Backgrounder

Published by The Heritage Foundation

No. 2392
March 24, 2010

The Cause of High Unemployment: *Still* Due to Dwindling Job Creation

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Abstract: *While layoffs increased during this recession, they are* not *the primary cause of the nearly 10 percent unemployment rate. The main factor driving the unemployment rate so high during this recession was, and continues to be, the sharp drop in creation of new jobs. Government spending still does not create jobs or prosperity, either. Washington should finally admit this fact and encourage private-sector investment and entrepreneurship—the best job creators that history has produced.*

While unemployment has risen rapidly during this recession, the increase in jobless Americans has *not* been primarily due to job losses.[1] Employers shed 2.6 million *more* jobs six quarters into the 2001 recession than they had six quarters (most recent data available) into the current recession. However, unemployment has risen much more in this recession than in 2001.[2] It is the sharp drop in creation of new jobs that explains the severity of this recession. The credit crunch, the collapse of the housing bubble, and harmful economic policies have made the economy less hospitable to entrepreneurs. This bad business climate discourages business owners from expanding.

More government spending, as many in Congress propose, will not reduce unemployment because government spending does not encourage businesses to invest and hire. Congress should instead focus on promoting innovation and entrepreneurship—which promote wealth creation and, consequently, more jobs.

Talking Points

- Unemployment has doubled since the recession began—9.7 percent of Americans in the labor force are now unemployed.
- The conventional wisdom that unemployment is high because of increased layoffs is only partly true. Job losses increased, but were far worse during the 2001 recession. Layoffs have now returned to their pre-recessionary levels.
- Unemployment is rising because private-sector job creation has dropped sharply. Lower job creation accounts for 59 percent of the decrease in employment during this current recession.
- Reduced hiring is a particular problem among small businesses. Small businesses account for 36 percent of the net job losses in this recession compared to just 12 percent in 2001 because small business *hiring* has fallen.
- To reduce unemployment, Congress should enact policies that encourage risk-taking and investment by entrepreneurs. Government spending will not achieve this. Congress should eliminate rules and regulations that erect barriers to private-sector investment and wealth creation.

This paper, in its entirety, can be found at: *http://report.heritage.org/bg2392*

Produced by the Center for Data Analysis

Published by The Heritage Foundation
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Washington, DC 20002–4999
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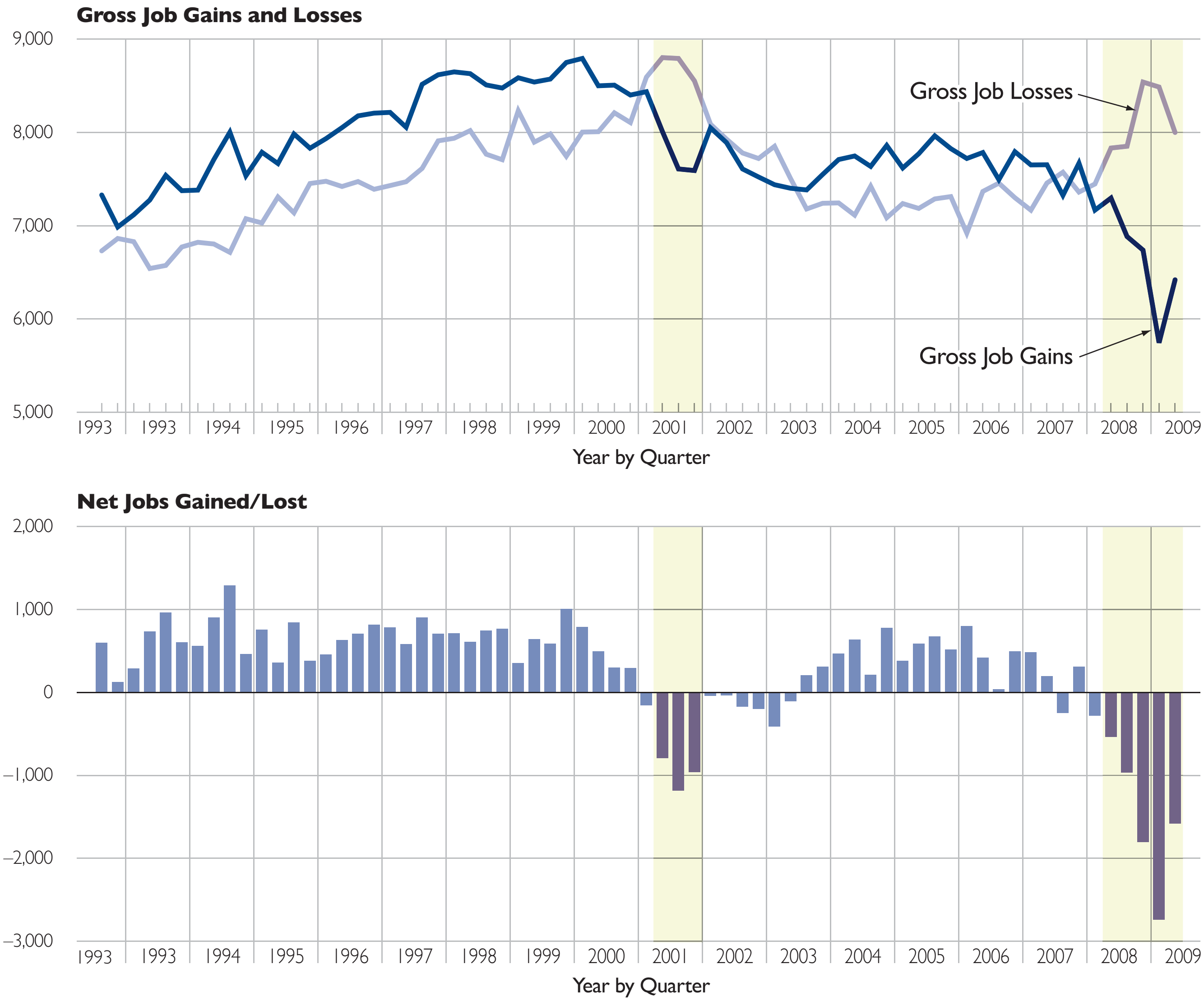
Job *Creation* Affects Employment More than Job *Losses*

Unemployment has almost doubled since the recession began in December 2007, rising from 5 percent to a peak of 10.1 percent in October 2009. As of February 2010, unemployment stands at 9.7 percent. Unemployment has risen far more than in most past recessions. Following the 2001 recession, unemployment peaked at 6.3 percent; after the 1990–1991 recession unemployment reached a high of 7.8 percent.

Media coverage of this rising unemployment has focused on job losses. Behind this coverage lies the view that unemployment rises during downturns

Lack of Job Creation Is Leading Factor in Unemployment

During periods of high unemployment, such as in 2001 and 2008–2009, there were rapid declines in the number of new jobs created (gross job gains), coupled with an increase in people losing their jobs (gross job losses).



Source: U.S. Department of Labor, Bureau of Labor Statistics, Business Employment Dynamics data, at *http://www.bls.gov/bdm* (March 23, 2010).

Chart 1 • B 2392 heritage.org

primarily because firms become more likely to lay off employees. The data, however, do not support this conventional wisdom.

The Bureau of Labor Statistics (BLS) Business Employment Dynamics (BED) data use unemployment insurance (UI) records to measure gross job gains and gross job losses at businesses. Gross job gains are the total increase in jobs at a company over time, and gross job losses are the total decrease in jobs. Almost all private-sector companies must pay UI taxes, so BED data reflect the job market very accurately.

The most recent available BED data are for the second quarter (Q2) of 2009, and cover the quarters in which the highest job losses of this recession occurred.[3]

BED figures show that employers created 7.7 million jobs and shed 7.4 million jobs in the last quarter of 2007—enough net new jobs to keep unemployment steady as new workers entered the labor force. If job creation and job losses had remained at those levels through Q2 2009, employers would have *created* 5.8 million more jobs and *eliminated* 4 million fewer jobs than they actually did.[4] Lower job creation accounts for 59 percent of the recession's decreased employment.

In Q2 2009, gross job losses were 8.7 percent (699,000 jobs) above pre-recession levels, while gross job gains were 16.3 percent (1.4 million jobs) below them. The number of people laid off by companies going out of business rose by 3.8 percent (48,000 jobs), and the number of people hired at newly formed businesses fell by 10.4 percent (235,000 jobs).[5] Unemployment has risen primarily because private-sector job creation has dropped sharply.

More Jobs Lost in 2001 Recession

A surprising fact clearly illustrates the importance of reduced hiring. Table 1 shows the change in the unemployment rate, net employment, gross job losses, and gross job gains through the first six quarters of the 2001 recession and the first six quarters of the 2008–2009 recession.[6]

Employers shed 2.6 million more jobs at this point of the 2001 recession than in the current recession. Job losses were worse then than now. Net employ-

Comparing the 2001 and 2008–2009 Recessions

Number of Jobs in Thousands

Period	Change in Unemployment Rate	Net Change in Jobs	Gross Job Gains	Gross Job Losses
Q1 2001 to Q2 2002	1.5	–3,169	47,583	50,752
Q1 2008 to Q2 2009	4.3	–7,903	40,251	48,154
Difference	2.8	–4,734	–7,332	–2,598

Source: U.S. Department of Labor, Bureau of Labor Statistics, Business Employment Dynamics data, at *http://www.bls.gov/bdm* (March 23, 2010).

Table 1 • B 2392 heritage.org

1. Robert E. 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* (March 17, 2010); Robert Shimer, "Reassessing the Ins and Outs of Unemployment," NBER *Working Paper* No. W13421, September 2007, at *http://www.nber.org/papers/w13421* (March 22, 2010), and Michael Elsby, Ryan Michaels, and Gary Solon, "The Ins and Outs of Cyclical Unemployment," NBER *Working Paper* No. W12853, January 2007, at *http://ssrn.com/abstract=959129* (March 17, 2010).
2. Heritage Foundation calculations based on data from the Department of Labor, Bureau of Labor Statistics, Business Employment Dynamics, 2001–2009. The figures compare gross job losses from Q1 2008 to Q2 2009 (the most recent available) and Q1 2000 to Q2 2002.
3. Q4 2008 and Q1 and Q2 of 2009.
4. Heritage Foundation calculations based on data from the Department of Labor, Bureau of Labor Statistics, Business Employment Dynamics.
5. Department of Labor, Bureau of Labor Statistics, Business Employment Dynamics.
6. That is, Q1 2001 to Q2 2002, and Q1 2008 to Q2 2009.

ment has fallen more during the current recession because employers have created 7.3 million *fewer new jobs* than during the 2001 recession.

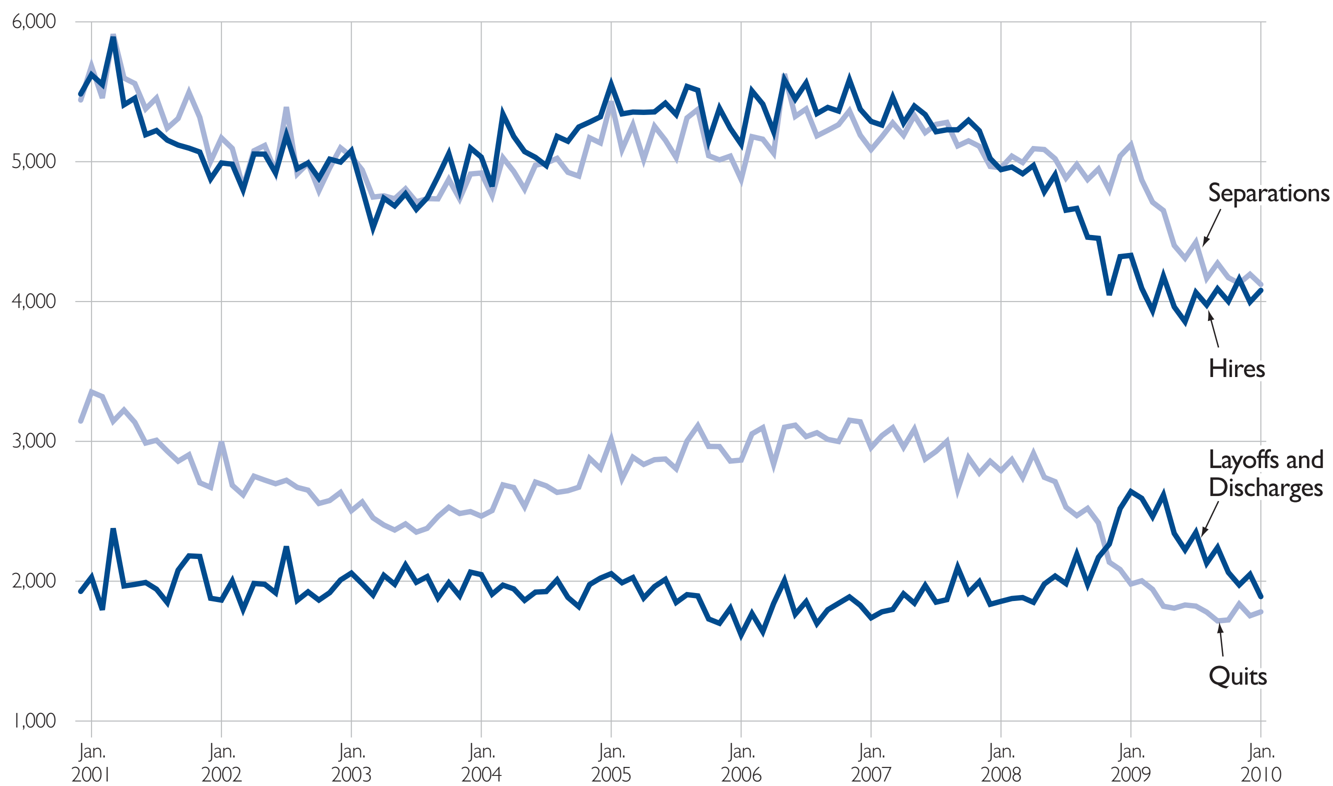
JOLTS. Decreased hiring is the most important factor driving unemployment up. A survey with more recent data than the BED's also leads to this conclusion. The BLS's Job Openings and Labor Turnover Survey (JOLTS) tracks monthly movements of workers between jobs, and is current through January 2010.

In the last three months of 2007, the last quarter before the recession, private-sector employers laid off an average of 1.9 million workers per month. That figure rose to 2.6 million laid-off workers in January 2009, and has since fallen back to 1.9 million workers in January 2010. Layoffs have now returned to their pre-recessionary levels. Hiring has not.

Between the last quarter of 2007 and January 2010, the number of monthly new hires fell from 5.2 million to 4.1 million—a drop of 1.1 million workers.[7] Today, hiring remains well below pre-recessionary rates, while layoffs have returned to normal levels.

The fact that JOLTS data measure movements of workers *between existing* jobs, not job creation, does complicate the interpretation of these figures. Changes in layoffs and hiring do not directly equate to jobs created and lost because workers have also become less likely to quit their jobs.[8]

Layoffs Have Returned to Pre-Recession Levels—Hiring Has Not



Source: U.S. Department of Labor, Bureau of Labor Statistics, Job Openings and Labor Turnover Survey, at *http://www.bls.gov/jlt* (March 23, 2010).

Chart 2 • B 2392 heritage.org

7. *Ibid.*

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Nonetheless, the JOLTS data paint the same picture as the more easily interpreted BED figures, and they confirm the findings of academic research. The main reason why unemployment rises during economic downturns is that job *creation* falls while the labor force continues to grow, making new jobs harder to find.[9] Those without work remain unemployed longer, driving up the unemployment rate. Research into past downturns suggests that lower job creation will continue to account for most of the net job losses throughout the remainder of this recession.[10]

This trend 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. However, it is nonetheless true and implies distinct policy strategies to reduce unemployment.

Less Investment and Entrepreneurship

Low hiring is primarily a *symptom* of America's economic weakness, not its cause. Businesses did not suddenly decide to stop hiring. Rather, economic and political conditions changed in ways that discourage investment and entrepreneurship. Annual private fixed nonresidential investment has fallen by $327 billion since the recession started—a 19 percent drop. Less private investment means less hiring.

What are the factors that lead to reduced investment and fewer new business start-ups? There are now fewer funds available for businesses to invest, and business owners are less confident of their enterprises' futures.

Fewer Resources to Invest. The housing bubble of the 2000s consumed huge quantities of capital in housing investments that proved to be worth much less than investors anticipated. Banks and wealthy investors lost hundreds of billions of dollars in bad investments. These funds no longer exist to loan to entrepreneurs. Banks now want to restore their balance sheets and have tightened their lending standards. Lenders have become less risk tolerant, so many business investments go unfunded.

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 economy. When the government increases spending, it crowds out the resources that business owners could have invested in their enterprises. Private investment falls sharply when government spending rises.[11]

The recession has worsened this effect because most lenders consider the federal government one of the safest investments possible. Many lenders are now loaning to the government rather than to private businesses.[12]

Less Desire to Invest. In the current weak economy, business owners have also become cautious about risking their capital in new enterprises. The policy choices in Washington have contributed to that caution. One in 10 small owners surveyed by the National Federation of Independent Business

8. 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. However, if one worker quit, another was fired, and the business owner hired seven new workers, the JOLTS would record seven new hires and two separations.
9. "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.
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. 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.
12. David Malpass, "GDP Data Show Narrowing Base of Growth, Weak Topline," Encima Global, November 24, 2009.

said that because of the current political climate it is a bad time to expand.[13]

Many items on the congressional agenda—the gargantuan health care legislation that passed on March 21, cap-and-trade regulations of CO_2 emissions, and abolishing private ballots for union organizing—would significantly raise taxes *and* business costs. In addition, enormous increases in federal spending raise the prospects of yet higher taxes and rapidly rising inflation.

In the face of such a threatening environment it is not surprising that many companies are making only the most critical investments. They are choosing to wait and see what Congress passes into law, and whether their business projects will still be viable, before investing their capital in risky projects. This caution, however, means less investment and fewer new jobs.

Small Business Hiring Stalled. These combined factors have particularly affected small businesses. Large corporations denied bank credit can raise funds through issuing debt or equity. Small businesses cannot do this—they rely on banks to finance investments. Small businesses also have less room to absorb the cost of additional regulations or taxes.

Unsurprisingly, then, small business hiring has dropped much more sharply than in the past. During the 2001 recession, net employment by small businesses fell by 371,000 jobs. That figure constituted relatively little (11.8 percent) of the total job losses in that downturn. In this recession, however, small business employment has fallen by a staggering 2.9 million jobs. Small businesses now account for 35.8 percent of job losses in this downturn—triple the 2001 amount.[14]

As with the overall economy, changes in hiring explain virtually all of the difference in severity between the two recessions. Failed or contracting small businesses have shed 163,000 more jobs than in 2001. New or expanding small businesses have added 2.4 million fewer employees. Small business hiring has plunged much more than during previous downturns, making this recession significantly more painful.

Employment Changes in Businesses with Fewer than 50 Workers in the 2001 and 2008–2009 Recessions

Number of Jobs in Thousands

Period	Gross Job Gains	Gross Job Losses	Net Change in Jobs
Q1 2001 to Q2 2002	20,345	20,716	–371
Q1 2008 to Q2 2009	17,982	20,879	–2,897
Difference	–2,363	163	–2,526

Note: Because of the BLS methodology, the figures for job gains and losses broken down by firm size do not exactly match those for the overall economy reported in Table 1.

Source: U.S. Department of Labor, Bureau of Labor Statistics, Business Employment Dynamics data, at *http://www.bls.gov/bdm* (March 23, 2010).

Table 2 • B 2392 heritage.org

Government Spending Is *Not* the Answer

Many congressional "jobs bills" attempt to solve the problem of low private hiring by increasing government hiring. This approach has historically failed for two reasons.

First, government spending does not encourage private entrepreneurship or investment. Government highway construction, for example, while funding construction jobs, does not address the underlying factors that discourage investment.

Second, the resources the government spends do not materialize out of thin air—they are taken from the private sector. Each dollar the government borrows is one less dollar that entrepreneurs can borrow to fund new operations or that private consumers can spend. Research shows that government spending crowds out private investment. Each $1 increase in

13. William C. Dunkelberg and Holly Wade, "NFIB Small Business Economic Trends Survey," National Federation of Independent Business, March 2010, p. 5, at *http://www.nfib.com/Portals/0/PDF/sbet/sbet201003.pdf* (March 19, 2010).
14. Heritage Foundation calculations based on data from the Department of Labor, Bureau of Labor Statistics, Business Employment Dynamics.

government spending reduces private-sector investment by between $0.46 and $0.97 after two years, and $0.74 and $0.95 over five years.[15] Government spending substitutes for private-sector investment; it does not supplement it. Increased government spending will further reduce private-sector investment, making the problem of low job creation worse.

This is why countries in which the government spends heavily to create jobs—such as France and Germany—do *not* enjoy higher employment rates. In fact, the opposite is true. Countries with greater government spending and with larger public-sector payrolls have higher unemployment.[16] Government spending eliminates more jobs than it creates.

The Answer? Create a Better Business Climate

If the Members of Congress want to increase investment and hiring, they should create a better climate for entrepreneurs and businesses. Reducing business costs and risks will spur investors and entrepreneurs to invest their money and efforts in new enterprises. As they do so, they will create new, lasting jobs. Congress should treat the underlying problem of a weak economy, not simply the symptom of unemployment.

One of the best ways for Congress to encourage business investment is by reducing the corporate tax rate—America has one of the highest corporate tax rates in the developed world. Businesses take account of the opportunity cost of using capital. Reducing the business tax rate increases after-tax returns on investment. As a result, lower corporate taxes would encourage businesses to invest in projects whose after-tax return would then exceed their cost of capital. Businesses would respond to lower taxes by investing in new and expanded operations. *That* is what creates jobs. Heritage Foundation analysts have found that reducing the corporate tax rate from 35 to 25 percent, while keeping the capital gains tax at 15 percent, would create an average of at least 2 million jobs a year over the next decade.[17]

No-Cost Stimulus. Given the current size of the deficit, Congress may consider such tax relief unaffordable. But Congress could pass many other policies to promote entrepreneurship and wealth creation without adding to the deficit. Such a no-cost stimulus would:

- Freeze all proposed tax hikes and costly regulations until unemployment falls below 7 percent;
- Freeze spending and rescind unspent stimulus funds;
- Reform business regulations, such as repealing Section 404 of the Sarbanes–Oxley Act in order to reduce excessive auditing costs;
- Reform the tort system to lower costs and uncertainty facing businesses;
- Remove barriers to domestic energy production in Alaska and the Outer Continental Shelf;
- Repeal the job-killing Davis–Bacon Act;
- Pass the pending free-trade agreements with South Korea, Colombia, and Panama; and
- Reduce taxes on companies' foreign earnings if they repatriate those earnings to the United States.

Conclusion

The unemployment rate has nearly doubled since the recession began. Congress should understand that increased layoffs are not the main reason unemployment has risen; layoffs were worse in the 2001 recession. The main factor increasing unemployment has been businesses cutting back on

15. Alesina *et al*., "Fiscal Policy, Profits, and Investment," and Blanchard and Perotti, "An Empirical Characterization of the Dynamic Effects of Changes in Government Spending and Taxes on Output."

16. Yann Algan, Pierre Cahuc, and André Zylberberg, "Public Employment and Labour Market Performance," *Economic Policy*, Vol. 17, No. 34 (2004), pp. 7–66; Jim Malley and Thomas Moutos, "Does Government Employment 'Crowd-Out' Private Employment? Evidence from Sweden," *Scandinavian Journal of Economics*, Vol. 98, No. 2 (1996), pp. 289–302; Horst Feldmann, "Government Size and Unemployment: Evidence from Industrial Countries," *Public Choice*, Vol. 127, No. 3 (June 2006), pp. 443–459.

17. William W. Beach, Karen Campbell, Rea S. Hederman, Jr., and Guinevere Nell, "The Obama and McCain Tax Plans: How Do They Compare?" Heritage Foundation *Center for Data Analysis Report* No. 08-09, October 15, 2008, at *http://www.heritage.org/Research/Taxes/cda08-09.cfm*. This report features original Heritage research.

investment and entrepreneurs starting fewer companies. Consequently, they have created fewer jobs.

Businesses have cut back on investing because funds have become less available and because they have less certainty about the future economic climate. To increase job creation, Congress must treat the disease, not manage the symptoms. Government hiring will not spur private investment—it will crowd it out. Congress should instead promote private-sector investment and entrepreneurship—which promote wealth creation.

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