

Unemployment and Stimulus

By BRIAN S. WESBURY

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The strangest thing happened on Friday. It was reported that the U.S. economy lost 600,000 jobs in January and the unemployment rate jumped to 7.6%, but the stock market rallied anyway. Partly, this was because the stock market is a forward-looking indicator and employment is a backward-looking indicator. If the economy is near a turning point, the stock market will reflect it well before the employment report.

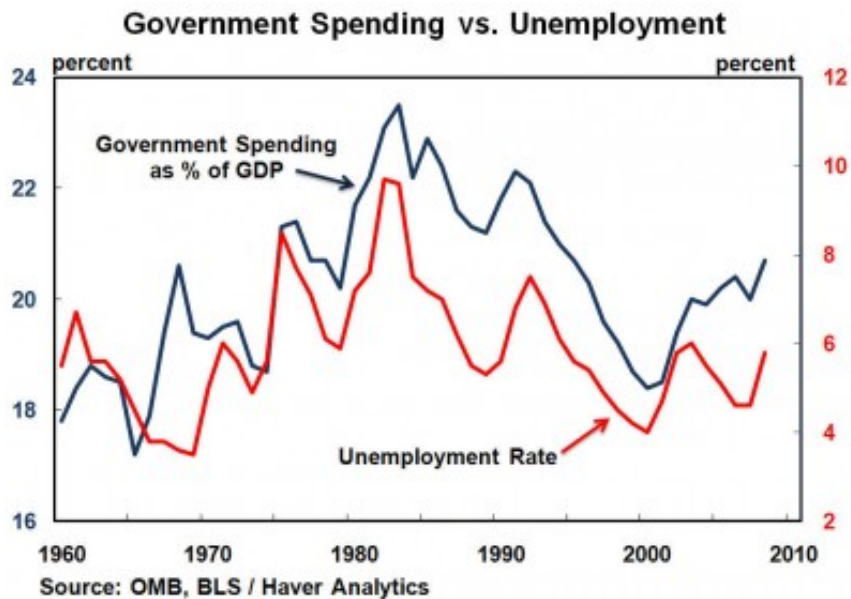
But there is another explanation -- one that is believed by most of the journalistic punditry -- and that is that a bad employment report makes a stimulus package more likely. As Christina Romer (Chairwoman of the President's Council of Economic Advisors) said on Friday, "these numbers...reinforce the need for bold fiscal action." What's interesting about this is that there is absolutely no long-term economic evidence that higher government spending creates jobs.

Academic economists will debate this until the end of time, but because they have their eyes glued to the computer screen, calculating multipliers (whether a dollar of government spending means more than a dollar of growth for the economy), they rarely look out the window. So let's do it for them. The chart below compares the

unemployment rate back to 1960 with federal government spending as a share of GDP.

Clearly, the chart shows that more government spending does not create jobs. In fact, it is exactly the opposite. More government spending is correlated with higher levels of unemployment. In 1965, federal government spending was 17.2% of GDP and the unemployment rate was 4%. By 1982, spending had increased to 23.1% of GDP and unemployment

And this is a very interesting development. During the quarter-century after 1982, when government spending was shrinking as a share of GDP and tax rates were cut, the unemployment rate experienced lower peaks and lower troughs during each business cycle. This was the opposite of the 1960s and 1970s, when government was growing and tax rates were rising. Then, each peak and each trough in the unemployment rate was higher in each successive business cycle.



had climbed to almost 11%.

Government spending then fell from its early-1980s peak back to a new low of 18.4% of GDP in 2000, and the unemployment rate fell back to a low of 3.8% in 2000. Lately, due mostly to the profligate spending of the Bush Administration, government spending has increased to 20.7% of GDP. And guess what, the unemployment rate is up, not down. In fact, for the first time in over 25 years, the unemployment rate is higher today than it was at its peak during the last recession.

The reality is that every dollar the federal government spends must be borrowed or taxed from the private sector. And the more resources the government usurps from the private sector, the less job creation occurs.

It is also true that most government spending is less efficient than private sector spending. While there may be a few areas that government spending makes sense -- let's say defense or some R&D -- the vast majority of government spending has nothing to do with creating new wealth. It often competes against the private sector -- the postal service and Amtrak -- and much of it is pure re-distribution.

So, this raises a serious question. Why is the government trying the same old spending stimulus that the evidence clearly shows does not work? President Carter spent

billions of dollars on alternative energy plans, but unemployment rose anyway. If the U.S. and the new administration are serious about "change" and "getting rid of the old ways of doing things," why not try something truly new?

With nearly \$1 trillion dollars to spend, the government could do some astounding and positive things. The U.S. could rewrite its tax code and move to a flat tax that would make the U.S. much more competitive in the global economy. Or, we could rethink and rework the entire entitlement system, so that it wouldn't eat our budget and economy alive like Pac-Man in the next few decades. Charles Murray, in his 2006

book, *In Our Hands*, laid out a plan to give every American over 21 years old \$10,000 per year for life in exchange for giving up Social Security, Medicare and every other welfare state program.

We can see the problems that the welfare state is causing in just about every other major industrial country around the world that is ahead of the U.S. on the demographic aging scale. Why not change our course right now and implement true change so that we don't end up like Japan or much of Western Europe? It's a shame that the U.S. is not thinking along these lines.

Yes, the political pressures of a rising unemployment rate make it difficult for politicians to think or plan for the

long-term. But the U.S. has a historic opportunity today and there is still time to change course. Let's deal with the immediate banking problems by getting rid of mark-to-market accounting and creating a bad bank or whatever, but let's use our trillion dollar opportunity to make real changes that will provide a stronger economy for generations to come. Spending in the same old way as we have tried so many times in the past is a recipe for higher unemployment in future years, not lower.

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