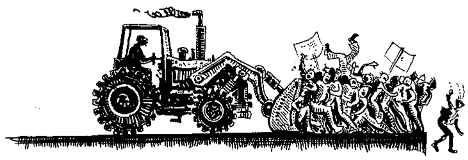

The Jobless Recovery and Its Structures

The liberals in power face an economic problem that could become a political one as well.

by Joseph Lawler

WHEN THE DEMOCRATS TOOK CONTROL of the White House in 2008, they inherited, along with the burden of a deep worldwide recession, the enormous promise of the political capital guaranteed to accrue to whoever presided over an economic recovery. Indeed, many forecasters are tentatively predicting such a turnaround. Even assuming the rosiest projections come true, however, there remains a looming threat to the incumbents' agenda and reelection chances, not to mention the country's well-being: the jobless recovery.

Barack Obama and company would not be the first political victims of a jobless recovery. When Bill Clinton successfully framed his 1992 campaign's rhetoric with "it's the economy, stupid," the country was actually no longer in a recession, gross domestic product (GDP, a measure of a country's total production) growth having resumed in March of 1991. The fact that the recovery was "jobless," meaning that unemployment stayed high long after GDP began growing, undermined George H. W. Bush's chances. The Obama administration knows that, despite recent improvements in the economic outlook, a jobless recovery will have Obama facing the same criticisms Bush I faced—and also that if recent history holds up, a jobless recovery is likely.

The past two recessions have broken previous downturns' patterns of GDP growth and unemployment. In 1962 the Yale economist Arthur Okun developed a rule of thumb, soon known as Okun's Law, that every 2 percent decrease of GDP from potential output (what the economy could produce if it were functioning at full capacity) is related to a 1 percent increase in unemployment. From WWII through the late 1980s, this relationship held fairly closely.

The recovery from the 1991 recession, however, featured an employment outlook that actually worsened as GDP grew: it was not until more than four years after the official end of the recession that there were more Americans employed than before the recession began. The recovery after the 2001 recession was similarly jobless. Unemployment did not peak until the recession had officially ended, and remained high even into 2004.

The current downturn, which began in December 2007, is the third consecutive recession to defy Okun's Law. Unemployment has increased at a faster rate than the law would predict, ballooning to 9.8 percent without a correspondingly huge drop in GDP. And even as most economists believe the recession is over or nearly over, job losses continue to pile up. Assuming that the turnaround is for real and we've escaped the worst of the recession (no small assumption), the question isn't whether we'll have another jobless recovery, but whether it will be even worse than the previous two episodes. The situation hasn't escaped the political radar of Speaker of the House Nancy Pelosi, who in October told the press that the "number-one subject on the minds of the American people" was "jobs, jobs, jobs, and jobs."

THE MOST RECENT unemployment statistics must terrify the president, especially because his policy options are constrained by economists' lack of understanding of the causes of jobless recoveries.

There are a few competing theories. Economists of a statist or Keynesian bent tend to posit that modern managers are quicker to fire employees and squeeze extra productivity out of their remaining workers, and then explore why that might be so. For instance, executive compensation schemes have changed since the 1980s, resulting in more incentives for managers to keep profits high by laying off under-exploited workers. Another example: highly trained workers are no longer as important as brand image, technology, and flexibility, and consequently they are the first asset to go in a downturn.

There is a more compelling, more market-based explanation that borrows insights from Austrian-style economists like Joseph Schumpeter and Chicago business cycle theorists like Fischer Black. It focuses on the changes that the modern labor market has undergone, and explores the possibility that recessions now cause structural, as opposed to cyclical, changes in hiring. Cyclical changes are responses to the business cycle: companies across all industries tighten their belts and start laying off employees when austerity threatens, but then rehire the workers they laid off when good times roll again.

A structural change in the labor market, on the other hand, occurs when hiring patterns change not as a function of economic fluctuations, but because of shifts in the economy's production that reallocate workers among industries. In other words, a mismatch between what consumers demand and what producers are making necessitates a shake-up in the mix of industries. Perhaps the most familiar example of a structural change is the Industrial Revolution, when, starting in the 18th century, Great Britain's labor force transitioned from manual labor to machine-aided manufacturing jobs in great numbers.

This hypothesis makes sense intuitively, because it is much easier for workers to slip back into their old jobs than to find a new line of work. The employment recovery following a downturn will be much slower if, to expand on the Industrial Revolution example, the laid-off worker has to pack his bags and leave the farm, move to the city, and learn how to operate and maintain a steam engine.

The difference between Okun's days and the present is that we now have recessions with structural shifts. Two reasons for this come to mind. First, modern technologically advanced firms do a better job calculating their optimal amount of labor without resorting to temporary layoffs—if they downsize, they downsize permanently because their industry is shrinking. Second, thanks to wiser officials and the lessons of time, the Federal Reserve is less likely to mismanage the money supply and create recessions entailing mass temporary layoffs owing to an artificial scarcity of money. Of course, the Fed still can only do so much to anticipate real scarcity and structural changes.

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The beauty of the structural change theory of jobless recoveries is that it is testable. If hiring is determined by shifts in what the economy produces, then the data will show that permanent layoffs outnumber temporary layoffs—that is, workers aren't returning to their old companies. Also, there would be noticeable differences in hiring and firing patterns between different industries before and after the recession. The market would determine in which activities firms were overinvested, and which were ripe for further growth.

The data does seem to conform to the theory. In a 2003 study, Federal Reserve economists Erica L. Groshen and Simon Potter found that in past recessions, temporary layoffs spiked. They also found that the two recent jobless recoveries involved clear winning and losing industries, a conclusion they arrived at by looking at payrolls in different industries before and after the recession. The industry that best exemplifies this trend is the dot-com boom of the the late '90s. During the recession of 2001 it became clear that there was a bubble in web companies, and the industry began rapidly to shed trained workers. The extreme over-investment in the dot-com bubble is an identifiable reason why the job reports were so bleak so long after the end of the downturn. It simply took a long time for the economy to shake out where the former dot-com workers belonged. One industry, notably, that did take off in the wake of the '01 recession was...housing.

WITH ECONOMIC "GREEN SHOOTS"—encouraging signs—cropping up even as the employment outlook languishes, the current recession seems to follow the precedents set by the past two. As for structural changes, no one knows what the next big thing will be, but it doesn't seem to difficult to guess which industries will be pruned, most apparently the housing industry. John Cochrane of Chicago memorably suggested that the recession meant that the construction industry should contract: "People who spend their lives pounding nails in Nevada need something else to do."

If the recessions of 1991 and 2001 are any indication, unemployment will be a serious problem for a while. Furthermore, the current recession includes a banking crisis, which will likely create difficulties that we were spared in the previous two jobless recoveries. With the financial system still in disarray, lenders and borrowers are less able to get credit to new engines of growth and employment that need financing. Edward Knotek of the Kansas City Federal Reserve estimates, based on a review of the past two jobless recoveries and recoveries in countries that simultaneously suffered a banking crisis, that a middle-of-the-road projection has unemployment increasing beyond 10 percent and remaining at that level through 2011.

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Clearly, unemployment anywhere near that dismal projection would be a weight around the Democrats' neck that would surely drag them under in the 2010 midterms. And in the ramp-up to the 2012 elections, President Obama would find it difficult to make the case that he fulfilled his promise to restore vitality to the damaged country his predecessor had left him.

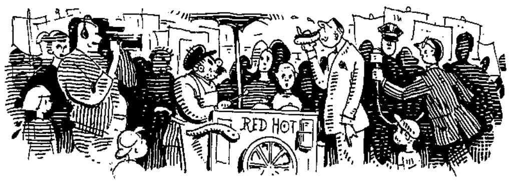
The administration is keenly aware both that a jobless recovery means prolonged real suffering for millions of people, and that allowing it on its watch will take a toll on its political capital. That is why the president and his team have emphasized the jobs "created or saved" by the $787 billion stimulus plan. When the stimulus was enacted, at the height of the panic, the administration made the—conveniently unfalsifiable—claim that it would "create or save" 3.5 million jobs.

The administration has maintained this messaging tactic even as unemployment has skyrocketed. In late October, the Obama team brazenly reported saving 250,000 jobs in education alone—a claim for which it provided scant evidence. Throughout the year, the administration has reaffirmed with each grim job report that the stimulus is on track to save or create more than 1 million jobs by the start of 2010. This, despite the fact that unemployment has only worsened, documented jobs created by the stimulus are very few, and even the Office of Management and Budget, the White House's own economic outfit, predicts unemployment to stay at 9.7 percent through 2010.

The Obama stimulus is more conducive to a government-subsidized jobless stasis than to growth if indeed the labor market changes are not cyclical. And if they are structural, fired workers won't be able to rejoin their old companies once they get off the government's payroll. The market will still need to find them a new growth industry, a process that the temporary government jobs might simply have *postponed*. Instead of forestalling the jobless period altogether, the stimulus-funded jobs could spread the pain out over an even longer time.

The labor market becomes more complex, more dynamic, and, accordingly, more difficult to manage every day. The Obama administration and the Democrats know that reversing the trend of jobless recoveries will be the key to success in the upcoming elections, but they have chosen a blunt and inflexible tool—government intervention—for that task. If they find themselves increasingly unemployed in 2010 and 2012, it will be because so many others were as well.

Joseph Lawler *is* The American Spectator*'s assistant managing editor.*



Battle Cry in the North Country

Doug Hoffman's campaign in upstate New York isn't necessarily over.

by Robert Stacy McCain

YATES WALKER ATE BREAKFAST in the Blue Moon Café on Main Street in Saranac Lake, New York, on the morning of November 4, and delivered an after-action report on the battle that had just been fought in the upstate 23rd District.

"We took a CPA from 9 percent to 46 percent in two and a half weeks," said Walker, a young veteran of the 82nd Airborne Division who had been hired 18 days earlier to work on Doug Hoffman's congressional campaign staff. "I couldn't be prouder."

He fell 5,000 votes short of defeating Democrat Bill Owens, but Hoffman's surprising surge in the closing weeks of the three-way special election in upstate New York had, in Walker's words, turned the bespectacled accountant into "an electric symbol of conservatism."

A month before Election Day, the Hoffman campaign had been nearly broke. Despite endorsements from organizations like Club for Growth and the pro-life Susan B. Anthony List, the Conservative Party candidate's challenge to liberal Republican state assemblywoman Dede Scozzafava was on the verge of fizzling out in early October.

"Truth be known, for a long time, we were running on empty," said Hoffman, sitting in his campaign headquarters the morning after the election. "If we didn't get the support when we got it—well, it was touch-and-go for a while."

In the second week of October, however, Hoffman's campaign took off—thanks in large measure to a relentless push from Internet activists like Erick Erickson of the popular conservative blog RedState.com. Erickson endorsed Hoffman in August, about a month after local GOP leaders met at a pizza restaurant in Potsdam, New York, and chose Scozzafava as the Republican nominee for the special election to replace nine-term Republican Rep. John McHugh, who had been appointed secretary of the army by President Obama.

The backroom dealings that led to the choice of Scozzafava became the subject of bitter recriminations after Republicans learned of the nominee's liberal record. Married to a union organizer, Scozzafava had enjoyed the support of the Working Families Party, a political arm of the left-wing nonprofit group Association of Community Organizations for Reform Now (ACORN). Scozzafava was not only pro-choice and pro-gay marriage, she had also amassed a voting record in Albany that put her to the left of many Democrats in the state assembly, and had furthermore praised Obama's bailout-and-stimulus economic agenda.

Mike Long, the chairman of New York's Conservative Party, said he warned state and local GOP leaders that, of the nine Republicans seeking the nomination to replace McHugh, Scozzafava was the