



The Jerome Levy Economics Institute of Bard College

Public Policy Brief

Public Employment and Economic Flexibility

The Job Opportunity Approach to
Full Employment

Mathew Forstater

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LEVY INSTITUTE

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Contents

Preface	
<i>Dimitri B. Papadimitriou</i>	5
Public Employment and Economic Flexibility	
<i>Mathew Forstater</i>	7
About the Author	22

Preface

Many commentators point to the longest peacetime expansion in U.S. history, dwindling welfare rolls, and the lowest level of unemployment in over 30 years and insist that, despite stock market volatility and global financial turmoil, the U.S. economy looks good at the outset of 1999. But all of our economic problems have not disappeared. In regard to the labor market, two questions cannot be ignored. Is the current level of employment the best the economy can do in a time of expansion and are we prepared for the next economic downturn? Even with today's official unemployment rate at a relatively low 4.3 percent, there are over 6 million people who are unemployed, millions more who are involuntarily working part-time or at below-poverty wages, and an estimated 15 million who are officially classified as out of the labor force but would be willing to work if the opportunity arose. When the economy slows, in a regular cyclical pattern or in a more drastic downturn, what will happen to former welfare recipients struggling to find work and to the now employed workers who lose their jobs?

In order to find answers to these questions, Visiting Scholar Mathew Forstater looks to means of achieving economic flexibility. Flexibility is the ability of an economic system to adapt its labor force and capital equipment to changing circumstances—new technologies, new products, changing supplies of natural resources, changing consumer demand, and so forth. Inflexibility in the face of change results in bottlenecks in production, sluggish growth, and inflationary pressures. Traditionally, capitalism has sought to achieve flexibility through excess capacity and the maintenance of a pool of unemployed workers (politically enforced through monetary and fiscal policy) from which private

firms could draw in times of expansion. But flexibility attained through unemployment comes at unacceptably high social and economic costs.

Forstater advocates a public service employment program conceived by Hyman P. Minsky and developed at the Levy Institute in a number of briefs and other publications. Forstater's contribution to this body of work is the extension of the concept of flexibility to the program. He demonstrates how the public service employment program can promote flexibility not only in labor but also in capital goods, natural resources, environmental protection, methods of production, and location of economic activity, thereby helping us during inevitable downturns without the costs of the current approach and with important social and economic benefits. I welcome your comments.

Dimitri B. Papadimitriou, *President*
February 1999

Public Employment and Economic Flexibility

The term “flexibility” has become something of a buzzword in economics. It is often used in different ways and its meaning can be unclear. Flexibility here refers to the ability of an economy to respond to various kinds of change. For example, we live in an era of ongoing technological advance, and technological change causes firms to reorganize their productive methods. Some jobs may become obsolete, some new ones may be created, there may be a shift in the skills employers are looking for in workers, firms may require new types of materials and services, and so on. We also live in an era in which new products are constantly appearing and in which the amount and kind of products desired by consumers change rapidly. Again, firms must respond to these market circumstances.

Inflexible economic systems—those that are unable to respond to various kinds of change—may be characterized by bottlenecks in production, sluggish growth, inflationary pressures, and other negative consequences. Bottlenecks in key industries, such as the machine tools industry, can cause economy-wide disruptions and prevent smooth expansion. Flexible economies are better able to sustain higher rates of economic growth and higher levels of employment without inflation. Modern capitalist economies, however, gain much of their flexibility from the existence of unemployed resources, including labor, and excess productive capacity. Thus, flexibility, although it is a desirable feature of an economic system, may be attained at a high social and economic cost.

This policy brief proposes an approach to the promotion of economic flexibility that is based on the strategic utilization of public sector activity. Called the job opportunity approach, it is compatible with high levels

of employment and capacity utilization and, at the same time, benefits the economy and the community through providing socially useful public services. First, the brief argues that the current approach to maintaining system flexibility—politically enforced unemployment and excess capacity—comes at an unacceptably high social and economic cost. Second, it presents an overview of the job opportunity approach in the context of recent economic events. Third, it turns to the ways in which public sector activity through the job opportunity approach can promote system flexibility without the costs of the current approach and with important social and economic benefits.

Flexibility at What Cost?

Market competition necessitates that firms be prepared to capture new sales should such opportunities arise. If there is an unexpected increase in demand, firms that want to capture some of the potential sales must be able to increase output without having to wait until they can build new capital equipment. Thus firms build above and beyond the scale required to meet normal and expected demand (that is, beyond the capacity associated with the normal operating level) so they can meet peak and unexpected demand. This is planned reserve capacity. A firm that is unable to respond to new opportunities for higher sales will lose out to firms that are prepared. However, not every firm that carries reserve capacity will be successful in capturing the new sales. This means that reserve capacity at the firm level translates into excess capacity at industry and economy levels. Excess capacity adds to system flexibility. It makes possible bursts of capital accumulation by overcoming structural rigidities.

Individual firms can plan reserve capacity when making decisions concerning the scale of plant and equipment, but they cannot (with some exceptions) maintain laborers on the payroll who will not be required when operating at normal capacity. However, the ability to respond requires not only reserve capacity in terms of capital equipment, but also the ability to hire workers to add to production lines or to work additional shifts. Historically, firms have been able to hire these workers when needed from the reserve pools of labor that capitalism maintains at the system level.

In the past several decades a target rate of unemployment has been politically enforced through tightening monetary policy or fiscal policy or both. Reserve pools of labor have historically served several purposes. Most of these fall under the categories of flexibility and stability. A pool of unemployed workers increases system flexibility by providing a pool of labor from which firms can draw during expansions. It serves wage and therefore price stability by weakening the bargaining position of labor. Its presence as a source of replacement workers also serves as a threat to the employed who ask for a raise, make other demands, or do not meet performance standards.

Unemployment, however, though it may bring flexibility, comes with unacceptably high social and economic costs. Unemployment assigns workers and their families to poverty and to some form of assistance. In implementing policies to maintain a reserve pool of labor, central banks, national governments, and international organizations betray the commitment to full employment that has been embodied in many nations' legislation since World War II and in proclamations by the United Nations supporting the right to work as a fundamental human right.

Unemployment causes permanent losses in potential output of goods and services; losses of tax revenues; higher government spending in the form of public assistance; crime, physical and mental ill health, suicide, and deterioration of labor skills and productivity; and more. The argument that unemployment contributes to social instability may also be included here. In sum, unemployment is not consistent with ethical and legal obligations of countries to promote full employment and entails direct and indirect social and economic costs (Jahoda 1982; Hughes and Perelman 1984; Kelvin and Jarrett 1985; Dawson 1992; Moosa 1997; Piachaud 1997).

The Job Opportunity Approach

For the past two or three decades monetary policy has chosen unemployment as a means of achieving price stability in the belief that low inflation is incompatible with low unemployment. Recently, however, the U.S. economy has approached what *appears* to many to be full employment—6 million involuntarily unemployed—with low and stable

inflation. This condition coincides with signs of global deflation, domestic deficit reduction, and U.S. implementation of a “welfare reform” that seeks to force recipients off assistance through setting time and other limits on eligibility, while leaving it to individual states to try to find employment for these individuals, a task they are unable—even if they are willing—to shoulder. Failure to find employment leaves individuals without a means to provide for themselves and their families. This development is part of an overall trend toward the dismantling of the social safety net that has traditionally protected the most vulnerable sectors of the population against the economic and other hardships that result from being unable to find a job.

We are faced with two important questions with regard to unemployment. If we are to believe the pundits who claim we have finally reached “full employment,” is 6 million unemployed and other millions out of the labor force the best we are capable of achieving in this “best of times”? Are we prepared to deal with the sudden surge in unemployment and poverty that will occur should we enter a serious economic downturn?

During the Great Depression, unemployment was combated by the federal government through job creation. The work programs were discontinued with the economic recovery that accompanied U.S. entry into World War II. After the war the Murray-Wagner Full Employment Bill was put forward as an attempt to establish once and for all that the federal government would guarantee full employment. The bill passed overwhelmingly in the Senate, but failed to make it through the House. Compromise resulted in the Employment Act of 1946, in which the “guarantee of full employment” was replaced with the “promotion of maximum employment.”

In the postwar era the promotion of maximum employment has failed to live up to the ideals expressed by FDR in his 1944 State of the Union Address (and codified by the United Nations in the Universal Declaration of Human Rights) that the “right to employment” is a fundamental human right. The notion of a trade-off between price stability and full employment has become so ingrained that virtually all economists and policymakers agree that even a 5 percent official unemployment rate is too inflationary. They are willing to adopt economic

measures that force millions of individuals who are ready, willing, and able to work into a pool of unemployed labor in the belief that the existence of this pool is a means by which prices can be controlled.

If we are to uphold the “right to employment,” we must craft a policy alternative—one that provides jobs for those who are willing and able, but does not interfere with the micro decisions of individual employers; that does not rely on the failed approach of fine-tuning aggregate demand; that is not inflationary; that can keep millions out of poverty in the face of an economic recession; and that is consistent with the American value that socially productive work is superior to income maintenance.

That the situation calls for bold measures has been recognized by a number of scholars across the theoretical and political spectrum. The measures proposed include a wage subsidy program and a work-sharing program. In a plan that has received considerable attention, Edmund Phelps, an economics professor at Columbia University, proposes that employment of low-wage, lower-skilled workers be subsidized by the federal government (Phelps 1997). Questions have been raised about the effectiveness of the subsidies and the possibility that employers will seek to substitute subsidized workers for those currently employed. There is reason to believe that subsidizing employment in the private sector, if successful in substantially increasing employment, will result in the inflation and sluggish growth associated with tight labor markets and structural rigidities. Also, Phelps estimates that the initial cost of the program would be about \$125 billion—a high price-tag for a plan that cannot guarantee full employment.

Another employment strategy that has gained substantial currency, especially in Europe, is work sharing. Work-sharing programs would limit the number of hours of presently employed individuals and bring in others to share the same amount of work, keeping the amount of work equal to that needed to produce present GDP.

The Levy Institute distinguished scholar Hyman P. Minsky was skeptical of full employment plans based on subsidies, which he believed were liable to result in inflation, financial crisis, and serious instability. He proposed an alternative strategy, called an “employer of last resort”

policy, under which the government would provide a job guarantee but without the inflationary pressures and structural rigidities usually associated with full employment (Minsky 1986). Philip Harvey, an associate professor at the Rutgers School of Law, supports a similar plan. He calculated the annual net cost of such a program for an earlier high unemployment period to be about \$20 billion per year, without counting in some significant benefits likely to result (Harvey 1989). Wendell Gordon, a professor of economics at the University of Texas, estimated the annual net cost of a similar plan for a more recent period to be approximately \$41 billion (Gordon 1997).

The job opportunity program proposed here is based on Minsky's concept. The first component of the proposal is relatively simple. The government announces the wage at which it will hire anyone who wants to work in the public sector and then hires all who seek employment at that job opportunity wage. Normal public sector employment remains a vital and separate part of the public sector and is not affected by the job opportunity program. This component of the program will, as a matter of logic, eliminate all involuntary unemployment by providing jobs for every person ready, willing, and able to work, but unable to find work in the private sector. Certainly, there will still be many individuals who remain unemployed: some will be unwilling to work for the government at any wage; some who are between jobs will prefer to remain unemployed while looking for another job; and so on. But any person willing and able to work will have the opportunity to do so. In other words, involuntary unemployment will be zero.

Unlike "welfare-to-work" schemes, the job opportunity program is voluntary, it ensures a job is available, and it has no lifetime limits. Funding comes from the federal government, but the program can be administered by state or even local governments. Given current levels of unemployment, the net cost of the program is estimated at \$25 billion to \$50 billion. Obviously, the budgetary effects of the plan are quite small, relative to the size of the federal budget and to the size of GDP. In addition, this estimate does not include a number of indirect benefits likely to result from the program, such as decreases in the social costs of unemployment (for example, criminal activity and physical and mental health problems), and the benefits of some public sector projects (for example, environmental protection and improvements in infrastructure).

An important question, however, concerns the impact this program would have on aggregate demand. Will full employment increase aggregate demand enough to bring about accelerating demand-pull inflation? Alternatively, can aggregate demand increase sufficiently with the additional government deficit spending without generating inflation? The answer is easy to obtain.

The fact that public sector plus private sector spending now provides a level of employment that leaves 6 million workers involuntarily unemployed is de facto evidence that aggregate demand is below the level required for full employment. If aggregate demand were higher, the population would be spending more and creating more jobs for the unemployed. This means that the government can safely increase its deficit spending for this program. As long as additional government deficit spending does increase employment, aggregate demand must still be below the full employment level.

The job opportunity program is designed to ensure that the deficit will rise only to the point at which all involuntary employment is eliminated. Once there are no workers willing to accept a program job, spending will not be increased further. Thus the deficit will not become excessive, that is, it will not cause aggregate demand to increase beyond the full employment level. The program does not preclude aggregate demand fine-tuning of the job pool. Changes in taxation and in the composition of government expenditure can be used to increase and decrease the pool's size.

The design of the plan and the ability to fine-tune the job pool should eliminate the fear that a full employment policy must necessarily generate demand-pull inflation. However, it can still be objected that full employment will generate cost-push inflation by placing pressure on wages and thus on costs and prices. This leads to the second component of the proposal: exogenous wage setting by the government.

The price paid by the government for program employment is set exogenously. That is, because the government is willing to hire as few or as many people who want to work at the job opportunity wage, it is free to fix the wage arbitrarily rather than having to pay a market-determined wage. What are the implications for wages and prices? Clearly, being fixed, the program's wage is perfectly stable and sets a benchmark price

for labor. True, most low-wage jobs that pay less than the program wage before the program is implemented will experience a one-time increase of wages (or will disappear altogether). Employers will be forced to cover the higher labor cost through a combination of higher product prices, greater labor productivity, and lower realized profits. Thus, some product prices should experience a one-time jump as the job opportunity program is implemented. This, however, is not inflation nor can it be accelerating inflation as these terms are normally defined by economists.

Another cost factor to consider is the high rate of “depreciation” on idle human capital. The productivity of workers falls quickly when they are unemployed, and beyond some point they may become unemployable. With the job opportunity program, however, those who are not employed in the private sector continue to work and their skills will not depreciate as quickly, if at all. A program that keeps people employed might actually enhance the human capital of the job opportunity pool. The enhanced human capital would reduce the productivity-adjusted cost of hiring out of this pool relative to unemployed workers and thereby diminish inflationary pressures.

Opponents of the job opportunity program argue that it could generate continuous inflationary pressure on wages and prices. It is unlikely that full employment under such a program would be more inflationary than the current system. The current system pays some people for not working, allows human capital to depreciate, and results in high social and economic costs associated with unemployment. In addition, while income maintenance programs increase aggregate demand without increasing aggregate supply, the job opportunity program increases both aggregate supply and aggregate demand, placing less pressure on prices.

The job opportunity solution provides an approach that ensures full employment while retaining system flexibility and stability. Such an approach will be relatively inexpensive and may even pay for itself. Job opportunity employment may preserve and even enhance the productivity of the reserve pool of program job holders and also provide valuable public services, including those that reduce social and environmental costs. Only a perfectly responsive demand for labor can guarantee full employment without setting off a wage-price spiral, and only direct job creation by the government can provide such responsive demand.

The Contribution of Public Sector Activity to Economic Flexibility

An understanding of the role public sector activity may play in promoting economic flexibility leads to a shift in the criteria for evaluating the efficiency of public employment and resource use. Promotion of flexibility through public sector activity means that higher rates of economic growth can be sustained without the persistence of a pool of unemployed resources and without the threat of inflation.

Key to understanding the flexibility of public sector activity is understanding the constraints within which private firms operate. Competitive pressures compel private firms to make decisions based on a narrow set of criteria. Firms must make decisions concerning what to produce and how to produce it based on their best estimate of the profitability of such decisions. Of course, a number of issues come into play in these decisions, and we would not want to depict them as uncomplicated. But in a capitalist economy competitive pressures greatly restrict the discretion firms have with regard to the products they make and the methods of production they use.

Profitability requires the minimization of private costs. Firms have no direct market incentive to concern themselves with the minimization of social costs—costs that are a burden on third parties or society at large but not on the firm itself. A classic example is pollution. The use of a method of production that pollutes may be efficient from the narrow vantage point of the firm's profitability, but it imposes costs on third parties or society as a whole. Similarly, it may not be desirable in terms of private cost minimization for a firm to hire a worker if the benefit of the revenue the worker can generate does not justify the worker's wages, but it may be desirable in terms of social costs when one compares the benefits of full employment to the costs of unemployment.

Public sector activity does not have to be concerned solely with the competitive pressures so important to private firms, since government is not in business to make a profit. Government can choose to engage in a line of production that no private firm would engage in. It can choose a method of production that may be different from the method that would be chosen if the decision were based exclusively on "efficiency" criteria,

where efficiency is defined as private cost minimization. Government can make its decisions based on other criteria, such as an assessment of broader macroeconomic concerns or social values. By making its decisions on such alternative criteria, government can have a positive impact on the private sector in a number of ways.

Fundamental to this approach is the distinction between “normal” (meaning essential or regular) public sector activity and employment and what we call here “discretionary” public sector activity and employment. Of course, what is regarded as “normal” is a matter of social policy and may change over time, but at any given time there is a set of activities that are considered essential and that cannot be modified, delayed, or discontinued without harm to the public good. The employees that are engaged in the operation and management of these necessary functions are regular (i.e., permanent) public sector employees and are not part of what is termed “discretionary” public employment.

Designation of employment or activities as “discretionary” does not mean that they provide no public benefit. It means that they are something that society could use or benefit from but could do without, at least for the time being. Thus, these activities can be undertaken when there is available labor from the private sector, and they can be delayed or discontinued when private sector demand for labor rises. Of course, some functions that are considered discretionary may be designated as normal under changing circumstances. Also, some public sector activities may be taken up by the private sector.

The following sections outline the manner in which the job opportunity approach can simultaneously promote and maintain economic flexibility and full employment. In addition to flexibility with regard to labor, the approach can also promote flexibility with regard to capital goods, natural resources and environmental protection, methods of production, and geographical location of economic activity. Thus, there are real benefits to the job opportunity approach, which replaces the socially and economically costly approach that uses unemployment and excess capacity for promoting and maintaining economic flexibility.

Labor

The benefits of public employment in promoting flexibility with regard to labor have been perhaps the most discussed (Minsky 1986; Mosler 1997–98; Mitchell 1998; Wray 1999). Although the discretionary public sector workers are employed at a living wage, they serve the same function as a reserve pool of the unemployed; they remain available to the private sector if the demand for labor should increase. Firms need only bid them away from the public sector by offering them a mark-up over the job opportunity wage, benefits, an opportunity for career advancement, or any other incentive to move into the private sector.

As private sector demand for labor rises, the discretionary public sector pool will shrink, and as private sector demand for labor falls, the discretionary public sector pool will increase. The mechanism thus works something like the pool of unemployed, but workers move between private sector and public sector employment rather than between employment and unemployment. We thus have full employment without overly tight labor markets.

Labor market rigidities result from full employment. With job opportunity employment, an element of labor market flexibility is retained without unemployment. Firms can maintain numerical flexibility, adding shifts or workers to production lines, and thus increase the responsiveness of supply in firms, the industry, and the system as a whole. By being employed, workers who would have otherwise been unemployed have the opportunity to maintain and enhance their skill and knowledge—a benefit to the individual workers and the economy as a whole. Thus, while providing numerical flexibility without relying on unemployment, discretionary public sector employment also leads to higher flexibility in the economy.

Capital Goods

Schemes that promote increases in labor employment by stimulating private sector activity will result also in higher degrees of capacity utilization in those industries that experience a higher demand for their product and in those industries that provide their inputs. Increased demand for capital goods, whether due to increased private sector

activity or public sector activity, can result in bottlenecks, resulting from higher capacity utilization rates. Such bottlenecks are a source of structural rigidities and inflationary pressures.

The job opportunity approach presents opportunities to enhance flexibility with regard to capital goods (Lowe 1988). In its discretionary public sector activity government has greater latitude in its choice of projects and production methods than it has in its regular public sector activity and than the private sector has. In choosing which discretionary activities to engage in, government can consider the general trends in the composition of economic activity and decide not to engage in activities that utilize those types of capital equipment that are already in high demand or short supply. Engaging in activities that utilize such equipment would lead to bottlenecks in the same way that higher levels of private sector activity do. Since public sector decisions are not driven by competitive pressures, government can choose to engage in those activities that utilize equipment for which there is sufficient supply or responsiveness of supply is known to be high. Also, for some types of capital equipment in short supply at higher levels of economic activity, government could choose to help avoid bottlenecks by increasing public sector production of the goods in short supply or the goods required to produce those goods.

It is also quite possible for public sector workers to engage in activities that use little or no capital equipment, should that be perceived as beneficial in avoiding structural rigidities while promoting full employment. There is a whole spectrum of near pure services that are beneficial to the economy and society, but use almost no capital equipment. Much environmental clean up; additional “helping hands” in schools, on playgrounds, in communities, in hospitals, in subway stations; and a host of other public services all can provide beneficial services without resulting in increased use of capital equipment. In these ways, higher levels of employment of labor are possible with more flexibility than would be the case if the same level of employment were achieved through stimulating demand in the private sector.

Natural Resources and Environmental Protection

Similar arguments can be made with regard to natural resources and environmental protection. Bottlenecks and rigidities can result from

pressures on the supply of natural resources, especially nonrenewable resources. Government can choose to engage in socially and economically beneficial activities that do not use exhaustible resources or that use them less intensively. (Again, this is for discretionary activities; obviously, for essential government services, there is not the same latitude.) Thus, bottlenecks due to increased demand for scarce natural resources do not have to arise from higher levels of employment.

The same cannot be said for higher levels of employment that result from employment approaches based on increasing private sector activity, whether through wage subsidies or the stimulation of private sector demand through fiscal and monetary policy. It cannot be claimed that higher levels of such activity will not result in more use or more intensive use of natural resources and that the higher levels of utilization will not result in inflationary pressures and structural rigidities. Government can choose not to use; with the private sector there is no guarantee.

While the supply of exhaustible natural resources cannot be increased through public sector production in the same way that the supply of capital goods can be, government does have some means to relieve the pressure on the supply. Public sector activity can be devoted to developing renewable substitutes for exhaustible natural resources and increasing recycling efforts.

Government also may choose to engage in activities that do not pollute or pollute as little as possible in order to avoid or reduce pressures on the local and global assimilative capacities of the environment. While higher levels of private sector activity may increase pollution, public sector activity can be geared toward projects and production methods that do not tax the assimilative capacity and, as in the case of natural resources, that even enhance that capacity, such as reforestation.

Methods of Production

As we have seen, government can promote a more flexible full employment not only by choosing from among alternative projects but also by choosing from among alternative methods of production. Whereas private firms are compelled by competitive pressures to choose the method of production that will maximize profits, government is not constrained

by those same pressures. For any given activity, choice of technique can be based not on criteria of private cost minimization but on criteria of impacts on the system as a whole. More labor-intensive methods may be utilized, for example, even where more capital-intensive methods are available and might be chosen under different conditions. The key is to choose those methods that will promote employment, avoid bottlenecks, and add to the flexibility of the system.

The same principle holds for natural resources and the environment. Alternative technical means may be utilized to ease pressures on natural resources or the assimilative capacity of the environment. While such technologies or production techniques may not be “optimal” for a private firm, government has the option of considering the impact of production methods on the system as a whole.

Geographical Location

Firms are constrained by competitive pressures in their decisions concerning where to locate, but the same is not true of government. Of course, there are still constraints on location for some public sector activities, and certain types of activities cannot be located just anywhere. However, many activities have no locational restrictions, and decreased costs of transportation and the expansion of information complexes have reduced such restrictions for many others.

There are significant regional and local differences in unemployment rates. Locational flexibility means that public employment need not cause disruptive dislocation for workers. Rather, employment opportunities can be located where there are unemployed. The local administration of discretionary public employment programs would facilitate this approach.

Conclusion

High employment and high capacity utilization rates are associated with structural rigidities that have a number of undesirable consequences. For

this reason, central banks, national governments, and international organizations have resisted policies that would promote full employment. What has been almost entirely overlooked, however, is the way in which public employment might promote higher levels of employment without the loss of system flexibility. The job opportunity approach recognizes and capitalizes on the manner in which public sector employment can create truly full employment, enhance system flexibility, reduce the social and economic costs of unemployment, and promote socially beneficial public works without structural rigidity or inflation.

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