds rate to align with the "neutral" rate of interest. As Tim Sablik discusses in "The Fault in R-star" in this issue, our calculations of the neutral rate are imprecise; even the economist who helped develop one widely used estimate has described them as a "fuzzy blur."

Blurry as our estimates might be, they all point to the same general trend: a decline in the neutral rate. And if the neutral rate is the rate consistent with the economy performing at potential, then a lower rate implies lower potential as well. What's holding us back?

One major contributor appears to be a decline in productivity growth. Between 1985 and 2005, the United States had a productivity boom, with average annual growth of 2.3 percent. Over the past decade or so, however, productivity growth has slowed — with average annual growth of just 1.3 percent between 2006 and the present. I have to admit I find this very surprising from my perspective as a business consultant. I didn't observe any particular cliff around 2005. In fact, I saw management equally motivated to drive a focus on the bottom line. I saw new, powerful practices being implemented, such as artificial intelligence, voice recognition, digitization, and offshoring. I saw my individual clients get more productive.

One possibility is that the mix of businesses has shifted, for example, because of the growth in services or productive sectors moving to foreign locales. But the slowdown is widespread. Nearly every sector has experienced some decline in productivity growth since the mid-2000s (although the extent varies across sectors).

Another possibility is mismeasurement. Some surely exists; for example, the leisure value of free apps on a smartphone isn't measured, while toys are. (Of course, the economic statistics do include the ads that pay for many of those free apps.) But again, the widespread nature of the decline makes mismeasurement unlikely as an across-the-board explanation.

Productivity growth could also be hampered by regulatory costs and the expense of implementing cybersecurity: Costs have certainly been created that don't generate revenues. But back-of-the-envelope calculations suggest these costs aren't large enough to explain the slowdown.

So what do I think I know? I believe the productivity slowdown is real, and part of the explanation is nearly two decades of business underinvestment. Since 2000, investment has been low relative to measures of corporate profitability, driven by industry leaders not investing in growth the way they once did. Airlines have moderated capacity growth, banks aren't adding branches, and even successful retailers aren't adding stores. And in my view, it's easy to draw a line from lower investment to lower productivity growth.

Why has investment been low? My sense is that several things are going on. Short-termism has been increasing as CEO tenure has decreased and corporate activism has escalated. Share repurchases have become a compelling alternate use of capital. Cyclical industries have learned the lessons of overcapacity. And finally, companies are still feeling skittish after the Great Recession. For example, I've spoken with business leaders who, even if they see opportunities for investment, are reluctant to take them. They continually see the next recession as "just around the corner." That's certainly true today.

Another factor in slowing productivity growth is declining startup rates. Successful entrants drive innovation, which drives productivity. But the data show a massive reduction in entry rates in all states and all sectors. Startups accounted for 12 percent of all firms in the late 1980s. That fell to 10.6 percent in the mid-2000s and to 8 percent after 2008. As with investment, some of this decline might reflect lingering risk aversion after the Great Recession. Some might be the impact of regulation. Research also points to the slow growth of the working-age population as an explanation. In addition, I hear that there are tangible impediments — such as acquiring the necessary technology and talent — to building the scale and sophistication entrants require to be successful.

The good news is that change is possible. As the Great Recession fades further into memory, economic tailwinds may give both entrepreneurs and existing firms more confidence. Technological innovations such as AI aren't going away. And policymakers can promote a healthy environment for business investment. American businesses are practical and innovative. If the rules are clear and the environment is stable, they will find a way to become more productive. **EF**

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