THE BLEYZER FOUNDATION
Turning Transitions Into Prosperity

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The US at the Crossroad: The Need for a Policy Change to Sustain Economic Growth and Create New Jobs

Executive Summary

After almost three years of zero interest rates and over $800 billion in fiscal stimulus, the jobless rate in the US is stuck at 9%. This points to a failure of traditional fiscal and monetary policies to kick start a globalized open economy, recovering from a recession. In fact, major policy shortcomings appear to come from an almost exclusive reliance on demand-side measures aimed at stimulating consumption. Budget policy is geared toward fiscal handouts and more federal spending, while the Fed is trying to push the private sector to borrow even more. Yet, the private-sector deleveraging implies that borrowers continue to reduce debt while lenders, which have their own balance sheet problems, are not willing to lend. More than that, a shift in consumer behavior toward frugality and less debt means that the bulk of the temporary increase in federal spending goes to saving not consumption.

An even bigger problem is the lack of recognition of the fact that the U.S. job crisis is a result of the policymakers' failure to address challenges of the technological progress and globalization. Over the past decades, these forces have been gradually hollowing out middle skill manufacturing and office occupations, threatening the very foundation of the America's middle class. Thus, there is an urgent need to have well-designed supply-side policies promoting innovation, productivity growth and investments in education and training - the necessary prerequisites to creating well-paying sustainable jobs.

However, innovation and technology will not create jobs if the cost of doing business is prohibitively high. On that count, many international studies as well as national surveys single out undue government meddling as the major constraints to doing business in America. Thus, the U.S. government must urgently remove excessive regulatory complexity and tax burden on domestic businesses. Yet, unless the bloated federal government is reduced to a more manageable size, there will be little room to pay for investor-friendly tax reforms. This calls for credible and big policy adjustments to bring the fiscal budget under tight control. At present, the threats of exploding public debt and inflation are already reaching critical limits, beyond which it becomes extremely difficult to contain these risks and maintain macroeconomic stability. Lack of immediate actions will be devastating for consumer and business confidence and private investments.

Yet, spending cuts alone, though necessary, are not sufficient to move the U.S. economy on a path of robust and stable growth. Without supply-side policies encouraging innovations and investments in human capital, it will be very difficult to decrease the level of public debt, reduce unemployment and arrest the ongoing stagnation of consumer incomes. Some useful steps include measures to improve the investment climate, reduce uncertainty about future business taxes, remove obstacles for businesses, provide and maintain vital public goods and services and continue to encourage exports through free trade agreements with key foreign partners.

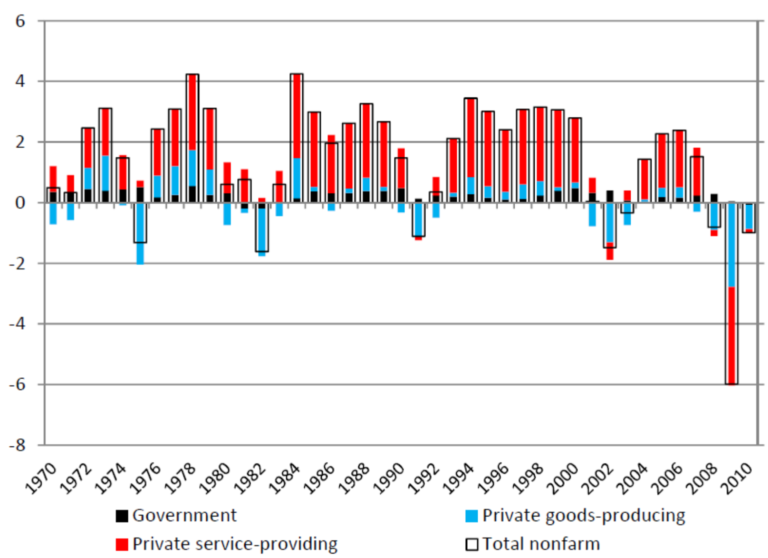
After all, the U.S. private sector enjoys an unrivaled capacity to undertake groundbreaking investments and bring innovative products to the market. Silicon Valley, New England biotech and the Wichita aerospace clusters are just few of the example that testify to the phenomenal ability of American companies to prosper in highly competitive global industries. The role of the government is not to obstruct entrepreneurial zeal with burdensome regulations but to enhance conditions that shaped the success of the likes of Microsoft, Apple, Dell, Google and Boeing. Only this will pave the way to good and safe jobs and the healing of the social and political tensions escalated by unwise policy decisions.

Introduction

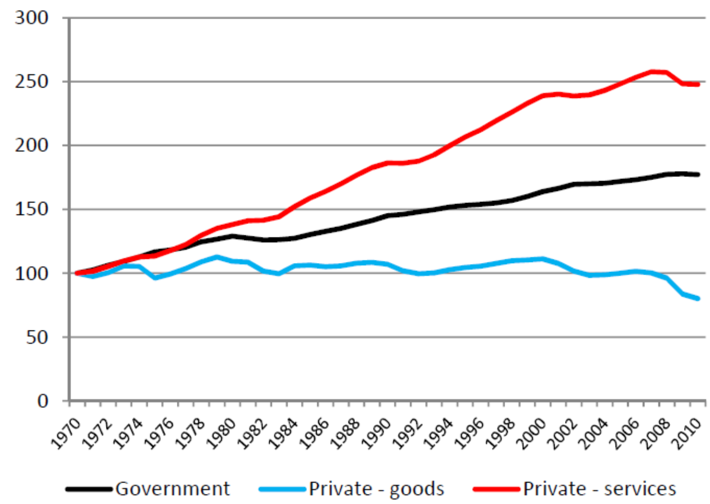
The America's job-creation engine has been misfiring for over three years as the national unemployment rate is stubbornly stuck at 9%. Indeed, notwithstanding hundreds of billions of dollars in fiscal stimulus and ultra-loose monetary policy, the private sector is creating jobs at a rate that is not fast enough to catch up with the population growth, let alone to reduce the unemployment rate. And this points to the fact that the current mix of economic policies is ill-designed to tackle the U.S. job crisis. A big part of the problem is the failure of policymakers to recognize that conventional demand-side policy prescriptions may be of little help to kick-start an open globalized economy in the aftermath of the deep financial crisis. Above all, in the global economy, consumer demand goes to the cost-competitive producers and countries. This means that additional fiscal spending is likely to leak abroad rather than boost domestic production and employment.

More than that, globalization forced U.S. manufacturers to survive through innovation and productivity gains, putting a limit on growth potential for factory jobs. In fact, over the past 40 years, the goods-providing private industries ended up bearing the brunt of economic slowdowns (see chart 1). As a result, prior to the Great Recession, the number of private-sector goods-producing jobs remained more or less flat. This trend, however, conceals a pronounced shift in the distribution of jobs in goods-producing industries – from more open to international competition manufacturing jobs to less competition-affected construction jobs (see chart 2).

Chart 1. Change in employment by sector, million jobs

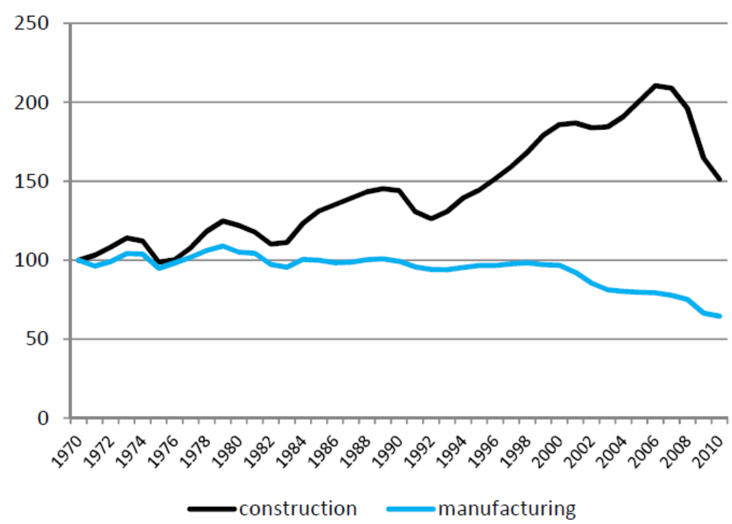


Number of jobs, 1970=100



Source: The U.S. Bureau of Labor Statistics

Chart 2. Jobs in construction and manufacturing, 1970=100



Source: The U.S. Bureau of Labor Statistics

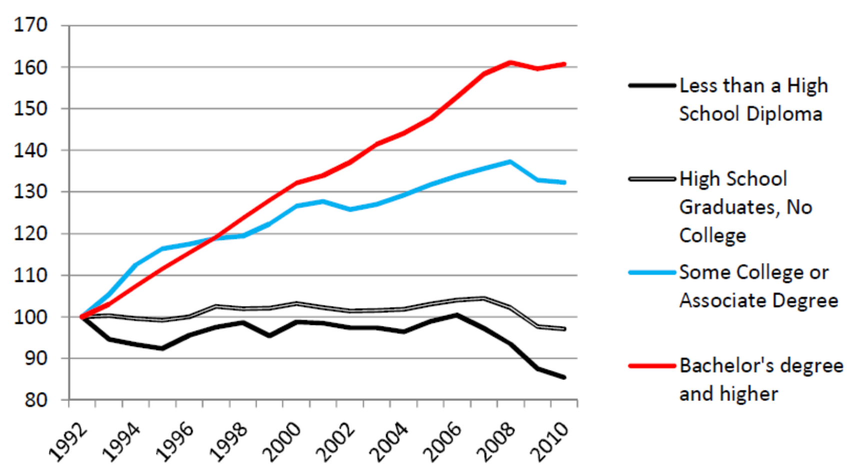
One may argue about the sources of the U.S. housing boom, including loose monetary policy, global liquidity surpluses and an unprecedented expansion of the government role in the residential housing market. Its consequences are less contentious – a debt-fuelled and unsustainable residential housing activity helped protect many uncompetitive low skill jobs that were disappearing from manufacturing. Indeed, a study by Michael Spence and Sandile Hlatshwayo[1], found that precrisis jobs growth was almost exclusively concentrated in the nontradable sectors (i.e. closed to international competition) of the U.S. economy, such as construction and service occupations. Meanwhile, technological improvements have significantly cut the cost of performing routine tasks, especially in tradable industries. This facilitated the

[1] Michael Spence and Sandile Hlatshwayo, The Evolving Structure of the American Economy and the Employment Challenge, The Council on Foreign Relations Working Paper, March 2011.

outsourcing of not only low skill production jobs but although service jobs involving simple and well-defined routines, such as bookkeeping, customer support and data analysis. At the same time, practical limitations of applying automation to manual low skill service jobs that frequently involve in-person service tasks (such as personal care, housekeeping, food preparation and serving) triggered a shift of low skill labor to those occupations.

All being said, technology and globalization have been behind a distributional shift in the occupational structure of the U.S. labor market. This change is frequently referred to as a polarization of employment and wages[2] and is observed in other industrialized countries as well.[3] In particular, the shares of low skill jobs and high skill occupations in total employment tend to grow at the expense of middle skill manufacturing and routine office workers. One of the consequences of this polarization of employment was an oversupply of low skill jobs supported by debt-fuelled consumption and residential investments. Thus, consumer deleveraging, which typically follows most financial crises, had a much bigger impact on low skill jobs versus better educated workers (see chart 3). Several other factor help explain why better educated workers enjoy safer job environment. First, it is harder to outsource high skill and complex tasks, be it in goods-producing or service-providing sectors. Second, people with education and training beyond high school have been benefitting from the growing number of jobs in the service-providing industries, including business and professional services, education and healthcare as well as the government (see chart 4). These jobs are less exposed to international competition and are partly sustained by demographic trends.

Chart 3. Employed workers 25 years old and older by education, 1992=100



Source: The U.S. Bureau of Labor Statistics

Chart 3. Jobs in the private service-providing industries, 1990=100

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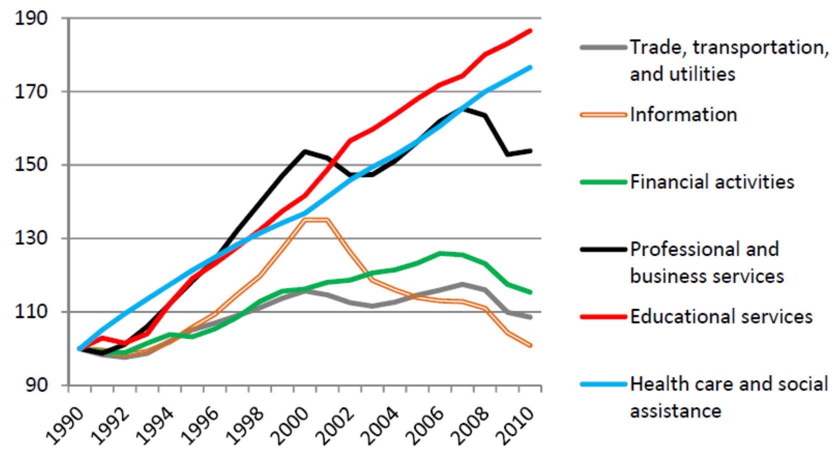
[2] David H. Autor and David Dorn, The Growth of Low Skill Service Jobs and the Polarization of the U.S. Labor Market, June 2011.

[3] Maarten Goos, Alan Manning and Anna Salomons, Explaining Job Polarization in Europe: The Roles of Technology, Globalization and Institutions, CEP Discussion Paper No 1026, November 2010.



Source: The U.S. Bureau of Labor Statistics

In a nutshell, technology and globalization, which have been reshaping the U.S. labor market over the past decades, will continue to exert a major influence on job creation and economic growth. In particular, easy to computerize and automate jobs will be leaving the U.S. to low-cost countries, putting at risk middle skill jobs in the tradable sectors. Meanwhile, significant excesses capacity in construction and related services means that many low skill workers will not be able to find occupations similar to their previous jobs. At the same time, fiscal austerity as well as an enduring shift in consumer spending and behavior toward frugality and less reliance on debt indicates that the job creation capacity of the nontradable sectors may be reaching its limits. Thus, jobs environment is likely to remain particularly challenging for low skill workers. Contrary to this, high skill occupations as well as a variety of jobs in the middle of the labor market[4] will continue to grow.

All this has important implications for economic policies aimed at job creation and growth. Most of all, one-off fiscal expansions may not have a meaningful and durable impact on employment because consumers are more likely to save extra income (see chart 5) while demand will leak abroad through imports (see chart 6). Indeed, a temporarily increase of the government spending usually fails to trigger a sustainable shift in consumer behavior because of the expectations of policy reversals in the future. As a result, consumers either save more or bring forward future purchases, as the case of the first home buyer tax credit and the cash-for-clunkers programs clearly illustrated (see chart 7). For example, a study by the Fed argues that the 2008 Tax Rebates had a rather modest impact on consumption virus the cost of this policy to taxpayers.[5] In addition, government agencies, which have a rather tarnished reputation as wasteful and inefficient spenders even in normal economic circumstances, are likely to make more mistakes considering the size and hastiness of the recent fiscal stimulus. However, careful design, implementation and delivery of the

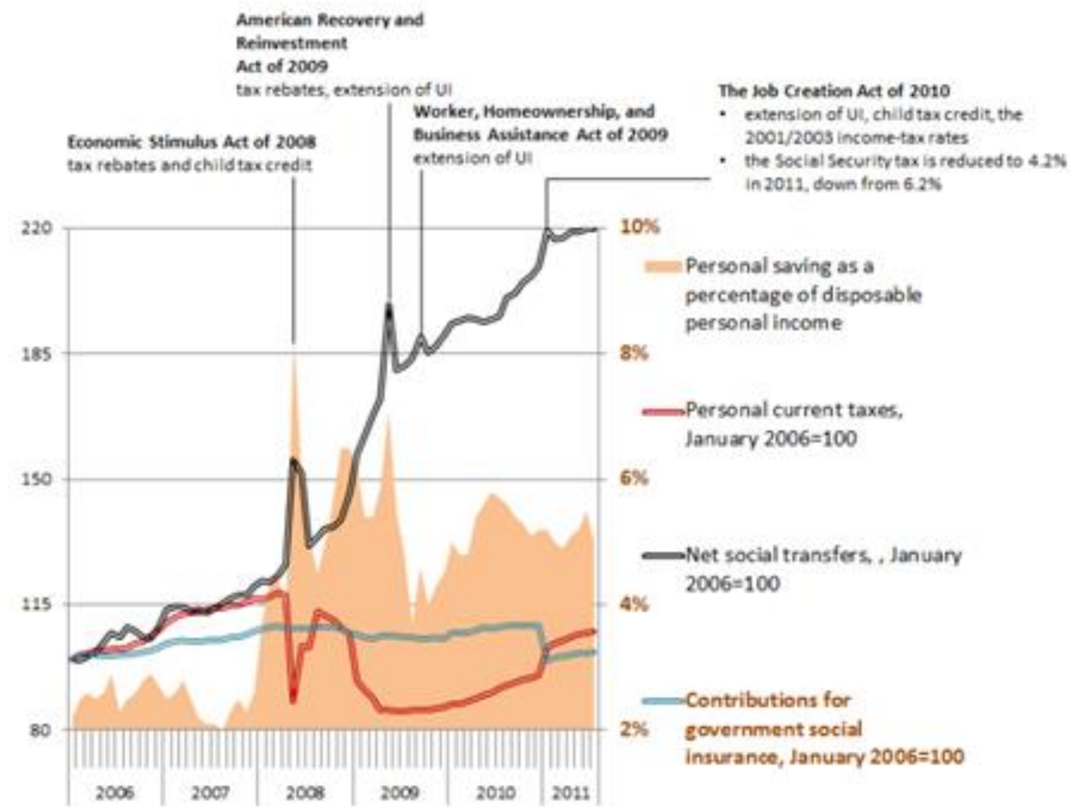
[4] For example, in healthcare. Middle skill jobs generally require some education and training beyond high school but less than a bachelor's degree.

[5] Source: Claudia R. Sahm, Matthew D. Shapiro, and Joel Slemrod, *Household Response to the 2008 Tax Rebates: Survey Evidence and Aggregate Implications*, The Federal Reserve Board, Finance and Economics Discussion Series, 2009

expansionary fiscal policy are as important for good results as its size.[6] After all badly advised and unproductive actions are particularly dangerous because they erode the private sector confidence and raise doubts about the ability of authorities to steer the country back to growth.

More importantly, demand-side measures, though they may temporarily increase employment, will not address the loss of international competitiveness. More than that, the mere fact that the jobless rate for less educated workers is more than three times higher versus people with advanced degrees points to a widening gap between the occupational requirements and education and training obtained by current and future workers. Thus, there is a pressing need to shift to supply-side economic policies that both make U.S. businesses more competitive and minimize skills mismatch between employer demands and available labor supply.

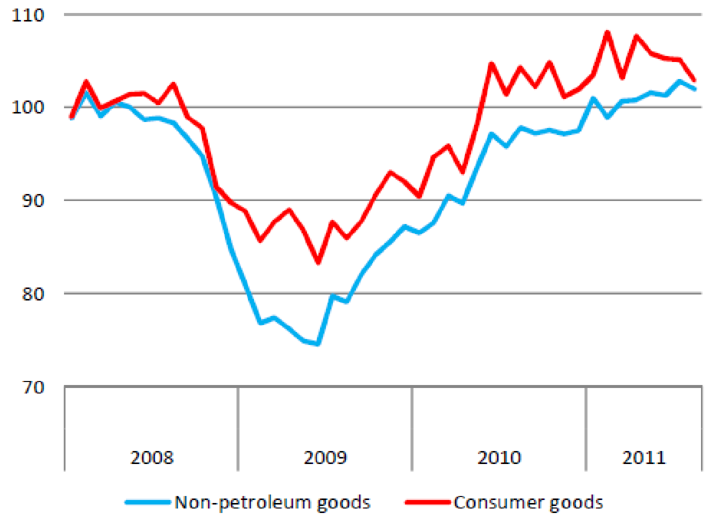
Chart 5. Fiscal stimulus goes to savings



Source: The U.S. Bureau of Economic Analysis

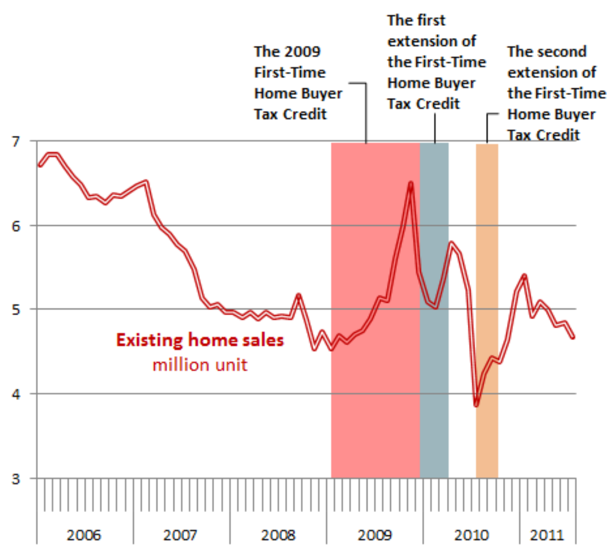
Chart 6. Demand for imports bounced back, *seasonally adjusted real imports, 2007=100*

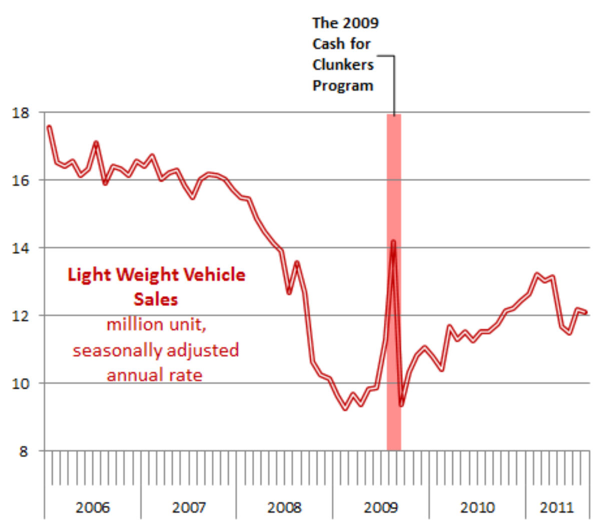
[6] See, for example, a discussion of the Making Work Pay tax credit by Claudia R. Sahm, Matthew D. Shapiro, and Joel Slemrod, *Check in the Mail or More in the Paycheck: Does the Effectiveness of Fiscal Stimulus Depend on How It Is Delivered*? The Federal Reserve Board, Finance and Economics Discussion Series, 2010



Source: The U.S. Census Bureau

Chart 7. Temporary policy shifts fail to generate a long-lasting response





Source: The National Association of Realtors, The Federal Reserve Bank of St. Louis

Supply-side policies to create jobs

In the modern global economy, the prospects for growth and job creation are predominantly driven by the national capacity to innovate and apply new technologies. After all, successful private companies are maintaining their competitive edge through relentless improvements of business processes aligning design, production and delivery of goods and services with the wants and needs of clients. On that count, several think-tanks, including The Bleyzer Foundation, have identified the main drivers that shape a favorable environment for innovation and technological progress. These drivers span across multiple dimensions including production costs, training and education, institutions, regulations and taxes, infrastructure and public governance. Above all, they create incentives for the private sector to fund productivity-boosting investments, which is the only way to spur growth and job creation. More than that, innovation and technology, which by definition make many low skill jobs obsolete, generate demand for high skill occupations. These new jobs are the main source of sustained innovation and better resilience of the U.S. labor market to outsourcing and foreign completion. Yet without new investments and a broad reform of education and training, U.S. jobs will continue to move abroad and the scarcity of skills will curb economic growth.

Innovation and technology will not create jobs if the cost of doing business is prohibitively high. New technologies could be developed; but their manufacturing may take place elsewhere. Therefore, **the first priority should be to remove** urgently those **conditions that make difficult and more costly to do businesses in the US**. On that count, several studies, including the World Bank's Doing Business Report and the World Economic Forum's Global Competitiveness Report, point to taxation and regulations as the major constraints to doing business in the U.S. In addition, surveys of small businesses – the backbone of the U.S. economy and job creation, - indicate that healthcare costs, taxes on business income, tax complexity and business regulation are far more serious obstacles than workers' compensation costs.[7] Meanwhile, unfriendly government regulations and policies continue to erode business confidence.[8] This means that a recent proposal of Obama administration to extend temporary payroll and tax cuts are of questionable value in creating sustainable jobs because they mostly fail to address these issues. Thus, the U.S. government must urgently reduce the regulatory complexity and tax burden on domestic businesses. The fact that mnay state governments are aggressively competing for private business by streamlining local business taxes and cutting red tape points to a substantial scope for the federal authorities to do the same.

Yet, there is a big bureaucratic obstacle to reform the U.S. tax and regulatory systems. High and undue taxes are a readily available source of funds to sustain the bloated federal government. Thus, unless the size of the federal government is reduced, there will be little room for investor-friendly tax reforms. This means that **the fiscal deficit must be brought under tight control**. At present, unsustainable fiscal policies significantly elevate the threats of exploding public debt and money supply (if the Fed chooses to finance fiscal deficit by printing money). The U.S. is already reaching critical limits, beyond which it becomes extremely difficult to contain these risks and maintain macroeconomic stability. Without credible and big policy adjustments, the impact on consumer and business confidence and private investments will be devastating.

The TFB's studies show that fiscal and macroeconomic balance is a vital "pre-condition" for investments and growth. Yet, balancing the budget is already not enough. After all, the high and increasing level of public debt is a manifestation of past fiscal imprudence. At 100% of GDP, public debt will grow exponentially, assuming reasonable rates of GDP growth and interest rates. The goal is to reduce the level of public debt to a more manageable 60% of GDP or below, for the debt to be stable. And this means that the primary fiscal budget must move into the positive territory over the next few years.

International experience is very clear on the mix of policies that can achieve this target. First and foremost, **only sizable spending cuts are sustainable.** Tax increases rarely work, particularly if taxes are already high,

[7] Source: The National Federation of Independent Business
[8] Source: The Chief Executive Magazine CEO Confidence Index

since they distort business and consumer decisions, discourage investments and retard growth. On the spending side, the federal budget is quite heavy on mandatory entitlement programs such as Social Security, Medicaid and Medicare, which account for over a half of all spending (Social Security, 20%; Medicare and Medicaid, 23%; Others, 12%). These programs are neither sustainable nor efficient. In particular, federally managed and funded programs frequently overlap and poorly serve the needs of taxpayers. In fact, the nonpartisan Government Accountability Office has recently identified billions of dollars that can be saved by streamlining many federal agencies and programs.[9] Another report points to a staggering $70 billion in improper payments due to fraud, waste and abuse of Medicare and Medicated programs (or about 10% of total federal outlays on those programs in FY 2010).[10]

Reducing government waste, therefore, offers durable and feasible solutions to repair federal budget. Canada, Australia, New Zealand and other countries did it in the 1980's with great success. Every single government program must be reviewed to determine if it is necessary, effective and, efficient; if it could better be done by the private sector; or if it can be transferred to the states (along with its financing sources). In addition, transferring functions from the federal to state levels will bring public service delivery and financing closer to the end users, improving their design, efficiency and control. They could also be better tailored to the specific needs of each state. Furthermore, states are constitutionally bound to run balanced budgets. And this makes them value each and every dollar of revenues and, thus, leaves little space for wasteful and inefficient government spending. In fact, most countries are finding useful to limit the role of the federal government only to the elaboration and monitoring of national policies. Implementation is then transferred totally to the state level. Mexico did this in the 1990's; Canada, Poland, Colombia and New Zealand, among others, also did it successfully. For the US this would mean that Medicare and Medicaid should be transferred to the states, together with their financing.

Yet, spending cuts alone, though necessary, are not sufficient to move the U.S. economy on a path of robust and stable growth. Without supply-side policies encouraging innovations and investments in human capital, it will be very difficult to decrease the level of public debt, reduce unemployment and arrest the ongoing stagnation of consumer incomes. Safe and well-paying employment is the foundation of the American middle-class. It reduces the need to rely on government handouts and greatly expands the capacity to make personal choices about, among other things, education and healthcare. The goal of the federal government is to nurture conditions that help private businesses create such jobs in the U.S. This should be done through measures that improve the investment climate, remove obstacles for businesses, and provide and maintain public goods and services (for example, vital infrastructure) that the private sector may not be willing to create, despite their benefits to the business community as a whole (due to their spill-over effects). On that count, it is necessary to acknowledge that the U.S. private sector enjoys an unrivaled capacity to undertake groundbreaking investments and bring innovative products to the market. Silicon Valley, New England biotech and the Wichita aerospace clusters are just few of the example that testify to the phenomenal ability of American companies to maintain international competitiveness in rapidly expanding high tech industries. The role of the government is not to obstruct private businesses with burdensome regulations but to enhance conditions that shaped the success of those companies.

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[9] Source: The Government Accountability Office, Opportunities to Reduce Potential Duplication in Government Programs, Save Tax Dollars, and Enhance Revenue, March 2011.

[10] Source: The Centers for Medicare & Medicaid Services

First, business capacity to access and process reliable and up-to-date information about new technology, evolving consumer tastes and emerging investment opportunities is a vital ingredient in the recipe for innovation and success in the global economy. The government, therefore, has to encourage and promote the growth of a well-developed information, communication and internet infrastructure that can facilitate the effective communication, dissemination, and processing of information.

Second, effective innovation system is a web of dynamic interactions between the government, the world of science and technology and the world of business that can tap into the growing stock of global knowledge, adapt it to consumer needs, and transform it into products valued by markets. Indeed, in the past, this collaboration between government, businesses and universities was very important to create global high tech leaders in the U.S. However, the intensity of the knowledge exchange between academia and business has been declining. As a result, the U.S. is now standing below many of its foreign rivals in global ratings of spending on research and development.[11] A gradual hollowing out of the U.S. manufacturing base, for example, in manufacturing of electronic equipment,[12] is partly to blame. Flat or falling federal spending on basic and applied research does not help either.[13] This means that the governments should encourage an expansion in the number of university programs with support and collaboration with businesses.

Third, only an educated, creative, and skilled population can create and make better use of knowledge. More than that, education is also an important destination for R&D spending. However, the U.S. labor market is plagued by the chronic shortages of high skill workers, especially those with engineering degrees. Meanwhile, the U.S. higher education expenditure on R&D as a share of GDP is significantly below other countries. Broadly speaking, poor quality of public education in the U.S. undermines the future prospects of the economy. There is an urgent need to improve the quality of America's teachers. International experience as well as American experiments with charter schools shows that this can be achieved by encouraging more flexible partnerships between the private sector NGOs, local government and communities in the delivery of educational services. In addition, the government should encourage the private sector to increase financing of educational facilities both at the university level and at all other levels of education. For example, the use of education vouchers to permit parents to select the primary and secondary schools for their children will expand consumer choice, increase competition and encourage better education.

Fourth, well-designed technology parks have proven to be effective in reducing the cost of doing business for high technology firms. These parks can be especially productive to sustain local economic development. In particular, state government can promote the establishment of these parks with government support of infrastructure, but with private sector management.

Lastly, competitive exporting economies, Germany is a good example, attach a particular importance to cultivating skills through various apprenticeship programs. These programs can help businesses across all

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[11] Source: OECD, Science and Technology Indicators

[12] See, for example, an article Gary P. Pisano and Willy C. Shin, Restoring American Competitiveness, in the Harvard Business Review.

[13] Federal government provides 57% and 32% of total spending on basic and applied research, respectively. Source: National Science Board, Science and Engineering Indicators 2010

sectors by bridging the gap between demand for and supply of talent, especially in middle skill occupations. Yet, taking into account that private sector investments in training are often suboptimal and limited by a variety of market failures (for example, there is always a risk that investment will be lost if trained workers are rehired by a competitor), the government should play a role in strengthening the link between employers in sectors with high potential for jobs growth and prospective workers. True, there are many such programs in the U.S. both at the federal as well as state levels. However federal programs are often very poorly designed – according to the Government Accountability Office, 44 out 47 job-training programs funded by the federal government and costing taxpayers $18 billion in FY 2009 provided similar types of employment and training services with little evidence about the effectiveness of most programs.[14] Thus there is a need to shift more government funding of education and training to the state level, where these programs can be much more precisely tuned to address local economic development needs.

[14] Source: The Government Accountability Office, Multiple Employment and Training Program, January 2011