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First Trust

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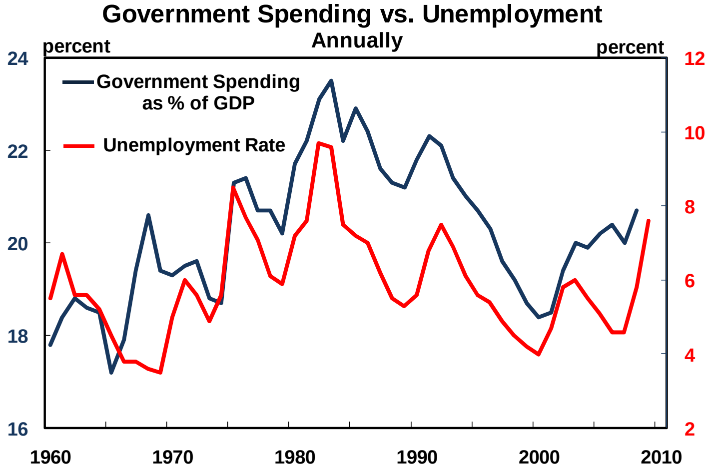
Economic Commentary

Unemployment and Stimulus II

Last week we published a piece in The American Spectator (link here), which argued that government stimulus did not create jobs. In fact, as the following chart shows, as government spending as a share of GDP increased between the 1960s and early 1980s the unemployment rate increased.

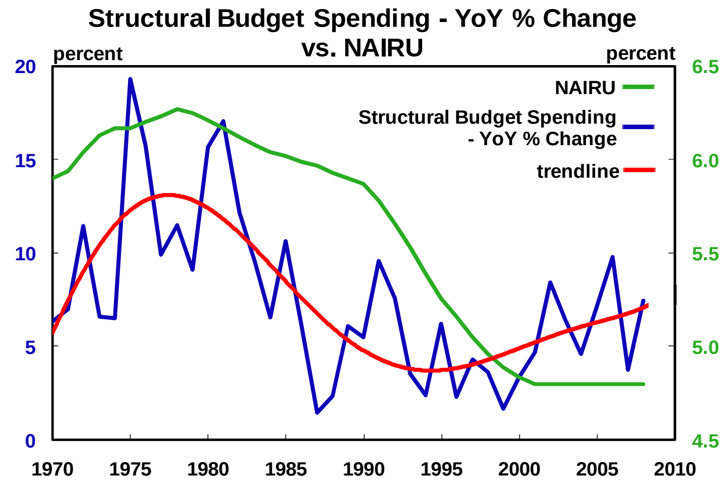


Source: OMB, BLS / Haver Analytics

This is exactly the opposite argument we are hearing these days about the stimulus bill. But, the Keynesian theory that increases in government spending creates jobs is just not observable in the historical data. Nonetheless, we have received a number of comments on our analysis and it is important to address those issues directly.

1) Some have argued that the above chart is biased because it is unemployment that drives government spending, not the other way around. This argument, correctly, suggests that government spending (for unemployment benefits, welfare, food stamps, etc.) goes up in a recession. Therefore, the positive correlation between government spending and unemployment is driven by unemployment, not government spending.
2) Some pointed out that there are always many other things going on in the economy, such as Fed policy, tax policy and regulations. The point here is that if the government is spending, but monetary policy is tight, then we may not see unemployment fall.
3) Finally, some argue that there are both cyclical and structural issues taking place at all times. They suggest that not adjusting for these factors biases the results. In other words, we should back out of the data any factor that is cyclical (either recession or bubble), so that we can look at underlying trends.

There is truth in each and every one of these arguments. So, we are publishing a second chart which handles each of these issues directly by comparing the Congressional Budget Office's (CBO) estimates of the NAIRU (The Non-Accelerating Inflation Rate of Unemployment) and the change in Structural Federal Government Spending. This is a comparison of the natural rate of unemployment and the annual change in non-cyclical, or the underlying level of, government spending.



Source:CBO, Haver Analytics

If government spending created jobs, we should see an increase in structural federal spending leading to a drop in the natural rate of unemployment. Clearly, this is not the case. The polynomial trendline (basically a moving average) of annual changes in government spending is positively correlated to the unemployment rate.

In fact, the chart suggests that the increase in structural spending put in place by President Bush may have already increased NAIRU even though the CBO has not yet identified it. Government spending does not create jobs and therefore the stimulus package, to the extent it lifts structural patterns of government spending, will not do what many in government are suggesting it will.

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