October 22, 1982

UNEMPLOYMENT: WHAT'S TO BLAME?

INTRODUCTION

Unemployment in September mounted to 10.1 percent, the highest level since 1941. The fundamental reason for this surge in unemployment is the economy's lack of growth. With over 11 million jobless workers, many Americans are tempted to look to the government for solutions. Yet, it is precisely because of the legacy of decades of government intervention in the marketplace that the U.S. suffers from its current economic malaise. Though occasional "market failure" may justify selective and occasional government action, most of the economic problems experienced in recent years are the result of "government failure."

A healthy and growing economy is a prerequisite for creating jobs for the jobless and raising the standard of living for all. In an attempt to reach full employment, postwar economic policy sought to generate an adequate level of demand for goods and services, and fiscal and monetary instruments were adopted toward these ends. But these measures largely ignored the incentives and other factors that would have set the economy running at full employment. U.S. policies led instead to serious inflation, and, postwar history suggests, contributed to the unemployment problem.

Governments at all levels have aggravated the situation by adopting laws and regulations that impede the free operation of market forces. Because this diminishes the ability of the economy to adjust quickly to changing conditions, it increases what is known as frictional unemployment. These government imposed restraints also have slowed the growth of job-creating sectors. The minimum wage laws and occupational licensing restrictions, for example, are particularly damaging because they tend to restrict employment opportunities for the nation's most

disadvantaged. Ironically, efforts to ameliorate the economic hardship of joblessness through unemployment compensation and other programs appear to have increased unemployment by reducing incentives to find permanent private sector jobs.

If the federal government genuinely wants to reduce unemployment, it should go to the root of the problem: government itself. The evidence clearly shows that much of today's unemployment is a product of government programs, restrictions, and other barriers that inhibit job creation. It would be far better to terminate these than to suffer through even heavier doses of ineffective government intervention.

The Unemployment Rate as a Signal

The unemployment rate measures the proportion of the labor force that is not working but is available for and actively seeking work. Among other things, it serves as a barometer of general economic conditions and as a benchmark for future policy decisions. The current 10.1 percent unemployment rate has attracted much concern because it is the highest level experienced in the postwar era. But, although the present unemployment level is clearly a signal of widespread economic problems, it is misleading to compare today's unemployment rate with those of earlier years.

Many factors affect the level of unemployment. Even in a dynamic economy, some level of unemployment is normal, and actually desirable, because it means resources are shifting to meet the changing needs of the economy. Some workers are voluntarily between jobs, others are new entrants to the labor force, while yet others are temporarily laid off due to seasonal factors, such as bad weather in the construction industry. Thus, the measured rate of unemployment will always be greater than zero, even in a healthy economy.

A number of other factors further account for today's unemployment rate. For example, labor force size and composition have undergone considerable change since the 1950s. Women and youth make up a larger share of the labor force today than they did in earlier years. These groups tend to experience higher rates of unemployment than do adult males because they generally have less training and experience. When the number of women and youth increases as a proportion of the labor force, the unemployment rate will generally rise. Similarly, the liberalization of unemployment compensation as well as the growth in multi-earner families have contributed to an increase in the unemployment rate because these factors allow the unemployed to be more selective in looking for work.

Moreover, the expansion of unemployment compensation may actually discourage working. In addition, welfare programs such as Aid to Families with Dependent Children and Food Stamps have grown rapidly and accompanying rules have increasingly required beneficiaries to register for work as a prerequisite for aid.

Thus, many who otherwise would not have been counted as part of the labor force are now included as part of the unemployed, even if they have no real intention of working were a job to become available.

Some factors, of course, may lead to an understatement of unemployment. For example, there are a number of people working part time because full-time positions are not available for them, and others may simply have become so discouraged that they do not even seek work--and so do not appear in the statistics. The combined effect of these factors is difficult to measure, but an awareness of their existence is important to understanding the unemployment problem.

Because of the difficulties in measuring unemployment, some economists have suggested that a better barometer of the economic climate would be the employment rate that measures the proportion of the total employed adult population. This could give a different picture of the state of the economy than does the unemployment rate. For example, despite a September unemployment rate of 10.1 percent, some 57 percent of the total adult population had jobs. By contrast, in 1969 when the unemployment rate was a tiny 3.5 percent, only 56.5 percent of the adult population was employed.

The unemployment rate in and of itself may be a misleading indicator of economic hardship. In fact, recent Department of Labor surveys indicate that the average annual family income of an unemployed person exceeds $19,000. Many of the unemployed collect unemployment compensation, have spouses who work, and own their own homes. This is not to say that segments of the unemployed do not suffer serious problems; it does indicate that they may not be as bad off as the unemployed of a decade or more ago, to say nothing of the 1930s when the image of unemployed suffering was fixed in the public's mind.

ECONOMIC GROWTH

Policies affecting economic growth are a *sine qua non* to any discussion of unemployment, because the more attractive the climate for economic growth, the more labor will be needed for production. Decades of irresponsible fiscal and monetary policies, however, have steadily eroded the incentives needed for sustained economic growth. These policies were largely a reflection of the views of British economist John Maynard Keynes and the assumption that central planning can make an economy run smoothly. The wide acceptance of this philosophy among policymakers led to an ever increasing role for government in the economy and inexorable increases in the tax burden borne by the private sector. Yet, private and public sector spending are not equal in their results. While government spending may stimulate the economy to some degree, it generally diverts spending and investment from more efficient, and hence productive, uses that would be made in a freely operating market economy.

How Fiscal Policy Contributes to Unemployment

According to the Keynesian doctrine, persistent unemployment is due to inadequate demand in the economy, and it thus falls to government to stimulate aggregate demand by increasing government spending or reducing taxes. The additional spending, it is argued, will stimulate the demand for goods and services and will promote greater economic activity. The promised result was reduced unemployment. Similarly, Keynesians argue that inflationary pressures result when demand exceeds economic capacity, thereby bidding up the price level. If this happens, government action is needed to restrain aggregate demand by cutting back on spending through a reduction in public spending or an increase in taxes.

In contrast to Keynesians, who emphasize demand management policies, the Reagan Administration shares the traditional view of free market economists who stress the importance of incentives to produce. These require a reduction in taxes and government spending. Government intervention, rather than maintaining full employment, disrupts the efficient allocation of resources and causes unemployment. These economists maintain that a greater reliance on market forces is needed to ensure steady economic growth, an expansion in employment, and a higher standard of living.

The centerpiece of the Reagan economic recovery program is the 25 percent cut in personal income tax rates over three years. This is not based on the Keynesian tactic of stimulating aggregate demand by reducing taxes, but on the belief that a reduction in marginal tax rates (the rate on the last dollar earned) encourages economic activity by increasing the rewards for work, saving, and investment by making activities such as leisure, consumption, and tax shelters relatively more expensive. The Administration recognizes correctly that decisions between consumption and saving and between work and leisure are heavily influenced by the after-tax return on individuals' capital and labor. Without adequate incentives, many find unemployment compensation and welfare benefits more attractive than wages, which have to be earned. Lower marginal tax rates also improve the after-tax returns on investment and induce employers to expand investment, leading in turn to increased employment.

Regrettably, the lion's share of the Reagan cuts will merely offset tax increases in the pipeline, due to inflation induced bracket creep and the social security payroll tax increases legislated during the Carter Administration. After taking into account expected inflation over the next three years, marginal tax rates will decline only to their 1977-1980 levels, still substantially higher than they were before 1975. For the marginal rate reduction to have its intended impact, Congress should insure that bracket creep stops eroding the tax cuts. The way to do this would be to index the tax code immediately, rather than waiting until 1985. Congress also should enact further tax cuts.

Spending too must be reduced. Despite all the rhetoric about massive budget cuts, spending under the Reagan Administration rose to a record 24 percent of GNP in fiscal year 1982. This is considerably higher than spending levels in earlier years, which averaged 21.5 percent over the ten-year period from 1971-1980 and just 19.5 percent in the previous decade. Although spending is projected to decline somewhat in the coming years, it is nonetheless expected to average 23 percent of GNP until 1985. This growth in government spending will put a brake on job creation in the private sector because the money needed must come from increased taxes, expanded federal borrowing, or the inflationary creation of money to cover federal deficits. Each of these drains the private sector, discouraging the expansion of existing firms and the creation of new ones.

The experiences of the Reagan Administration show just how difficult it is to cut government programs, even when the White House is determined to do so. A major reason for this is that the most rapidly growing components of spending in recent years are entitlement programs, such as social security, Medicare, public pensions, and a number of others over which Congress and the agencies have only limited control. From 1960 to 1981, spending on these programs grew from about 26 percent of the federal budget to 50 percent.[1] Unless these expenditures are brought under control, they may undermine the future growth of the U.S. economy.

By taxing work and subsidizing leisure, some government programs, particularly those financed by payroll taxes, compound unemployment problems. As the taxes that finance these programs continue to grow, more and more Americans may choose not to work and to enjoy more leisure. Those eligible for social security, for example, may decide to retire at an earlier age, while recipients of unemployment compensation may voluntarily prolong their joblessness. Others avoid taxes simply by moving into the underground economy--this alone may be responsible for overstating the unemployment rate by as much as two percentage points.[2] Such decisions reduce the number of workers paying taxes and increase the number or people eligible for income support. This, in turn, puts further upward pressure on taxes, aggravating economic problems. This vicious circle is pushing the tax burden to unacceptable and counterproductive levels.

Many of the "insurance" programs financed by the payroll tax, such as social security, may also inhibit job creation indirectly by lowering savings and investment. A number of these

---

1 The percentage of the federal budget spent on defense has actually declined since 1960, when it comprised 48 percent--compared to only 22 percent in 1981.

2 "The Underground Economy's Hidden Force," Business Week, April 5, 1982, p.66.

programs are financed on a pay-as-you-go basis: the taxes paid by current workers are not saved and invested, but used to pay benefits to today's beneficiaries. This can lower private savings and investment because many individuals come to view their "contributions" to these programs as a form of forced savings to protect them from such contingencies as the loss of income associated with retirement, disability, and unemployment and may therefore save less of their money themselves. Because the government uses the contributions to pay current beneficiaries, there is no corresponding increase in public savings to balance the decline in private savings. By decreasing aggregate saving, these programs reduce the money available for capital formation and job creation.

Many of the welfare programs financed by general revenues create substantial work disincentives for the poor. These programs, in combination with the tax code, have fostered permanent dependency on welfare by providing benefits of greater value than the after-tax income individuals can earn by working. Notes University of Chicago economist Yale Brozen:

> Because we pay the unemployed and those living in poverty so well, we are getting a rise in the number of people living in poverty. The amount of unemployment responds to the demand for unemployment and poverty.[3]

Thus, by eroding the American work ethic, these programs have had the unintended effect of adding an increment to the unemployment rate, which was much less evident before the Great Society programs were enacted.

Monetary Policy Effects on Unemployment

In late 1979, the Federal Reserve Board under Chairman Paul Volcker, embarked on a policy of restraining inflation by slowing the growth rate in the money supply. This was a radical departure from the course followed after World War II, which aimed at controlling interest rates rather than the quantity of money. This change in approach reflected the impact of the monetarist philosophy, which holds that the key to achieving economic stability without inflation is to set a steady rate of growth in the money supply in line with the underlying growth in output.

For many years, economists had believed that economic growth and full employment could be achieved by employing an expansionary monetary policy. This view held that an acceleration in the money supply would lower interest rates, and it was thought that by reaching this "price" of money government could stimulate investment and raise output. Slowing the increase in the supply

---

[3] Yale Brozen, "Government and the Rich", National Review, July 9, 1982, p.828.

of money was believed to do the opposite by raising interest rates and discouraging investment.

An expansionary monetary policy, however, can only stimulate growth and reduce unemployment if people do not anticipate future inflation due to the easy money policy. In that case, businesses produce more than they otherwise would because of a perceived increase in demand and lower investment costs. These positive effects on employment and output, however, tend to be short-lived because, once workers and investors become aware of inflation, the short-term gains disappear, the stimulus evaporates, and with it the new jobs. Moreover, once current and anticipated inflation rises, interest rates are pushed beyond their original levels, and even higher, as investors begin to demand an "inflation premium" to compensate their loss of current and future purchasing power. Rather than reducing interest rates and unemployment, pre-Volcker policy drove up inflation and interest rates and weakened the economy.

Having realized that expansionary monetary policy will not bring down interest rates or stimulate the economy for any length of time, the Federal Reserve is now trying to control the rate of growth in the money supply. The overall success of this policy is reflected in the dramatic reduction in the inflation rate.

Critics of "the Fed's" policy claim that in the process of bringing down inflation it has created the current recession and the high rate of joblessness. The recession, however, is to a large degree an inevitable but short-term side effect of the transition to a noninflationary economic environment. As Milton Friedman has explained, the economy has to go through a "drying out" period after an overdose of easy money. University of Virginia economist Herbert Stein points to the inevitable dilemma implied thereby for public policy:

> A special problem exists when, as has recently been our case, we start with an inflation rate that has been high for some time. On the one hand, the more promptly the inflation rate was reduced to a negligible level, the more certain would be the predictability of the price level. On the other hand, the more rapid the decline of the inflation rate, the more people who counted on continuation of the past inflation rate would be disappointed and hurt, with damage to the economy as a whole. There is no objective way to strike the optimum balance between the two considerations.[4]

---

[4] Herbert Stein, "Problems in the Conduct of Monetary Policy," in The AEI Economist (Washington, D.C.: American Enterprise Institute for Public Policy Research, July 1982), p. 3.

Today's predicament, in other words, is largely a result of inflation coming down faster than anyone had anticipated. Many workers, investors, and employers had anticipated a higher rate of inflation and contracted for wage rates and loans on that basis. So businesses are now forced to adapt to softer than expected output prices by shedding labor and cutting other costs. Once people's decisions and expectations adjust to low inflation, the economy will grow in a healthy manner, rather than in the distressed way that characterized the era of high inflation. The current recession represents the painful withdrawal symptoms associated with the drying out stage during the recovery from inflation. It is difficult for government to hold firm during this stage, but it is the only way if the U.S. is to spare its economy the ravages of inflation.

The short-term dislocation has not been helped by the Fed's erratic control of the money supply. In the past, slower growth in the money supply has tended to lower economic activity and raise unemployment within about two quarters. But within the eighth quarter, such monetary restraint has usually lowered inflation and set the framework for a healthy recovery. The current yo-yo changes in the money supply, however, have increased uncertainty for lenders regarding the value of future interest and principal payments. This has caused them to demand a risk premium in interest rates (on top of the inflation premium) to compensate for the risk of capital losses, should the price level rise. Uncertainty of this kind tends to destabilize business investment and capital plans and is a major cause of the recent record high real interest rates. Milton Friedman warns, "Until it [the Fed] mends its ways and produces stability in monetary growth, we shall not, I fear, achieve greater stability in either interest rates or economic growth."[5] The investment community has been deceived too many times in the past for it to make decisions on the basis of Fed targets. The Fed will have to earn credibility through its actions and restore public confidence that monetary policy will remain on a firm anti-inflation course. As this happens, interest rates will fall, generating economic growth and providing jobs for the unemployed. In the meantime, policymakers must not give in to critics pressing for looser control of the money supply.[6] To do so would repeat mistakes of the past, further erode confidence in the Fed, and obtain short-term economic relief at the cost of substantial long-term damage.

---

5 Milton Friedman, "The Federal Reserve and Monetary Instability," The Wall Street Journal, February 1, 1982.

6 Supporters of Senator Byrd's (D-W Va.) proposed Balanced Monetary Policy Act of 1982, for example, suggest a return to the policy of controlling interest rates. Similarly, Representative Jack Kemp (R-N.Y.) and other supply-siders have suggested that the Federal Reserve should, among other things, target real interest rates.

GOVERNMENT AND THE LABOR MARKET

While it is clear that government monetary and fiscal policies affecting economic growth play a critical role in establishing the climate for job creation, government regulatory policies that influence employment and income decisions in the labor market are also of crucial importance. Many laws and regulations in this area have contributed to unemployment by raising the cost to employers of hiring labor, inducing a shift to other factors of production, and restricting entry into an occupation. Other policies, such as the various unemployment compensation programs, have tended to prolong the duration and frequency of joblessness by reducing the cost of being unemployed. Although these policies may be designed to meet a social objective, they tend to work at cross-purposes with other government goals, most notably full employment. Moreover, they impose enormous costs on consumers, businesses, and workers, while benefiting few.

The Minimum Wage

The federal minimum wage was passed by Congress in 1928 as part of the Fair Labor Standards Act and was initially set at 25 cents an hour for a limited segment of the workforce. Since that time, both the level of the legislated minimum (in inflation adjusted terms) and the percentage of workers covered have roughly doubled. The original purpose of the minimum wage was to alleviate poverty by insuring an adequate standard of living for all workers. Not only has it failed to achieve its stated objective, but it has impoverished a large segment of the population by exacerbating unemployment and inhibiting the skill development of the nation's most disadvantaged citizens.[7]

The minimum wage creates unemployment by setting the wage rate at a level above that which would have been reached through the operation of market forces. This restricts employment opportunities for the least productive workers by pricing their services out of the market. By altering relative prices, employers who might have hired workers at lower wages may now substitute other inputs such as capital and more skilled labor, thereby distorting the efficient allocation of resources. Increased production costs put pressure on prices, thereby reducing sales and creating more unemployment.[8]

Even workers who retain their jobs at the minimum wage, however, may find that they are worse off than before because,

---

[7] See Walter Williams, "Government Sanctioned Restraints That Reduce Economic Opportunities for Minorities," Policy Review, Fall 1977, pp. 7-30; and Peter Germanis, "The Minimum Wage: Restricting Jobs for Youth," Heritage Foundation Backgrounder No. 147, July 1, 1981.

[8] See Finis Welch, Minimum Wages: Issues and Evidence (Washington, D.C.: American Enterprise Institute, 1978).

although they have a higher money wage, other nonmonetary forms of compensation such as fringe benefits and on-the-job training have been reduced. Employers are willing to supply such benefits because workers in fact pay for them with lower wages. Similarly, many employees are willing to accept a low wage initially, in return for training, because such an investment in "human capital" may enable them to command greater earnings in the future. Thus, the minimum wage may lower the future earnings potential for many workers by reducing their training opportunities. This contributes to the unemployment problem by curtailing opportunities for the skill development necessary to compete in a dynamic economy.

Many economists, notably the newly named Nobel Prize winner, George Stigler, have called attention to the deficiencies of the minimum wage. And Ronald Reagan, while campaigning for election, declared: "The minimum wage has caused more misery and unemployment than anything since the Great Depression." This observation is poignantly true regarding teenagers and minorities, whose lack of skills and education precludes their obtaining employment even at the minimum wage. A proposal that would limit the harmful consequences of the minimum wage would be the creation of a special youth wage rate, below the adult minimum, which would create financial incentives for employers to hire young, unskilled workers.[9] Because the minimum wage affects not only the youth labor market but also young adults, the less educated, the elderly, and other groups, a strong argument could be made for abolishing the minimum wage altogether.

The Role of Unions

Unions impose costs on society similar to those created by the minimum wage. Through collective bargaining agreements, unions also can push wage rates above levels at which employers can afford to hire more workers. When the economy turns down, these bloated contract agreements mean more layoffs than necessary. The ability of unions to win such agreements reflects the monopoly power in the bargaining process that government has granted them. Union gains, however, come at the expense of others, primarily those unable to obtain employment in the unionized sector at the higher wage rate.

The Davis-Bacon Act

The Davis-Bacon Act and other prevailing wage laws are yet another form of wage regulation leading to unemployment.[10] Passed by Congress in 1931, Davis-Bacon requires contractors on

---

9 Last year, Senator Orrin Hatch (R-Utah), Chairman of the Senate Labor and Human Resources Committee, introduced the Youth Opportunity Wage Act of 1981 (S. 348), which would encourage youth employment by providing a lower minimum wage for teenage workers. Unfortunately, Senator Hatch and other Congressmen who have introduced similar legislation have bowed under pressure and have not actively pursued passage of their bills.

10 There are a number of other prevailing wage laws such as the Walsh-Healy Act and the O'Hara-McNamara Services Act. Their implications for employment policy are similar to those of Davis-Bacon.

federally funded construction projects to pay the "prevailing" wage, meaning generally the wage paid to at least 30 percent of similarly employed workers in a locality. The original purpose of the Act was to protect local labor from the competition of new or intinerant contractors and their lower paid employees.

Since union members are more likely to be paid an identical wage rate, the so-called 30 percent rule often leads to the use of the higher union wage scales in federal projects, rather than the average construction wage. By artificially inflating wage levels, Davis-Bacon distorts the labor market and leads to higher levels of unemployment in the construction industry. These artificially high wage rates impose a discriminatory bias against the employment of nonunion labor because such workers may not be productive enough to retain their jobs at the new wage. As is the case with the minimum wage, this denies many of the poor and unskilled the opportunity to gain entry-level experience and on-the-job training. In addition, the Act restricts the proportion of apprentices and lower skilled workers who can work alongside journeymen--again reducing the employment opportunities for young people.

The Administration issued revised Davis-Bacon regulations addressing some of the problems with the Act and significantly reducing construction costs to the government. A federal judge, however, blocked the Labor Department from putting these new changes into effect. The future of these regulatory reforms is still in doubt. Alternative approaches to the problem include legislative changes to repeal the Act and exemptions for certain types of construction, such as military projects and low-income housing. Adopting either measure would promote employment in the construction industry, in addition to reducing the burden on the taxpayer.

Occupational Licensing

The minimum wage and Davis-Bacon Act create unemployment by artificially raising wages. Equally pernicious are government sanctioned restraints that limit the number of people who can enter a field of work by occupational licensing laws and certification requirements. These restrictions have been defended as a way of protecting the consumer from incompetent and dishonest service. Yet, all too often, this is a smoke screen for the creation of self-interest barriers designed to reduce entry into the occupation. The result is higher wages for those lucky enough to gain entry to the profession, but fewer total jobs.

Some level of certification and competency assessment may be needed in occupations, such as the health care professions, where the safety and well-being of the consumer are involved. In most cases, however, the free market can adequately serve the community's interests with less restrictive requirements. The taxicab business is a common example of the adverse effects

associated with policies that limit entry into an industry.[11] To operate a cab, the skill requirements are relatively low and the initial capital costs are minimal. Yet, in New York and many other cities, a taxi driver is required to own a "medallion" to provide cab service. In New York City, the supply of these medallions is fixed, and they can be purchased only from other operators at a going price of anywhere between $50,000 and $60,000. Thus, it is not surprising that there are fewer cabs (and hence cab driver jobs) per person in New York City than elsewhere in the country where the restrictions are not nearly as costly. In Washington, D.C., for example, there are no limits on entry. Not only does the city have one of the highest ratios of cabs anywhere in the country, but almost all drivers are from minority groups, who are usually hurt the most by professional regulations. Rather than protecting the consumer, in other words, licensing requirements frequently do nothing more than restrict entry to occupations and allow the fortunate few to earn monopoly profits for their services.

Unemployment Compensation

The unemployment insurance (UI) system was created over four decades ago to provide temporary income support for the unemployed. The program is financed by a payroll tax of 3.4 percent to be paid by employers on the first $6,000 of wages. It is possible for employers, however, to pay as little as 0.7 percent of taxable payroll because federal law allows them to receive a credit for contributions made to a state UI fund. Tax rates for employers vary substantially, due to a process known as "experience rating," which ties a firm's contributions to its previous unemployment experience. Firms with stable employment patterns pay a lower tax rate than firms with a history of frequent layoffs.

Though designed to ameliorate the hardships associated with unemployment, the UI system is responsible for creating some unemployment because it reduces the cost of being unemployed. There are basically three ways in which the UI system can increase either the frequency or duration of unemployment. First, because unemployment benefits often compare quite well with a worker's after-tax earnings, they reduce the incentive for an unemployed worker to return to work if a job becomes available.[12] A General Accounting Office study found that unemployment compensation replaced, on average, about 64 percent of a worker's pre-unemployment take-home pay.[13] If work related expenses such as

---

[11] See Williams, op. cit., pp. 26-28; and "New York City Looks at Taxi Regulation," Regulation, March/April 1982, pp. 11-13 and 36.

[12] For a more extensive discussion of the work disincentives inherent in the UI system, see Martin Feldstein, "Unemployment Compensation: Adverse Incentives and Distributional Anomalies," National Tax Journal, Vol. 27, No. 2 (June 1974), pp. 231-244.

[13] U.S. General Accounting Office Report, "Unemployment Insurance--Inequities and Work Disincentives in the Current System"(HRD-79-79, August 28, 1979), p.7.

transportation and child care are included, the rate of income loss from unemployment is very low for many workers. This is particularly important during a recession when job opportunities dwindle and pay levels fall. In these circumstances, the differential between unemployment insurance and take-home pay narrows yet further. In general, the larger the benefits are in relation to a worker's previous after-tax income, the more likely he is to remain unemployed waiting to be rehired, rather than search actively for a new job.

Unemployment compensation may also prolong unemployment spells by providing jobless workers with the means to extend their job search. This is helpful, in the sense that it allows people to take more care in choosing work, but it has the statistical result that unemployment figures are boosted. In a review of fourteen studies estimating the effect of UI on job search, economists Dan Heldman, James Bennett, and Manuel Johnson found that the empirical evidence supports the hypothesis that job search is extended by the availability of unemployment benefits, possibly by as much as 1.6 weeks.[14] This may not seem a significant extension, but these economists estimate the annual costs of this prolonged unemployment due to UI, in terms of foregone output and additional benefits, to be at least $2.2 billion.

Finally, unemployment compensation may make layoffs more attractive for an employer during an economic downturn.[15] This is so because the tax used to finance the UI system is not always directly related to the unemployment experience of the firm. An employer with an especially poor record of employee layoffs that is already facing the maximum tax rate may face no incremental cost for laying off an additional worker. This gives some firms little incentive to stabilize their employment patterns.

While it is only humane for society to assist the unemployed during hard times, there is little doubt that the UI system raises the unemployment rate. There are two steps the government could take to counter the negative effects of the program. First, it could subject all unemployment benefits to taxation. This would reduce some of the work disincentives of the program. Currently unemployment compensation under most government programs is already treated as taxable income for single taxpayers with incomes above $20,000 and couples with incomes above $25,000. Subjecting all income from UI to taxation would put them on the same footing as privately financed unemployment benefits, which have always been regarded as fully taxable. The resulting tax revenues could be channeled back into the UI fund and thereby preclude future tax rate and wage base increases.

---

14 Dan C. Heldman, James T. Bennett, and Manuel H. Johnson, Deregulating Labor Relations (Dallas, Texas: The Fisher Institute, 1981), p. 101.

15 See Martin Feldstein, "Temporary Layoffs in the Theory of Unemployment," Journal of Political Economy (October 1967), pp. 937-957.

A second measure to improve the UI system would be to improve experience rating by tying the tax rate an employer pays more closely to his actual employment experience. This could be done by lowering the minimum tax rate and raising the maximum. This would reduce much of the current cross-subsidization between firms and also remove some of the financial incentives for firms to lay off workers when demand falls off.[16]

CONCLUSION

America's unemployment problems are serious, but far from incurable. The key to restoring economic growth and job creation is to free the market from government intervention. Given the federal government's poor performance in managing the economy, its continued involvement in this area is questionable. As President Reagan observed: "The people have not created this disaster in our economy, the federal government has. It has outspent, overestimated, and overregulated." More of the same clearly is not what the U.S. economy needs.

Regrettably, the long-term health of the economy may be in jeopardy, because the recent double-digit unemployment rate will test the nerve of the American people. Many will find the short-term fix of a free-spending federal government very appealing. But that would be folly. It would lead the country back toward high inflation, high taxes, and low growth at precisely the time when the stock-market, interest rates, and other indicators show that firm policies are beginning to bear results.

President Reagan's original economic package of reduced federal spending and tax cuts was a step in the right direction. But it was a small step. For the strategy to work, these spending cuts and marginal tax rate reductions need to be pursued much more vigorously. Tax and spending increases are not the solution, they are part of the problem. Only when the tax burden is reduced will the private sector be willing and able to expand production and employment.

Similarly, government distortion and dislocation of the labor market must be eliminated. Reducing regulatory barriers and encouraging freer entry into the labor market would reduce unemployment and stimulate competition, benefiting both consumer and worker through lower priced and better quality goods and services. Rather than instituting a make-work public jobs program, as it has in the past, Congress could set in motion its most

---

16 Congress recently took some steps in the right direction by lowering the income thresholds for taxation to $12,000 for single taxpayers and $18,000 for couples, but this was to finance a new supplemental unemployment benefits program. This action may reduce some work disincentives while raising others. In addition, experience rating was improved somewhat.

successful jobs program ever--simply by repealing many of the laws, regulations, and policies that have unnecessarily restricted the ability and incentives for private sector job creation.

Peter G. Germanis
Schultz Fellow