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Sustained Job Growth Will Need Supportive Public Policies

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The pace of economic recovery appears to be slowing somewhat. Real gross domestic product grew at only 1.6% in the second quarter after increasing 3.7% in the first, and economic growth in the current quarter is tracking between 1.5% and 2.0%. The official unemployment rate — 9.6% as of August — is still highly elevated; it has been above 9% for more than 12 months. Meanwhile, the U-6 alternative measure that includes all persons who are marginally attached to the labor force and those employed part-time for economic reasons is hovering at nearly 17%, implying that the slack in the labor market is much higher than the official number would suggest.

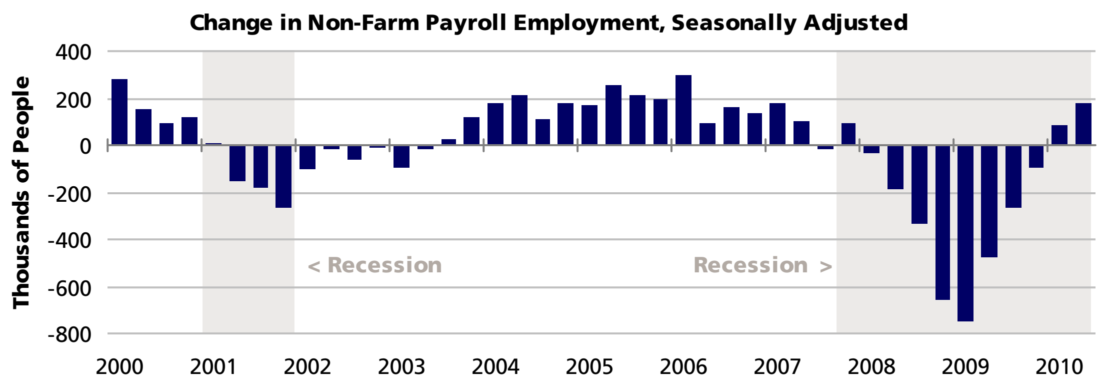
Clearly the U.S. economy needs sustained employment growth. Public policies should be designed to encourage the private sector to create jobs. In addition, policies could create large-scale public works programs in which the public sector will have a more active role in increasing labor demand by directly employing all those who want to work. I believe such policies could help get the U.S. economy back close to full employment in the near future.

The Slack in the Labor Market

The recent anemic pace of economic growth implies that the labor market could remain troubled for a long time. The U.S. economy shed jobs in all eight quarters of 2008 and 2009 as firms undertook massive restructurings and enacted mass layoffs in response to the financial crisis and the decline in aggregate demand. Since the beginning of 2010, non-farm payroll employment has risen, although tepidly (see Figure 1); job growth in the private sector has proved to be particularly troublesome. During the recession, firms increased labor productivity and kept their unit labor costs in check by slashing their payroll employment and by raising the output of those employees who remained. But employment growth has remained sluggish even as economic growth resumed and financial conditions improved.

The number of unemployed persons has risen by nearly 7 million since the beginning of the Great Recession — from around 7.7 million as of December 2007 to almost 14.9 million as of August 2010. And a

Figure 1. Job growth has been disappointing



Source: Reuters EcoWin

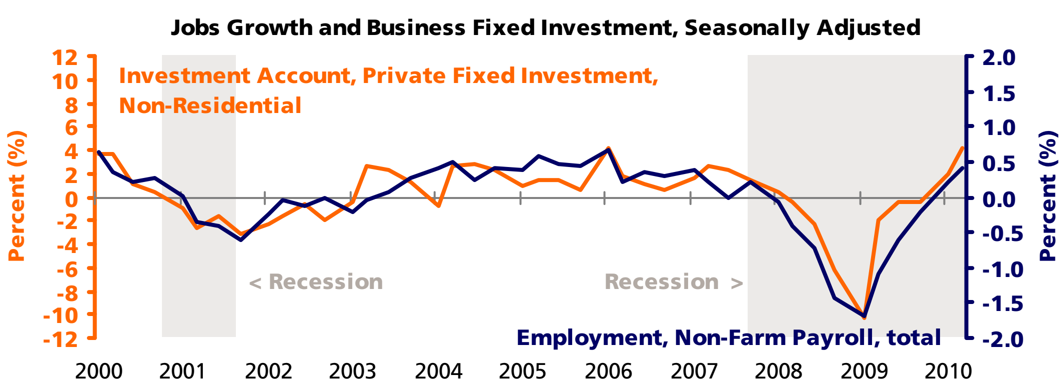
variety of other measures confirm the tremendous slack that exists in the U.S. labor market. The employment-to-population ratio has declined sharply, falling from 62.7% as of December 2007 to 58.5% as of August 2010, while the labor force participation rate fell from 66.0% to 64.7% during the same period. Moreover, a majority of the unemployed have fallen into long-term unemployment. Nearly 42% of all unemployed persons as of August 2010 have experienced unemployment spells of 27 weeks or more; in December 2007, less than 20% of the unemployed had endured similar periods of unemployment (see Figure 2 below).

Though firms sometimes spend on business fixed investment in equipment and software as a substitute for hiring additional workers, growth in employment and business fixed investment tend to occur in tandem (see Figure 3). Business fixed investment has gradually improved in the past months, even though new orders and shipments of core capital goods are below their pre-recession peaks. So far, the private sector has been reluctant to increase hiring because of insufficient current demand and uncertainty about prospects for future demand growth. Financial crises tend to create a lot of uncertainty in the private sector about growth, profits and policy; small businesses, in particular, have been stifled by the lack of access to credit, as banks — and regulators — have tightened lending standards. Softer business fixed investment and limited access to credit, particularly among smaller firms, imply that the employment outlook will stay bleak.

Figure 2. Long-term unemployment has risen sharply

Source: Reuters EcoWin

Figure 3. Increase in business fixed investment and employment usually occur in tandem



Source: Reuters EcoWin

Temporary employment, which tends to lead total employment, has also been slowing (see Figure 4), suggesting that firms are likely to be cautious about hiring workers on a permanent basis in the coming months.

But without sustained improvement of labor market conditions and growth in aggregate labor income, the pace of recovery is unlikely to accelerate. Personal consumption contributes approximately 70% to U.S. GDP, and the key drivers of consumption are real disposable income and households' real wealth. Without growth in these areas, there is limited scope for a rise in real personal consumer expenditures. Hence, in order to revitalize the U.S. economy and reignite consumer spending, policymakers will need to support public policies that create and sustain jobs and lead to growth in aggregate labor income. Proxy measures of aggregate nominal labor income do show growth, but at a rate less than it was before the Great Recession.

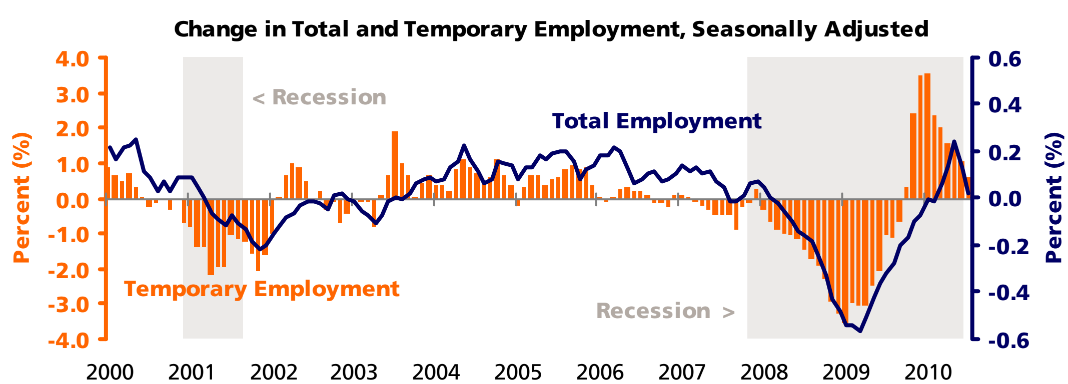
Large-Scale Public Works Programs Can Revitalize Economic Growth

In response to the crisis, the U.S. government aggressively increased fiscal spending and the Fed provided huge monetary stimulus by lowering the fed funds target rate, creating numerous liquidity facilities and purchasing financial assets. The massive response on the part of policymakers prevented the U.S. economy from collapsing into a depression, according to Blinder and Zandi's study.* While these policy measures may have prevented an even more acute decline in output and larger job losses, the economy has yet to witness sustained and solid job growth as it emerged from recession. Public policy will have to address this crucial failure of the fiscal stimulus through large-scale public works programs that create jobs directly. This would address the current weakness in the demand for labor and provide labor income to those who are currently unemployed but seek jobs.

Of course, a large-scale public works program will neither solve all the problems of the labor market nor the variety of other problems in the economy, such as the excesses of the housing bubble and toxic assets. But it can provide the basis for sustained recovery by acting as a powerful countercyclical mechanism that would lower the unemployment rate decisively and raise consumer purchasing power. Workers would gain not only from having a source of income, but also from maintaining and enhancing their human capital and technical skills and receiving training during these times of economic slack. The efforts of workers under such programs could be directed to valuable and useful public projects such as urban renewal, public construction of infrastructure and maintenance, social services, health services, and environmental cleanup and revitalization.

Ideally, such a program would be funded by the federal government but administered and managed at the state and local government levels. Undoubtedly, public works programs would have to be carefully designed to provide the right incentives and to prevent "gaming the system." Programs

Figure 4. Softness in temporary employment services suggest that firms will be cautious about hiring permanent workers



Source: Reuters EcoWin

*See Blinder, Alan S., and Zandi, Mark, "How the Great Recession Was Brought to an End" (Jul 27, 2010), http://www.economy.com/mark-zandi/documents/End-of-Great-Recession.pdf.

would be scaled back once the economy is back on track and private sector demand picks up; indeed, as aggregate demand starts to rise, the private sector will bid up average hourly wages and earnings and thus induce workers to shift from the public sector to the private sector.

Of course, some would dismiss the idea of any large-scale public works program over concerns about its contribution to the nation's fiscal deficit. However, the cost of such a program is entirely affordable, and the U.S. is not in any danger of defaulting on its public debt in the foreseeable future. Moreover, price action in financial markets show that there is ample domestic and international demand for dollar assets.

To assess the budget impact, let's suppose the government launched a new public works program that generated employment for some 15 million persons (the number of people currently unemployed) for 260 business days (one calendar year) for 8 hours per day at the rate of $8 per hour, directed to all those who are willing and able to work at this wage. The labor cost of such a program would amount to approximately $250 billion per year. Even assuming extremely high administrative costs of about $100 billion (approximately 40% of the labor cost), the program would cost only $350 billion in total. Contrast this with Troubled Assets Relief Program (TARP), an essential part of the administration's fiscal stimulus. Congress authorized $700 billion for the program, but the Treasury estimates that it expects to spend no more than $550 billion of the authorized funds. The current total disbursement from TARP stands at a bit above $380 billion, and TARP repayments have reached over $190 billion, half of current total disbursements. Therefore, the cost of this hypothetical public works program would not be much higher than that of TARP.

Furthermore, concerns about U.S. federal deficits and the rising public-debt-to-GDP ratio are often misplaced; their long-run ramifications are not related to solvency, but inflation and the value of the currency (exchange rate). At a time of slow economic growth and disinflation, however, the main policy challenges are restoring growth, creating jobs, raising real disposable income for households and lowering the unemployment rate. Rather than focusing strictly on the cost outlay of a public works program, the programs should be evaluated in terms of their cost effectiveness; deficit-induced public spending for investment and job creation is a valuable tool to restore growth.

It is often argued that the reduction of the federal deficit and public-debt-to-GDP ratio are beneficial because they lower interest rates. However, interest rates on government securities are already quite low by historical standards. Even if the authorities were to sharply reduce the deficit, the marginal gain of the concomitant reduction of interest rates is likely to be limited. Indeed, business fixed investment spending and household spending have not responded to the low interest rates and the improvement of financial conditions, engineered by the Federal Reserve's zero interest rate policy and asset purchase programs. In these circumstances, fiscal policy to boost demand — and specifically a policy to generate job growth through a large-scale public works program — can play a crucial role when the responsiveness of the private sector to lower rates has become inhibited.

Conclusion

A public works program would increase households' real disposable income. It would boost demand for the goods and services produced by the private sector. It would benefit state and local governments, as labor income would improve and tax revenues would rise. But it remains to be seen whether policymakers in the U.S. are willing to act boldly to revive the labor market using public works programs and public investment. ■