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Senate Jobs Bill: An Ineffective Means of Reducing Unemployment

James Sherk and J. D. Foster, Ph.D.

Reduced investment and a drop in job creation—not increased job losses—have been the primary factors driving unemployment higher over the past two years. The original bi-partisan Senate jobs bill, the Hiring Incentives to Restore Employment (HIRE) Act, did little to address this underlying problem. Instead the legislation was a vehicle for extending a number of separate taxes and spending policies that would otherwise expire.

For reasons unrelated to job creation, Senate Majority Leader Harry Reid (D–NV) side-tracked the HIRE Act by introducing his own partisan "jobs" bill. The Reid bill stripped the original bill down to two main provisions:

- Suspending the payroll tax for companies that hire new workers in 2010; and
- Increasing federal highway construction spending.

If enacted, this bill will do little to encourage new investment and hiring. Instead it will increase the debt, placing a further drag on private-sector investment, job creation, and the economy. Ultimately, Reid's bill will fail to achieve results at a lower cost than the original proposal.

Hiring Tax Credits Marginally Effective. Although the first major provision in Senator Reid's proposal appears to encourage job creation, it will ultimately fail to do so. The bill would suspend the 6.2 percent employer payroll tax on newly hired workers in 2010. Companies that keep these workers on their payrolls for at least one year would receive another $1,000 credit against their 2011 taxes. This proposal, however, would create few new jobs.

Jobs come from the creation of valuable goods and services by entrepreneurs. Companies hire when the additional earnings that a new worker creates by producing those goods and services exceed the cost of employing that worker. The payroll tax suspension would slightly lower the cost of hiring workers. As a result, it would probably cause some companies to hire workers they otherwise would not have.

However, suspending the payroll tax for one year would not create better opportunities to produce valuable goods and services; nor would it increase the earnings a new worker would create for his or her company. Simply reducing the cost of a potential job will not cause an actual job to emerge if consumers fail to signal that such a job should exist. As a result, most companies would not expand and hire permanent new workers.

Instead, most of the tax suspension benefits would be claimed by companies that already planned to hire new workers. Even in this recession firms are hiring new workers: 49.4 million workers were hired for new jobs in 2009. Suspending the

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(202) 546-4400 • heritage.org

payroll tax would cost billions of dollars, most of which was spent rewarding employers that would have hired new workers anyway. Indeed, when Congress passed a similar tax credit in the 1970s, that legislation created relatively few new jobs.[1] Why? Because the employers who hired new employees would have done so with or without a credit.

Even if the payroll tax suspension created the jobs, these gains would be offset by a similar number of job losses. The tax revenue foregone due to the payroll tax suspension will require an increase in federal borrowing by the same amount; borrowing that deprives the private sector of capital to use as it sees fit, whether for business investment or personal consumption. Thus, the primary effects of this tax are to reduce labor costs for certain employers and reduce the funds available to others.

Government Spending Depresses Job Creation. The new highway spending in the bill will also fail to create jobs for two reasons.

First, it does little to encourage private investment. The private sector creates net new jobs through the processes of entrepreneurship—investment, expansion, risk-taking, and seeking opportunity. Government spending does not encourage entrepreneurship because it only reallocates resources in the economy; it does not make potential business projects more likely to succeed. While government spending leads to directly observable construction jobs, it does not encourage additional private-sector investment.

Second, the increased federal highway construction spending will crowd out private spending, both consumption and investment. Analogous to the payroll tax suspension, the resources the government spends are taken from elsewhere in the economy: Each dollar the government borrows is one dollar entrepreneurs cannot invest and that private individuals cannot consume. Each $1.00 increase in 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, with the balance coming out of private consumption.[2] Government spending substitutes for private spending, it does not supplement or encourage it.

Such a "crowding out" effect is why countries in which the government spends heavily to create jobs have high unemployment rates. After all, government spending eliminates more jobs than it creates.

Low Job Creation Driving Unemployment Higher. To reduce unemployment Congress must first understand that the primary factor driving unemployment up has been a sharp drop in job creation—not increased job losses. From the start of the recession to the second quarter of 2009, job losses increased 8.7 percent while job creation fell 16.3 percent. Over that time the number of workers laid off at companies going out of business rose by 3.8 percent (48,000 jobs), and the number of workers hired at newly formed businesses fell by 10.4 percent (235,000 jobs).

This drop in hiring is unsurprising: annual private fixed investment has fallen by $313 billion since the recession started; a 20 percent drop. 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. Research into past economic downturns suggests that low job creation will explain most of the net job losses throughout this recession.[3]

1. Robert Tannenwald, "Are Wage and Training Subsidies Cost-Effective—Some Evidence from the New Jobs Tax Credit," *Federal Reserve Bank of Boston Economic Review* (September/October 1982).
2. Alberto Alesina, Silvia Ardagna, Roberto Perotti, and 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.
3. 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* (February 23, 2010).

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Recommendations to Congress. Reid's jobs bill would do little to reduce unemployment. Neither suspending the payroll tax for new hires nor increasing highway spending would notably raise the number of jobs in the economy. To lower the unemployment rate, Congress should create a better climate for entrepreneurs and businesses—without adding to the deficit. Congress should seriously examine a no-cost stimulus.

First, Congress should recognize that its threatened actions on taxes, health care, and cap and trade are creating an uncertain climate for businesses. In the face of these heightened, Washington-based uncertainties, businesses tend to hold off on expansions until the air clears and a more favorable economic environment begins to emerge.

In addition, there are positive steps that Congress should consider, including:

- Freeze taxes and costly regulations until unemployment falls below 7 percent;
- Rescind the unspent stimulus funds;
- Reduce unnecessary regulatory costs, such as repealing Section 404 of the Sarbanes-Oxley Act;
- Reform the tort system;
- Remove barriers to domestic energy production;
- Suspend the job-killing Davis-Bacon Act;
- Pass the pending free-trade agreements with South Korea, Colombia, and Panama; and
- Permit companies to bring foreign earnings to the U.S. without facing punitive taxation.

A cessation of threats from Washington combined with these positive measures would create a better business climate for entrepreneurs and encourage them to take risks, such as starting or expanding their firms. These recommendations would spur investment and meaningfully reduce the unemployment rate.

—James Sherk is Bradley Fellow in Labor Policy in the Center for Data Analysis and J. D. Foster, Ph.D., is Norman B. Ture Senior Fellow in the Economics of Fiscal Policy in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.