

ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

Jobs Creation and Government Policy

by Jerry L. Jordan

Before the Great Depression of the 1930s, the notion that government ought to be responsible for creating jobs would have seemed absurd. Today, however, we commonly hear aspiring politicians declare that their number-one economic objective would be to increase employment.

The intellectual justification for gearing government budgetary and monetary policies toward fine-tuning the economy (and, in particular, toward generating more employment) was provided by John Maynard Keynes' *The General Theory of Employment Interest and Money*.¹ Since the book's publication in 1936, the dominant view of economic policymakers has been that a competitive marketplace will fail to generate adequate employment opportunities. This view underlies the advocacy of government programs to "create jobs."

I am reminded of a story that a western businessman told me a few years ago. While touring China, he came upon a team of nearly 100 workers building an earthen dam with shovels. The businessman commented to a local official that with an earth-moving machine, a single worker could create the dam in an afternoon. The official's curious response was, "Yes, but think of all the *unemployment* that would create."

"Oh," said the businessman, "I thought you were building a dam. If it's *jobs* you want to create, then take away their shovels and give them spoons!"

In the final decade of this century, the Depression-era way of thinking about the role of government is fading. In the 21st century, creating *work* for people will not be viewed as a primary objective of government policy; fostering an environment for *wealth creation* will be.

■ Creating Work versus Creating Wealth

Work is the necessary means of achieving wealth: In order to be consumers, we must also be producers. Whatever good intentions are presumed, when the government focuses away from creating wealth and onto creating jobs, it inevitably engenders a lower average standard of living. A successful, wealth-augmenting government policy should simultaneously reduce the work burdens of the labor force. That does not mean people will need to share jobs, take low-paying jobs, or become unemployed. Wealth creation occurs as the "muscle" component of employment diminishes and the "brainware" component increases.

The work record of industrialized countries in the past century is clear. In the United States, for example, the average workweek has fallen by more than 40 percent in the last hundred years. Among the benefits of wealth accumulation is the increase in leisure that it affords. Very poor nations are typically characterized by people who work most of their waking hours. To do otherwise would be disastrous. Where one finds impoverished nations with high rates of joblessness, one also finds political/economic systems that have large disincentives to create and accumulate wealth.

Is creating jobs an appropriate focal point of public policy? Federal Reserve Bank of Cleveland President Jerry L. Jordan argues that creating wealth, and thus allowing for the highest standard of living, is the more sensible approach for both government and monetary policymakers.

The distinction between creating wealth and creating "work" can be illustrated by an economy that has experienced a catastrophic natural disaster. A well-known feature of market economies is that in the wake of a disaster, such as a hurricane or earthquake, employment and production tend to rise. One conclusion might be that market economies routinely hoard unused labor services—workers who are gratefully called into service by the new demands of rebuilding houses, roads, and all of the other investments that were damaged or destroyed.

But clearly, society is not better off because people are working long, hard hours. A more reasoned conclusion is that these natural disasters are *destroyers* of wealth—and creators of work in the sense that households and firms must now toil harder to help recover from their losses. I doubt that this is the sort of "jobs creation" program voters have in mind when they cast their ballots, although I suspect that many government "jobs" programs operate much like a post-disaster cleanup program.

■ Government and Jobs Preservation

Given the importance politicians generally assign to the task of creating employment for people, it is surprising how little they know about the nature of jobs creation in market economies. Studies of the U.S. record show no identifiable, systematic factors related to industry, region, wages, employer size, capital and energy intensity, or foreign competition that would account for a significant share of the types or number of jobs created or destroyed in the economy.

Because policymakers have no clear foresight of where entrepreneurial energies will be directed in the future, it's impossible for them to predict where jobs creation *should* occur. For example, two or three years ago, who could have predicted, let alone planned, that a rapidly growing occupation for people would be designing Web sites?

It is not surprising, then, that government policies which seek to direct the flow of entrepreneurial talents in an effort to promote "good" jobs, and presumably to discourage "bad" jobs, will have uncertain and potentially negative effects on economic prosperity.

Government-targeted employment policies breed special interest groups that inevitably reduce the efficiency of markets in allocating scarce resources. These policies tend to persist beyond the point of any economic desirability and inhibit a necessary antecedent to jobs creation: jobs destruction. In the United States, sectors and industries that claim the highest rates of net new jobs created are generally those that have the greatest rates of jobs destroyed. Similarly, nations with high rates of jobs creation also tend to have high rates of jobs destruction.²

In modern economies, can we conceive of any jobs creation that is not preceded by the destruction of some less efficient, and therefore less prosperous, jobs? Indeed, can we conceive of any major advance that does not make obsolete some less efficient way of producing things?

I am of the generation that can still operate a slide rule—for what purpose I can

only scarcely remember. But this technology must necessarily have been supplanted by the invention of electronic calculators, and already, miniature personal computers are making calculators obsolete. This is the nature of progress—to make obsolete old technology. Innovation is the process of "creatively destroying" the pre-existing order.

Because of their imperfect vision, government jobs programs are almost everywhere jobs protection policies, which by extension tend to inhibit the creation of new, wealth-enhancing technology. Europe's stagnant labor markets are a direct result of labor laws and regulations designed to protect existing jobs, even at the social cost of discouraging new capital formation and therefore wealth creation.

■ Borders, Prosperity, and Capital Freedom

The two sides of a political border illustrate what government can and cannot accomplish. Why economic prosperity varies greatly along a seemingly arbitrary boundary poses perhaps *the* critical question for an economic policymaker. What is the economic importance of borders that separate prosperity on one side and poverty on the other?

In the simplest terms, there can be only two reasons for divergent levels of per capita income: 1) different levels of resources or 2) differences in the allocation of resources (which may be either how the resources are employed or how many of the resources are employed). Moreover, these two sources of economic prosperity are interdependent: how a nation decides to allocate its resources will ultimately determine how many resources it has to allocate.

Borders often mark varying degrees of capital fertility—the incentives that promote the propagation of new capital that allows rich regions to achieve and maintain higher standards of living. The resources of the industrialized world were not all endowed; most were created by entrepreneurial effort within a congenial political/economic system. Entrepreneurial effort is not manufactured by social engineers, but allowed to take root

naturally in an economic soil untainted by deliberate policy intervention.

■ The Role of Government in the Economy

Government's role in the economy was laid out 10 years ago in a wonderful essay by the late economist Karl Brunner, "The Poverty of Nations."³

A person in an economy can use resources in only one of four basic endeavors: He can produce, trade, influence the political process to redirect greater resources to his advantage, or protect himself against the wealth-redistributing efforts of others.

In the first two uses—production and trade—the total welfare generated by the economy increases. In the language of economists, these activities represent a positive-sum (win-win) gain. However, the latter two efforts—redirecting the flow of resources and protecting against the wealth-redistributing efforts of others—are zero-sum, or even negative-sum, games. They add no value, waste time and effort, and thus generate a lower standard of living for people as resources are directed away from production and trade. Government institutions—laws, rules, regulations, and the judicial system—influence private decisions to allocate resources among these uses.

The influence of government as a wealth-redistributing body is well known in both eastern and western economies. As we have had ample opportunity to observe, government wealth redistribution by way of explicit or implicit taxation necessarily lowers the incentive to create and accumulate wealth, thereby lowering the potential productive power of the economic system. But governments also promote production and trade, because they are assignors and protectors of property rights, and provide for the enforcement of private contracts. These are wealth-enhancing activities that help the productive capacity of an economy to blossom. Thus, governments have two necessarily contradictory and coexisting modes: "the protective mode" and "the redistributive mode."

These modes suggest why arbitrary borders along a political boundary generally signify regions of varying prosperity. They are the frontiers of a government's authority and, as such, they mark the varying degrees of both the protective and redistributive modes. Both of these roles can negatively influence a nation's economic landscape: Too little protective power, or too much redistributive effort, inhibits the creation and retention of wealth and retards equilibrating forces that attempt to provide a standard of living comparable to that in neighboring countries.

Now that the concrete and barbed-wire walls that separated the eastern and western European economies no longer exist, we can expect to see a narrowing in the wealth differentials between the two regions. However, until a legislative and judicial infrastructure has been built that enhances the protective mode of government in the eastern regions, the gap in economic well-being will not be closed.

A necessary precondition for the accumulation of capital is the protection of property rights. Those countries that make the most rapid progress in adopting western legal, financial, and accounting practices will usher in a new era of prosperity for their economies. Similarly, until the redistributive modes of many western European economies are substantially curtailed, the stagnation in their standards of living will surely persist.

The ability of governments to influence wealth creation has been documented in a recent study produced by a consortium of research institutes in Canada, Mexico, and the United States. The study attempted to gauge, in a methodical way, the degree of economic freedom in each of a broad cross-section of nations.⁴ The conclusion from examining more than 100 countries over a 20-year period was that governments with a strong commitment to economic freedoms—free personal choice, the freedom of exchange, and the protection of private property—tended to be faster-growing and wealthier. No nation with a persistently high economic freedom rating failed to achieve a high level of income. Furthermore, the 17 countries with the most

improved freedom ratings all had positive and generally strong growth rates, while the 15 countries where economic freedoms declined recorded real per capita wealth declines.

■ A Wealth-Creation Role for Monetary Policy

There is a presumption that monetary policy in industrial democracies has two objectives—to promote price stability (low inflation) and to promote employment growth. Although many contend that these objectives are in conflict, I disagree. It's false to conclude that a trade-off exists between price stability and jobs creation. Such a perception puts proponents of stable monetary systems in the position of appearing to be anti-jobs. On the contrary, by protecting the purchasing power of a nation's money—and thereby protecting the property rights of the private enterprises that use the publicly provided money—the central bank promotes the creation and accumulation of wealth.

The alternative—allowing the purchasing power of a nation's monetary standard to erode over time—redirects resources from activities that create wealth toward efforts to protect existing wealth from the ravages of inflation and currency devaluations. If the redistributive effects become great enough—that is, if inflation becomes extremely high—people will abandon the domestic monetary standard and replace it with one that is set outside the country.

For example, the share of U.S. currency held outside the country has been increasing rapidly, so that today, more than two-thirds is held by non-U.S. residents. In the 1980s, the bulk of new U.S. currency was held in Latin America, where the dollar is commonly used to settle ordinary auto and real estate transactions. Since the tumbling of the Berlin Wall at the end of 1989, currency flows in Eastern Europe and the former Soviet republics have grown enormously as the dollar has become a readily accepted medium of exchange in these emerging market economies. In fact, in 1994, U.S. currency transfers to Russia alone accounted for more than half of all net foreign currency movements. In 1995,

gross shipments of U.S. currency to Russia are reported to have been as high as \$100 million per business day.⁵

The reason for the competing monetary system in Russia is clear: In order to gain revenue from seigniorage, the Russian central bank printed rubles rapidly, thereby debasing the domestic currency. Then, the implicit inflation tax on ruble transactions provided the incentive for Russian citizens to use a more stable currency—the U.S. dollar.

When we think of money as a public good that facilitates the operation of markets, we begin to see that a stable monetary standard need not be anti-jobs creation, but is pro-wealth creation. This is the realization in a wide variety of market economies around the world. In recent years, many nations have adopted targeting low or zero inflation as the sole objective of their central banks. In large part, these governments had become disenchanted with the role of the monetary authority as a fine-tuner of the economy. In virtually each instance, the unintended consequences of misguided short-run "countercyclical stabilization policies" were that the purchasing power of their moneys became unstable, fluctuations in business activity grew worse, and wealth was eroded.

The evidence on wealth creation and inflation is incomplete, but there can be little doubt that this view is gaining broad appeal. A recent study for the Bank of England reported that a 10 percentage-point increase in average inflation reduces the growth rate of real per capita income by about ¼ percentage point and lowers the ratio of investment to GDP.⁶ These results imply that the long-run effects of inflation on a nation's standard of living can be large when accumulated over a number of years. This work is consistent with findings by economists at the Federal Reserve: "...evidence consistently points to a negative correlation between inflation and the growth of productivity over the post-Korean War period in the United States."⁷

Economists will debate the details on how best to implement a stable price objective for central banks. Indeed, such

debates have been occurring in the United States for many years now, as they have around the world. But there is one essential element of this objective: Governments must abandon the notion that unstable inflationary payments systems are useful wealth (and jobs) creation strategies. The record on this point is clear. To allow for the highest standard of living, the central bank must provide the greatest possible incentive for the creation and accumulation of wealth. That, above all else, means that it must provide a stable monetary system.

■ Footnotes

1. This landmark book (New York: MacMillan, 1936) was the cornerstone of the economic doctrine that dominated western macroeconomic policies for several decades following World War II.

2. The correlation between jobs creation and destruction rates by industry in the United States over the 1973 to 1988 period is 0.77 percent, as calculated from data found in Steven J. Davis, John C. Haltiwanger, and Scott Schuh, *Job Creation and Destruction*, Cambridge, Mass.: MIT Press, 1996, table 3.1.

3. Karl Brunner, "The Poverty of Nations," *Business Economics*, January 1985, pp. 5-11.

4. See James Gwartney, Robert Lawson, and Walter Block, *Economic Freedom of the World: 1975-1995*, Vancouver: The Fraser Institute, 1996. A useful summary of the book is found in "Of liberty, and prosperity," *The Economist*, January 13, 1996, pp. 21-23.

5. See Richard D. Porter and Ruth A. Judson, "The Location of U.S. Currency: How Much Is Abroad?" Federal Reserve Board manuscript, June 1995.

6. See Robert J. Barro, "Inflation and Economic Growth," Harvard University and the Bank of England, *Bank of England Quarterly Bulletin*, vol. 35, no. 2 (1995), pp. 166-76.

7. See Glenn D. Rudebusch and David W. Wilcox, "Productivity and Inflation," Federal Reserve Board manuscript, May 1994.

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