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## U.S. Employment Outlook for 2014: Can the U.S. Economy Stand on Its Own?

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## **U.S. Employment Outlook for 2014 Can the U.S. Economy Stand on Its Own?**

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Six years have passed since the recession officially began in December 2007 and employment has still not returned to its pre-recession level. It is getting closer, but unlike GDP and the stock market (as measured by the S&P500 Index), payroll employment as of December 2013 is still shy of its pre-recession peak. We need another 1.3 million or 1 percent additional payroll jobs to get back to where we started right before the recession began. The economy has added jobs at a good pace during the past year, averaging 182,000 per month. At this pace, payroll employment should be back to the level prior to the recession by midyear.

The key question facing the labor market, and the economy in general, is whether it can continue to expand on its own without the help of further fiscal or monetary stimuli. Since the expansion began in July 2009, around \$835 billion has been pumped into the economy through the American Recovery and Reinvestment Act and the Federal Reserve System has purchased nearly \$3.7 trillion dollars in government bonds and mortgage-backed securities (under the three phases of quantitative easing), helping to keep short- and mid-term interest rates low. Some are skeptical that the stimulus has had much effect on the economy. However, the politically neutral Congressional Budget Office has attributed a good deal of the growth in employment and the economy to these policy measures. From 2009 through 2013, CBO estimates that employment was higher by as much as 8.1 million jobs, compared with what would have occurred otherwise.<sup>1</sup> The low interest rates through the Fed's quantitative easing program has also helped to revive the ailing housing and construction sectors and stimulate business startups and expansions, more than would have occurred without such efforts.

This coming year may see the end of any major economic stimulus. Virtually all of the ARRA funds were spent a year or two ago, and the end of the Fed's quantitative easing may be in sight, if the unemployment rate continues to fall toward the Fed's prescribed target of 6.5 percent for ending the third phase of its stimulus initiative. As the economy is weaned off the stimulus efforts, the question is whether the fundamentals for future growth are solidly in place or is the economy still vulnerable to shocks. Some analysts take comfort in the apparent resiliency of the economy during 2013, even in the face of fiscal uncertainties. The economy seemed to take in stride two showdowns in Congress over the federal budget and the debt ceiling. Even the stalemate in October, which partially closed the federal government for 16 days and furloughed most federal employees, did not significantly bother the economy, at least not with respect to employment and the stock market.<sup>2</sup> A similar situation in August 2011,

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<sup>1</sup>"Estimated Impact of the American Recovery and Reinvestment Act on Employment and Economic Output from October 2012 Through December 2012," Congressional Budget Office, February 2013. The CBO offered a range of 1.7 to 8.1 million jobs.

<sup>2</sup> GDP figures for the fourth quarter of 2014 have not yet been released but the S&P500 index has reached all-time highs.

even without a prolonged government shutdown, nearly derailed economic expansion, sending the stock market spiraling downward and slowing GDP growth.

### **Robust employment growth in 2013**

Throughout much of 2013 it appeared that job creation was back on track with net payroll job creation averaging 182,000 per month. This marked the second straight year that monthly payroll employment gains averaged more than 180,000, which offers signs that the economic expansion is on solid footing. At the current pace, it would take only seven months to fill the gap and bring payroll employment back to 138 million, the level achieved at the business cycle peak in December 2007. If that schedule is met, 78 months will have elapsed before employment returns to its pre-recession level. This may seem like an inordinately long period of time, and compared with previous business cycles it is. Of the past four business cycles, the first two (1981-82 and 1990-91) took roughly 28 months for employment to return to pre-recession levels, and the 2001-02 recession required about 45 months. Obviously, the prior three recessions were not as deep as the Great Recession and thus required less employment growth to return to pre-recession levels.

Much of the employment gains during the expansion have come from larger businesses. Small businesses still seem to be in the doldrums during the recovery. The National Federation of Independent businesses, for example, reports that the index of small business confidence is still about 10 points below the long run trend, which up to this recession and expansion has been relatively stable since the index was created in 1986. The Conference Board, on the other hand, reports that CEO confidence now stands at 60, which means that more CEOs are confident about the growth and viability of their companies than those who are not. This difference in sentiment between small and large employers may help explain the reduction during the expansion in the share of jobs from employers with less than 50 workers compared with the share of jobs from employers with more than 100 workers.

### **Slow economic recovery**

Even though employment growth has picked up in the past two years, the economy is simply not growing as fast as in previous business cycles, which leads to slower employment growth overall. After 18 quarters into this current expansion, real GDP has grown only 10.3 percent. Of the nine expansions since WWII, this expansion has been the slowest regardless of the length of the expansionary period.<sup>3</sup> Of the five expansions that have lasted for 18 quarters or more, the growth of real GDP after 18 quarters has averaged 19.3 percent, nearly double the current pace. Stated on an annualized basis, the annualized growth in real GDP after 18 quarters averaged over those five previous expansions was 4.2 percent, compared with only 2.3 percent for the current expansion.

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<sup>3</sup> The one exception is the five-quarter expansion after the recession in 1980. GDP growth during this expansion was 4.4 percent. However, this short-lived expansion was followed by the much more severe 1981-82 recession.

However, the latest GDP estimate released December 20, 2013 shows the economy picking up steam, with a strong third quarter performance of 4.1 percent annualized growth. This rate is close to the average of the previous expansions, but it does not appear sustainable. Forty percent of that increase resulted from inventory buildup, which could foretell slower growth into the fourth quarter and even into 2014.

It may be too early to tell, but the surprisingly slow employment growth in December 2013 may be a sign of possible slowing of economic growth into 2014, after the robust fourth quarter of GDP growth. After averaging 182,000 payroll jobs per month during 2013, the Bureau of Labor Statistics announced on January 10<sup>th</sup> that only 74,000 net new payroll jobs were created in December 2013. This marks the smallest increase since January 2011 when jobs grew by only 69,000 that month. Employment in sectors that had sustained economic growth during the expansion, such as health care, and sectors that saw a resurgence during that period, such as manufacturing, were flat at best in December. The Private goods-producing sector lost 3,000 jobs while the private service-producing sectors gained only 90,000. Government, specifically local government provided education, lost 15,000 jobs.

### **Looking Forward**

The Philadelphia Federal Reserve Bank Consensus forecast, based on a survey of 42 forecasters, calls for an increase in real GDP growth in 2014 but nothing near 4 percent. The consensus forecast is 2.6 percent. Yet, the expected growth is nearly a percentage point higher than the 1.7 percent increase they forecasted for 2013 and 0.6 points above the 2 percent annual growth actually registered through the third quarter of 2013. They are slightly more optimistic for employment, expecting payroll employment to grow by 189,900 jobs per month during 2014 compared to the actual rate of 182,000 jobs per month during 2013.

While forecasters see greater employment growth in 2014, comparing it with the real GDP growth estimate suggests that the forecasters expect fewer jobs to be created with the same increase in real GDP. The ratio of their forecasted employment growth to forecasted real GDP growth for 2014 is 0.65 (1.69/2.6) compared to a ratio of 0.98 (1.66/1.70) for 2013. Therefore, the greater forecasted real GDP growth is expected to generate a lower share of new jobs into 2014. Yet, the expected ratio for 2014, although lower than for 2013, is close to the actual ratio of employment growth to real GDP growth for the expansion so far after 53 month or 18 quarters into the expansion.

### **Structural Imbalances**

The slow economic recovery may be the result of structural issues caused by the recession more than by short-term factors, at least at this stage of the expansion. According to a CBO study, two-thirds of the slower growth is related to structural issues, which are embodied in what is referred to as potential output. The other third is related primarily to the

shorter-term factors such as the slowdown in government purchases and residential investment.<sup>4</sup>

Potential GDP growth reflects the underlying forces driving the economy: the labor and capital stock available for use in the economy and their quality and efficiency in use. According to the CBO study, the recession has reduced availability of these important two inputs. For labor, the massive layoff of workers during the recession has eroded the skills and connection to the labor force because they have been out of work for unprecedented long period of time. More than 3.9 million people (or 37.7 percent of the unemployed) are still unemployed for 27 weeks or more; yet employers still complain that they cannot find qualified workers to fill their job openings.

Other employment-related factors contributing to the lower potential GDP growth have to do with longer run trends. Baby boomers are retiring in greater numbers than ever before leading to a slower growth in the working age population. In addition, the long-run trend of increasing participation of women in the labor force has been slowing. The slower growth rate of potential workers in the economy not only affects economic growth directly, it also affects the economy indirectly by reducing the amount of capital needed to equip workers to perform their jobs. This assumes that the capital-to-labor ratio remains constant, but in many industries and occupations the capital requirements may be increasing. Nonetheless, the ratio of business domestic investment to GDP fell to its lowest level during the recession since WWII and is still five percentage points from its previous peak of 20 percent.

The relatively low rate of business investment is not for lack of profits that corporations can plow back into their businesses in the U.S. On the contrary, throughout this recovery the ratio of corporate profits to GDP is historically high, upwards of 12 percent and climbing. There are several reasons for the increase, but a primary cause is the combination of increased globalization and corporate taxes. Many corporations are making profits in the business activities abroad and keeping their profits there, encouraged to do so by lower corporate tax rates in many foreign countries than in the U.S. This means that there are less profits returning home to be invested in domestic business equipment and structures. It is unclear whether the profits held in foreign countries are used to invest in those countries, but it is clear that they are not being invested in the U.S.

### **Fiscal drag**

In the shorter run, Congress's push for fiscal austerity and its concern about mounting federal debt has put a drag on the economy. At the beginning of 2013, it appeared that Congress had averted the so-called fiscal cliff in which draconian budget cuts would automatically occur if the two political parties could not agree on a federal budget and how to deal with the federal debt. The proposed fiscal tightening would have slowed the economy

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<sup>4</sup> Congressional Budget Office, "What accounts for slow growth of the economy after the recession?" November 2012.

significantly. The CBO estimated that if the automatic spending cuts and tax increases would have gone into effect, nearly 3 million jobs would have been lost, raising the unemployment rate from 7.8 percent at the time to 9.1 percent by the fourth quarter of 2013.<sup>5</sup> Furthermore, those spending cuts and tax increases would have come shortly after the federal fiscal stimulus program had ended, adding to the fiscal drag. The American Recovery and Reinvestment Act (ARRA), signed into law in February 2009, authorized \$840 billion dollars over two years. Even though stimulus spending ended in September 2011, the Congressional Budget Office estimates that the stimulus program accounted for up to 1.2 million jobs in 2012 alone and 500,000 in 2013.

Unfortunately, the budget showdown was not resolved at that time, and Congress imposed across-the-board budget cuts for most of 2013. In order to raise the debt ceiling so the U.S. government would not default on its interest payments, Congress agreed in March to automatic spending cuts for both defense and non-defense spending, except Social Security. This amounted to a reduction of approximately \$45 billion in federal spending for 2013. The CBO estimated that such a reduction would reduce GDP growth by 0.6 percentage points and eliminate 750,000 jobs by the fourth quarter of 2013. Similar cuts are in place for 2014 and CBO estimates that 900,000 fewer jobs will be created that year than would have been created without the cuts.

While the level of future federal spending cuts may change, it is clear that spending will not return to its past growth rate, resulting in a drag on economic growth into the near future. On January 16, 2014, Congress passed an omnibus spending bill that restored some of the cuts under sequestration and offers a more rational approach to budgeting than simply across the board cuts. About \$20 billion is restored for domestic programs cut under sequestration last spring. Yet, the new budget of \$1.1 trillion is still less than Congress approved six years ago, when measured in real dollars adjusted for inflation, before the recession was in full force and President Obama was first in office,. The question is how much will these austerity measures affect the growth of the economy in the short-run in order to put it in a better position for longer-term growth by reducing the federal debt. The answer depends in part on the soundness of the economic fundamentals at this point in the expansion.

### **Fewer Government Employees**

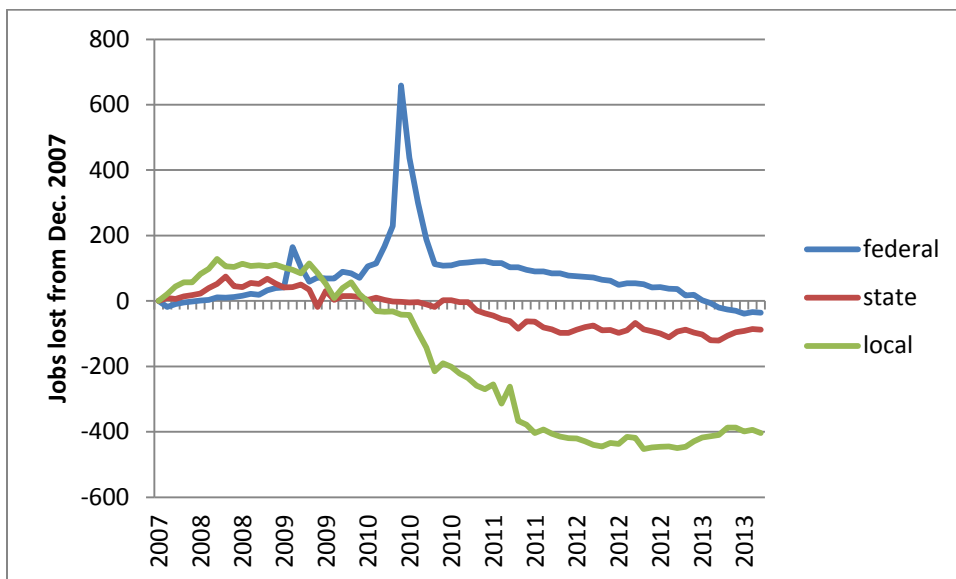
The slower economy and budget reductions at all levels of government have reduced the number of government employees throughout this expansion. This in itself places a drag on the employment picture, as the private sector tries to make up not only for the loss it experienced during the recession but also for the reduction in government jobs. At the end of 2013, there were 527,000 fewer government employees than at the previous peak of December 2007. As shown in figure 1, local government accounted for most of the loss, with 400,000 fewer jobs. Local government workers in education experienced the largest reduction both in percentage terms and in numbers, registering a 3.5 percent reduction or a loss of

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<sup>5</sup> Congressional Budget Office, "Economic Effects of Policies Contributing to Fiscal Tightening in 2013," November 2012.

276,000 workers. The number of federal employees actually increased during most of this period, with hiring under the American Recovery and Reinvestment Act and hiring for the 2010 Census count. State employment has experienced a gradual but steady decline until recently. Currently, federal, state, and local employment stands at 2.1 million, 5.1 million, and 14.1 million, respectively.

Figure 1: Change in Government Employment Relative to December 2007



### Affordable Care Act

Another concern expressed by some for the coming year is the effect of the Patient Protection and Affordable Care Act (ACA) on employment. The bill was enacted to expand health care coverage to the roughly 40 million uninsured Americans. Although it was passed in 2010, only in October 2013 could people begin to enroll in the state-organized labor exchanges where insurers compete for customers. The ACA has three key provisions to expand health care coverage: a mandate that individuals obtain coverage or pay a penalty, a mandate that employers must offer coverage or pay a penalty, and expansions of publicly-subsidized coverage. The penalties to employers for not offering health insurance coverage affect businesses with greater than 50 full-time equivalent employees (FTEs) and the penalty for not offering any coverage could be as high as \$3,000 per FTE. There is also a small increase in Medicare taxes and fees for larger businesses and higher-income taxpayers to pay for the expanded coverage. Therefore, the concern is that businesses will scale back hours and replace full-time jobs with part-time jobs or simply reduce the number of employees in order to avoid offering health insurance to their employees or to pay the additional tax. The penalty to individuals for not carrying health insurance takes effect in 2014, and the penalty to businesses does not occur until 2015, as the law is currently written.



Nonetheless, when health insurance enrollment on the state exchanges began in October, analysts were worried that the number of part-time workers would increase as employers tried to reduce their number of full-time employees to avoid offering coverage. The October BLS job's report showed the opposite occurring: the number of part-time jobs fell for the second straight month. In the longer-term, part-time employment is higher now than before the recession, but that trend began before the ACA became law in 2010. Moreover, growth in part-time jobs has taken place in sectors where work is already part-time, with little evidence of it rising in sectors that have traditionally been dominated by full-time jobs. While this is not a rigorous test of the effect of ACA, the short-term reduction in part-time jobs and the increase in total payroll employment in October put some minds at ease, at least for now.

More rigorous academic research suggests that the ACA may have little effect on employment but more on wages. A study of the state of Massachusetts health reform, which is similar to the ACA but enacted several years earlier, found that the rate at which employers offered health insurance rose from 70 percent before the state-mandated plan was implemented to 76 percent afterward, but wages were \$5,000 lower than they would have been without the plan. The lower wages suggest that ACA affects wages more than employment and suggests the value workers place on being insured.

The ACA could also affect future economic and employment growth if it adds to federal expenditures and the deficit. The CBO projected that the ACA would raise federal government spending by almost \$1 trillion over the next decade in order to increase health insurance coverage by 32 million people. However, CBO also projected that it would raise revenues and reduce spending by even more so that the bill overall reduced the federal budget deficit cost to the federal government. Therefore, from a fiscal perspective, the bill may have a neutral effect.

In spite of the academic analysis that shows little downside effects of the ACA on the economy and employment, recent surveys suggest that businesses, particularly smaller franchises, are concerned and may have already shed employees or reduced hours to avoid the cost of paying for healthcare coverage. However, the magnitude of this pessimism varies by survey. For example, a survey by the U.S. Chamber of Commerce and International Franchise Association conducted in September and October revealed that of the 400 businesses that responded some 64 percent of small business franchise owners (such as owners of fast food and retail stores) believe the law will have a "negative impact" on their business, while only 5 percent expect a "positive impact." For non-franchise businesses the ratio was 53 percent negative and 12 percent positive. Moreover, of those surveyed, 31 percent of franchise and 12 percent of non-franchise businesses said that they have already reduced worker hours. However, another survey conducted by the International Foundation of Employee Benefit Plans, with twice the number of responses, found that only 16 percent have adjusted or plan to adjust hours so that fewer employees qualify, and even fewer reported changing their hiring strategies.<sup>6</sup>

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<sup>6</sup> International Foundation of Employee Benefit Plans, "2013 Employer-Sponsored Health Care: ACA's Impact," 2013

## **Extended Unemployment Compensation**

Congress has also chosen to eliminate the extended unemployment compensation (EUC) for those who have been looking for work for more than 26 weeks. At the end of 2013, even though long-term unemployment remained historically high, Congress chose not to renew the compensation for long-term unemployment, as part of the federal budget compromise. This resulted in 1.3 million jobless workers cut off from federal extended compensation at the end of 2013, and it is expected that an additional 3.6 million people will lose access to UI benefits beyond 26 weeks by the end of 2014, as these people exhaust their regular state-funded benefits. Many of these UI recipients, about 1.7 million, would fall into poverty were it not for the extended benefits, according to estimates by the President's Council of Economic Advisers. The Council along with the CBO has also shown the EUC to be among the policies with the largest effects on output and employment per budget dollar. The Council estimates that allowing the EUC to expire will cost 240,000 jobs in 2014, and the CBO finds that eliminating the EUC will reduce real GDP by 0.2 to 0.4 percentage points this coming year.

## **Job Growth Initiatives**

Because of the gridlock in Congress, the only initiative the Obama administration has pursued to help spur growth is a middle class inter-governmental agency initiative. President Obama asked his Department Secretaries to explore ways to help the Middle Class cope with rising college and health care costs and declining house values and retirement savings. With little additional funding, the administration is left to tinker with existing programs. It proposes to nearly double the Child Care Tax Credit for families making under \$85,000 and provide an additional 1.6 billion to support child care as a way of helping to offset the soaring price of child care and increase accessibility. To ease student debt, the administration proposes to cap student college loans at 10 percent of a student's income above a basic living allowance. The administration also wants to increase retirement security through several initiatives. One is to establish an automatic system for any one of the 78 million workers who do not have an employer-sponsored retirement system. The employee contributions will be voluntary and matched by the Savers Tax Credit for eligible families. Another administration initiative is to simplify and expand the Savers Tax Credit so that workers can more easily navigate the system of saving for retirement. In addition, the administration is asking for more regulations of the 401 (k) plans, the primary vehicle for workers in a private, for-profit enterprise to save for retirement.

## **Conclusions**

For the past two years, employment in the U.S. has grown at a respectable rate of 182,000 jobs per month, and the unemployment rate has fallen to 6.7 percent. However, it has taken longer to return to pre-recession employment levels than in any recovery since WWII. Although it will probably happen this year, the recession and slower-than-normal recovery have left the economy with several critical imbalances. Chief among these is the large pool of unemployed, particularly those who have been unsuccessfully looking for a job for a half year or

more. This legacy of the recession has reduced the number of skilled workers available to fill job openings and has left millions of people dependent on the nation's social safety nets. Economic growth depends upon a highly skilled workforce with the social protections of adequate health care and social insurance. The decisions Congress makes in 2014 to help correct these imbalances and shore up the nation's social safety nets may prove pivotal for putting the economy on a more solid foundation as the remaining stimulus measures lapse.