Backgrounder

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Reduced Investment and Job Creation to Blame for High Unemployment

James Sherk

Abstract: *The unemployment rate in America jumped from 4.9 percent in late 2007 to 10 percent in November this year. The conventional wisdom that unemployment is rising because more people are losing their jobs is only partly true. Job-loss rates have increased, but the largest force driving unemployment is the sharp drop in private-sector job creation. The massive stimulus bill championed by President Obama did nothing to "create or save" millions of jobs. Heritage Foundation labor-policy expert James Sherk explains why any "jobs bill" that relies on government spending without improving the investment and entrepreneurship climate will fail.*

Despite assurances that the $787 billion stimulus bill would "create or save" millions of jobs, the unemployment rate has risen to 10 percent since it became law in February 2009. Members of Congress need to understand that sharply lower job creation has driven the largest part of this rise in unemployment. Businesses and entrepreneurs have cut back on investment, and are creating fewer job opportunities for unemployed workers. Any proposed "jobs bill" that relies on government spending without improving the climate for investment and entrepreneurship will fail.

Rising Unemployment

Since the recession began almost two years ago, unemployment has more than doubled, rising from 4.9 percent in December 2007 to 10 percent in

Talking Points

- Unemployment has doubled since the recession began—10 percent of Americans in the labor force are now unemployed.
- The conventional wisdom that unemployment is rising because more people are losing their jobs is only partly true. Job-loss rates have increased, but they are not the largest force increasing unemployment.
- Unemployment is rising because private-sector job creation has sharply dropped. Quarterly job creation has fallen by 25 percent while job losses have risen by 15 percent.
- Employers are creating fewer jobs because business investment and start-ups have dropped. Workers entering the labor force take more time to find work because they have fewer job opportunities.
- To reduce unemployment, Congress should enact policies that promote job creation and encourage risk-taking and investment. This will not be accomplished by more government spending. Government spending will make the problem *worse* by crowding out private investment.

This paper, in its entirety, can be found at:
www.heritage.org/Research/Economy/bg2349.cfm

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November 2009. This rising unemployment was the justification for the massive stimulus package Congress passed early this year. President Barack Obama promised that the stimulus package he signed would "create or save" 3.5 million jobs. His economic advisers warned that unemployment would rise to 9 percent by 2010 if Congress did not pass the stimulus bill, but that with the stimulus, unemployment would stay below 8 percent.[1]

Instead, unemployment has risen above the Administration's projections. Chart 1 shows the unemployment rates that the White House predicted would occur depending on whether Congress passed the stimulus, along with the actual unemployment rate since then. The number of Americans without jobs is now higher than that which the White House predicted if Congress were to do nothing. By the President's own measures, the stimulus has failed.

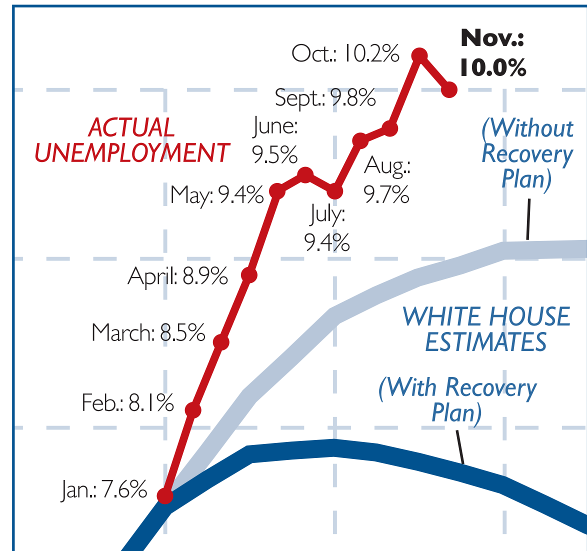
Unemployment Spikes: Don't Blame Layoffs

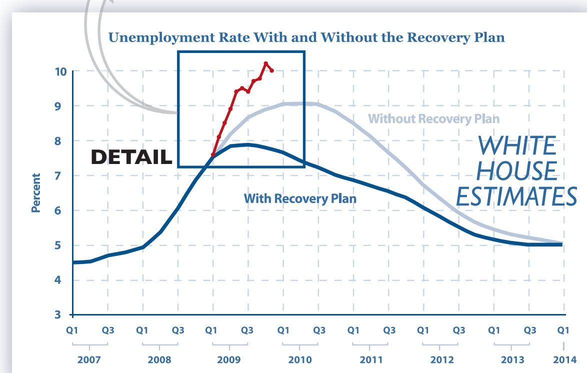
Much of the media coverage of the rising unemployment rate during the recession has focused on job losses.[2] Behind this coverage is the strong implication that unemployment rises during downturns because firms become more likely to lay off employees, swelling the ranks of the unemployed.

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 each month of Q4 of 2007, private-sector employers laid off or discharged an average of 1.8 million workers. That figure rose to 2.4 million workers a month in January, and currently stands at 2 million workers laid off in October 2009.[3] Layoffs rose by as much as one-third during the recession and are currently one-ninth higher than when the recession started. (See Chart 2.)

Unemployment Rate, November 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.



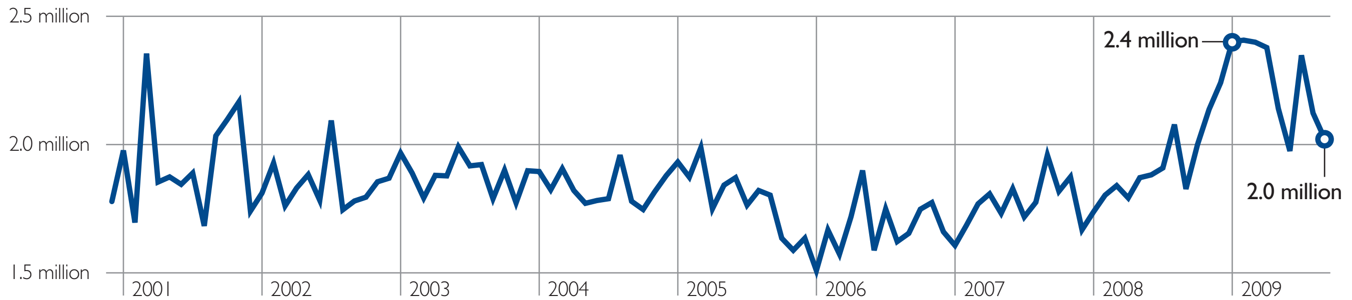


Sources: Unemployment data from the Bureau of Labor Statistics; original chart from Christina Romer and Jared Bernstein, "The Job Impact of the American Recovery and Reinvestment Plan," January 10, 2009.

Chart 1 • B 2349 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* (December 3, 2009).

Private Sector Layoffs and Discharges



Source: Department of Labor, Bureau of Labor Statistics, "Job Openings and Labor Turnover Survey," Layoffs and Discharges, seasonally adjusted.

Chart 2 • B 2349 heritage.org

These job losses are real and painful for the workers involved, but they are not large enough to explain why the unemployment rate has *doubled*. Recent research shows that an increased likelihood of workers separating from their jobs is not the main reason unemployment rises during downturns.[4] In the relatively mild 1990–1991 and 2001 recessions, greater job separations caused very little of the increase in unemployment. In more severe recessions, such as that in 1981–1982, a rise in job separations explained only one-third of the increased unemployment.[5]

***These job losses are real and painful for the workers involved, but they are not large enough to explain why the unemployment rate has* doubled.**

The main reason unemployment rises during economic downturns is that job *creation* falls while the labor force continues to grow, and new jobs are more difficult to find.[6] Those without work stay unemployed longer, driving up the unemployment rate. This may seem counterintuitive, and it is not the impression that most people receive from the media. It is also cold comfort to any breadwinner who has just received a pink slip, but it is nonetheless true and implies distinct policy strategies to reduce unemployment.

2. See, for example, Kelly Evans and Alex Frangos, "Rising Job Losses Damp Hopes of Recovery," *The Wall Street Journal*, July 3, 2009, at *http://online.wsj.com/article/SB124653569538485257.html* (December 3, 2009). See also Neil Irwin and Michael S. Rosenwald, "Job Losses Accelerate, Signaling Deeper Distress," *The Washington Post*, p. A1, October 23, 2008, at *http://www.washingtonpost.com/wp-dyn/content/article/2008/10/22/AR2008102203709.html?hpid=topnews* (December 3, 2009).
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* (December 16, 2008); Robert Shimer, "Reassessing the Ins and Outs of Unemployment," NBER *Working Paper* No. W13421, September 2007; and 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* (December 16, 2008).
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.

It is a drop in job creation, *not* a rise in job losses, which explains the majority of the increase in the unemployment rate during recessions.

Labor Market Dynamism

How does lower 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 rates or job-creation rates cause unemployment to rise. 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 naturally leave their jobs or enter the labor force have difficulty finding work—because fewer jobs are available. Consequently,

Industries continually expand and contract—entrepreneurs create new companies and uncompetitive firms go out of business.

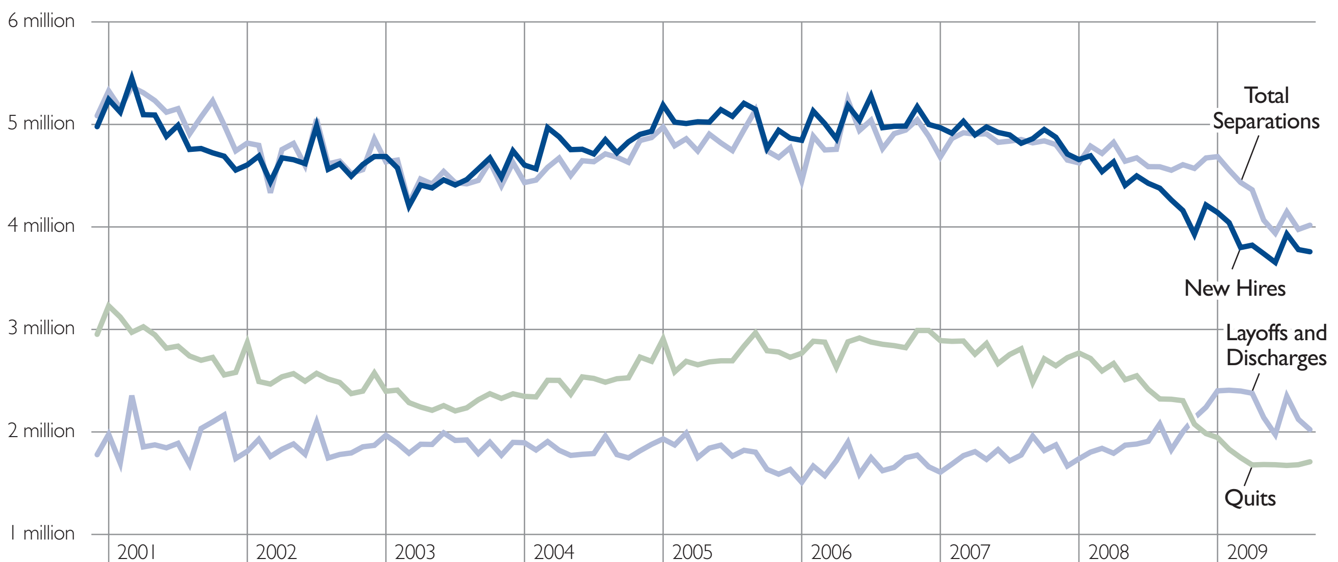
they remain unemployed longer and the unemployment rate rises.

In the average month in 2008, 4.7 million workers began new jobs, despite the recession. Another 4.9 million workers left their jobs, 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 rates and job-loss rates have large effects on net job losses.

Blame Decline in Job Creation

This is exactly what has happened since the recession began. JOLTS survey data reveal this clearly. Chart 3 displays the number of monthly job hires and job separations since December 2000. The figure also breaks down job separations into involuntary layoffs and voluntary terminations.

Private Sector Job Creation and Job Separations



Source: Department of Labor, Bureau of Labor Statistics, "Job Openings and Labor Turnover Survey," seasonally adjusted.

Chart 3 • B 2349 heritage.org

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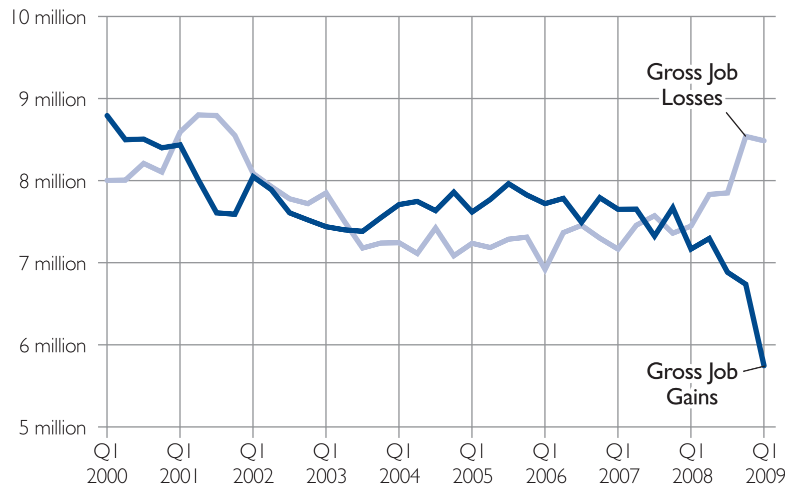
While layoffs have increased by 212,000 jobs per month since the beginning of the recession, new hires have fallen even farther. Between the last quarter of 2007 and October 2009, the number of new hires in the private sector fell each month by 1.2 million. JOLTS data suggest that a drop in business hiring explains far more of the unemployment increase than increased layoffs, despite high-profile layoffs, such as shuttered GM factories.

While suggestive, the JOLTS data are complicated by the fact that they measure movements of workers between jobs, not job creation. Changes in the layoff and hiring rates do not directly equate to jobs created and lost because workers have become much less likely to quit their jobs. One million fewer private-sector workers voluntarily quit in October 2009 than did each month in the last quarter before the recession. Fewer voluntary terminations affect both the hiring rate and layoff rate. Fewer quits means some businesses cannot use attrition to reduce their workforce and must resort to layoffs instead. Conversely, fewer voluntary terminations also means decreased hiring of replacement workers. Both of these factors complicate the interpretation of the JOLTS data.

Another government survey measures job creation and job destruction free of this complication. The Business Employment Dynamics (BED) data use unemployment insurance records to report gross job gains and gross job losses at businesses over time. Gross job gains are the total increase in *jobs* at a company and gross job losses are the total decrease in *jobs*.[8] Consequently—unlike the total number of *workers* hired or fired—BED figures are unaffected by voluntary terminations unless a company does not hire replacement workers. Unfortunately, it takes the government eight months to process unemployment insurance records in order to produce BED data, so the most recent data available are from the first quarter of 2009. While less recent than the JOLTS data, BED figures cover the quarters in which the worst job losses of the recession occurred.

Job Creation Lags Behind Job Losses

When job gains and job losses occur at the same rate, the unemployment rate remains relatively stable. When job losses began to rise in 2008, new job opportunities dropped sharply.



Source: Department of Labor, Bureau of Labor Statistics, Business Employment Dynamics / Haver Analytics.

Chart 4 • B 2349 heritage.org

Chart 4 shows BED private-sector job-gain figures and job-loss figures. The BED data tell the same story as the JOLTS: Fewer job gains account for most of the decrease in employment.

Since the recession began, quarterly gross job losses increased by 15 percent (1.1 million jobs) while gross job creation fell by 25 percent (1.9 million jobs). The number of workers laid off at businesses going out of business rose by 7 percent

8. Note that BED data on gross job gains and gross job losses will differ from the JOLTS measurement of new hires and separations. For example, a small business that increased from 12 to 17 workers would be recorded as having a gross job gain of five new workers, and no gross job losses in the BED. However, if two workers quit and the business owner hires seven new workers in total, then the JOLTS would record seven new hires and two separations.

(91,000 jobs) and the number of workers hired at newly formed businesses fell by 22 percent (313,000 jobs).

The most painful deterioration of the job market occurred in the first quarter of 2009. In that quarter net private sector employment fell by over 2 million jobs and the unemployment rate rose from 7.2 percent to 8.5 percent. Perhaps surprisingly, increased layoffs did not make Q1 the worst of the recession: Companies actually eliminated 53,000 fewer jobs in Q1 2009 than they did in Q4 2008. At the same time that layoffs declined, however, private-sector job creation plunged. New or expanding businesses created 992,000 fewer jobs in the first quarter of 2009 than they did in the last quarter of 2008. That sharp drop in job creation caused the sharp rise in unemployment.

Unemployment has primarily risen because private-sector job creation has dropped sharply. Federal Reserve Board Chairman Ben Bernanke estimates that the economy needs to create at least 100,000 new jobs for unemployment to hold steady as the labor force grows.[9] This is not happening. Unemployment is rising because the private sector is not creating enough new jobs. Research into past downturns suggests that lower job creation will continue to account for most of the net job losses throughout this recession.[10]

Less Investment and Entrepreneurship

Why has private-sector job creation fallen so sharply? The obvious answer is the recession. A more accurate answer is that businesses are retrenching wherever possible. 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. The House of Representatives has passed an increase in tax rates on small businesses to pay for the move to government-run health care. The health care bill also adds multiple expensive mandates onto businesses. Congress is moving forward with cap-and-trade policies that would make energy more expensive. Union "card-check"—which would allow labor unions to pressure workers into joining—would cripple business competitiveness and remains on Congress's agenda.

In addition, enormous increases in federal spending raise the prospects of vastly higher taxes or rapidly rising inflation. The federal government ran a $1.4 trillion deficit in FY 2009 and the deficit is expected to remain large 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 will 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.

Crowding Out Private Investment

Those business owners and entrepreneurs who do want to expand their businesses or start new ones now have increased difficulty obtaining financing. Chart 5 shows the total borrowing by businesses over the past 30 years, broken down between corporate businesses and non-corporate businesses and farms. A corporate business is a corporation, while non-corporate businesses do not have a separate legal identity from that of their owners and are typically small or family-owned.

Business borrowing has dropped dramatically in recent quarters. In the second quarter of 2009 business borrowing fell to a net –$203 billion.[11] Lenders loaned corporations just $72 billion, down dramatically from $830 billion before the recession began. In other words, corporations are borrowing less than one-tenth the amount they used to in order to finance business projects. Non-corporate

9. Michael McKee and Rich Miller, "Bernanke Lunches on Wall Street as Job Losses Mount," Bloomberg News, November 16, 2009, at *http://www.bloomberg.com/apps/news?pid=20601109&sid=atHiMqxlVsZY&pos=10* (December 2009).

10. Hall, "Job Loss, Job Finding, and Unemployment"; Shimer, "Reassessing the Ins and Outs of Unemployment"; and Elsby, Michaels, and Solon, "The Ins and Outs of Cyclical Unemployment."

11. Figures are seasonally adjusted and are quarterly figures expressed as annual rates.

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businesses, such as sole proprietorships, are now saving at an annual rate of $275 billion, a dramatic reversal from the $478 billion they borrowed before the recession. Many small business owners are now saving their business earnings instead of investing them, while small businesses that want loans have difficulty obtaining them.

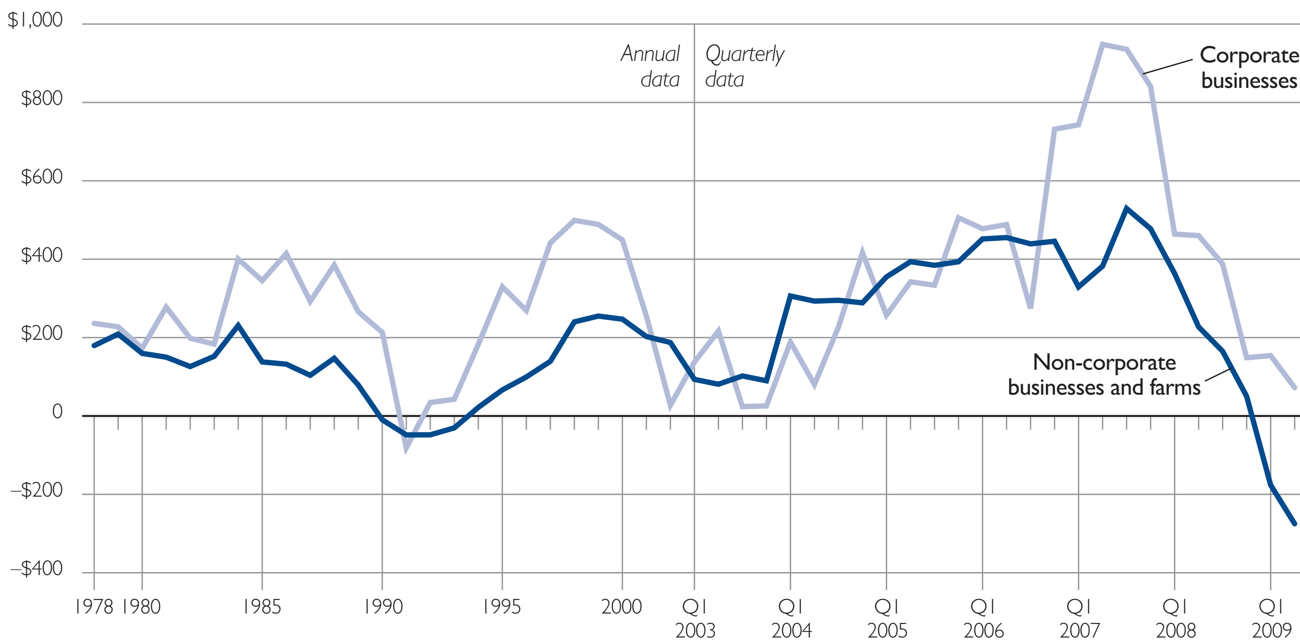
Much of this credit crunch occurred because of the financial crisis: Banks have lost hundreds of billions in capital and want to lend to the least risky borrowers possible. The large expansion of government is also contributing to the problem. The resources the government spends do not materialize out of thin air—they come from the rest of the economy. When the government increases spending, it crowds out the resources that business owners could have invested in their enterprises. Studies show that private investment falls sharply when government spending increases.[12]

When the government increases spending, it crowds out the resources that business owners could have invested in their enterprises.

The recession has worsened this effect because most lenders consider the federal government one of the safest investments possible. More lenders

Total Borrowing by Non-financial Businesses

Figures are in Billions of Dollars; Quarterly Figures are Seasonally Adjusted Annual Rates

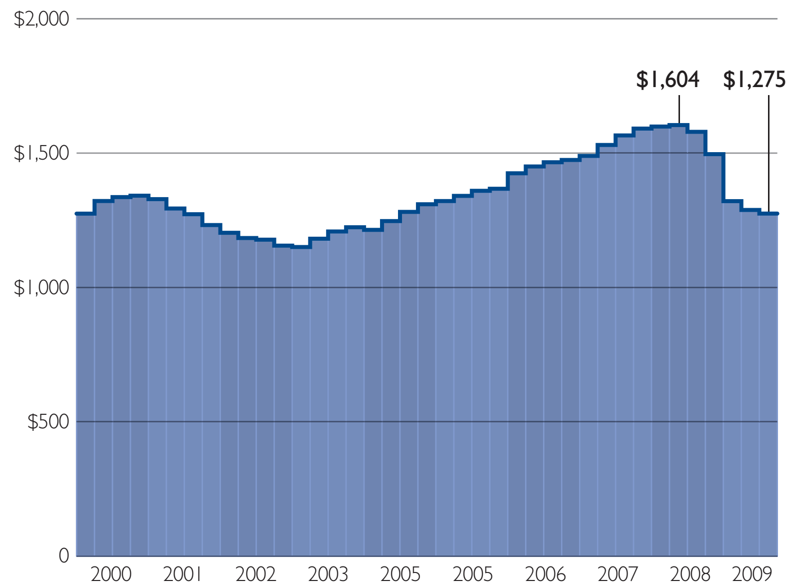


Source: Heritage Foundation calculations using data from the Federal Reserve Board, Flow of Funds Accounts of the United States, D.2, "Borrowing by Sector." Quarterly figures expressed in seasonally adjusted annual rates. Inflation adjusted to 2009 dollars using the CPI-U-RS. Corporate businesses excludes financial firms and farms. Non-corporate businesses and farms excludes financial non-corporate entities.

Chart 5 • B 2349 heritage.org

12. Alberto Alesina, Silvia Ardagna, Roberto Perotti, Fabio Schiantarelli, "Fiscal Policy, Profits, and Investment," *The American Economic Review*, Vol. 92, No. 3 (June 2002), pp. 571–589, and Olivier Blanchard and Roberto Perotti, "An Empirical Characterization of the Dynamic Effects of Changes in Government Spending and Taxes on Output," *The Quarterly Journal of Economics*, Vol. 117, No. 4 (November 2002), pp. 1329–1368.

now prefer to give loans to the government than to more risky private businesses.[13] However, the more Washington directs resources towards politically favored projects, the less private businesses can invest.



Source: Department of Commerce, Bureau of Economic Analysis / Haver Analytics. Figures are in 2005 dollars.

Chart 6 • B 2349 heritage.org

Less Investment and Fewer Jobs

The data show that as financing for private-sector ventures became scarce and businesses retrenched, investment slowed sharply. Chart 6 shows private fixed non-residential investment—that is to say, business investment in new buildings, equipment, or software. Annual private investment has fallen by $316 billion since the recession started, a 20 percent drop. It has continued to fall since the stimulus became law.

Less private investment means less job creation. As long as business investment remains low and entrepreneurs hold back from starting new enterprises, job creation will remain low and unemployment will stay high.

The data show this clearly. Chart 7 displays the percent year-by-year change in new hires as reported by the JOLTS survey, gross job gains as reported by the BED survey, and business investment.[14] They are strongly correlated. Job creation has fallen as investment has slowed.

Underutilized Economy

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.

The core problem facing the economy is that entrepreneurs and investors lack those opportunities. The economy is currently producing 93.5 percent of its potential output, the lowest use of resources since the 1981–1982 recession.[15] Gross domestic product is currently one trillion dollars below its potential level given the resources in the economy.

As long as business investment remains low, job creation will remain low—and unemployment will stay high.

After past recessions, entrepreneurs and businesses have seized opportunities for growth and the economy has quickly returned to its potential output. Public policy will play a key role in determin-

13. David Malpass, "GDP Data Show Narrowing Base of Growth, Weak Topline," Encima Global, November 24, 2009.
14. Business investment here is gross private non-residential fixed investment.
15. Heritage Foundation calculations using data from the Department of Commerce, Bureau of Economic Analysis and the Congressional Budget Office / Haver Analytics.

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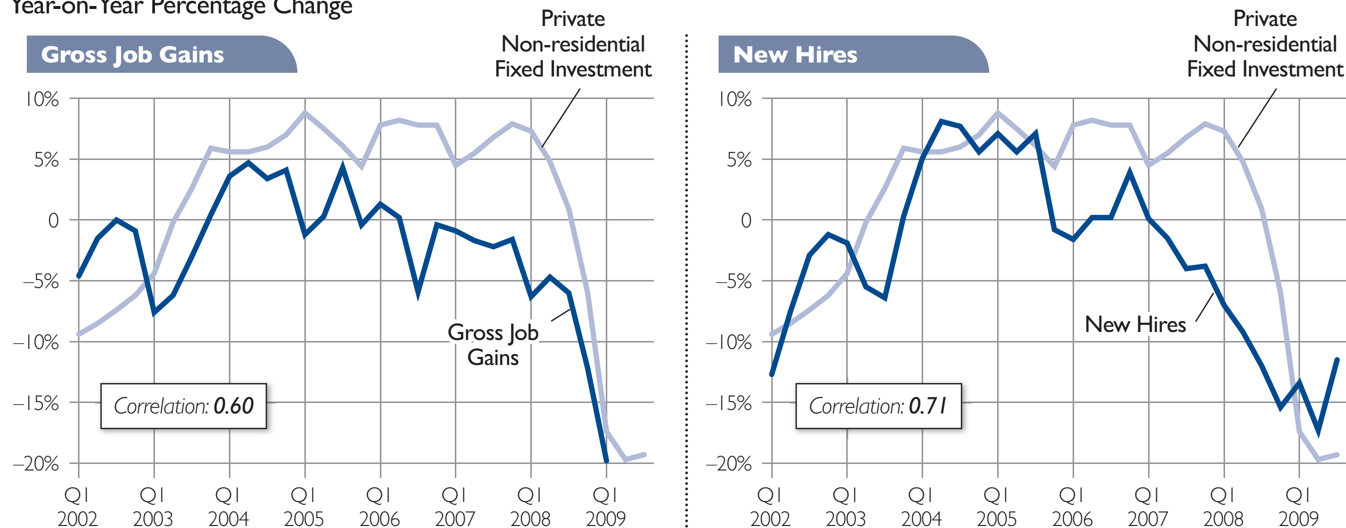
The Correlation Between Investment and Job Gains



Source: Source: Heritage Foundation Calculations using data from the Department of Labor, Bureau of Labor Statistics, and Department of Commerce, Bureau of Economic Analysis / Haver Analytics.

Chart 7 • B 2349 heritage.org

ing whether the economic environment favors the same outcome. Following the 1981–1982 recession President Reagan and Federal Reserve Chairman Paul Volker pursued low-tax, low-inflation policies that encouraged entrepreneurship and business expansion. Recent congressional spending policies have directed vast resources away from entrepreneurs and private businesses to politically influential interest groups.

What Congress Should Do

In order to reduce unemployment, Congress must encourage firms to innovate, invest, and take risks, and remove policies that discourage them from doing so. One policy proposed by President Obama would encourage innovation and job creation. During the election campaign, Senator Obama proposed eliminating the capital gains tax on start-up companies. Doing so 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 in the many failures with large profits on the handful of start-ups that succeed.

Congress must encourage firms to innovate, invest, and take risks—and remove policies that discourage them from doing so.

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

A broader, more powerful policy would be for the President and 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 tax rate hikes for

health care reform, no card-check legislation, and no new assessments associated with global warming legislation.

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

Conclusion

The unemployment rate has doubled since the recession began. Many American workers 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 companies. Consequently they have created fewer jobs. Increased federal spending will not spur the private-sector investment and risk-taking necessary to create jobs and reduce unemployment. Congress should instead reduce government spending to free up funds for private investment while committing to not passing any measures—such as card-check, cap and trade, or the health care mandates—that would make creating new jobs more expensive.

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