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FRBSF Weekly Letter

# Job Creation: A Post-Mortem?

The Reagan Administration has proposed cuts in many programs, but few are to be cut as deeply as the Labor Department's "job creation" effort—programs designed to encourage employment through the subsidization of employee wages. For fiscal 1982, the White House plans to cut $3.6 billion out of these programs, or almost one-tenth of its total proposed reductions.

With the nation's unemployment rate stuck near 7½ percent for most of the past year, critics argue that dismantling these programs could seriously jeopardize the uneasy peace with the unemployed in central cities. The Administration, on the other hand, argues that the programs are growing out of control, as well as posing serious management problems. Behind the political controversy, however, is an important economic debate concerning the usefulness of job-creation programs as a remedy for employment problems.

**The programs**

The notion that governments can and should directly stimulate employment is not new. Indeed, today's Federal job-creation programs can be traced to the work-relief and public-works programs of the Great Depression, which at their peak in 1938 employed nearly four million workers. The urban riots of the 1960's and the high unemployment rates of the 1970's later stimulated renewed interest in programs to counter the chronic unemployment problems of unskilled workers.

By the early 1970's, nearly 20 Federal jobs programs were in operation, involving both training projects and direct job creation. In 1973 these efforts were consolidated by the Comprehensive Employment and Training Act (CETA). In contrast to the programs it replaced, CETA provided for decentralized administration. Federal funds were channeled to prime sponsors—largely county and city governments—who then became responsible for providing training and creating job opportunities.

The programs and aims of CETA shifted significantly over time. Initially, it tried primarily to solve long-run or "structural" unemployment problems, by preparing individuals for the workforce through training and work-experience programs. Direct job creation—the focus of our discussion—represented less than a third of total spending in the early 1970's. However, as unemployment rates rose during the 1974-75 recession, the emphasis shifted to countercyclical job creation. As a result, this type of spending increased from $440 million in 1974 to $6.3 billion in 1979, or 60 percent of the CETA budget. At the peak of the public service employment effort, almost 700,000 jobs had been created by CETA subsidies.

**Theory of job creation**

Or had they? Does a government have the ability—even theoretically—to "create" jobs through subsidization of an employee's wages? The answer depends upon the structure and functioning of the labor market.

Proponents of job programs argue that the labor market is segmented, with different supply and demand processes for the skilled and unskilled segments. For skilled workers, movements in wage rates clear the market for their skills, so that few of them become involuntarily unemployed except during severe recessions. For unskilled workers, on the other hand, market imperfections (especially, some argue, the minimum wage) keep wages artificially high. This prevents the market for their services from clearing at prevailing wages, leading to high and relatively permanent levels of involuntary unemployment.

A public-service employment program, according to this view, could reduce unemployment of unskilled workers without creating general inflationary pressures on wages; this would be achieved by identifying and hiring those workers who were unable to get a job at the prevailing wage. (The same effect could be achieved by subsidizing a private employer to hire these individuals.) In this view, jobs *can* be "created": by circumventing the market imperfection, the program increases employment of unskilled workers without affecting the employment of others, for a net increase in employment and output.

Rejecting this "segmented markets" view, opponents of job creation argue that market imperfections are a relatively unimportant influence on unemployment. Rather, high unemployment rates among unskilled workers are seen to be the result of the high job-turnover rates inherent to these markets. Therefore, the wages of unskilled workers clear the market for their services, and any increase in demand resulting from job-creation programs only increases the wages paid these workers (relative to the wages of skilled workers). This in turn tends to reduce the private sector's demand for unskilled labor. In the extreme, therefore, a jobs program might simply convert private-sector employment into public-sector employment one-for-one, with no net job creation—but with an adverse effect on wage inflation.

**Targeting problems**

Such theoretical considerations have undoubtedly contributed to the lack of enthusiasm for job creation among Administration policymakers. But the efficacy of job creation programs can be questioned on operational grounds as well. For example, there is the difficulty of "targeting" job-creation expenditures on the individuals suffering employment problems. Market forces tend to cause inaccurate targeting of program expenditures. If the subsidized jobs pay the prevailing wage (or greater), they will attract individuals who have no employment problems, and the impact on the target group will be lost. This tendency would be weakened if subsidized jobs paid significantly less than the prevailing unskilled wage, but this is typically not the case.

The architects of CETA tried to solve the targeting problem by defining a set of eligibility criteria to identify truly disadvantaged workers. There is evidence to suggest, however, that despite these criteria, low-skill workers were not well represented among those in CETA job slots. Indeed, a 1977 study found that those receiving CETA public-service employment tended to be better educated than the experienced labor force as a whole; 76 percent of those in CETA job slots had 12 or more years of education, versus 71 percent for the experienced labor force. (Minorities did, however, tend to be better represented in CETA jobs.)

A related problem is the tendency by employers to use the funds to hire people that they would have hired anyway. The effect of this "fiscal substitution effect" is to convert the jobs program into a general-purpose subsidy to the employer.

This problem is difficult to handle through eligibility criteria or other administrative means, because an employer usually is better qualified than a jobs-program administrator to judge the potential value of an individual in a particular job—and hence what should be paid. Even without a subsidy, an employer might be quite willing to hire an individual who superficially appears to be in need of assistance.

Under CETA, employers apparently have found it easy to convert conventional employment to subsidized employment. In one study, economists George Johnson and James Tomola found almost perfect fiscal substitution among state-and-local government employers—after only six quarters, virtually all of the public-service slots had replaced conventional positions, leaving total employment unaffected. In effect, CETA unintentionally became a revenue-sharing program for public employers.

**Youth problem**

In view of these considerations, many economists see job-creation efforts as an unpromising method of dealing with the overall unemployment problem. Towards the end of

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the Carter Administration, in fact, Congress itself had begun shifting the emphasis of CETA away from public-service employment. Some enthusiasm remains, however, for the use of this approach in dealing with the *youth* unemployment problem—partly because of its severity (with 40-percent unemployment rates among minority youth) and partly because of the belief that market imperfections may be more important in youth labor markets. For this reason, the Carter Administration in 1980 sought to channel more CETA funds toward youthful workers.

Some economists are skeptical, however, that the "segmented markets" notion is operative even for youth. High unemployment among teenagers may reflect not only the wage rigidities created by the minimum wage and other market imperfections, but also young workers' (voluntarily) high job-turnover rates and lengthy job-search patterns. Such behavior may in turn be stimulated by improved nonwork income opportunities, particularly family-assistance (welfare) programs.

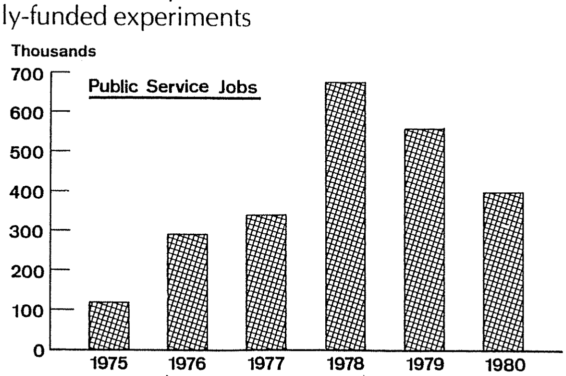
Both points of view may have some relevance. Many studies have found an association between the minimum wage and youth employment, suggesting the existence of a certain amount of "market segmentation." The association is far from perfect, however, and other forces appear to be at work. In addition, some direct support for the "voluntary turnover" view comes from recently completed welfare experiments (the Seattle and Denver Income Maintenance Experiments). These Federally-funded experiments studied the effects of family-income guarantees that were 25 to 30 percent more generous than conventional welfare programs. Economist Richard West of SRI International found that these experimental programs reduced the work effort of youth by 33 to 43 percent. These results suggest that it may be difficult for job-creation programs to significantly affect the youth unemployment problem.

**Future of job creation**

Overall, the theoretical uncertainties and practical difficulties involved with job creation have raised questions about the efficacy of such programs as a general remedy for hardcore unemployment. At the very least, the Carter Administration's ambitious plan to create one million jobs through such programs would not have the support today among labor economists and policymakers that it had in 1977. And in the short term, the Reagan Administration has made it clear that it is switching the emphasis of unemployment policy—from job creation to job training and fiscal reform, and from the public sector to private business and unions.

Nevertheless, job creation is a durable concept, made durable perhaps by the memory of the extensive Great Depression programs which *did* appear to "work"—albeit under radically different labor-market conditions. If unemployment does not yield to the new Administration's initiatives, job creation may return to the top of the labor-policy agenda once again.

**Randall Pozdena and Karen Vangsgard**



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## BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

| Selected Assets and Liabilities Large Commercial Banks | Amount Outstanding 5/6/81 | Change from 4/29/81 | Change from year ago Dollar | Percent |
|---|---|---|---|---|
| Loans (gross, adjusted) and investments* | 148,982 | 882 | 10,475 | 7.6 |
| Loans (gross, adjusted) — total# | 126,879 | 1,026 | 10,074 | 8.6 |
| Commercial and industrial | 37,809 | 545 | 3,456 | 10.1 |
| Real estate | 51,998 | 76 | 5,461 | 11.7 |
| Loans to individuals | 22,855 | – 50 | – 1,426 | – 5.9 |
| Securities loans | 1,662 | 163 | 787 | 89.9 |
| U.S. Treasury securities* | 6,465 | – 81 | 84 | 1.3 |
| Other securities* | 15,638 | – 63 | 321 | 2.1 |
| Demand deposits — total# | 41,312 | 771 | – 1,889 | – 4.4 |
| Demand deposits — adjusted | 28,852 | – 62 | – 1,859 | – 6.1 |
| Savings deposits — total | 30,503 | 240 | 4,269 | 16.3 |
| Time deposits — total# | 78,225 | 1,093 | 12,915 | 19.8 |
| Individuals, part. & corp. | 69,117 | 956 | 12,870 | 22.9 |
| (Large negotiable CD's) | 31,059 | 797 | 7,682 | 32.9 |

| Weekly Averages of Daily Figures | Week ended 4/6/81 | Week ended 4/29/81 | Comparable year-ago period |
|---|---|---|---|
| **Member Bank Reserve Position** | | | |
| Excess Reserves (+)/Deficiency (–) | n.a. | n.a. | 78 |
| Borrowings | 62.3 | 400.8 | 34 |
| Net free reserves (+)/Net borrowed(–) | n.a. | n.a. | – 44 |

* Excludes trading account securities.
# Includes items not shown separately.

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