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The Job Creating Machine

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Creating new jobs is critical in an election year. If people vote with their pockets, then the job issue will decide the fate of the coming presidential election. In a jobless recovery, employment is a measure of economic prosperity, and the trump card that could decide the leadership of the nation and its future.

Solutions are elusive. Both republicans and democrats lack credible proposals. Tax cuts are the official knee-jerk response, but many fear that the economy could drown in the vast sea of red ink already created by the current $x billion deficit. The democrats have not offered a clear alternative, even though a successful strategy on jobs could be their winning card in November. Why the lack of focus?

Perhaps it is fear of the unknown. The economy has changed. We are in the midst of the first 'jobless recovery' in memory, and the first time that productivity continues to increase in a downturn. Taking a stand under these conditions could be tricky. What's the cause of the jobless recovery? Are workers being replaced by machines and technology? Or are we losing jobs to overseas workers?

Both trends are real. Technology is replacing people, and at the same time US jobs are going overseas. IT outsourcing will continue. Up to 25% of traditional IT jobs are expected to relocate from developed to developing countries by 2010.[1] India has become a leading exporter of technology services, followed by China and Russia. In addition to exporting jobs, we are replacing people by machines at a record rate. In reality the service sector is no longer a bastion of human labor. Many services are now provided by lower cost machines, or by lower cost overseas workers. Anyone who calls their bank or their telephone company, who books a hotel, a train trip or an airline ticket, knows that voice - driven and web – based systems have become the rule, not the exception. Some of the voices we hear could be Chinese.

The loss of jobs has decelerated in the last nine months.[2] However, in a dynamic economy the creation of jobs is at least as important as their loss. When the economy shifts gears old jobs are lost, and new ones are created. The new jobs are often better than the old. What matters at the end is a positive jobs balance.

Outsourcing and new technology not only destroy jobs — they can also create opportunities for new jobs. Each in a different time scale: New jobs are created as

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[1] According to the IT consultancy Gartner, Financial Times, International Economy section, "Outsourcing of IT jobs predicted to continue", p. 6, March 17, 2004.

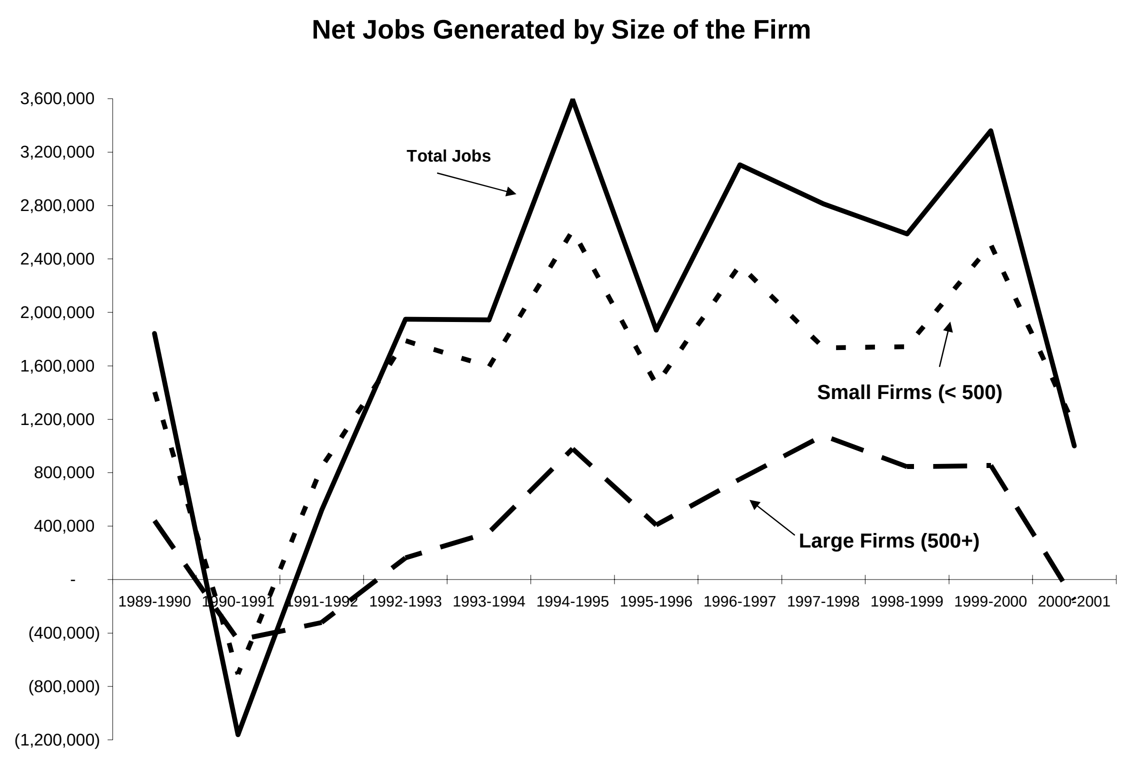
[2] According to Guy de Jonquieres "Job Loss pessimists should not blame offshoring". Financial Times, March 12, 2004, p. 15.

technology leads to new products and services –electronic entertainment, i-pods, intelligent homes, and the creation and management of new firms. Outsourcing could also be viewed as an opportunity for new jobs, because it can lead to more US exports to overseas customers who demand more of our products. We need to start thinking of foreigners as customers, and not just as competitors. Many technology firms in the export oriented economy of Oregon – where outsourcing is rampant — regard Asian people as customers as much as competitors. The bottom line is that new technology can create jobs today, while outsourcing can create them tomorrow. We need both.

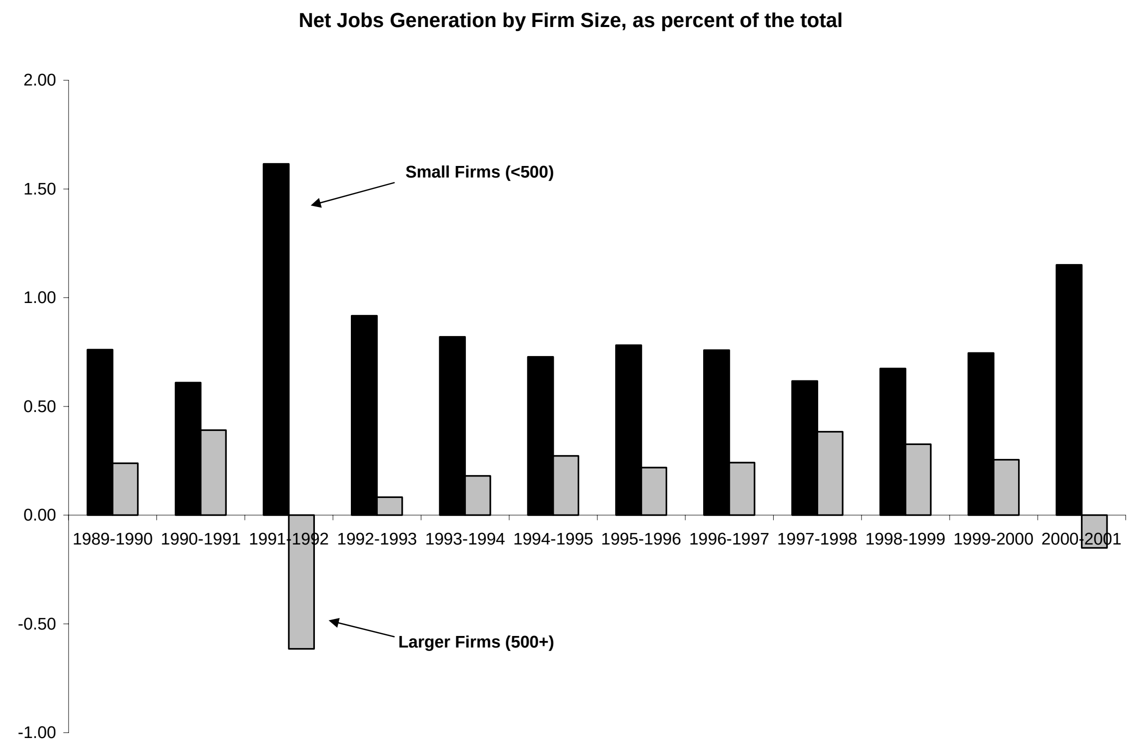
How to create jobs today? There is an emerging consensus that smaller firms account disproportionately for the creation of new jobs. About 50% of all workers work in small firms with fewer than 500 employees, but over the 1991-2001 period 60-80% of all jobs were created in the small firms (see picture below)[3].

Large firms on the other hand are responsible for most job losses. Most of the jobs lost in the last 10 years came from large firms shedding employees. Our dynamic economy creates new jobs in smaller firms, and sheds old jobs in larger firms.

The handwriting is on the wall. The US is becoming a conglomerate of dynamic small firms that create new jobs for the knowledge economy.



[3] Office of Advocacy, U.S. Small Business Administration, from data provided by the U.S. Bureau of the Census, Statistics of U.S. Business.



Will the US lose its historical advantage in mass production? Not quite. New findings show that in the knowledge economy, it is the size of the industry that matters, not the size of the firm. Small firms have external economies of scale – derived from the diffusion of knowledge in a large industry where workers move rapidly from firm to firm – remember the expression that 'in Silicon Valley people change their jobs more often than they change their parking lots'.

Economists increasingly agree that small firms are the closest thing we have to a 'job creating machine.' Small firms are the best source of newly created jobs. There is however no consensus among economists on how to activate this 'job creation machine'. I propose three ways.

Small firms are viewed as risky. As a result they have limited access to funds, face higher costs of capital, and have less access to top talent. Overcoming these obstacles is what will create most new jobs. My proposal is to decrease the risks faced by small firms.

Specific financial policies can be designed for this purpose. One is to aggregate the equity of smaller firms into 'bundles' that have a lower risk profile due to the 'law of large numbers'. By securitizing these bundles they can be sold in financial institutions – such as stock exchanges -- with access to global capital markets. The result is a much larger pool of funds for smaller firms, and lower cost of capital.

A second proposal is to create credit - enhancement instruments that facilitate the smaller firms' access to capital. A third proposal is to provide access to better borrowing rates for smaller firms by creating large baskets of equity across firms which offer less risk due to diversification – much like Freddie Mae has done successfully in the lower income home mortgage market. Instead of home equity, in this case the assets that back the securities would be the equity in the firms themselves, aggregated throughout many firms in order to reduce risk.

Lower income homeownership has provided a solid economic foundation to the American dream. Recently it helped diffused the benefits of lower interest rates. Our economy stands to gain as much from providing financial support to the smaller business as it has gained by supporting the small homeowner. This would unleash the market power of smaller firms, and facilitate the workings of our 'job creation machine.'