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Fiscally Illiberal: State and Local Projects Cannot Create Jobs Responsibly

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Executive Summary

To fund infrastructure and green energy projects, state and local governments must either raise taxes or increase deficits. If the state or local government raises taxes, total spending is not increased, undermining the correct justification for stimulus. If the governing body engages in deficit spending, it is borrowing at a higher rate than one offered to the Federal government. States and local governments do not have their own printing presses, so they have far less flexibility in dealing with deficits. When state and local government attempt deficit spending, they run the risk of becoming the next Greece.

Management of the total amount of spending in an economy, if it is to be done at all, must take place only at the Federal level. Other attempts at job creation are entirely irresponsible. Because of this, the number of jobs created should not be included in cost-benefit analyses of projects. More infrastructure and energy may be needed, but such projects should pass traditional cost-benefit analysis that is not concerned with the number of jobs the project purports to create.

Introduction

Proponents of state and local infrastructure and green energy projects frequently argue that their favored project will reduce unemployment. In Massachusetts, it is argued that "Cape Wind will create up to 1,000 jobs in the region during construction and will permanently employ approximately 50 people at its Cape Cod based headquarters to operate and maintain the wind farm"[1] with the help of subsidies coming from the state. Governor Deval Patrick, upon completion of a new commuter rail line announced, "we were able to create jobs while taking an important step forward in advancing passenger rail service to the South Coast."[2] The Union of Concerned Scientists claims that "[a] stronger [renewable portfolio standard] will create jobs" for California.[3] The California Labor Federation argues that also in California, "[b]uilding high speed rail will grow our economy and create long-term jobs."[4] Similar claims have been made about rail projects in Hawaii[5] and Portland,[6] renewable portfolio standards in Connecticut[7] and Michigan,[8] and biotech subsidies in Maryland[9] and Massachusetts.[10]

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[1] Cape Wind Associates, "Cape Wind & Massachusetts: Creating Jobs and Providing Clean Energy for Massachusetts," Cape Wind, posted May 1, 2012, http://www.capewind.org/downloads/CapeWind&Massachusetts2.pdf (accessed December 12, 2012).

[2] Massachusetts Department of Transportation, "South Coast Rail: New Bedford Bridges Completed," *Commonwealth Conversations*, posted November 29, 2011, http://transportation.blog.state.ma.us/blog/2011/11/south-coast-rail-new-bedford-bridges-completed.html (accessed December 12th, 2012).

[3] Union of Concerned Scientists, "California's Renewable Energy," *Union of Concerned Scientist Fact Sheet*, http://www.ucsusa.org/assets/documents/clean_energy/33_percent_res.pdf (accessed December 12, 2012).

[4] California Labor Federation, "Build High-Speed Rail in California," California Labor Federation, http://www.calaborfed.org/index.php/site/page/build_high_speed_rail_in_california (accessed December 12th, 2012).

[5] Honolulu Rail Transit, "Environmental Analysis, Consequences, and Mitigation," Chapter 4 of *Honolulu High-Capacity Transit Corridor Project Environmental Impact Statement*, Honolulu: Honolulu Authority for Rapid Transit, http://www.honolulutransit.org/baf/final_eis_04_part4.pdf (accessed December 12, 2012).

[6] Tri-County Metropolitan Transportation District of Oregon, "Connecting People to Jobs," Portland-Milwaukee Light Rail Transit Project, http://trimet.org/pm/economicbenefits/index.htm (accessed December 12, 2012).

[7] NAW Staff, "Connecticut Considering an Increase to Its Renewable Portfolio Standard," North American Wind Power, posted October 8, 2012, http://www.nawindpower.com/naw/e107_plugins/content/content.php?content.10502 (accessed December 12, 2012).

[8] Union of Concerned Scientists, "Michigan Energy, Michigan Jobs," http://www.ucsusa.org/clean_energy/smart-energy-solutions/increase-renewables/michigan-renewable-energy-ballot-initiative.html (accessed December 12th, 2012)

Those who are against the project typically will not include employment data as a benefit for the projects. They subsequently get different results when weighing the economic costs and benefits of the project. For instance, a rail project employing 1,000 may cost $20,000,000 to provide rail services valued at $19,000,000. If the project increases employment by 1,000 but nothing else changes, it could be worth it. However, the 1,000 jobs created are not considered in traditional economic cost-benefit analysis. The proponents will point to this as evidence that their political opponents are unfairly stacking the deck against them.[11] Opponents will, in turn, respond that employment of workers is a cost, not a benefit, without explaining the details as to why that is the case even when unemployment is high.[12] This analysis will explain why in terms of textbook economics.

There are two sides of everything in economics. There is the supply side to employment, which includes the willingness to work and the ease of finding a job for workers. There is the demand side, which is the ability of employers to profitably find ways of employing workers given the wage rate on the market. These two parts are frequently conflated by both sides of the political spectrum. Variables on the supply side will determine the level of unemployment during normal economic times. Variables on the demand side will generally determine the extra unemployment we have during recessions. For government investment to "create jobs," it typically (though not always) means that the government's intervention has a positive effect on variables on the demand side. Spending on state and local projects can, in principle, perform this function, but they are very poor tools given possible alternatives.

[9] Maryland Department of Business & Economic Development, "$8M for Biotech Tax Credit in FY 2013 Draws More Than 125 Registrations," *Choose Maryland*, posted July 9, 2012, http://www.choosemaryland.org/pressroom/Pages/$8MforBiotechTaxCreditinFY2013DrawsMoreThan125Registrations.aspx (accessed December 12, 2012).

[10] The 187th General Court of The Commonwealth of Massachusetts, "Massachusetts General Laws, Chapter 67D," The General Court, http://www.malegislature.gov/Laws/GeneralLaws/PartI/TitleIX/Chapter62C/Section67D (accessed December 12, 2012).

[11] For example, Michael Conathan, "Koch Brothers Fund Bogus Study Bashing Offshore Wind in New Jersey," *Think Progress*, posted August 17, 2012, http://thinkprogress.org/climate/2011/08/17/297394/koch-brothers-fund-bogus-study-bashing-offshore-wind-in-new-jersey/ (accessed December 12th, 2012).

[12] For example, Tim Worstall, "Green Jobs are a Cost, Not a Benefit," *Forbes*, posted February 29, 2012, http://www.forbes.com/sites/timworstall/2012/02/29/green-jobs-are-a-cost-not-a-benefit-2/ (accessed December 12, 2012).

The Supply Side

It is unreasonable to expect the market to provide employment immediately to absolutely every worker. The supply side reflects those realities. The two components of such unemployment are known by economists as *frictional* and *structural* unemployment. There will always be some number of people in between jobs. If a worker is laid off or fired, we cannot assume that the worker will instantly be able to find new employment. The number of people in that situation is the *frictional unemployment*.

Structural unemployment accounts for those who are out of work because demands for workers shift across industries in a growing, dynamic economy. Laid-off workers such as those shed from the housing and construction sector, who are trying to find a new job to best apply their abilities and efforts, are part of this number. Frictional and structural unemployment add up to what is known as the *natural* rate of unemployment, which is estimated to be roughly 5%.[13] If we want this number to be lower, we need to identify the supply side factors determining it. And though there may be more to the story for the excessive unemployment we observe today, a minority of economists will argue that the unemployment problems are entirely the result of failures on the supply side.[14]

The policies which could decrease the natural rate of unemployment are often those which have other benefits that many across the political spectrum would feel uncomfortable eliminating. Whether or not we should keep such policies is outside the scope of this analysis, but we must recognize that the tradeoff exists. One such policy is cutting unemployment benefits. The lower the unemployment benefits are, the more

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[13] One recent estimate suggests that in the current recession, the natural rate has increased from 5% to 6%: Mary C. Daly, Bart Hobijn, Aysegul Sahin, and Robert G. Valletta, 2012, "A Search and Matching Approach to Labor Markets: Did the Natural Rate of Unemployment Rise?" *Journal of Economic Perspectives* 26, no. 3 (2012): 3-26.

[14] John B. Taylor, *First Principles: Five Keys to Restoring America's Prosperity* (New York, New York: W.W. Norton & Company, 2012); Robert Barro, "The Folly of Subsidizing Unemployment," *The Wall Street Journal Online*, posted August 30, 2010, http://online.wsj.com/article/SB10001424052748703959704575454431457720188.html (accessed October 5, 2012) ; Gary S. Becker, Steven J. Davis, and Kevin M. Murphy, "Uncertainty and the Slow Recovery," *The Wall Street Journal Online*, posted January 4, 2010, http://online.wsj.com/article/SB10001424052748703278604574624711732528426.html (accessed October 5, 2012).

urgent it is for the worker to find employment, even if it may not suit her perfectly. Not everyone will find a job instantly, but lower benefits will lead to some workers finding jobs faster. Excessive unemployment benefits push upwards on frictional unemployment, leading to natural rates of unemployment estimated to be higher throughout Europe than in the United States. The increase in unemployment benefits in the United States to 99 weeks has been estimated to be about 2.7 percentage points[15], but another estimate places it between 0.77 and 1.54 percentage points. [16] This finding does not explain all of the Great Recession, but it is a factor.

Those on the left have grown tired of hearing of how tax cuts create jobs. A particularly uneconomic explanation by those on the right is that business owners would hire more if the government did not tax away all of their revenues.[17] Unconditional tax cuts that do not also cut spending will not have an effect on the supply side, although later we will discuss how it may have an effect on the demand side.[18] Credibly lowering taxes by cutting the size of government will encourage entrepreneurs to invest with the possibility of higher take-home profits, which in turn increases the availability of jobs and the productivity of labor. Those who are hit with the highest marginal tax rates may today be choosing leisure over work because they see little financial benefit out of the additional hours they may work.[19] More importantly perhaps, it also encourages those on the fringes of the workforce to reenter.[20] Before the Kemp-Roth Tax Cut of 1981 and the Tax Reform Act of 1986, spouses of high-income earners would only keep

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[15] Meaning, it would push up the natural rate of unemployment from 5.0% to 7.7%.

[16] Steven D. Mullins, "The Unemployment Impact of the 2008 Extension of Unemployment Insurance: As High as Robert Barro suggested?" *Econ Journal Watch* 9, no. 1 (2012): 3-20.

[17] The argument from the right only applies to taxes which charge employers for employing workers, namely payroll taxes. It is nonsensical when discussing income and similar taxes. The profit-maximizing number of workers stays the same, regardless the portion of the business owner's income the government takes, and until it takes so much that the owner closes the business.

[18] Assuming that Ricardian equivalence holds, which follows trivially from the fact that we are currently discussing supply-side effects. See Robert Barro, "Are Government Bonds Net Wealth?" *Journal of Political Economy* 82, no. 6 (1974): 1095-1117.

[19] N. Gregory N. Mankiw, "I Can Afford Higher Taxes. But They'll Make Me Work Less," *The New York Times Online*, posted October 9, 2010, http://www.nytimes.com/2010/10/10/business/economy/10view.html (accessed October 4, 2012).

[20] Much of the difference between countries in the supply of labor can be explained by looking at the tax code. See Edward Prescott, "Why Do Americans Work So Much More Than Europeans?" *Federal Reserve Bank of Minneapolis Quarterly Review* 28, no. 1 (2004): 2-13.

thirty-six cents on the dollar of any work they perform when filing jointly.[21] These reforms convinced the spouses to rejoin the workforce. Effects of unemployment benefits and tax rates and on employment such as these are incorporated into mainstream economic models such as The Beacon Hill Institute's STAMP model.[22]

Regulations also have detrimental effects to the natural rate of unemployment. In France, Germany, and Italy, employers are very apprehensive of hiring new workers, because labor regulations make it so difficult to fire workers.[23] For example, Article 18 of Italy's labor code makes layoffs impossible without lengthy lawsuits. Similarly, France's Code du Travail only allows firing for a set of specified reasons. Table 1 provides an index of such labor market regulations compiled by the OECD. The United States, with its culture of at-will employment, has the least intrusive regulations.

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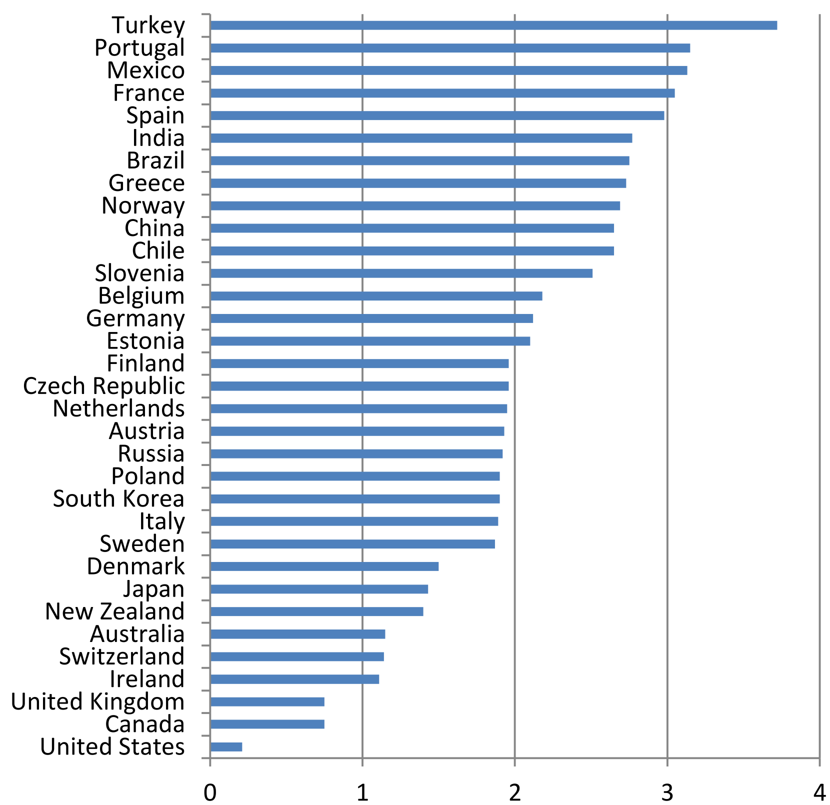
[21] Jerry A. Hausman and James M. Porteba, "Household Behavior and the Tax Reform Act of 1986," *Journal of Economic Perspectives* 1 (1987): 101-119.
[22] The Beacon Hill Institute, "What Is Stamp?" http://www.beaconhill.org/STAMP-Method/STAMP.pdf (accessed December 23rd, 2012).
[23] Olaf Gersemann, *Cowboy Capitalism: European Myths, America Reality* (Washington, DC: CATO Institute, 2004).

Table 1: Strictness of Employment Protection Legislation (2008)



Data Source: OECD
(http://stats.oecd.org/Index.aspx?DatasetCode=EPL_OV)

Regulation may further inhibit the labor market in a modern, dynamic economy. Economist Arnold Kling[24] has emphasized the need for identifying new Patterns of Sustainable Specialization and Trade (PSST), i.e. ways of finding useful methods of employing those who were previously in construction and real estate, to eliminate the unemployment of the Great Recession. His only policy prescription is to deregulate to make it easier for entrepreneurs to find new ways of profitably employing workers. In his view, excessive regulation has led to the continued unemployment of those initially left unemployed following the housing bubble.

[24] Arnold Kling, *Patterns of Sustainable Specialization and Trade: A Smith-Ricardo Theory of Macroeconomics* (UK: ASI (Research) Ltd, 2012), http://www.adamsmith.org/sites/default/files/research/files/PSST.pdf (accessed October 4, 2012).

This is not to argue that we should eliminate unemployment benefits, enact a flat tax, or completely de-regulate markets. But levels of social insurance, taxes, and regulations do have some impact on the level of unemployment we observe. Again, this is only one side of the issue which we have discussed largely to acknowledge and distinguish such factors from why investment in infrastructure and green energy projects could increase employment.

The Demand Side

The total amount of money spent in the economy can only purchase a certain number of goods if the prices of those goods are difficult to move downwards. For a very abstract example, consider an economy in which there are only two goods, both priced at $7, but consumers only have $10. If consumers cannot access additional funds, one of those goods will not be purchased or prices will need to be cut. There is significant evidence that many prices on the market, especially the price of labor (wages), are "sticky" downwards, meaning that prices do not fall easily even when they "should" fall.[25] While many economists who are not too distant from the political center deny that these problems exist,[26] these (or very similar) problems must be present for there to be unemployment caused by the demand side.

This unemployment is referred to "cyclical" unemployment, and can be thought of as the unemployment over and above the natural rate of unemployment during a recession. For instance, if the natural rate of unemployment is 5%, and the unemployment on the market is 8%, then the cyclical unemployment is 3%. Government investment, should it create jobs, should do so by increasing spending in such a way that drives down that 3%.

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[25] George Akerlof, William T. Dickens, and George L. Perry. "The Macroeconomics of Low Inflation," *Brookings Papers on Economic Activity* 27, no. 1 (1996): 1-76; Lawrence J. Christiano, Martin Eichenbaum, and Charles L. Evans. "Nominal Rigidities and the Dynamic Effects of a Shock to Monetary Policy," *Journal of Political Economy* 113, no. 1 (2005): 1–45.

[26] David Laidler, "Wage and Price Stickiness in Macroeconomics - An Historical Perspective," University of Western Ontario, Department of Banking and Finance, Research Report 9201, January 1992, http://fraser.stlouisfed.org/docs/meltzer/laiwag92.pdf (accessed October 4, 2012).

Before concluding that is desirable, first we should ask why the market is unable to "heal" itself and employ the workers who are cyclically unemployed. If the issue is just that there is too little spending on the market, the most natural response is to just print more money to give people the ability to spend more. This is what happens when the Federal Reserve is "cutting interest rates." As arcane as that sounds, in "cutting interest rates" the Fed is simply printing money in hopes of spurring private investment by giving banks access to more money to lend. This may eventually lead to inflation, of course, but since the solution to demand-side problems is increasing spending, that is actually the point.

Can the Federal Reserve always increase spending by printing money? This point too is debatable.[27] Many economists believe that there are strange circumstances when it cannot. If it keeps "cutting interest rates" until the target interest rate (the Fed Funds Rate) hits zero, the Federal Reserve may not be able to increase spending further. This is known as the liquidity trap. Economists' solution to this problem is fiscal stimulus, which comes in three forms.

- Keep government spending constant, and cut taxes.
- Keep taxes constant, and increase government spending.
- Cut taxes and increase government spending

By "forcing the issue," so to speak, the government in principle can get the economy running again. But note here that all of this is *deficit spending*. If the spending did not increase the deficit, there would be little point in performing the fiscal stimulus.[28] This deficit, by definition, will increase the government's debt.

[27] The issue may be solved as simply as adopting national income (or Nominal Gross Domestic Product) as a target instead of interest rates. See Michael Woodford, "Methods of Policy Accommodation at the Interest-Rate Lower Bound," paper presented at Jackson Hole Symposium, "The Changing Policy Landscape," August 31 – September 1, 2012, http://kansascityfed.org/publicat/sympos/2012/mw.pdf?sm=jh083112-4 (accessed October 4, 2012). For a popularization for the layman see Scott Sumner, "Re-Targeting the Fed," *National Affairs* Issue 9 (Fall 2011), http://www.nationalaffairs.com/publications/detail/re-targeting-the-fed (accessed October 4, 2012).

[28] This simplifies by ignoring the balanced budget multiplier, which is more common in introductory textbooks than in advanced discussions of the issues. Calculations of increased employment caused by local projects rarely, if ever, use the balanced budget multiplier to calculate their effects. Such calculations would mute the employment effects if performed.

This gets us to the crux of the issue as to why the employment effects of state and local infrastructure projects are so irrelevant. The Federal Government is in a unique position in providing fiscal stimulus. It borrows money at a much lower rate than the states and municipalities, meaning it can force more spending out for every future tax dollar it will need to spend to service the debt. And if it determines it cannot raise enough taxes to pay the debt, *the Federal Government has the keys to the printing presses*. The worst case scenario is that it prints money to pay down the debt. Unlike states and municipalities, it will not go bankrupt. The fiscal problems taking place in Europe right now are the direct result of separating fiscal policy and monetary policy into different levels of governance. If it had never joined the currency union, Greece could simply devalue its currency to pay off its creditors. State and local governments which try to stimulate the local economies via deficit spending run the risk of becoming Greece. Like Greece which surrendered its ability to perform monetary policy to the European Union and the ECB, state and local governments do not have a currency to devaluate. Examples from history include New York City in the 1970s. The State of California is providing a prospective lesson of the inherent disadvantage of fiscal stimulus performed at the subnational level when the federal government has the monopoly on the printing press.

The bottom line is that the extent to which state and local government investment succeeds in employing people at the local level, it drives up deficits that are only manageable by the Federal Government. This is why state and local government spending aiming to create jobs, if it is at all effective, is wholly irresponsible.[29] Of course, any money handed out by the Federal Government earmarked for infrastructure or green energy projects should be spent on them. But during recessions, states are facing deficits and difficult choices, since the fall in economic activity also causes a fall in tax revenue. If the Federal Government unconditionally gives money to states, states should simply use this to pay off their own debts or avoid taxes increases, which is what they practically did with the last stimulus.[30] If more stimulus is needed, that remains the responsibility of the Federal Government, since it can always borrow at a lower rate than the states and bail itself out with the printing press if worse comes to worse. Under no circumstances should states or localities determine that a recession is a

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[29] A cost-benefit analysis may justify issuing bonds to finance a project. However, that is not the same argument as running a deficit for the sake of creating jobs.

[30] John F. Cogan and John B. Taylor, "What the Government Purchases Multiplier Actually Multiplied in the 2009 Stimulus Package," *NBER Working Paper*, No. 16505.

good reason for new spending on projects. Economics may be able to justify fiscal stimulus at the federal level, but it cannot justify it at the state and local level.

Conclusion

Prudent fiscal stimulus, should it be undertaken at all, must only happen at the same level of government that has control over monetary policy. Deficit spending is the only real mechanism for increasing employment via government spending. Since such demand management is beyond the scope of responsible state and local governance, it cannot enter cost-benefit analyses of state and local governments. Tried and true arguments based on consumers' revealed preferences and externalities on the market may not be exciting compared with promises to create thousands of new jobs. But those promises sound much less exciting when it is recognized that the creation of those jobs *necessitates* deficit spending. And why argue for your state or municipality to borrow at a rate higher than what the Federal Government would pay – especially when there is no reason why the Federal Government cannot itself borrow the money and give it to the states? If we set aside irresponsible attempts at localized demand management, what we are left with is the baseline assumption that in employing workers in one activity, we are taking them away from another economically useful activity. In that sense, employing workers in state and local projects is a cost, not a benefit, of the projects.

About the Author

Ryan Murphy is a PhD candidate in economics at Suffolk University and a research assistant at the Beacon Hill Institute. He received his BA in economics and scientific computation from Boston College.

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