The Economist

The American economy

America's lost oomph

The country's potential growth rate is barely half what it was two decades ago. Here's how to raise it

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BACK in the mid-1990s, America's economic prospects suddenly brightened. Productivity soared. Immigrants and foreign capital flocked to take advantage of what was quickly dubbed the "New Economy". The jobless rate fell to 4%, yet inflation remained low. All this led economists to conclude that America's potential rate of growth—the speed at which the economy can expand while keeping unemployment steady and inflation stable—had risen sharply from its decades-long average of 3%, to 3.5% or even higher.

Sadly, the New Economy is no more. The recovery from the recession of 2008-09 has been the weakest of the post-war era, and evidence is mounting that America's potential growth rate has plummeted. Its two big determinants, the supply of workers and the rise in their productivity, have both fallen short. Performance in the past year has been particularly feeble: America's labour force has not grown at all and output per hour worked has fallen. The IMF recently cut its estimate of the country's potential rate of growth to 2%. Other economists put it as low as 1.75% (see article (http://www.economist.com/news/briefing/21607810-new-figures-show-speed-which-americas-economy-can-grow-without-stoking-inflation-has)).

So far, the slide in potential has had little practical impact. Because the recession was so deep and the recovery so weak, the economy is still operating below its capacity. But in the long term a halving of the economic speed limit would have grim consequences. Living standards would rise more slowly, tax revenues would be lower and the burden of paying today's debts heavier.

Solving the short-term problem means boosting demand, so the Federal Reserve should keep interest rates low. But to pep up long-term growth, America also needs to address the supply side. In particular, it needs more workers and faster increases in productivity.

The not-so-mysterious case of the disappearing worker

The number of working-age Americans rose by an average of 1.2% a year in the 1990s, and by a mere 0.4% in 2013. The proportion of them actually in the workforce has fallen from over 67% to less than 63%. The recession is partly to blame, because after years of joblessness some people have given up looking for work. That is one reason why boosting the recovery is important. The ageing of the baby-boomers is another reason. The number of people in their late 50s (when participation in the workforce starts to drop) and older is rising fast.

Both these vulnerabilities are exacerbated by a self-inflicted problem: policies that depress the supply of workers. Most damaging is America's broken immigration system. Getting into the country has become much more difficult. The number of visas issued today for highly skilled people is a fraction of what it was in the 1990s, even as the number of unfilled vacancies for skilled workers soars. Deportations have surged and the southern border has become far harder to cross.

Obamacare, though good in other respects, tends to shrink the labour force because it helps people get health care without working. There is less to be said for the outdated social safety net, which manages both to be stingy and to discourage work. America spends a smaller proportion of its GDP than other rich countries on retraining the jobless and helping them find work. It has not raised the retirement age and it has allowed its disability-insurance system to become an ersatz welfare scheme. The number of workers on disability, hardly any of whom will work again, has doubled since 1997 to 9m. For once, Europe could teach America some labour-market lessons: thanks to welfare reforms, the proportion of Europeans in the workforce is now rising.

The mystery of the slump in productivity

In the long run, the most powerful way to boost growth is for workers to become more productive, as they did in the 1990s. But raising productivity is hard, and the recent slump puzzling. Innovation drives productivity growth, and a dizzying array of new developments, from "big data" to the "internet of things", suggests that innovation is speeding up. Yet the growth in the average worker's output per hour was slowing before the 2007 crisis and has fallen further since.

That may change, because it takes a while for firms to react to disruptive technologies. Computers started to spread in the 1980s but their impact did not show up in the data for more than a decade. The latest surge in innovation will also take a few years to translate into higher output per hour. The slow recovery from the recession may have lengthened this delay, by deterring many firms from investing in information technology. But here, too, politicians have made matters worse.

There is much America's government could do to boost investment. It could, for instance, increase public spending on infrastructure. It could reduce the sky-high corporate tax rate which encourages firms—such as AbbVie, which is proposing to shift its base to Britain by buying Shire (see article (http://www.economist.com/news/business/21607859-shires-focus-rare-disease-treatments-may-prove-long-term-advantage-new-home-orphans))—to move abroad rather than invest at home. And it could start cutting the endless sprawl of job-destroying regulations that companies say is a worse problem even than taxes. It is doing none of these things.

The impact of a supply-side revolution, with immigration reform, an overhaul of disability and training schemes, infrastructure investment, deregulation and corporate-tax reform all high on the agenda would be gradual. But even the prospect would strengthen the recovery, by encouraging investment and deterring the Fed from raising interest rates too soon.

Thoughtful politicians have produced schemes for radical change in almost all of these areas, but their plans—like so much else—have fallen victim to America's polarised politics. The Republicans stand in the way of loosening immigration rules, while Democrats fear that supply-side reforms are a plot to hurt the average Joe. Both sides hoover up cash from special interests keen to keep anticompetitive regulations in place. Barack Obama, the least business-friendly president for decades, has devoted far too little attention to the problem. So the odds rise that America's economy will continue to lumber along at an underwhelming pace, and Americans will have no one to blame but their leaders.

From the print edition: Leaders