The Heritage Foundation Backgrounder

No. 252 The Heritage Foundation 214 Massachusetts Avenue N.E. Washington, D.C. 20002 (202) 546-4400

March 3, 1983

CREATING REAL JOBS: A TEN POINT STRATEGY

INTRODUCTION

Day after day, good news mounts about the nation's economy. The index of leading economic indicators jumps 3.6 percent for January, the biggest monthly leap since 1950. Spending for new construction soars 8.9 percent, the largest monthly gain since 1946. U.S. automaker output for the first two months of this year accelerates a dizzying 53 percent ahead of last year. And gross national product, the broadest measure of economic health, is growing at least at a 4 percent annual rate--well ahead of the pace predicted even a few months ago by Administration economists.

This welcome news has been headlined in newspapers and breathlessly proclaimed by TV and radio newscasters in such an unrelenting barrage that Americans ought, by now, to be aware that recession has ended and a vigorous recovery begun. Only Congress seems not to have heard the news. Why else would the House of Representatives approve a "jobs bill" and the Senate consider such a bill at the very moment when nearly every bit of new economic data demonstrates that the bill is not needed? Even in the worst of economic times, it is questionable whether federal programs really can add jobs to the economy. And in these times of recovery, a jobs bill not only becomes unnecessary, but actually can be damaging by fueling inflation, creating inefficiencies, swelling the deficit, misallocating resources and bloating the bureaucracy.

To be sure, the unemployment rate is still over ten percent, an unacceptably high level. This unemployment, however, will not be trimmed and Americans will not be put back to work by the kind of legislation seemingly favored by the Congress and the White House. Only economic growth will get Americans working again. If the Congress and the President are serious about fighting unemployment, then they will take those steps to fuel the growth that the economy already is dramatically demonstrating.

Politicians understandably want to appear to be doing something about unemployment; they understandably want to appear compassionate. Voting for a "jobs bill" is the easiest way of putting their concern and compassion on the record. In reality, they "create" one set of jobs at the expense of another, and mislead and betray those most in need of work. Jobs programs, in short, are a cruel hoax on America's unemployed.

To avoid this hoax, legislators and the White House must understand that unemployment is composed of two distinct parts: cyclical and structural. Cyclical unemployment is associated with downturns in economic activity and represents about 40 percent of total unemployment today. Structural unemployment refers to long-term unemployment that would persist even if the economy were booming. It results primarily from a mismatch between the education, skill, work experience, and/or geographical location of potential workers and the job requirements of employers. Chronic unemployment is concentrated among poorly educated and dislocated workers who do not have the skills to meet today's labor market needs.

Advocates of jobs programs claim that their counter-cyclical program would create employment opportunities during the troughs of the business cycle, while a counter-structural program would provide jobs for the hard-core unemployed.

The evidence suggests that neither approach works very well. Even if counter-cyclical programs did create the employment their supporters claim, they always seem to miss the boat when it comes to timing--and clearly would now. Government sponsored "jobs" programs do little to deal with long-term structural problems. For the latter group, carefully crafted training programs, based on the private sector, are far more effective. What Congress and the Reagan Administration ought to be doing is crafting legislation that would promote employment by creating economic growth and by removing institutional barriers to employment now sanctioned by the government. Among the steps that can be taken are: the removal of government sanctioned restraints on employment opportunities--such as the minimum wage and Davis-Bacon Act; experimentation with innovative approaches to stimulate employment, such as enterprise zones; raising the nation's pool of savings by expanding the features of Individual Retirement Accounts; changing tax policy to encourage, rather than discourage, small business formation; and adopting fiscal and monetary policies that provide incentives for work, saving, and investment, the prerequisites for sound economic growth.

"JOBS" BILLS--A POOR TRACK RECORD

The Invisible Victim

What jobs program advocates usually ignore are the damaging side-effects these programs have on the economy--including real job creation. The money to finance programs comes out of new taxes, increased borrowing and/or the inflationary creation of money. This drains resources from the private sector, discouraging the job-generating expansion of existing firms and the establishment of new enterprises. These financing mechanisms are particularly devastating to small businesses. This is a bitter irony, since small, new firms tend not only to be labor intensive, but are the principal job-creating sector of the economy. Firms with fewer than twenty employees create two-thirds of all net new jobs in America.[1]

Public jobs programs provide visible jobs that Congress can claim as evidence that it is taking action. But such programs only redistribute jobs from the private sector to the government sector or between existing government programs. If the government spends $5 billion on roads and bridges, for instance, new work (although not necessarily net new jobs) will be created for people in the construction industry. But $5 billion in new taxes means that taxpayers will have less to spend on other goods and services, so employment in other industries will decline. There even could be a net reduction in total employment. Americans who lose their jobs, or who fail to get a job, because new taxes or borrowing is used to "create" jobs, are the invisible victims of so-called jobs programs. If Congress avoids pouring billions of dollars into these so-called jobs programs, and leaves the money in the private sector, many more jobs--permanent jobs--would be created.

The Cost of Government Jobs

Historically, government employment programs have delivered few jobs per dollar invested. A recent New York Times article pointed out that each job created through public works spending on highways, bridges and sewage treatment plans costs the taxpayer between $28,000 and $40,000.[2] A 1979 Office of Management and Budget (OMB) study estimates the cost of creating public works jobs anywhere from $70,000 to $200,000 for each job.[3]

According to the OMB study, only 22 percent of the money spent went directly on employment--and as little as 12 to 27 percent of that goes to workers from the ranks of the unemployed. Data such as this make a mockery of the job creation estimates advanced by proponents of jobs bills. In addition, because public works projects must comply with Davis-Bacon requirements, wage levels and skill requirements tend to be inflated, leaving

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1 David Birch, The Job Generation Process (Cambridge, Massachusetts: MIT, 1980).

2 Martin Tolchin, "Senate G.O.P. Seek Public Works Bill with 200,000 Jobs," The New York Times, November 9, 1982, p. A27.

3 See Bruce Bartlett, "Public Works Programs Don't Create Jobs," The Wall Street Journal, November 30, 1982.

less money for job creation among the structurally unemployed, whose poor skill levels often preclude them from finding a job at the artificially high wage rates.

It appears also that in many instances the availability of federal money has simply led state and local governments to substitute federal funds for projects they would have funded themselves, and to hire employees who would have been hired anyway. Known as fiscal substitution, this appears to be quite significant. The 1979 OMB report found that 65 percent of the money the federal government spent went to projects that local governments otherwise would have funded.

Not only are these jobs expensive, but they generally appear months after economic recovery begins. For example, the Accelerated Public Works Program, designed to mitigate the unemployment of the 1960-1961 recession, did not provide significant funding until 1962-1963, when recovery was well underway. Similarly, the 1969-1970 recession led to another public works program that only took effect in 1972-1973.[4] Though designed to be counter-cyclical, these projects actually intensified the ups and downs in the business cycle.

Mismatch of Jobs

Public works are seldom needed where the highest levels of unemployment persist; and even if they are needed, their merit must be weighed against the goods and services that would have otherwise been produced by the private sector. There also tends to be a mismatch between the skills needed for these projects and those of the unemployed. Few auto workers, for example, have the skills to build bridges. Moreover, since public works projects generally require skilled workers, the primary beneficiaries of such programs are likely to be adult males in the heavily unionized construction industry, not the unskilled, chronic unemployed.

Public works projects are also unlikely to provide lasting job training. Most jobs are available for a very short period of time. For example, the average duration under the Public Works Impact Program of the early seventies was just 4.1 weeks, dropping to only 3.5 weeks for the two major public works programs initiated in 1976 and 1977.[5] Moreover, only 27 percent of all jobs under the Public Works Impact Program were filled by the previously unemployed, and only 12 percent went to the jobless under the more recent public works programs of 1976 and 1977.[6]

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4 See Harrison Donnelly, "Creating Jobs: It's Not As Easy As It Seems," Congressional Quarterly, November 20, 1982, p. 2872; and Council of Economic Advisers, Economic Report of the President, February 1983, pp. 38-40.

5 Council of Economic Advisers, op. cit., p. 41.

6 Ibid.

Public Service Employment

Public service employment (PSE) is often advocated as an alternative to public works programs because, it is argued, PSE can put people to work quickly, and more jobs can be created, because of its labor-intensive nature. But these programs may be even less effective. Title VI of CETA, for instance, was enacted to combat the high unemployment of the 1974-1975 recession. But high levels of PSE employment were not achieved until 1977-1978.[7] Moreover, in their haste to create jobs, local governments abandoned many of the controls needed to ensure the efficient use of resources. Programs thus tended to be make-work, characterized by excessive administrative costs, waste, fraud, and abuse.[8]

Training

While jobs programs have failed consistently to achieve their stated objective of creating the right jobs at the right time, they would, nevertheless, have some value if they were to provide the unemployed with the training necessary to make them more employable. Yet even if unemployed workers receive training in employment programs, they can rarely find similar jobs in the private sector when the program expires.[9]

AN ALTERNATE APPROACH

Far better than "jobs programs" to combat unemployment would be policies to promote faster economic growth. This could best be done by reducing the federal government's counterproductive interference in the marketplace. In addition, well-designed job training and assistance could be targeted to those individuals and areas with the greatest need. The following are just some of the possible measures. In some cases, the proposals are based on solid experience; in other cases they are experiments the federal government should undertake. But even experiments are superior to another expensive dose of policies which have failed consistently.

(1) Regulatory Reform

Proposal: The burden of federal regulations should be reduced by eliminating or modifying those regulations where the costs exceed the benefits, and by improving administrative efficiency. In particular, the maze of controls restricting financial

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7 Office of Management and Budget, Fiscal Year 1982 Budget Revisions: Additional Details on Budget Savings, April 1981, p. 235.

8 See James Bovard, forthcoming Policy Review, for examples and a bibliography of government documents demonstrating the inefficiency.

9 For an assessment of the various programs, see Peter Germanis, "The Job Training Act of 1982," Heritage Foundation Issue Bulletin No. 84, May 6, 1982, pp. 3-7.

institutions needs to be streamlined, to ease the flow of new capital, and the pressure for Congress to enact protectionist measures must be ignored.

Analysis: Excessive regulation has raised the costs of investment and increased business uncertainty. It has also shifted investments from job-creating plant and equipment to job-destructive items such as pollution controls and other compliance costs. While many of these regulations bestow important social benefits, they do so at an enormous cost in jobs. For example, restrictions on financial institutions have contributed to the high cost and inefficient use of capital, thereby restricting the private sector's job creation abilities. In addition, efforts to "save" jobs through protectionist regulations may indeed save jobs in particular industries, but because they tend to raise costs and prices, they are likely to lead to a net reduction in total jobs. Regulatory costs are already estimated at over $100 billion and, according to one estimate, have lowered the economic growth rate by 1 percent.[10]

(2) Labor Market Restrictions

Proposal: Repeal or modify government sanctioned barriers to employment in the labor market, such as the universal minimum wage, the Davis-Bacon Act, and occupational licensing laws.

Analysis: While excessive regulation has posed serious economic problems, government regulatory policies that directly influence employment and income decisions in the labor market have been especially harmful, by raising the cost of hiring labor and by restricting entry into certain occupations.

The minimum wage restricts employment opportunities by pricing the services of the least productive workers (especially minority teenagers) out of the job market. Even workers who retain their jobs may find that they are worse off because, although they have a higher wage, other non-monetary forms of compensation such as fringe benefits and on-the-job training are reduced correspondingly. This combination of increased direct unemployment and reduced training serves as a double whammy to those in greatest need.

A special youth-adjusted minimum wage rate would create financial incentives for employers to hire young and unskilled workers. President Reagan recently proposed allowing employers

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10 See David J. Teece, "The New Social Regulation: Implications and Alternatives," in Michael Boskin, ed., The Economy in the 1980s: A Program for Growth and Stability (San Francisco: Institute for Contemporary Studies, 1980) p. 124. See also, Catherine England, "Domestic Content Laws: Will They Save the Auto Industry?" Heritage Foundation Issue Bulletin No. 87, August 24, 1982.

to pay 75 percent of the minimum wage to 16 to 22 year-olds hired for summer jobs. This is a modest step in the right direction. The Minimum Wage Study Commission created by Congress to examine the effects of the minimum wage, reported that a youth differential set at 75 percent of the minimum wage could have created 250,000 to 350,000 jobs in 1981.[11]

The Davis-Bacon Act and other prevailing wage laws are another form of government mandated wage regulation that lead to unemployment. Passed by Congress in 1931 to prevent lower-paid workers (very often minorities) from competing for jobs or government contracts, the Act requires contractors to pay the "prevailing" wage, which generally means union scale. These artificially high wage rates have increased the cost of federal construction by as much as 10 to 15 percent--meaning more tax money has to be drawn from the private sector--and they price out of the market those with low skills. The measure has had the effect of reducing substantially the opportunities for young workers in federal housing construction and rehabilitative projects in the inner cities--areas where youth unemployment has been at disaster levels for many years. The Act should either be repealed or, at the least, the rules changed to minimize these effects. The U.S. Chamber of Commerce has estimated that full repeal of the Act would save the federal government $2 billion and create 100,000 new jobs.[12]

Equally pernicious are government sanctioned restraints that limit the number of people who can enter a field of work by occupational licensing laws and certification requirements. This leads to higher wages for those lucky enough to gain entry to the profession, but fewer total jobs. Tight levels of certification and competency assessment may be needed in certain occupations, such as the health care professions, but in most cases they are unnecessary.

(3) <u>Job Training and Education</u>

<u>Proposal</u>: Training should be given greater emphasis in federal manpower programs and the private sector should be given a greater role in education to help structurally unemployed gain the skills to compete in the job market.

<u>Analysis</u>: Congress and the President have already taken the first step by passing the Job Training Partnership Act, the successor to the Comprehensive Employment and Training Act. The program devotes a far greater proportion of available funds to economically disadvantaged youth than the CETA program it replaced.

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11 Report of the Minimum Wage Study Commission, May 24, 1981, p. 47.

12 Statement of the Chamber of Commerce of the United States by Madeline B. Hemmings before the Subcommittee on Employment and Productivity of the Senate Committee on Labor and Human Resources, January 21, 1983, p. 6.

The increased participation of the private sector in the design of training projects should greatly enhance the program's success rate.

More important than a federal training program is that the nation's schools once again begin turning out graduates who have the basic skills needed for employment. While the federal government's role in education should be minimal, it should encourage higher standards by giving parents the ability to place their children in the most competent schools. In part, this could be achieved through tuition tax credits or a voucher system.

(4) Reform Unemployment Insurance

Proposal: An employer's unemployment insurance tax rate should be tied more closely to his actual employment experience. This could be accomplished by lowering the minimum tax rate and raising the maximum.

Analysis: The unemployment insurance (UI) system was created to provide temporary income support for the unemployed. Tax rates for employers vary substantially, due to a process known as "experience rating," which links a firm's contributions to its previous unemployment experience. Firms with stable employment patterns pay a lower tax rate than firms with a history of frequent layoffs.

Though designed to alleviate the hardships associated with unemployment, the UI system is responsible for adding to unemployment by reducing the cost of remaining unemployed. For some workers, UI benefits replace over 70 percent of after-tax income and create incentives to remain out of work and to take more time in searching for new employment. The UI system also makes layoffs more attractive for employers during an economic downturn if they have an especially poor record of employee layoffs and already pay the maximum tax rate. Widening the tax rate band would reduce these perverse incentives.

Another plan now being considered is to provide an optional job voucher for the long-term unemployed to allow them, in effect, to receive vouchers instead of their supplemental weekly benefits to "buy" a job. Unemployed workers could give these vouchers to employers who hire them. The employers, in turn, would be able to exchange the vouchers for tax credits. This could provide employers with incentives to hire the long-term unemployed. One problem with this, however, is that the vouchers may be spent on workers who would have been hired anyway. This plan, moreover, is of no help to the long-term unemployed who have already exhausted all of their unemployment benefits.

(5) Enterprise Zones

Proposal: Establish enterprise zones in areas of massive urban unemployment to stimulate real private sector job creation.

Analysis: Many inner-city neighborhoods have become unemployment disaster areas. Federal programs costing billions of dollars have done little to improve the situation. Enterprise zones would lower tax and regulatory burdens to those pockets of mass unemployment, with the objective of stimulating new and small businesses in the areas.

(6) Expanding IRAs

Proposal: Raise the maximum that can be invested in IRAs and Keogh accounts to stimulate savings.

Analysis: Expanding IRAs and Keogh accounts would generate new saving for capital formation and job creation. The tax code, especially when combined with inflation, has reduced the incentives to save. The proposed change would reduce the tax code's bias favoring consumption.

(7) Creating "Individual Business Accounts"

Proposal: As a two-year experiment, individuals should be allowed to claim deductions from their taxable income of up to $15,000 ($30,000 on a joint return) for the purchase of new stock issued by small businesses.[13] The stock would have to be held for at least three years and it would be subject to income and capital taxes when finally sold.

Analysis: Though small businesses create most new jobs, they often are unable to obtain the funds they need to become established because they cannot offer the same tax attractions as large, sophisticated firms and unproductive tax shelters. While this proposal may be an imperfect step in the direction of reducing taxes on saving and investment, it is precisely the kind of experiment Congress should undertake if it really intends to foster job creation. And it may help to suggest a general strategy to offset the preferential treatment the tax code gives larger, more capital intensive firms.[14]

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Several important fiscal and monetary measures could be adopted to spur the economy and create jobs.

(8) Tax Reductions:

Proposal: Advance the 10 percent personal income tax cut scheduled for July 1; move to a flat tax of 20 percent and elimi-

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[13] See William Raspberry, "A Productive Tax Write-Off?" The Washington Post, February 11, 1983.

[14] See Bruce Bartlett, "The Future of Small Business in America," Policy Report, February 1983.

nate most deductions, exemptions and credits; change the tax base to consumption rather than income. These would all expand job creation in the private sector. In addition, the capital gains tax rate should be reduced and for tax purposes the gain should be indexed for inflation.

Analysis: If the economy is to grow rapidly, and thereby reduce unemployment quickly, further reductions in personal and capital gains taxes are needed to encourage the formation of new, small businesses--the principal job-generators. The capital for new, small businesses comes almost exclusively from individual savings. Heavy taxes on personal income and capital gains mean that individuals find it more attractive to consume than to save, and so they invest in tax shelters rather than productive, but taxable, enterprises. Moreover, if Congress is primarily interested in job creation, stimulating small business formation would be the best strategy, because small firms are the primary job-generators in the economy. Surveys by the National Federation of Independent Business and other organizations show that start-up capital for such firms comes predominantly from personal savings or loans from friends and the individual income tax and capital gains tax is of much greater concern to owners than are business taxes.

Since the Social Security payroll tax is essentially a tax on labor, it tends to place a disproportionately large burden on small businesses precisely because they tend to be labor intensive.[15] Further compounding this problem is the fact that it is levied on all firms, even if they are not yet profitable. This makes it particularly difficult for new business ventures even to get off the ground. Unfortunately, the recommendations proposed by the National Commission on Social Security Reform not only fail to fix the ailing Social Security system, but are likely to exacerbate small business formation and job creation because they rely so heavily on tax increases.

The lion's share of the scheduled Reagan tax cuts will merely provide modest relief from other tax increases: Social Security payroll tax hikes, last year's Tax Equity and Fiscal Responsibility Act, the 5-cent-a-gallon gasoline tax starting in April and inflation-induced bracket creep, which will be with us until 1985 when the tax code is scheduled to be indexed for inflation. To make matters worse, Congress is considering further tax increases. If Congress really means to create jobs, rather than boondoggles, tax rates must be reduced, not increased.

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15 For more details, see U.S. Small Business Administration, Social Security: A Tax on Labor, A Report of the Small Business Task Force on Social Security, January 1983.

(9) Lower Government Spending

Proposal: The growth of federal spending and entitlement programs must be reduced and many of the programs must be restructured to encourage, rather than discourage, work.[16]

Analysis: Despite the impassioned rhetoric about "massive" budget cuts, the federal government now consumes a larger share of GNP than ever before (over 24 percent). Unless the government's claim on the private sector's resources is reduced, the money needed for investment and job creation will be diverted to government programs.

The most rapidly growing component of the federal budget has been spending on entitlement programs, growing from 26 percent of the federal budget in 1960 to 50 percent in 1981.[17] Many of these programs, while providing important financial safeguards, have actually compounded our unemployment problem by erecting disincentives to work. In combination with the tax code these programs have fostered permanent dependency on welfare by providing benefits of greater value than the after-tax income individuals can earn by working.

There should be a complete overhaul of the incentive structure of the welfare and social insurance programs to combine the safety net with an incentive to seek work. Eliminating the Social Security earnings test (to encourage delayed retirement) and establishing mandatory workfare for most welfare programs (to overcome some of the disincentive effects of these programs) are some of the policies that could be examined closely.

(10) Monetary Policy

Proposal: Maintain a slow and steady growth rate of the money supply.

Analysis: Inflation has often been termed the "cruelest tax" of all. Recent experience with high rates of inflation is one of the major factors contributing to current economic problems. Because inflation increases the uncertainty surrounding the return to investments, it reduces incentives to save and invest. It thus thwarts job-creation. Inflation's interaction with the unindexed tax system exacerbates this destructive effect.

Loose monetary policy is unlikely to give even short-term relief from cyclical unemployment, because Americans now rightly

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16 For a review of ineffective and costly programs, see John Palffy, "Saving $111 Billion: How to Do It," Heritage Foundation Backgrounder Nos. 240-242, and Richard Holwill (ed.) Agenda '83 (Washington, D.C.: The Heritage Foundation, 1983).

17 Council of Economic Advisers, Economic Report of the President, February 1982, p. 83.

associate increased money growth with future inflation. The principal (and possibly the only) effect of an easy money policy is to shift resources from productive investments to inflation hedges, compounding the problem of structural unemployment.

The cure for inflation is restraint in the growth rate of the money supply. The Federal Reserve has been successful in dramatically reducing inflation by adopting this policy, though it has been painful in the short term.[18] But Milton Friedman has explained, the economy must go through a "drying out" period after an overdose of easy money. The worst thing that policymakers could do now is to give in to critics pressing for looser control of the money supply. This would repeat mistakes of the past, erode confidence in the Fed, and create substantial long-term economic damage--without reducing unemployment.

CONCLUSION

America's structural unemployment problems are serious but far from incurable. Through the short-term fix of a jobs program may be appealing, it would lead the country back toward high inflation, high taxes and low growth. It would merely confirm Santayana's aphorism that those who cannot remember the past are condemned to repeat it. Moreover, the role of government is not to create jobs through putative "jobs" programs; it cannot. The government should create the right climate for the private sector to generate real jobs.

This means restoring long-term economic growth and reducing cyclical unemployment by freeing the market from constraints imposed by government. Fiscal and monetary policies need to be adopted that will enhance, rather than impede, business and job formation. Programs should emphasize timing and adjustment, rather than seeking to "create" jobs in one place while eliminating jobs through higher tax rates elsewhere. Regulatory policies need to be examined more carefully so that they do not achieve one social goal, while destroying another. And new, innovative policies need to be tried and developed to replace the failed policies of the past. These initiatives could be especially fruitful if they are targeted to the small, innovative businesses that are more likely to provide permanent employment opportunities to the jobless. Like many experiments, these too may fail, but at least the country will be breaking new ground in policy development, rather than merely reviving tried and tested failures in an effort to "do something."

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18 Some critics of the Federal Reserve's policy argue that the Fed could have minimized this pain by adopting a more stable growth of the money supply as well.