

Beyond Pump Priming

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The American Jobs Act, whole or in pieces, faces a Sisyphean struggle in Congress. From a policy perspective, it represents a continuation of many of the ideas contained in the stimulus bill of 2009 and the payroll tax agreement of late 2010. Apart from a very small direct job creation component in the form of infrastructure investment, it otherwise relies largely on a “pump priming” strategy: injecting demand into a frail economy and hoping that this boosts growth sufficiently to have a measurable effect on the unemployment rate. Passage would admittedly be a positive development, particularly when one considers that the alternative is fiscal contraction—a shrinking of aggregate demand.

But even if some form of AJA-style aggregate demand support is signed into law, there are drawbacks to relying solely on this type of pump-priming approach—and not just because the original proposal, at \$447 billion, is small relative to the size of the output gap. It is not just the size of program, but also the nature of the approach that comes up short. While beneficial in setting a floor beneath economic collapse, there are shortcomings to relying almost exclusively on aggregate demand management (ADM). The ADM approach fails to produce and maintain full employment, while doing little to address income inequality.

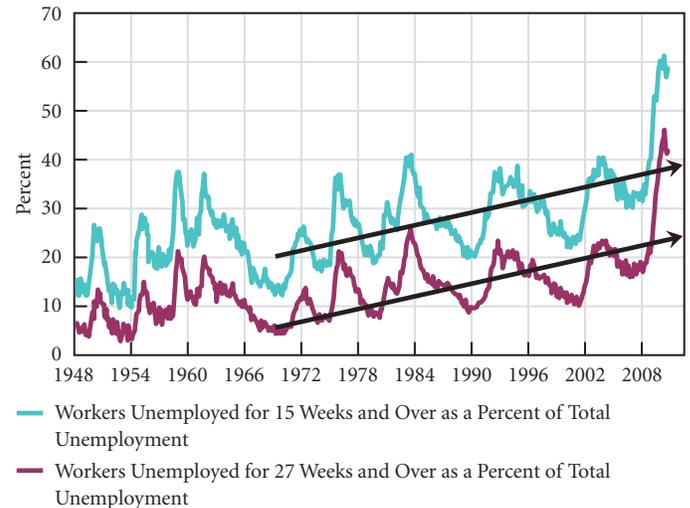
The alternative is to take dead aim at the employment outcomes we need—to directly target the unemployed. In other words, instead of trying to close the demand gap for output, fiscal policy could be redirected to closing the demand gap for labor. We should not expect a return to full employment and broadly shared prosperity without a more direct focus on providing paid work to all those willing to do their part.

As the figure illustrates, long-term unemployment has been following an alarming upward trend for the last several decades. It rises during a recession, and while policy and cyclical forces slowly bring it back down, it does not return to its previous low. In a pernicious ratchet effect, long-term unemployment climbs higher and higher.

The challenge for ADM is that the effects of changes in aggregate demand are asymmetric: that is, a fall in aggregate demand produces rapid contraction and swift rises in unemployment, but a boost to aggregate demand does not as rapidly reverse these trends. A gravitational force prevails, with greater and greater injections of demand required to bring the economy back to cruising altitude.

Compounding this gravitational challenge, ADM tends to operate by first helping highly educated, highly skilled workers, whose

Long-Term Unemployment



Sources: Bureau of Labor Statistics and author's calculations

increased outlays eventually trickle down to those lower on the skill and income pyramid. However, because wages at the top of the distribution are boosted first, inflationary pressures can cause governments to abandon growth supports well before full employment is reached.

It is only by chance that ADM generates enough jobs at the right places for all of those who need them. ADM must be supplemented by policies that directly employ the unemployed. In contrast to aggregate demand management, labor demand management can target particular distressed areas and regions, while offering a guaranteed job and retraining to the cyclically, structurally, and long-term unemployed. Instead of the “trickle down” of conventional ADM, what we get from offering guaranteed employment at all phases of the business cycle is a “bubbling up,” as Hyman P. Minsky put it, since labor targeting operates by first stabilizing incomes and employment among workers at the lower end of the wage scale.

There is no question that this economy needs more demand. But if we want to short-circuit the forces driving long-term unemployment and unequally shared prosperity, we need to go beyond pump priming.

A more detailed discussion of this topic can be found at www.levyinstitute.org/pubs/wp_649.pdf and www.levyinstitute.org/pubs/wp_650.pdf.

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