Backgrounder

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Why Job Creation Matters More than Job Losses

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The $787 billion economic stimulus package that President Barack Obama championed has not stemmed the unemployment rate, which has risen sharply since the recession began. Sharply reduced creation of new jobs has driven this rise in unemployment. Businesses and entrepreneurs have cut back on investment, so they create fewer jobs. Had job creation remained at the same level throughout the recession as during the last quarter of 2007 the private sector would have created three million net jobs despite increased layoffs. A third stimulus bill with yet more government spending, as some in Congress propose, will do just as little to reduce unemployment because, once again, it will not encourage the entrepreneurship and risk-taking that create jobs.

Rising Unemployment

Unemployment has risen sharply since the economy entered a recession in early 2008, rising from its low during the previous expansion of 4.4 percent in March 2007 to 9.4 percent in July 2009.

This rising unemployment has attracted significant political attention. It was the justification for both the $152 billion stimulus the Congress passed in February 2008 and the $787 billion stimulus package Congress passed in February 2009.

President Obama promised that the stimulus package he signed would "create or save" 3.5 million jobs. His economic advisers predicted that unemployment would rise to 9 percent by 2010 if Congress did not

Talking Points

- Conventional wisdom says that increases in unemployment are due to increased job losses. This is only partly true.
- Job losses have increased, but they are *not* the largest reason for the 9.4 percent unemployment rate.
- The main reason unemployment rises during economic downturns is that job *creation* falls while the labor force continues to grow, making available jobs scarcer.
- To reduce unemployment, Congress should support policies that encourage entrepreneurial risk-taking and investment—which create jobs.
- Two huge stimulus bills have already been passed—in 2008 and 2009—and a third one is proposed.
- A third stimulus bill will not create jobs any more than the first two. Government spending hundreds of billions of dollars on traditional liberal interests does nothing to encourage entrepreneurs to start new companies or businesses.

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pass the stimulus bill, and that with the stimulus unemployment would stay below 8 percent.[1]

That has not happened. Chart 1 shows the unemployment rate that the President's economic advisers predicted in January as well as actual unemployment since then. By the President's own measures, the stimulus has failed.

Layoffs Not Driving Unemployment Increases

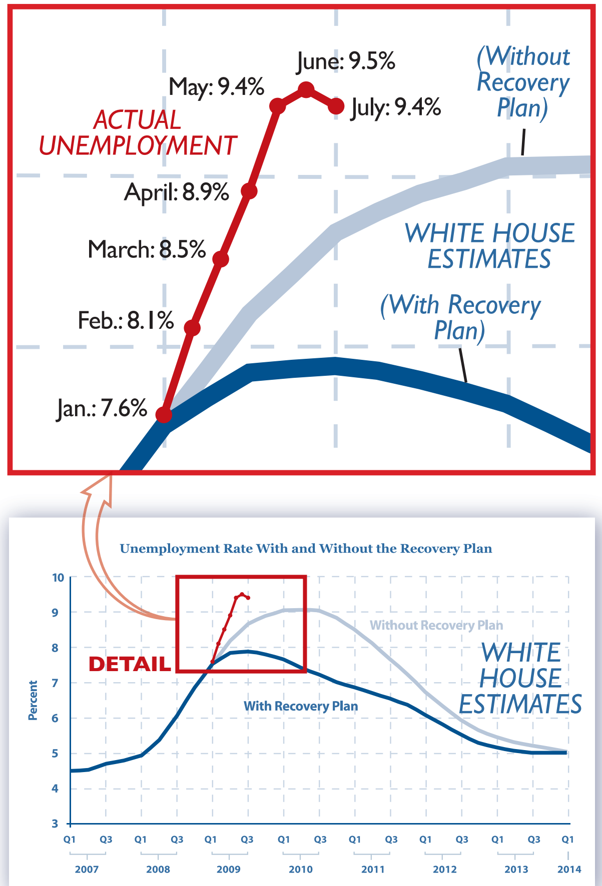
Most media coverage of the rising unemployment has focused on losses of existing jobs.[2] Behind this coverage is the strong implication that the unemployment rate rises during economic downturns because firms become more likely to lay off employees, swelling the ranks of the unemployed.

This view is understandable—it was conventional economic wisdom for many years. It also contains a large element of truth. Layoffs have increased noticeably over the past year and a half. The Bureau of Labor Statistics' Job Openings and Labor Turnover Survey (JOLTS) tracks new hires and job separations on a monthly basis. In the last quarter of 2007 private-sector employers laid off or discharged 1.5 percent of their workers. That rate had risen to 1.8 percent by June 2009.[3] Layoff rates are now one-fifth higher than at the start of the recession. (See Chart 2.)

These job losses are real and painful for the workers involved. But they alone do not explain why the unemployment rate has more than doubled since mid-2007. Recent research shows that an increased likelihood of layoffs is *not* the main reason that unemployment rises during economic slumps.[4] In the relatively mild 1990–1991 and 2001 recessions, greater job losses caused very little of the total increase in unemployment. In more severe recessions, such as that in 1981–1982, a rise in job losses explained only one-third of the total increase in unemployment.[5]

Unemployment Rate for July 2009

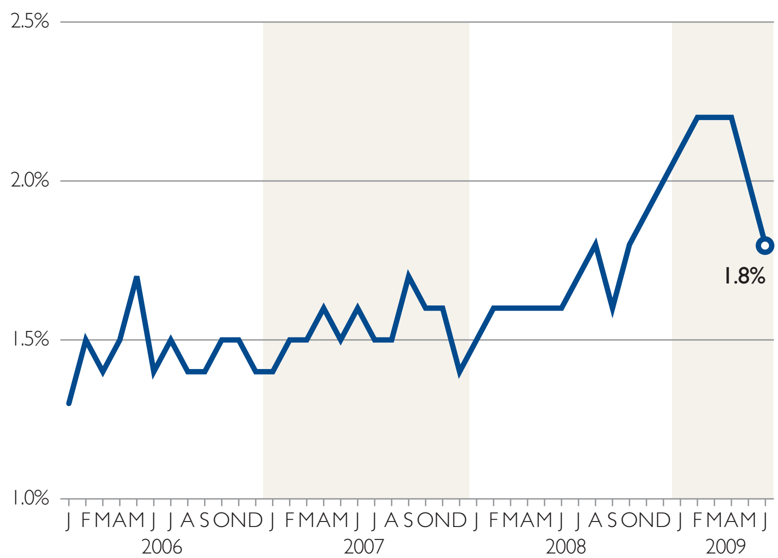
President Obama promised that government spending would "stimulate" the economy and quell rising unemployment by "creating or saving" millions of jobs. In January, Obama's advisers produced a chart (bottom) visualizing the positive results of his recovery plan. But actual unemployment (below, detail from box at bottom) has far exceeded the White House estimates.



Sources: Unemployment data from the Bureau of Labor Statistics; original chart from Christina Romer and Jared Bernstein, "The Job Impact of the American Recovery and Reinvestment Plan," January 10, 2009.

Chart 1 • B 2310 heritage.org

1. Christina Romer and Jared Bernstein, "The Job Impact of the American Recovery and Reinvestment Plan," January 10, 2009, p. 2, at *http://otrans.3cdn.net/45593e8ecbd339d074_l3m6bt1te.pdf* (August 12, 2009).
2. See, for example, Louis Uchitelle, "Jobless Rate Climbs to 5.7% as 51,000 Jobs Are Lost in July," *The New York Times*, August 2, 2008, at *http://www.nytimes.com/2008/08/02/business/02econ.html* (August 12, 2009). See also Neil Irwin and Michael S. Rosenwald, "Job Losses Accelerate, Signaling Deeper Distress," *The Washington Post*, October 23, 2008, p. A01, at *http://www.washingtonpost.com/wp-dyn/content/article/2008/10/22/AR2008102203709.html?hpid=topnews* (August 12, 2009).



Source: Department of Labor, Bureau of Labor Statistics, Job Opportunities and Labor Turnover Survey, Total Private Layoffs and Discharges, seasonally adjusted.

Chart 2 • B 2310 heritage.org

The main reason unemployment rises during economic downturns is that job *creation* falls while the labor force continues to grow, making available jobs scarcer.[6] As a result, many without work stay unemployed longer, driving up the unemployment rate. This may seem counterintuitive, and it is not the impression the media creates. It is also cold comfort to any breadwinner who has just received a pink slip. But the fact remains nonetheless that it is a drop in job creation, not a rise in job losses, that accounts for the majority of unemployment increases during recessions. This fact implies distinct policy strategies for reducing unemployment.

Dynamic Labor Markets

How does reduced job creation send unemployment skyward? The American economy is highly dynamic. Industries continually expand and contract while entrepreneurs create new companies and uncompetitive firms go out of business. Workers move between jobs frequently as this occurs. In good times and bad, the number of jobs created or lost each month is the difference between the number of workers starting new jobs and the number of workers leaving old ones.

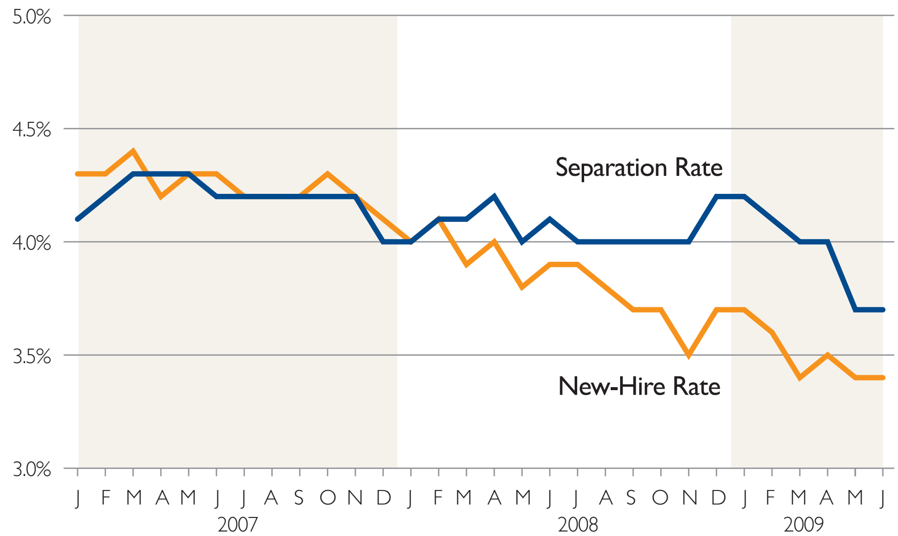
Changes in either job-loss or job-creation rates affect unemployment. Unemployment obviously rises when employees leave their jobs—either voluntarily or involuntarily—directly increasing the number of job seekers. But unemployment also rises when job creation falls. In that case, even if workers are no more likely to lose their jobs, the workers who do leave their jobs, or who enter or re-enter the labor force have a harder time finding work—because fewer jobs are available. Consequently, these job-seekers remain unemployed longer and the unemployment rate rises.

During the average month in 2008, 4.7 million workers started new jobs despite the recession. Another 4.9 million workers left their jobs each

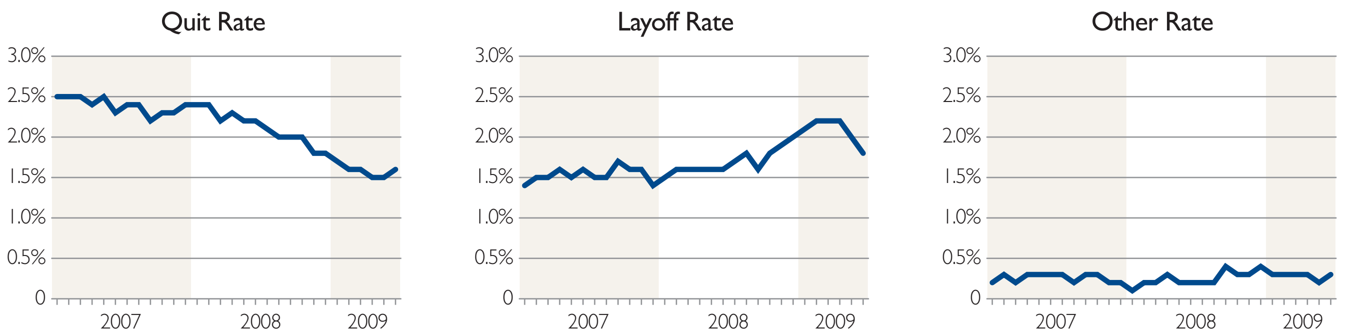
3. Department of Labor, Bureau of Labor Statistics, Job Opportunities and Labor Turnover Survey, Total Private Layoffs and Discharges, Seasonally Adjusted.
4. Robert Hall, "Job Loss, Job Finding, and Unemployment in the U.S. Economy over the Past Fifty Years," National Bureau of Economic Research *Macroeconomics Annual* 2005 (Cambridge, Mass.: MIT Press, 2005), at *http://www.stanford.edu/~rehall/nberjobloss.pdf* (August 12, 2009); Robert Shimer, "Reassessing the Ins and Outs of Unemployment," NBER *Working Paper* No. W13421, September 2007; Michael Elsby, Ryan Michaels, and Gary Solon, "The Ins and Outs of Cyclical Unemployment," January 2007, NBER *Working Paper* No. W12853, at *http://ssrn.com/abstract=959129* (August 12, 2009).
5. Elsby, Michaels, and Solon, "The Ins and Outs of Cyclical Unemployment," p. 11.
6. "The job-finding rate is the key variable in understanding the large fluctuations in unemployment over the past 50 years. The separation rate, the other determinant of unemployment, has been stable, by all the available evidence." Hall, "Job Loss, Job Finding, and Unemployment," p. 135.

New-Job-Hire Rate Dropping Faster than Separation Rate

Unemployment in 2007 was relatively steady because the job-separation rate (workers getting laid off or quitting their jobs) was roughly equal to the rate of new hires. Beginning in 2008, the new-hire rate dropped below the separation rate, meaning new jobs were harder to find even though workers were leaving their jobs at an even pace.



Separation Rates, by Type



Source: Department of Labor, Bureau of Labor Statistics, Job Opportunities and Labor Turnover Survey, Seasonally Adjusted. The new-hire rate is the number of workers who start a new job in a given month divided by the total number of workers reported by the establishment survey. The job-separation rate is the total number of workers who leave their job in a given month, divided by the total number of employees reported in the establishment survey.

Chart 3 • B 2310 heritage.org

month, either voluntarily or involuntarily. These vast movements in and out of jobs dwarf the net 200,000 jobs that were lost each month in 2008 and that the media typically reports.[7] Even small shifts in job creation and job loss rates have large effects on net job losses.

Decline in Job Creation at Fault

This is exactly what has happened since the recession began. JOLTS survey data reveal this clearly. Chart 3 displays the job hire and separation rates since January 2007. The figure also breaks down job separations into involuntary layoffs, voluntary departures, and other separations, such as retirement.

Overall job-separation rates have not increased. In fact, they have fallen. In the fourth quarter of 2007, 4.1 percent of workers left their jobs compared to 3.7 percent in June 2009. Overall job separations fell by 0.4 percentage point, despite

7. Heritage Foundation calculations based on data from the Department of Labor, Bureau of Labor Statistics, "Job Openings and Labor Turnover Survey," 2008 / Haver Analytics. More precisely, in the average month in 2008, 4,950,000 workers separated from the job they held in the previous month, and 4,707,000 workers started a new job, for net monthly job losses of 242,000.

increased layoffs, because workers became much less likely to quit their jobs; 2.3 percent of workers quit their jobs in the fourth quarter of 2007. By June 2009—in the midst of the uncertainty of the recession—only 1.6 percent of private-sector workers voluntarily quit their jobs. Overall, private-sector workers are leaving their jobs in smaller numbers than before the recession began.

How can unemployment rise so sharply when fewer workers are leaving their jobs each month? Hiring has fallen sharply since the recession began. In the last quarter before the recession, 4.2 percent of private-sector workers started work with a new employer; today that number is only 3.4 percent. So while monthly layoff rates have increased by 0.3 percentage point—roughly 300,000 jobs a month—private-sector job creation has fallen even further, by 0.8 percentage point. That represents more than 900,000 fewer private-sector jobs created each month.[8] Thus far into the current downturn, unemployment has primarily risen because private-sector job creation has dropped sharply. Research into past downturns suggests that this will continue to be the case throughout this recession.[9]

More Job *Creation* Needed to Reduce Unemployment

Over the past 12 months, an average of 424,000 more workers in the private sector have left their jobs than have started new ones.[10] Had job creation rates remained at their Q4 2007 level, the economy would have instead averaged 223,000 net new jobs a month despite the increase in layoff rates.[11] Had job creation remained stable private-sector employers would have created 3 million net new jobs during the recession, even with the increased firings and plant closings. Instead, because businesses and entrepreneurs are creating fewer new jobs, private-sector employment has fallen by 6 million net jobs.[12] Private-sector job creation must rise for the unemployment rate to fall significantly.

Less Investment and Entrepreneurship. Why has private-sector job creation fallen so sharply? The obvious and broad answer is the recession. A more precise answer is that businesses are retrenching wherever they can. While taking measures to survive the immediate downturn, such as laying off workers, and conserving cash, businesses have also grown wary about the future of the economy, especially in light of the many new threats emanating from the White House and the Congress. In addition to the various tax hikes President Obama has proposed to fund his climate-change legislation, he has also proposed tax hikes specifically targeted at small businesses. Now, the House of Representatives is considering raising tax rates on small businesses to pay for the move to government-run health care.

In addition, enormous increases in federal spending on traditional liberal priorities, such as for government-run health care, raise the prospects of vastly higher taxes or rapidly rising inflation. The federal deficit is expected to approach $2 trillion this year, and to remain well above $1 trillion for many years to come, doubling the national debt in just five years. This situation is not sustainable, but businesses can only guess how the federal government will restore order to its fiscal house, knowing full well that successful businesses make an attractive tax target.

In the face of such a threatening environment, it is not surprising that companies are likely to make only the most critical investments. In addition, the credit crunch has made credit less available to entrepreneurs who want to start new businesses, thereby adding to the shortfall in business investment and business hiring.

8. Figures do not add perfectly due to rounding.
9. Hall, "Job Loss, Job Finding, and Unemployment in the U.S"; Shimer, "Reassessing the Ins and Outs of Unemployment"; Elsby, Michaels, and Solon, "The Ins and Outs of Cyclical Unemployment."
10. Heritage Foundation calculations using data from the Department of Labor, Bureau of Labor Statistics, Job Openings and Labor Turnover Survey from 2008–2009.
11. *Ibid.*
12. *Ibid.*

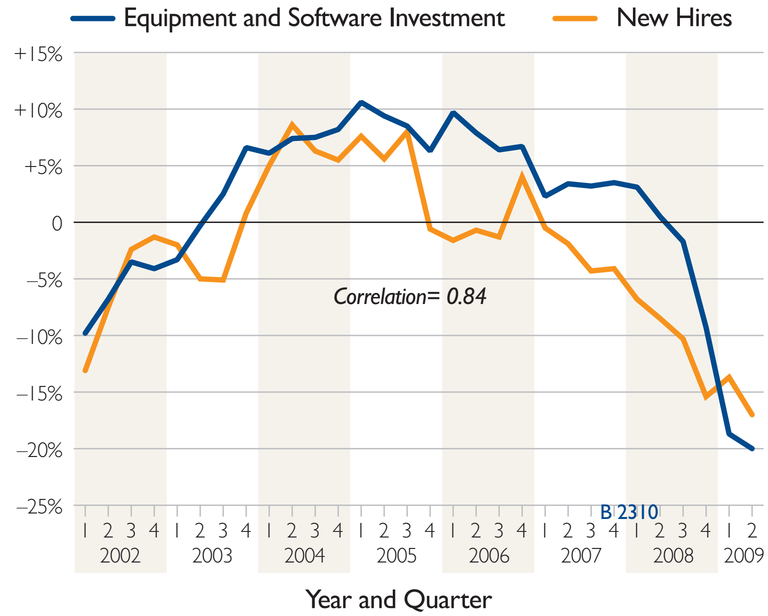
Gross private investment in equipment and software—a good measure of business investment spending—has fallen by a full 20 percent since the recession began. As long as business investment remains low and entrepreneurs hold back from starting new enterprises, job creation will remain low—and unemployment, high.

Less Investment Means Fewer Jobs. The data show this clearly. Chart 4 shows the percent year-to-year change in new hires and business investment.[13] The two are strongly correlated. Business hiring has fallen as investment has dried up.

What creates jobs? Employers with profitable businesses, innovating and creating wealth. As long as entrepreneurs and investors have reduced opportunities to create wealth, unemployment will remain high.

Investment in Equipment vs. New Hires

Year-to-Year Percent Change in Business Investment and Job Creation



Source: Heritage Foundation calculations using data from the Department of Commerce, Bureau of Economic Analysis / Haver Analytics, Gross Domestic Product. Seasonally adjusted and using chained 2000 dollars. Also using data from the Department of Labor, Bureau of Labor Statistics, Job Opportunities and Labor Turnover Survey, seasonally adjusted.

Chart 4 • B 2310 heritage.org

The Congressional Response

To reduce unemployment, Congress needs to encourage firms to innovate, invest, and take risks—and Congress must remove policies that discourage them from doing so. One policy proposed by President Obama would encourage innovation and job creation. During the election campaign, Candidate Obama had proposed eliminating the capital gains tax on startup companies. Repealing the capital gains tax on startups would encourage more venture capital investment in new businesses. Most new businesses fail. Venture capital funds invest in many new companies and make up the losses of the many failures with large profits on the handful of startups that do succeed.

If Congress repealed the capital gains tax on startup businesses, investors would earn greater after-tax profits on the few successful startups. The higher returns would encourage venture capital funds to invest in more new companies, including some riskier ventures they will not now invest in. The greater profits from successful companies would compensate for the risk of failure from others. The net result would be more investment, more startup businesses, and more jobs. This would increase job creation and lower unemployment.

A broader, more powerful policy would be for the President and the Congress to commit to restraining spending to alleviate this threat of higher interest rates and higher inflation. They should also commit to raise no taxes and impose no new burdens on businesses at least until the economy is approaching full employment. This means no rate hikes for health care reform, no rate hikes to pay for the massive hike in federal spending, and no new assessments associated with global warming legislation.

13. Business investment here is gross private investment in equipment and software.

American businesses and the American economy need time to recover and heal from this deep recession before facing new threats from massive government intervention in the economy. Presented with a more certain path forward, businesses will regain their optimism for the future, and will resume making the investments they need in order to expand and to compete in the global marketplace.

Conclusion

The unemployment rate has doubled since the recession began in 2008. Many Americans fear that their jobs are at risk, and Congress passed two stimulus bills to reduce unemployment. Congress and the American public should understand that increased layoffs are *not* the main reason unemployment has risen. While layoffs have increased, the larger factor increasing unemployment has been businesses cutting back on investment and entrepreneurs starting fewer new companies. Consequently they have created fewer jobs. Hundreds of billions in federal spending will not spur private-sector investment and risk-taking. A third stimulus bill will not promote job creation or reduce the unemployment rate any more than the first two. Congress should reject any calls for a third stimulus package.

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