

Growth through Innovation

The Immediate Jobs Crisis and Our Long-Run Labor Market Problem

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Executive Summary

Two critical problems afflict the U.S. job market: the short-term problem of high unemployment and anemic job creation; and the long-term problem of stagnating wages and eroding job prospects that began long before the Great Recession.

The immediate cause of the recession was the unraveling of the housing price bubble and the associated deterioration of household wealth. Stock prices fell 50 percent, and household net worth declined 25 percent. This huge loss of wealth has reduced households' capacity and willingness to spend, severely damaged the credit-worthiness of tens of millions of potential borrowers and reduced the willingness of financial institutions to take lending risks.

The simplest, most persuasive explanation for the current jobs crisis is the shortfall in aggregate demand. The federal stimulus and drop in short-term interest rates have been insufficient to offset the wealth losses and tougher credit constraints. As a result, we remain in a protracted slump, with stubbornly high unemployment.

Other explanations for persistently high unemployment have been put forward. One is that the unemployed receive too much protection. But, the United States ranks near the bottom of industrialized countries in the generosity of its social safety net. A sophisticated version of the generous safety net argument is that American programs for the unemployed have become more generous in the current slump compared with earlier ones. That claim is largely true. Congress extended unemployment insurance (UI) benefits for an unprecedented 73 weeks. But, the increased generosity of the UI program increased the unemployment rate only modestly.

A more influential alternative theory to explain continued high joblessness is that the skills of unemployed workers are unsuitable for the job vacancies that now exist. Although this theory explains only a very small part of today's high unemployment rate, it is true that, even as business prospects improved and the job vacancy rate began to rise, joblessness has failed to decline at the expected rate.

Currently slow wage progress stands in contrast to the experience of previous generations. Earnings gains used to be as strong at the bottom of the wage ladder as at the top. The turning point occurred in the 1970s, when economic growth slowed and widening income inequality reduced the gains of working Americans at the bottom of the ladder. Since then, technological change, globalization and weakening of unions and the minimum wage have all increased the importance of skills and education in determining an individual worker's opportunities.

In the past 40 years, average real annual earnings shrank 40 percent among men with a high school diploma, but slipped just 3 percent among men who hold a college degree. For both men and women, the earnings premium from obtaining a college degree has risen almost continuously since the late 1970s. Job prospects also are diverging on the basis of the level of overall skill required to obtain the job. We are seeing a long-term rise in the relative demand for very highly skilled workers who can perform abstract tasks, relative stability in the demand for workers with the lowest skills, and a decline in the relative demand for workers with a middle range of skills.

Fiscal policy has been too conservative in combating the effects of the slump. The federal stimulus package was not nearly large enough to make up for the drop in aggregate demand. Although it makes sense to address the federal debt, it makes equally good sense to shrink the huge gap between actual and potential output. The nation can and should simultaneously address long-run fiscal problems and provide additional short- and medium-run stimulus. Long-term policies also should seek to raise educational achievement and attainment, and more closely align investments in education and skills to employers' needs. Further, a wide variety of improvements, supported by research, should be made to our education systems.

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Two critical problems afflict the U.S. job market. The first, short-term problem is that joblessness is falling at an unacceptably slow pace from an unacceptably high level. The unemployment rate has exceeded 8 percent for the past 34 months, a record span since World War II. And, it may not dip below that high level anytime soon.

The anemic pace of American job creation means that laid-off workers face an unprecedented challenge finding work. The median duration of an unemployment spell has exceeded 20 weeks for the past two years. In no previous slump since 1945 has the median unemployment duration exceeded 14 weeks. Since the Great Recession began in late 2007, the proportion of 25-54 year-olds who hold a job has fallen almost 5 percentage points, and the bounce-back from the lows in 2009 and 2010 has amounted to less than a half percentage point.

The sharp drop in the fraction of working-age Americans who hold jobs represents a vast waste of human potential. Experience from past recessions suggests that the career interruptions suffered by jobless workers can reduce their potential earnings for a decade or more.

The second challenge is that many Americans were struggling in the labor market even before the Great Recession. In 2007, before the recession began, the median male worker had not seen a noticeable improvement in real wages for more than a generation. The median female worker enjoyed faster wage gains, but those increases slowed to a crawl in the most recent decade.

Because of the challenge of finding decent jobs, a rising share of adults no longer participates in the labor market at all. In 2007, one in ten prime-age Americans (age 30 to 50) did not participate in the paid workforce, care for children, or work in the home—more than three times the level in the late 1960s. The reasons so many Americans no longer work are often related to poor job market prospects: inability to find work, a past spell of incarceration, a return to school in order to upgrade skills, and receipt of a disability check. Because of stagnant wages among men who work and rising rates of male joblessness, the median earnings of 25-to-64-year-old men are now roughly one-quarter less than those of their counterparts in 1969.

The anemic improvement in median earnings has dramatically slowed the improvement in middle-class living standards compared with the early post-war era. Real incomes have continued to improve among older households and among households headed by high-income workers. Women have enjoyed somewhat faster wage gains than men, and they are now far more

likely to participate in the labor market. Indeed, rising female earnings are an important force supporting middle-class living standards over the last few decades. But, gains in living standards have been painfully slow for most families headed by a working-age adult.

The first part of the following discussion focuses on the current job crisis and its causes and potential cures. The second part looks at the longer term challenge. Then, policy remedies are explored and proposed.

The Immediate Crisis

Origins and Scope of the Recession

Most economists agree that the proximate cause of the recession was the unraveling of the housing price bubble and the subsequent deterioration at financial institutions that held securities backed by real estate loans. Until early 2007, U.S. and world financial markets had an apparently unquenchable appetite for financial securities backed by U.S. mortgages. The easy availability of home loans helped support the steep rise in home prices, which peaked in 2006. Then, in parts of the United States, home prices began to fall, about in half.

The decline in home prices caused a huge drop in homeowner equity. Even homeowners with mortgage balances lower than the value of their homes often suffered an enormous percentage loss in their net worth. For many low- and moderate-income families, net equity in a home is the leading component of household wealth. The sizeable loss in housing wealth put a severe cramp on many homeowners' capacity to borrow and spend. Many home buyers who purchased houses with small down payments had little incentive to repay their loans, because their homes were worth substantially less than their remaining mortgages, and so a rising percentage of home owners defaulted on their mortgages.

As real estate prices declined, the financial institutions that had lent funds to homebuyers or purchased securities backed by home loans saw the value of their assets plummet. Some of these institutions were highly leveraged. The potential losses these firms faced on their portfolios of mortgages and mortgage-backed securities were large enough to threaten their solvency. Recognizing these risks, investors avoided the riskiest institutions. The ensuing financial panic threatened the survival of many of the nation's largest and most important financial institutions—and, by extension, the normal operations of the entire U.S. financial system.

That calamity was averted, but financial institutions saw sharp drops in their equity and bond prices. And, the market decline affected stock and bond prices of non-financial as well as financial companies. Between fall 2007 and late winter 2009, U.S. stock prices fell 50 percent. Between the second quarter of 2007 and the first quarter of 2009, Federal Reserve estimates show, household net worth declined \$16.3 trillion, or one-quarter. About two-fifths of the loss was subsequently erased as security prices, though not home prices, rebounded. Nonetheless, U.S. households now are \$9.4 trillion poorer than they were five years ago.

The huge loss of wealth has reduced households' capacity and willingness to spend. The financial crisis of 2008-2009 severely damaged the credit-worthiness of tens of millions of

potential borrowers and reduced the willingness of financial institutions to lend to borrowers with less-than-perfect records. One result is that the household saving rate has more than doubled since the end of the last economic expansion. (In the three years to December 2007 the personal saving rate averaged just 2.2% of disposable income; since then it has averaged 5.1%.)

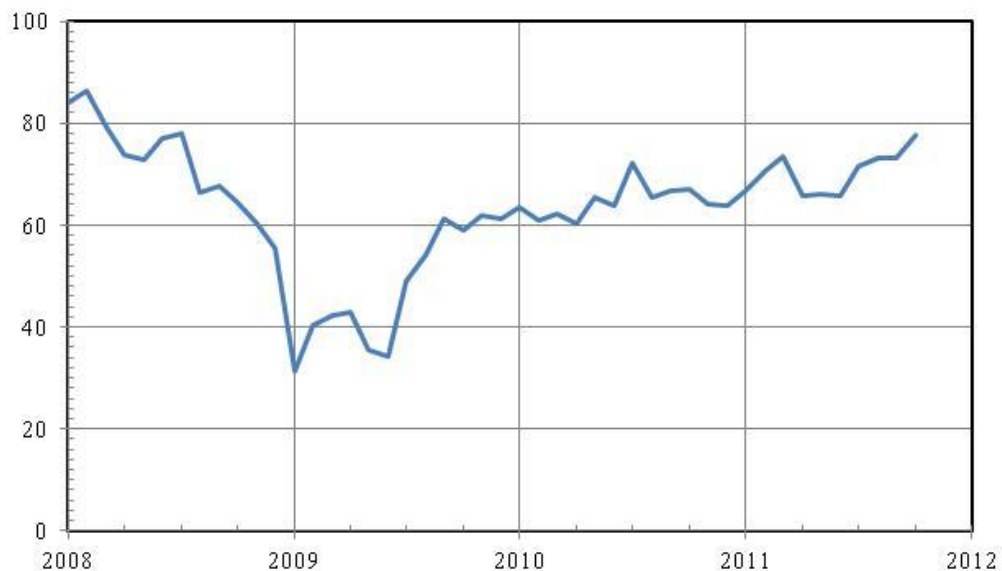
The Standard Story: A Shortfall in Aggregate Demand

The simplest, most persuasive explanation for the current jobs crisis is the shortfall in aggregate demand. Families' capacity to spend and borrow has been curtailed as a result of the loss of household wealth and the weakness of lending institutions. With the onset of the recession in 2008, businesses saw sizeable declines in consumer demand. Many anticipated future weakness as both households and lending institutions came to understand the consequences of plunging home values for household borrowing and spending. New home construction plunged. With a surplus of unoccupied houses on the market and a growing number of home sales forced by foreclosures, home builders saw little prospect for earning good returns on new development projects. Between 2006 and 2011, employment in the construction industry fell 2.2 million, or 28 percent. Unlike previous economic recoveries, the current recovery has not seen a rebound in homebuilding, nor do forecasters predict a robust rebound anytime soon. BLS estimates based on homebuilder payrolls show essentially no recovery at all in construction employment through November 2011.

The absence of a rebound in home building has depressed purchases of consumer durable items needed to equip or furnish new homes. Households' constrained spending is also reflected in purchases of new cars and trucks. As Figure 1 shows, U.S. motor vehicle production plunged steeply in late 2008 before shifting upward. Even though production continues to edge up, the pace is still 20 percent below the 1994-2007 average.

Figure 1. Motor Vehicle Assemblies, 2008-2011

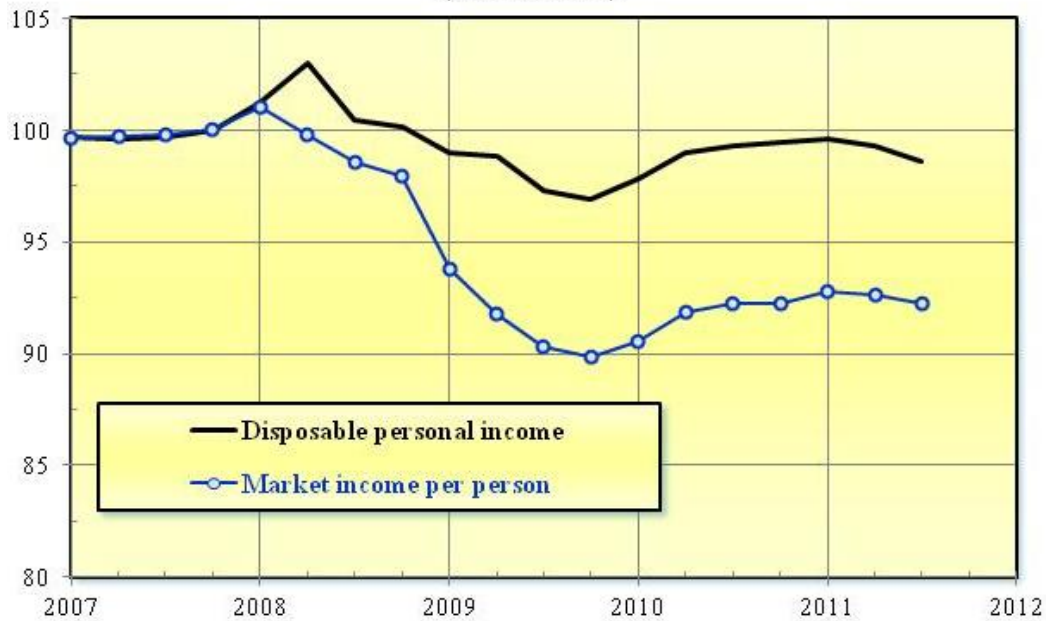
(Percent of average assemblies, 1994-2007)



Federal monetary and fiscal policy has attempted to offset the effect of shrunken household wealth on consumption and investment. Short-term interest rates are at or near all-time lows, though the impact on many consumer borrowing rates has been muted. Fiscal policy has cushioned the impact of declining household market income by reducing tax liabilities and increasing government benefits.

Figure 2 shows the 2007-2011 trend in per capita market income (that is, pretax income excluding government transfers) and per capita personal disposable income. Incomes are measured in inflation-adjusted dollars and shown as a percentage of the corresponding income levels at the end of the last expansion (that is, the fourth quarter of 2007). According to current Department of Commerce estimates, real market income fell a total of 10% between 2007:IV and 2009:IV and has recovered modestly since that time. In contrast, per capita disposable income fell only about 3% during the same two-year period. The difference between the two income trends is explained by lower household personal and payroll taxes and bigger transfers from the government. In addition, the federal government provided unprecedented fiscal relief to hard-pressed state governments, permitting them to spend more or tax less than they otherwise would have been compelled to do. Only a small percentage of federal stimulus funds has been allocated to direct purchases, that is, to public investment and final government consumption. The net increase in public investment at all levels of government represents a small fraction of the drop in residential plus business investment. Thus, direct stimulus spending on government investment and consumption has been modest in relation to the drop in aggregate demand attributable to losses in household wealth.

Figure 2. Real Market Income and Disposable Personal Income Per Person, 2007:I to 2011:II
(2007:IV = 100)



To sum up, the loss of wealth has induced households to reduce spending, and federal stimulus efforts and the drop in short-term interest rates have been insufficient to offset the impact of wealth losses and tougher credit constraints on consumption and investment. As a result, we remain in a protracted slump. A stubbornly high unemployment rate is the logical result.

An Overly Generous Safety Net?

There are alternative explanations for the severity and persistence of high unemployment. One is that the unemployed receive too much protection. According to this explanation of our labor market woes, the U.S. social safety net is too generous, and workers and their families now receive such lavish income protection against job loss that breadwinners do not need to exert the effort to find a job after being laid off.

At first glance, this theory does not seem terribly convincing. Most cross-national comparisons show the United States ranks near the bottom of industrialized countries in the generosity of its social safety net. Yet, unemployment has increased proportionally more in the United States than in most other industrialized countries, even though our social safety net is significantly less generous. A second challenge is to explain why U.S. unemployment increased proportionately more in the recent slump even though the percentage drop in U.S. output was below the average for other industrialized countries, including those with more generous safety nets.

A sophisticated version of the generous safety net argument is that American programs for the unemployed have become significantly more generous in the current slump compared with earlier ones. That claim is certainly valid. Income protection for the unemployed improved in four ways during the current slump. In 2008 and 2009, Congress authorized extensions in unemployment insurance (UI) benefits that added 73 weeks of benefit payments to the standard duration permitted in ordinary times. It funded states to boost average weekly benefit payments by roughly 8 percent of the previous average benefit level. It exempted part of workers' annual UI benefits from federal income taxation. And, it subsidized 65 percent of the cost to laid-off workers of continuing their health insurance protection under the health plan offered by their former employer.

The benefit extensions probably had the most important practical effect. As Figure 3 shows, in no previous recession has Congress authorized a benefit extension that lasted longer than 39 weeks, and in most recessions the extensions were shorter. Historically, benefit extensions served to increase the percentage of the unemployed who claimed UI checks, as Figure 4 shows. In 2009 and 2010, nearly two-thirds of the unemployed claimed UI benefits. In the 1980, 1981-82, 1990-91, and 2001 recessions and recoveries, a far smaller percentage of the unemployed collected UI.

A reasonable estimate is that in 2010 and 2011 the increased generosity of the UI program may have added between 0.2 and 0.8 percent to the unemployment rate. Even if we subtract 0.8 percent from today's unemployment rate, however, the level of joblessness would be exceptionally high for a U.S. economy that has been growing for 2½ years.¹

Figure 3. Maximum Duration of UI Benefits in States Eligible for Maximum Temporary Federal Benefits, 1958-2011

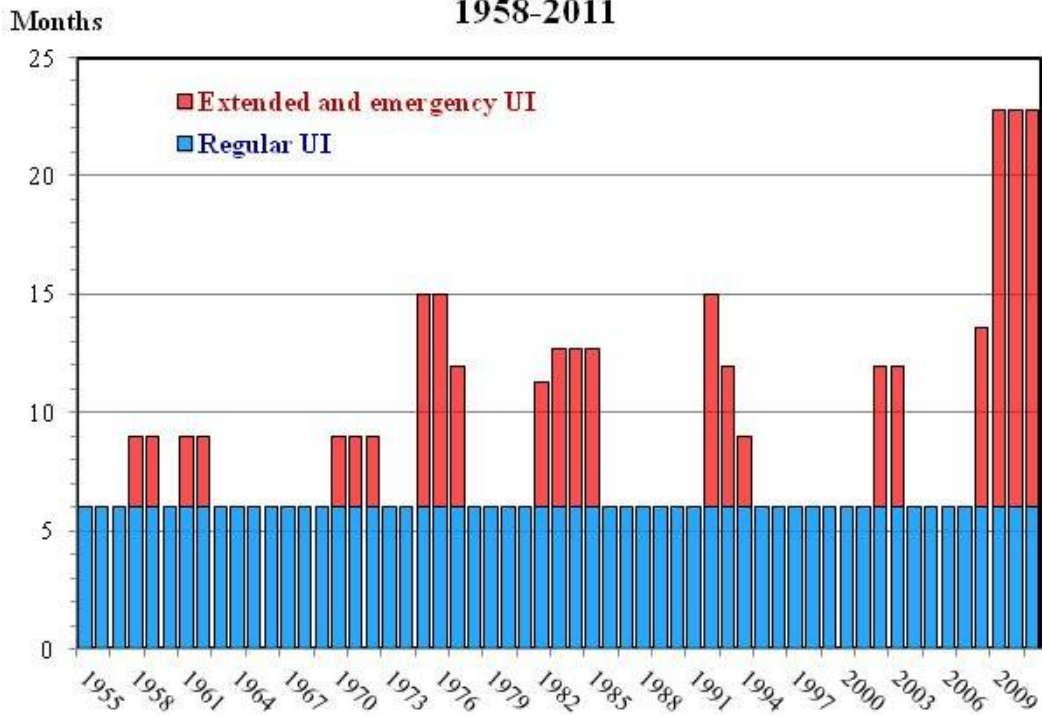
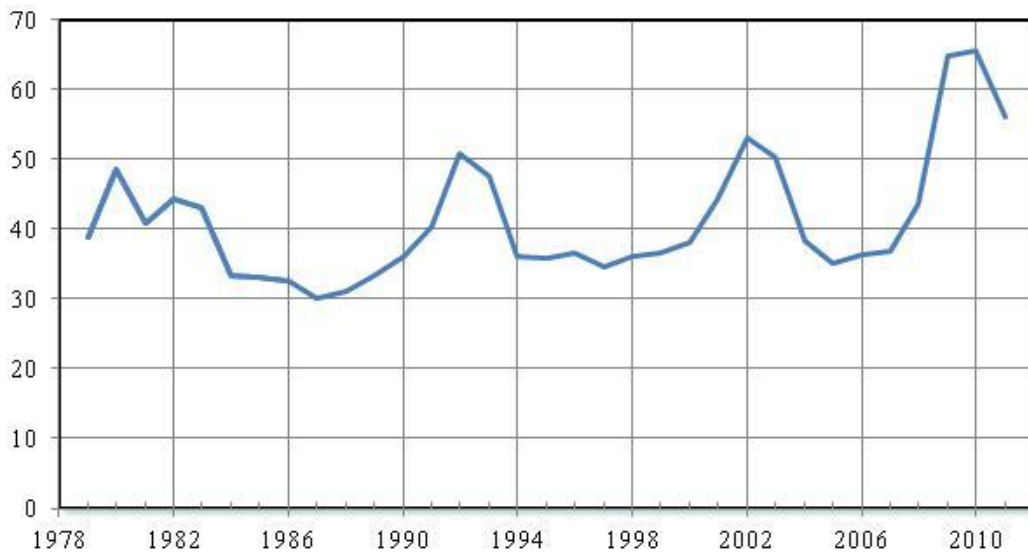


Figure 4. Unemployment Insurance Recipients Under All UI Programs as a Percent of the Unemployed (9-month centered average estimates)



The social protection argument, then, is weak. If the United States has enacted social protection programs that have unexpectedly increased the unemployment rate more than in the past, the problem is at worst a temporary one. All of the recent improvements in UI benefit generosity are explicitly time-limited. Several have already come to an end, including the 8-percent hike in weekly benefit payments, the favorable tax treatment of UI benefits, and the federal subsidies for continuation of health insurance coverage.² The temporary UI benefit extensions will almost certainly end, perhaps sooner rather than later. In order to restore solvency to their regular UI programs, a number of state governments have already curbed benefit payouts. It is hard to believe that explicitly temporary increases in unemployment benefit generosity will produce a long-lasting impact on the unemployment rate.

A Skills Mismatch?

A more influential alternative theory to explain continued high joblessness is that the skills of unemployed workers are unsuitable for the job vacancies that now exist. Employers need workers, but the currently unemployed do not possess the educational backgrounds or specific skills needed to fill the vacancies. Of course, this description of the awkward mating dance of job seekers and employers is always true to some degree, even when the unemployment rate is low. The particular claim now being advanced is that, for a variety of reasons, the mismatch between unemployed workers' skills and the skill requirements of unfilled jobs is exceptionally wide. As a result, job openings go begging that in previous recoveries would have been filled, and job seekers are forced to spend much longer finding job vacancies for which they are suitable candidates.

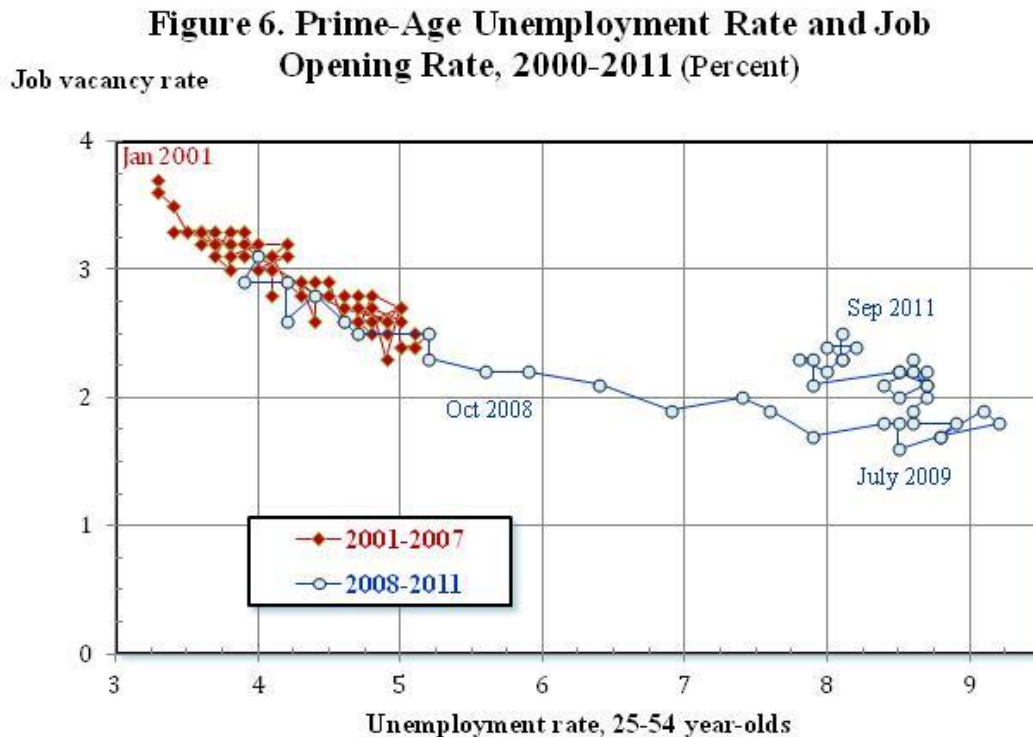
The usual course of events can be illustrated with diagrams familiar to labor economists. As Figure 5 shows, the 10-year trend in the prime-age unemployment rate and the 10-year trend in the job vacancy rate are mirror images of each other; as one rises, the other falls. Economists have long known about this relationship.

Figure 5. Prime-Age Unemployment Rate and Job Vacancy Rate, 2001-2011



Source: U.S. BLS. The job vacancy rate is computed by dividing the number of employer-reported job openings by the sum of employment and job openings.

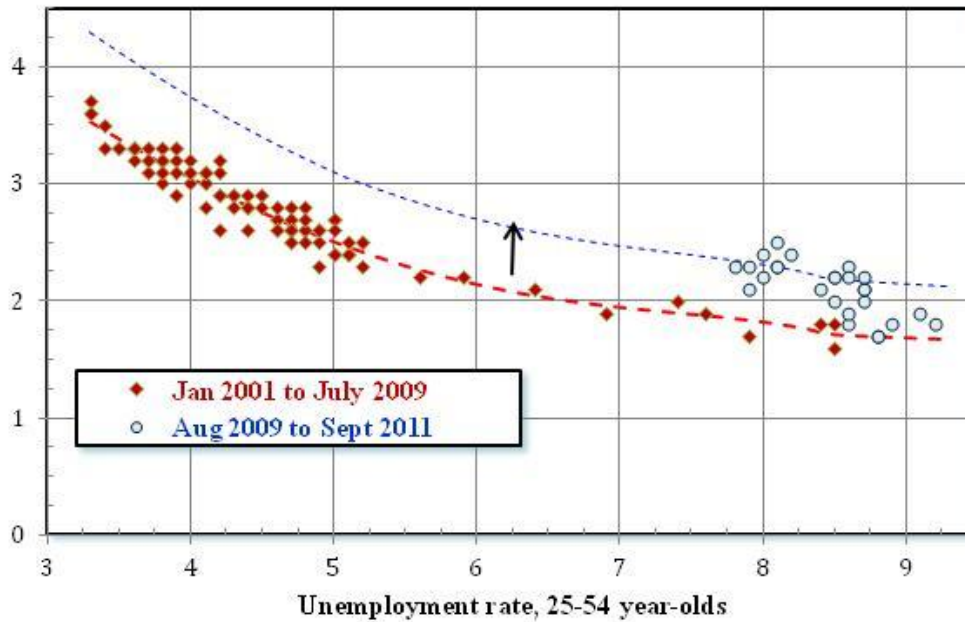
Figure 6 shows another way to display the same information. Each point in the chart shows the combination of unemployment rate (on the horizontal axis) and job vacancy rate (on the vertical axis) that is observed at successive points in time. In the chart we distinguish between unemployment rate / vacancy rate combinations observed between 2001 and 2007 and those observed after the start of the slump in late 2007. Before the slump caused by the Great Recession, prime-age unemployment was low or moderate, while vacancies were comparatively plentiful. The recession caused joblessness to climb rapidly, and the vacancy rate fell. This relationship was no surprise. The disquieting aspect of the picture is what started to happen in late 2009. As business prospects improved and the job vacancy rate began to increase, the unemployment rate failed to decline as fast as we would expect if the underlying relationship between vacancies and the unemployment rate had remained stable.



A new relationship between unemployment and vacancies would be bad news for several reasons. One reason is that prospects for maintaining stable inflation would dim when the unemployment rate falls and the vacancy rate improves. At the moment, the issue of inflation is not very worrisome. Wage increases are slower than labor productivity gains, and employers have seen their unit labor costs decline. But, as Figure 7 shows, there is an outward movement of the unemployment rate / vacancy rate curve. This suggests that an acceleration in inflation could become a problem at an unemployment rate that is uncomfortably high.

Figure 7. Prime-Age Unemployment Rate and Job Opening Rate, 2000-2011 (Percent)

Job vacancy rate



There are competing potential explanations for the outward movement of the unemployment rate / vacancy rate curve. One explanation focuses on the skills mismatch hypothesis, as we have seen. Another highlights the geographical mismatch between job seekers and job openings. Still another emphasizes increases in the generosity of the social safety net, which may induce some unemployed workers to reject job vacancies they would have accepted if they were provided less income security after a layoff. All of these explanations rely on the assumption that the employment environment has grown *worse* over time. There have always been unfilled job openings and job seekers who do not have the exact qualifications needed to fill the vacancies. There have always been regions that are growing, prospering and providing new job opportunities, and unemployed workers who live in places where vacancies are rare. And, since the end of the Great Depression, there has been a government safety net for laid-off workers. To account for unusually high or unusually persistent unemployment in the current slump, each of these explanations must be based on empirical evidence showing that some crucial feature affecting the unemployment / vacancy relationship has worsened: the skills mismatch has grown worse; the geographical distance separating job vacancies and job seekers has widened; the generosity of the social safety net has increased.

Like the social protection argument, the skills mismatch argument, too, does not offer a persuasive explanation of the current high level of unemployment. Even if we could endow several million unemployed job seekers with exactly the skills needed to prosper in the industries that are currently expanding, we would reduce the unemployment rate only modestly, and for a very simple reason: There are comparatively few expanding industries in need of the surplus workers who were forced to leave industries that shrank in the Great Recession. Similarly, the geographic distribution of job seekers and job openings would not have to change very much for

the ratio of job seekers and job openings to be nearly the same across the most populated parts of the country. There are geographic pockets with high job vacancy rates, but they tend to be in lightly populated regions.

The Long-run Labor Market Problem

Rising Inequality Within a General Slowdown

In a longer-term perspective, the job losses during the recent recession and tepid recovery have exacerbated the difficulties many U.S. workers have been experiencing for years. Their slow wage progress stands in contrast to the labor market experience of previous generations. For the first few decades after World War II, the American job market was a reliable engine of upward mobility. Robust economic growth fueled the growth of worker incomes. Earnings gains were as strong at the bottom of the wage ladder as at the top. At a time when virtually all prime-age American men and an increasing percentage of American women participated in the paid workforce, wage gains lifted the living standards of nearly all working-age families. As noted by President Kennedy in 1963, “A rising tide lifts all boats.”

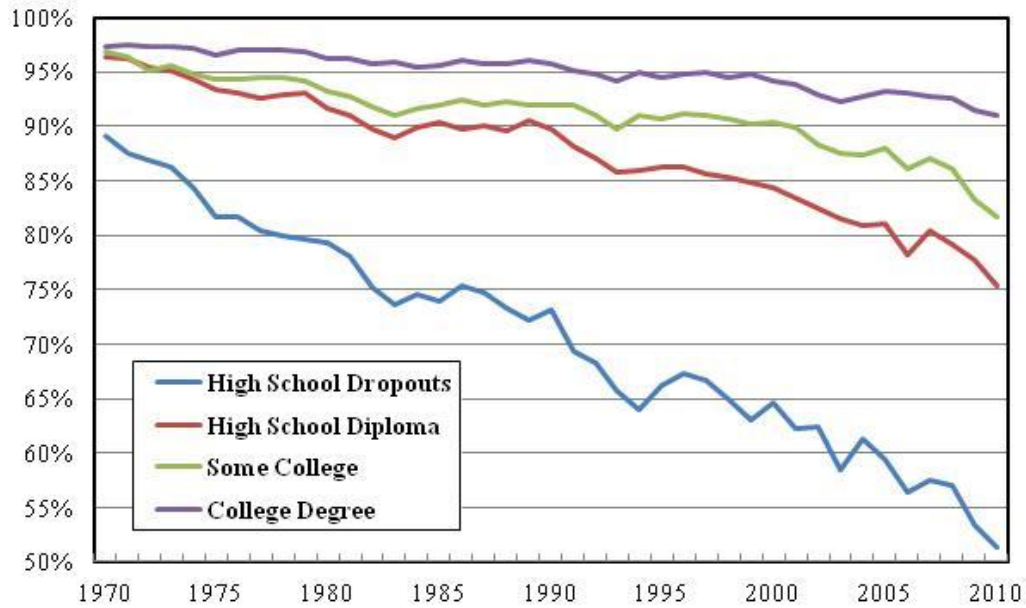
The turning point occurred in the mid-1970s, when aggregate economic growth slowed and widening income inequality reduced the gains of working Americans at the bottom of the wage ladder. The causes of increasing wage inequality include important demand-related factors. One of these is technological change, which has allowed machines and computers to take on a growing role in routine production and clerical tasks. Other factors include globalization and changing patterns of world trade, which expand the effective worldwide supply of labor that competes with low- and middle-skill U.S. workers. Also, crucial labor market institutions, such as unions and the minimum wage, have weakened and now provide less protection to workers who have modest skills. A common characteristic of these developments is they have all tended to make the role of skills and education more important in determining an individual worker’s wages and employment opportunities.

The “Education Premium” is Growing

The evidence that skills and education are increasingly important is reflected in a wide variety of labor market indicators. Workers with the lowest levels of formal schooling have experienced the largest declines in employment and earnings over the past few decades. In 1970, 96 percent of men between the ages of 25-64 worked, regardless of their education attainment, as Figure 8 shows. In the past 40 years, the fraction of high-school educated men that holds a job has fallen 21 percentage points, but the employment rate of college-educated men has edged down just 6 percentage points. Similarly, as Figure 9 shows, average annual earnings shrank almost 40 percent among men with a high school diploma, fell one-third among men with some college credits, and slipped just 3 percent among men who hold a college degree.

Figure 8. Employment Rates of Men

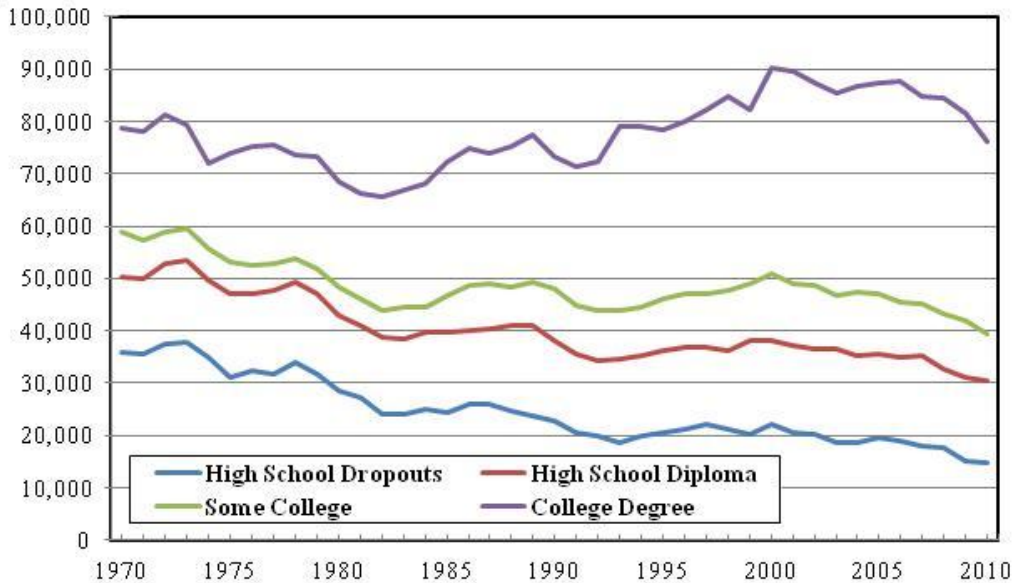
Share Employed



Source: Current Population Survey (CPS 1971-2011) and U.S. Census and American Community Survey (U.S. Census 1970-2010). Note: The sample is restricted to non-Hispanic whites and blacks aged twenty-five to sixty-four.

Figure 9. Mean Earnings of Men

Annual Earnings (\$2010)

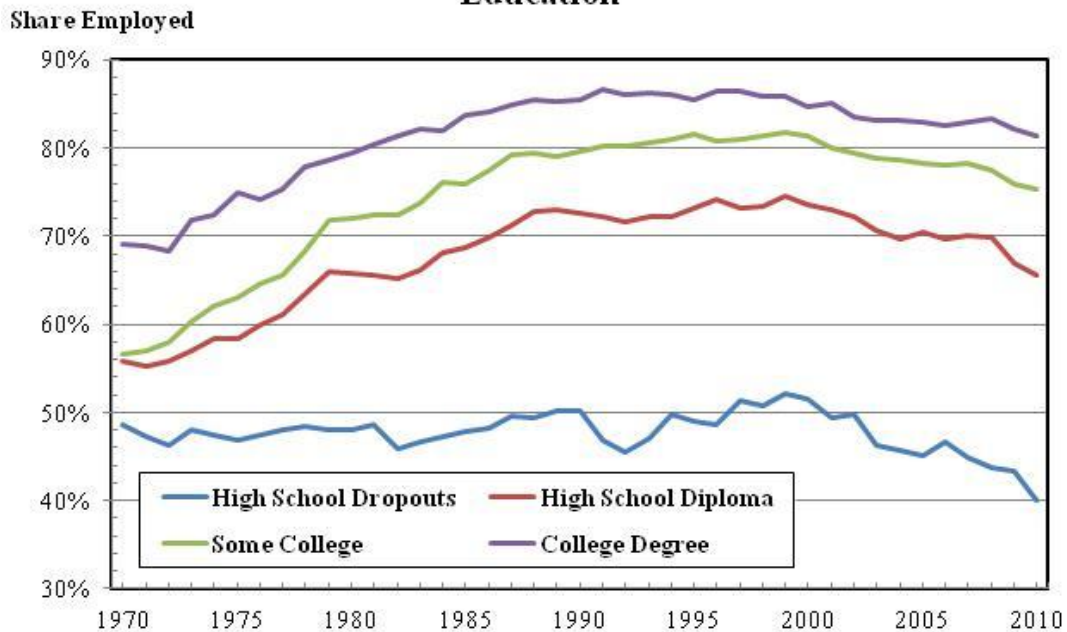


Source: Current Population Survey (CPS 1971-2011) and U.S. Census and American Community Survey (U.S. Census 1970-2010). Note: The sample is restricted to non-Hispanic whites and blacks aged twenty-five to sixty-four. Dollar figures deflated using the CPI-U.

For women, the most important trend over the last 40 years is the overwhelmingly positive impact on earnings of rising participation in the paid labor force. Women’s improved schooling and the greater continuity of their careers has permitted them to enter better paying occupations and ascend to higher positions on the job ladder. But, for women as for men, the biggest gains in the job market have been enjoyed by workers with the best educational credentials, as Figure 10 shows. Wage differentials based on schooling are larger today than ever before (Figure 11). Since the end of the 1990s, however, women’s employment gains have slowed at older ages and been reversed at younger ages. Female college graduates’ earnings have stagnated, and real earnings have declined among women with lower levels of schooling.

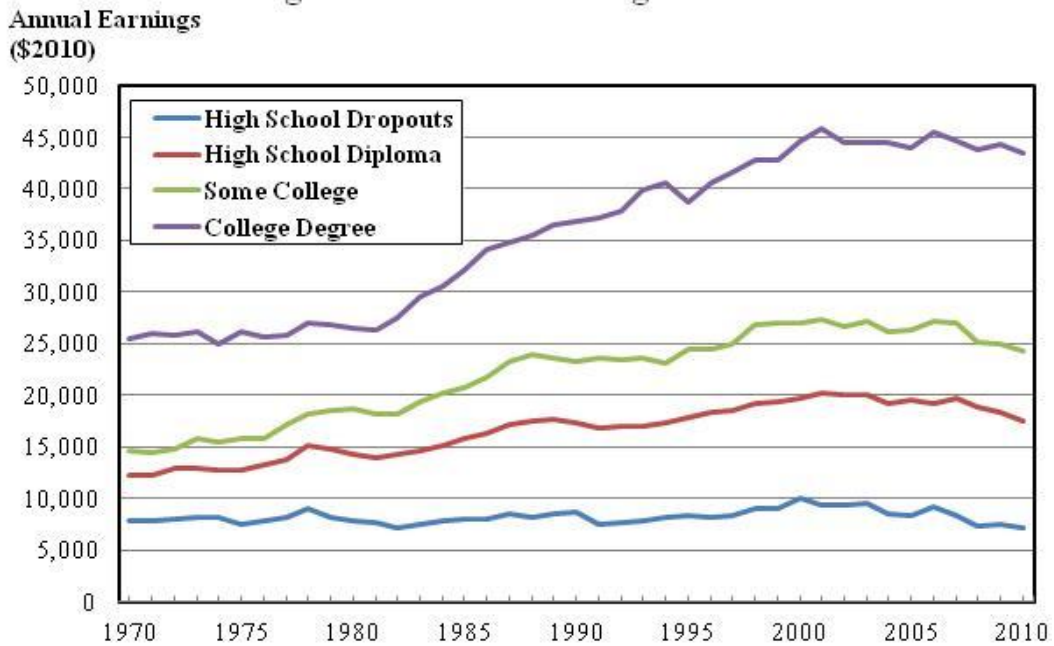
For both men and women, the earnings premium from obtaining a college degree has risen almost continuously since the late 1970s (Figure 12). In the early 1960s, the average hourly wage of college graduates was approximately 1.4 times the hourly wage of high school graduates. College graduates now earn almost double the amount earned by a worker whose formal education ended with a high school diploma. The college pay premium continued to grow during the recent recession.

Figure 10. Employment Rates of Women By Education



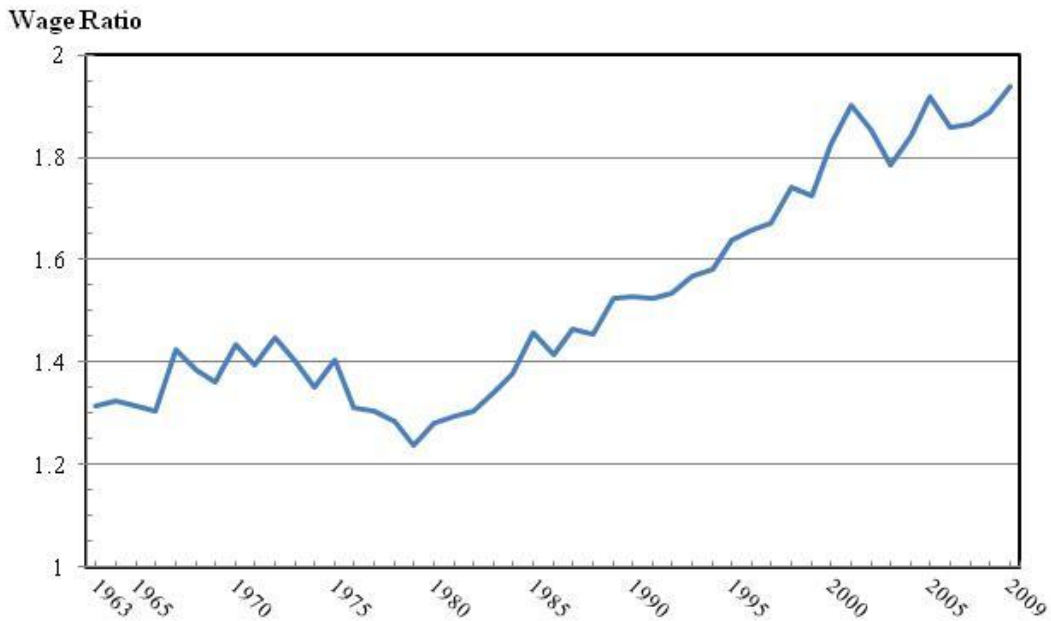
Source: Current Population Survey (CPS 1971-2011) and U.S. Census and American Community Survey (U.S. Census 1970-2010). Note: The sample is restricted to non-Hispanic whites and blacks aged twenty-five to sixty-four.

Figure 11. Mean Earnings of Women



Source: Current Population Survey (CPS 1971-2011) and U.S. Census and American Community Survey (U.S. Census 1970-2010). Note: The sample is restricted to non-Hispanic whites and blacks aged twenty-five to sixty-four. Dollar figures deflated using the CPI-U.

Figure 12. College Degree vs. High School Diploma, Weekly Wage Ratio, 1963-2009



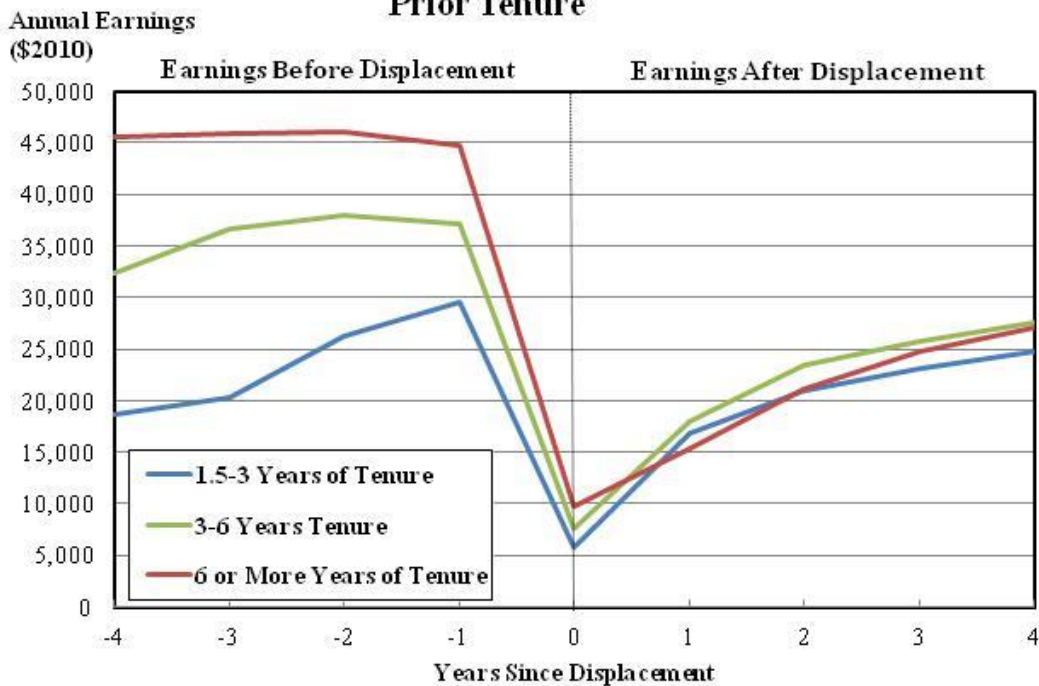
Source: March CPS 1963-2010.

Employment-rate differences among education groups also have widened. The number of employed high school dropouts plunged 16 percent after 2007, while the number of employed high school graduates fell 8 percent. Over the same period, the number of employed college graduates actually increased 2 percent. Among young workers just getting established in the job market, educational attainment is clearly critical. Looking at adults who are exactly 24 years old, 88 percent of college graduates hold jobs, compared with just 65 percent of 24-year-olds whose schooling ended with a high school degree.

Prospects Depend Partly on Skill Level

Formal education is only one dimension of a worker's qualifications. Other dimensions are also important. Industry- and employer-specific skills, learned over the course of years on the job, help determine the wages and promotion prospects of long-tenured workers. These workers, who may have accumulated crucial job- or industry-specific skills, are particularly hard hit when plants close, shifts are shut down, and their positions are eliminated. For instance, workers with 6 or more years on the job who were laid off during the early 1980s recessions suffered earnings losses of 30 percent even five years after job loss (Figure 13). The earnings losses are very persistent. Displaced workers with lengthy job tenures will earn less than their non-displaced peers even 20 years after a layoff. The problems of these workers are likely to be especially severe in the next few years. The latest evidence suggests that long-tenured workers displaced during recessions experience twice the loss of workers displaced when the economy is growing strongly.

Figure 13. Earnings of Displaced Workers by Prior Tenure



Source: Louis Jacobson, Robert LaLonde, and Daniel Sullivan (2005), "Is Retraining Displaced Workers a Good Investment?" *Economic Perspectives* QII: 46-66, Federal Reserve Bank of Chicago.

New evidence on the rising polarization of job opportunities suggests that the growth prospects of different kinds of jobs are diverging, based on job-specific tasks as well as the level of overall skill required to obtain the job. In recent years, advances in information technology and communications methods have significantly increased the demand for the cognitive, decision-making, and interpersonal skills of managers and professionals who are adept at performing abstract, non-routine tasks. The same technical advances have reduced the relative demand for routine clerical, analytical, and mechanical tasks that can now be performed more cheaply with the assistance of machines, such as personal computers, or by poorly paid workers outside the United States. Technical advance has been less successful in reducing the need for people who perform some of the economy's least-well paid tasks, many of which require the on-the-spot presence of a manual worker. A variety of low-skill, low-pay, service sector occupations fit this description—health aides, security guards, hospital orderlies, cleaners, and fast food servers. The result has been a long-term rise in the relative demand for very highly skilled workers who can perform abstract, non-routine tasks, comparative stability in the demand for workers with the lowest skills, and a decline in the relative demand for workers with a middle range of skills.

Policy Remedies

America's labor market woes have both a short- and a long-run dimension. The short-run problem – an unacceptably high and persistent unemployment rate – commands the lion's share attention today. But even in the midst of the current slump it is worth addressing the long-term problems that would otherwise mar the future prospects of millions middle class workers.

Fiscal Stimulus

As noted above, the evidence appears overwhelming that the principal cause of high current unemployment is a sizeable shortfall in aggregate demand. The combined demand of domestic and foreign consumers and businesses, plus the government, is too small to employ all the workers and productive capacity that would be put to use at full employment. The standard response to such a shortfall is monetary easing, that is, a reduction in short-term interest rates to make consumer and business borrowing more attractive and additional private spending more feasible. The Federal Reserve Board pushed short-term rates to zero early in the crisis, and it is not possible to push them lower using ordinary tools of monetary policy.

In these circumstances, the standard policy prescription is to use fiscal policy to increase aggregate demand. By reducing tax burdens on households and businesses, increasing consumer incomes through additional benefits or boosting government consumption and investment, the federal government can increase the demand for goods and services produced in the United States. This policy, too, has been tried, both by the Bush and Obama Administrations. The best known effort along these lines was the American Recovery and Reinvestment Act of 2009 (ARRA), known as the stimulus law. The Congressional Budget Office (CBO)'s analysis of this law suggests that, at the peak level of spending in fiscal year 2010, expenditures under the law amounted to 2.5 percent of potential GDP. However, the shortfall—that is, the percentage that actual GDP lagged below potential GDP—that year was between 6½ percent and 7½ percent of potential GDP. In other words, the gap between actual and potential GDP was considerably larger than the temporary stimulus authorized by Congress.

The shortfall clearly would have been even greater without the fiscal stimulus provided under ARRA. But, the stimulus was not nearly large enough to make up for the drop in aggregate demand on the part of American households and businesses. Many of the temporary tax and benefit provisions authorized by ARRA have lapsed, and all of the temporary measures to provide fiscal relief to state and local governments have come to an end. The ARRA provisions funding public infrastructure and investment projects continue to offer financing for government investment, but total expenditures on these projects is modest. How modest? The CBO estimated that, even at the peak rate of outlays on ARRA-funded capital projects, this kind of investment spending amounted to only 0.3 percent of potential GDP. The decline in private investment spending on residential and nonresidential buildings has been many times greater than this amount. ARRA-funded public investment has offset less than a tenth of the drop in demand for buildings originating in the private sector.

In short, fiscal policy has been too conservative in combating the effects of the slump. Although critics of activist fiscal policy predict that increased public borrowing will be futile or, worse, could spark panic in world capital markets, the evidence for these claims is unpersuasive. Households and private businesses are reluctant or unable to spend. At the same time, there are millions of unemployed workers who are eager to find jobs and thousands of businesses that would be willing to expand if they could identify credit-worthy customers. The world's savers are willing to purchase U.S. government debt at record-low interest rates, implying that market participants are not seriously concerned that the government will eventually default on its bonds. Under these circumstances, the government should spur job creation and business expansion by investing in government capital projects and providing incentives so that consumers and businesses will prefer to spend sooner rather than later.

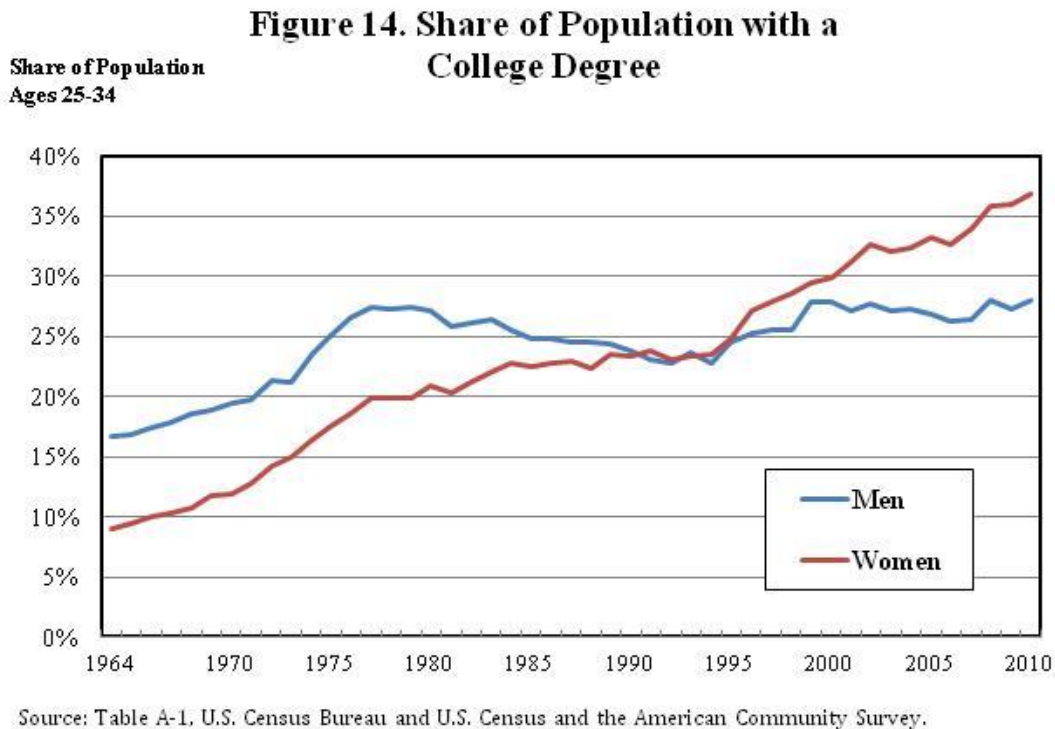
Voters and policymakers are legitimately concerned about the long-term consequences of bigger federal deficits, but the plain fact is that the current deficit is exceptionally large because the economy is exceptionally weak. It makes sense to address the nation's long-term fiscal imbalance, but it makes equally good sense to shrink the huge gap between actual and potential output. As astonishing as it may seem, it is possible simultaneously to address long-run fiscal problems and still provide additional short- and medium-run stimulus to spur growth in the near term. That, in fact, is the policy combination most likely to help, both in the near term and the long run.

The Long-Run Problem

Though a skills mismatch does not account for a very large portion of today's unemployment, a policy that spurs skills acquisition among teens and young workers would help address the long-term problem of wage stagnation. Addressing the long-run labor market problem is obviously a challenge for which solutions would take years to implement and require decades for the full effects to be seen. Further, a holistic discussion of policies to improve the long-run earnings, job opportunities and living standards of American workers is likely to involve a wide-ranging discussion of the size and scope of government.

To illustrate one area of policy opportunity, the evidence clearly shows the rewards to education and skills in the labor market have increased. But at the same time that the labor market has seen

a rise in the relative demand for education and for decision-making and cognitive skills, by many measures the educational investments of young Americans have stagnated. The average standardized test score of high school seniors, as measured by the National Assessment of Educational Progress, has remained essentially unchanged over the past 35 years. High-school completion rates have actually declined over that time span, if we do not count the GED degrees awarded to youngsters and adults who fail to fulfill the graduation requirements of local high schools. Even in post-secondary schooling, the nation's recent record looks poor in comparison with that of other industrialized countries. While women continue to earn college degrees in increasing numbers, college completion rates among men stand as low as they did 35 years ago, as Figure 14 shows.



Policies that are responsive to these labor market demands and raise educational achievement and attainment, or more closely align investments in education and skills to emerging needs of employers, could improve the employment opportunities and earnings of Americans over time. Moreover, research over the past few decades on educational policy suggests a wide variety of improvements that could be made to improve our educational systems, if political and financial hurdles could be cleared. For example, research identifies potential improvements at many levels of education from early childhood interventions, from policies to promote effective teaching or reorganize schools on the model of certain successful schools at the K-12 level and from policies that encourage college completion.

Addressing a problem that extends throughout the economy and encompasses both macroeconomic and microeconomic issues will require the evaluation of a broad range of policy

responses. Improved education and training policy will be only one component of a broad menu of policies aimed at aligning the skills of future workers with the shifting demands of U.S. employers.

References

¹ Rob Valletta and Katherine Kuang, “Extended Unemployment and UI Benefits,” *Economic Letter* 2010-12 (San Francisco, Federal Reserve Bank of San Francisco); and Jesse Rothstein, “Unemployment Insurance and Job Search in the Great Recession,” *Brookings Papers on Economic Activity*, Fall 2011.

² If the Affordable Care Act is fully implemented later in this decade, laid off workers will be given access to subsidized health insurance after they lose their jobs. This may reduce the pressure on jobless workers to find employment after they are laid off from a job that provides health insurance coverage.