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CAN MORE FISCAL STIMULUS FIX AMERICA'S LABOR MARKET WOES?

HIGHLIGHTS

- Policy initiatives aimed at getting Americans working again should prove modestly beneficial in the short-term, but these measures are bound to disappoint hopes for a material economic improvement.
- Type matters when it comes to fiscal stimulus; not all policies are created equal in boosting spending and employment. In addition, there is a real risk that the effectiveness of fiscal stimulus in bringing down unemployment is blunted in a post-financial crisis environment.
- The financial crisis gave rise to two key structural problems rooted in the labor market: depressed home values that create housing lock and skills mismatch/atrophy that perpetuates long-term unemployment.
- There are no quick-fix solutions to either. Even with well-crafted, forward-looking policies targeted at these areas, structural problems take years to resolve and require patience among the American public.
- If you believe that skills mismatch is a symptom of labor immobility, then part of the solution to unlocking employment potential is in fixing the problems in the housing market.

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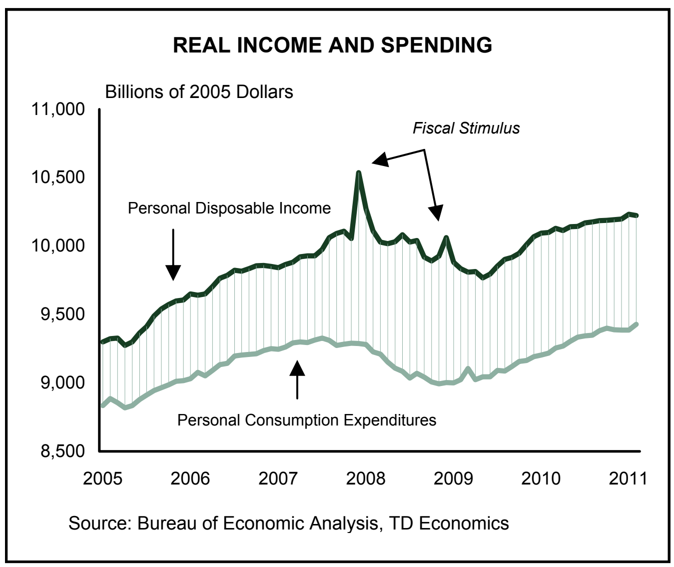
Stubbornly high unemployment remains a source of dismay among policymakers who have tried repeatedly to jump-start hiring with fiscal stimulus. Most economists agree that fiscal stimulus offered some support to the labor market during the downturn. However, with an unemployment rate still above 9%, fiscal initiatives definitely fell flat for those expecting a quick fix. The President is expected to outline in a speech to Congress on Thursday night another set of policy initiatives aimed at getting Americans working again. Among the options being considered that directly target the labor market: a 2% cut to the payroll tax on employers, an extension of the cuts already in place for employees, and increased funding for job retraining programs.

If enacted these policies should modestly benefit the economy in the short term, but they are unlikely to result in substantial improvements in unemployment. When it comes to fiscal stimulus policy, type matters. Not all policies are created equal in boosting economic and employment growth. In addition, there is a real risk that the effectiveness of fiscal stimulus in bringing down the unemployment rate is blunted in a post-financial crisis environment. The majority of stimulus intended to boost household incomes is likely to be saved rather than spent, blunting the positive feedback loop to more job creation. Any successful plan for reviving the labor market must also address the structural impediments to employment growth that have arisen since the recession: depressed home values, skills atrophy and an elevated mismatch of skills between vacant jobs and unemployed workers. Even with well-crafted, forward-looking policies targeted at these areas, structural problems take years to resolve and require patience from the American public. Unfortunately, the national conversation is dominated by talk of more quick-fix measures that are bound to disappoint hopes for material economic improvement.



To whom shall we make out the check?

In general, policies aimed at stimulating employment do one of two things. They either spur aggregate demand, which in turn causes firms to respond to higher demand for goods and services; or, they subsidize job creation directly by giving firms an incentive to hire new workers.

A payroll tax cut for employees temporarily boosts workers' take-home pay, which has both political and economic appeal in lifting aggregate demand. Ideally, with more money in their pockets, consumers will spend more. More spending causes the economy to grow and generate new jobs in the process. Since the stimulus is normally administered through the tax system, it can be aimed at lower income earners who tend to spend a greater share of their disposable income, thus maximizing its stimulative effects.

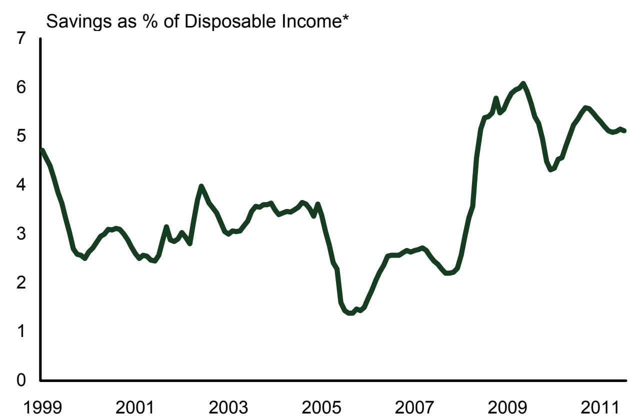
Similar policies have had success in the past. During the 2001 recession, roughly 90 million households received $38 billion in tax rebate checks. At the time, many economists questioned whether the one-off income boost would actually induce households to spend more. But subsequent studies found households did just that, spending roughly one-third of their rebates in the quarter they were received, and another third in the following quarter.[1]

There have been at least three attempts by fiscal policymakers to temporarily boost incomes since 2008: the 2008 tax rebate checks, the Making Work Pay Tax Credit in 2009 and 2010, and the 2% payroll tax cut for workers in 2011. Among the studies we located, most conclude that they were less effective than the 2001 rebates in boosting jobs and economic growth.[2,3,4]

What separates today from the 2001 experience is the recent credit bust and subsequent banking crisis. The effectiveness of these tax cuts in spurring aggregate demand is diminished in today's environment of tighter credit and de-leveraged household balance sheets. Roughly 23% of households owe more on their mortgages than they're worth. An uncertain global outlook has tempered expectations of future income growth. And, the national savings rate has roughly doubled from its pre-recession level, as precautionary saving and debt repayment have taken renewed priority over spending.

In other words, a temporary boost to income doesn't carry the same incentive to spend that it did ten years ago. A consumer expenditure survey found that 54-58% of the 2008 tax rebates were used to pay down debt among the prime working age group of 25-54 year olds, while another 13-15% of the rebate went towards savings.[5] American households spent less than one-third of their tax rebates in 2008, generating about half the impact on aggregate consumption relative to the rebates in 2001. Some estimates place the 2008 spending impact even lower, in the 12-30% range.[6]

PERSONAL SAVINGS RATE



*6-month moving average
Source: Bureau of Economic Analysis, TD Economics

If the policy is meant to have a direct and immediate impact on consumer spending, payroll tax cuts will likely prove disappointing. Debt paydown helps shore up household finances; with time this should feed through to higher spending. But this would occur with a lag, and its effectivenes would ultimately depend on whether consumer confidence improved sufficiently enough to temper precautionary savings behavior.

Given their diminished effectiveness today, are income-based stimulus measures worth their budgetary costs? In his speech on Thursday, the President is expected to propose an extension of the 2% employee payroll tax holiday, which the Congressional Budget Office (CBO) estimates will have already cost the government $111 billion this year.[7] A CBO study from 2010 found that such a tax break might generate anywhere between 335,000 to 1,000,000 new full-time equivalent jobs.[8] However, since the CBO conducted the study under different assumptions, prior to stagnant economic momentum materializing in the first half of 2011, we judge the lower estimate of this range as more realistic. More recently, Macroeconomic Advisers found that extending the holiday would generate roughly 400,000 new jobs by the end of 2012.[9]

No doubt these prospects are appealing, given an economy that couldn't generate any jobs at all in August. But, 400,000 is a small dent in the 7 million jobs lost during the recession that have yet to be recovered. Another payroll tax holiday won't be the silver bullet that solves the country's job woes.

Employer tax breaks offer mixed opinions

If stimulus measures that target take-home pay can only modestly boost employment growth, what about measures that subsidize new hiring directly? Surely these would seem like a better solution for the troubled labor market, since they work to make hiring immediately more appealing to firms. According to the CBO, a policy that temporarily reduces firms' labor costs could have a higher fiscal multiplier than one that increases employees' take-home pay. Last year they estimated that a 2% cut to the employer portion of the payroll tax would generate between 558,000 and 1,451,000 new full-time equivalent jobs. Again, given the timing of their study, we believe that the job gains would be on the lower end of this range at best.

An employer payroll tax holiday could be made conditional on new hiring or could be given to all firms regardless of whether they actually expand their payrolls. In the latter case, the policy's effectiveness would hinge crucially on how firms choose to respond to the temporary savings. Instead of hiring more workers, they could use the tax holiday as an opportunity to reduce prices charged and expand sales. They could also pass their savings on to their employees in the form of higher wages. Or, they could choose to retain the tax savings as profits.[10]

The appeal of this last option – especially in times of heightened economic and fiscal uncertainty – is one reason why employment gains from such a policy are likely to be marginal at best. The Fed's Beige Book is littered with references to uncertainty holding back business activity. Thus, there's a good chance that firms will delay new hiring and pocket any temporary tax savings as they await an improvement in the macroeconomic outlook. The temporary nature of the tax holiday only reinforces this strategy, as any worker hired during the tax holiday will become more expensive once the tax break expires.

Past ≠ future

On their own, the gains from an employee or an employer tax holiday are small compared to the number of people that need to be re-absorbed into the workforce. However, estimates of their combined impact suggest a possible gain of 1,000,000 new jobs, which carries some heft.

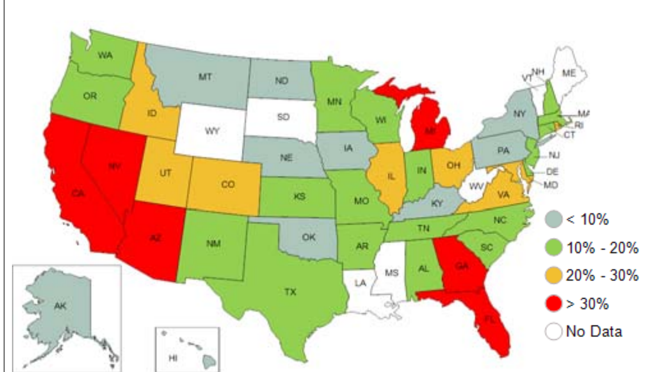
This would be great if we can be assured of these gains, but this estimate – and any one estimate for that matter – needs to be interpreted with care. First, these new jobs come with a substantial price tag in a fiscal environment that doesn't have much wiggle room left. According to one IMF study, fiscal policy responses following a financial crisis are less effective when a government's balance sheet is already highly levered.[11] In the case of the U.S., fiscal stimulus could lose its effectiveness if financial markets, businesses and individuals associate larger deficits with negative future policy risks, such as higher taxes. Second, the timing of the stimulus matters too for its effectiveness. The same IMF study found that fiscal stimulus is most effective during a crisis, when the economy is still contracting. It tends not to significantly impact output after the crisis has ended and the recovery is underway. The study deemed a crisis having ended once real GDP had expanded by a minimum of 0.5% for two consecutive years. The U.S. economy now fits this criteria.

Thus, the estimates stated above on the potential for additional fiscal stimulus to generate jobs may be overstating the benefit. Any additional rounds of fiscal stimulus will be constrained in an environment where consumers' desire to save trumps their desire to spend and businesses have adopted a "wait-and-see" attitude towards hiring. And, their effectiveness will further be blunted by structural challenges that continue weighing on the labor market's recovery – challenges which various short-term tax incentives have a limited ability to influence.

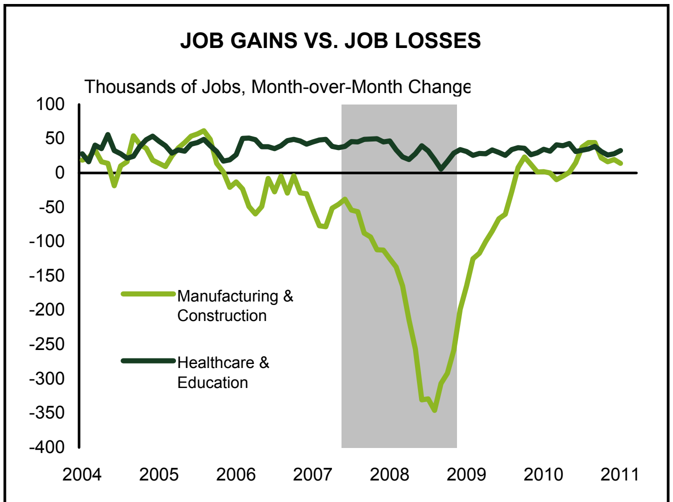
It's harder to target structural fixes

The credit bubble, housing boom, and subsequent bust gave rise to two structural factors that are at the root of the labor market's malaise. The first relates to depressed home values. At their peak, non-current loans represented 15% of total mortgages outstanding. Homeowners who have been delinquent in the past may have difficulty accessing credit in the future. This, in combination with the large share of households with negative home equity, has resulted in widespread "housing lock". Job seekers run into difficulty when they try to move to another job market if they

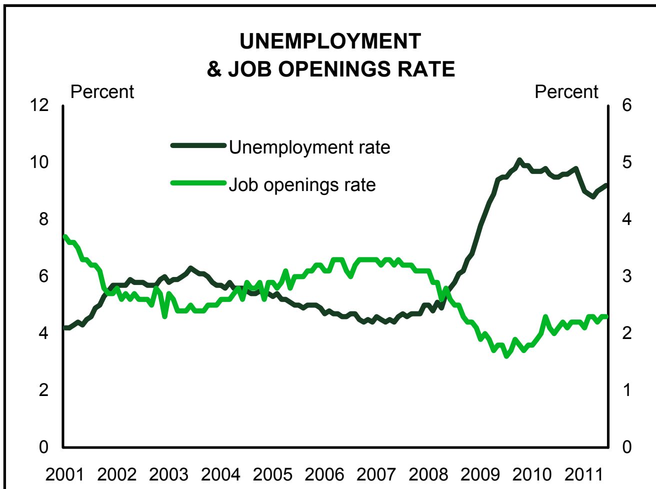
NEGATIVE EQUITY SHARE OF OUTSTANDING MORTGAGES BY STATE



*As of Q1 2011
Source: CoreLogic, Moody's Economy.com, TD Economics



Source: Bureau of Labor Statistics, TD Economics



Source: Bureau of Labor Statistics

are shackled to a property they are unable to sell or are not deemed credit worthy for a new purchase. Researchers at the IMF estimate that housing lock and its accompanying labor immobility has accounted for a one-percentage point rise in the unemployment rate since 2007.[12]

Another 0.5 percentage point increase is accounted for by the second structural problem: a growing mismatch of skills between unemployed workers and the task requirements of current job openings.[13,14] Consider that nearly half of the 8.7 million jobs lost during the recession were in construction and manufacturing. However, one-third of all new jobs created so far have been in health and education. With the line between job losers and job winners drawn deeply along industries, it is difficult and time consuming for the former to retool their work experience to jobs in new industries.

Rising skills mismatch has led to a swelling in the ranks of the long-term unemployed. Since mid-2008, the average duration of unemployment has gone up from just 17 weeks to over 40 weeks today. The median duration is 22 weeks. This is the widest disparity that has ever existed between the two, and is an indication of a large pool of workers who seem to be terminally stuck in long-term unemployment.

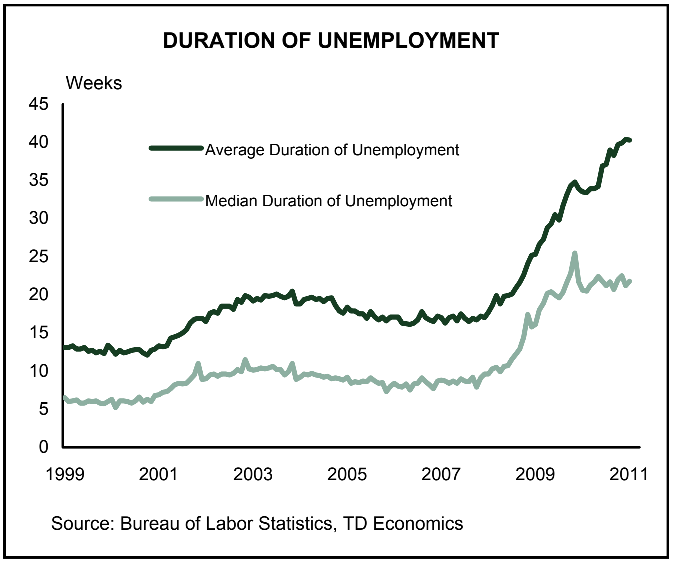
What can be done?

Part of the solution to the problem of skills mismatch lies in the retraining of idle workers to take up jobs in high-demand industries. Indeed, this may be one of the proposals that comes out of the President's speech on Thursday. Training programs along the lines of Georgia Work$, which sponsors unemployed Georgian residents to take on eight-week unpaid internships with prospective employers, are garnering much attention in Washington.[15] However, these programs must be carefully executed and are not a panacea. Despite their promise, evidence from OECD countries suggests that they won't be effective for increasing employment in the aggregate.[16,17] The success of these types of programs hinges on them being well-targeted and relatively small in scope. The more people who join a program, the less individualized attention the participants receive, potentially watering down its benefits. In addition, scaling these programs to the national level would require massive sums of government money – order of magnitudes beyond that which is likely politically feasible at the moment.

A large scale, federally-administered training program may not be the answer to the labor market's woes, but that doesn't mean programs similar to Georgia Work$ shouldn't be part of the solution. By increasing transfers to states, for example, the federal government can help promote worker retraining programs while giving states the freedom to tailor them to their specific needs. A transfer policy would also make use of existing administrative infrastructure. Like Georgia, many states and municipalities already have some kind of skills training program in place.

A fiscal stimulus package that makes heavy use of transfers to states has the added benefit of helping states close their budget gaps. Large revenue shortfalls have forced most states to enact sweeping cuts to core public services, particularly in the education sector. This has led to substantial layoffs at the state and local level, to the tune of 400,000 workers in the past 13 months. While the jobs-recession ended for the private sector last year, it lingers on in the public sector.

Increasing aid to states would directly limit job cuts and indirectly promote economic growth by reducing the



need for spending cuts and tax increases. Macroeconomic Advisers estimates that $50 billion in federal aid to state and local governments could directly create 150,000 jobs in 2012 and indirectly generate another 290,000 positions, if the funds prevented personal income tax hikes. This is pretty good bang for the buck relative to the other estimates on employment generated by payroll tax cuts. And, unlike these latter programs, there is general assurance that states will spend (and not save) the Federal transfers in order to prevent further budgetary cuts. Forty-two states are anticipating financing shortfalls in fiscal year 2012.

Are we treating the symptom and not the cause?

Even if we receive the most well thought out, forward looking policy to address the skills mismatch come Thursday, it may still not have the intended impact on reducing joblessness in America. If you believe that skills mismatch is a symptom of labor immobility caused by housing lock, then part of the solution to unlocking employment potential is in fixing the problems in the housing market.

As we noted in a previous report *(Resolving U.S. Housing Problem Essential To Avoiding Japanese Experience)*, the key lesson learned from Japan's lost decade over the 1990s is that allowing non-performing loans to linger for an extended period on the balance sheets of financial institutions hinders the functionality of the banking system. This, in turn, limits economic and employment growth, and the effectiveness that fiscal policy can have on the labor market.

In failing to adequately address the dysfunctional mortgage market, the U.S. risks mimicking the slow-growth experience of Japan. Our estimate of current and potential non-performing loans is roughly 7 million mortgages, though others have come up with even higher figures. The dialogue in America should be focused on how to resolve the bad debts that remain outstanding on the balance sheets of financial institutions and the government alike, in particular the government-sponsored entities (GSEs) Fannie Mae and Freddie Mac.

While the solution likely needs to be multi-fold, part of it must involve more aggressive modifications, and hence more aggressive loan write-downs by financial institutions and GSEs. However, any policy attempt to refinance mortgages among the latter would constitute a loss in tax-payer dollars, which might be deemed politically unfeasible at the moment. But since GSEs are the largest mortgage holders, their involvement is a necessary component of any effective solution. Other factors may include the expedition of the foreclosure process which currently takes an average of 23 ½ months, and some other innovative thinking, like opening up financing to investor opportunities on foreclosed properties to provide rental or other opportunities. Unfortunately, resolving the mortgage debt problem is so mass and complex, that it is understandable why governments prefer to take a more targeted approach in providing labor market stimulus. Our concern is that when we finally climb to the top and max out fiscal stimulus options in the labor market, we may find that we have had the ladder up against the wrong wall and there may be no more political or public appetite for additional fiscal measures targeted at the housing market.

Conclusion

Fiscal stimulus spared the labor market from the worst of the downturn. But, as we move further away from the crisis, additional rounds of stimulus may not generate substantial new employment growth. Households and businesses are operating in an environment of heightened economic, financial and fiscal uncertainty. This lends them to more conservative behaviour, be it spending or hiring.

Furthermore, short-term fiscal stimulus acts as only a band-aide over the structural problems that currently tear at the labor market. These include a growing mismatch of skills between unemployed workers and prospective employers, as well as a deeply depressed housing market that is impeding labor mobility. While any new initiatives out of Washington may deliver some well-intended relief for the labor market, there are no quick fixes to structural problems. Fiscal measures need to be pursued and evaluated with that understanding.

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