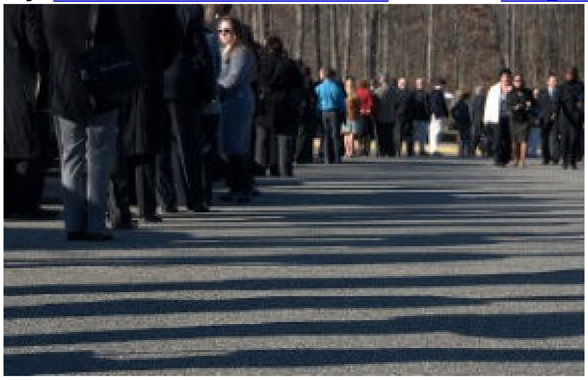
Stimulus needed: How to create jobs

by Bruce P. Rittenhouse in the August 22, 2012 issue



Applicants wait in line at a federal job fair in Stafford, Virginia. Attribution by Senator Mark Warner.

Millions of people remain unemployed in the wake of the recession. Among workers age 25 to 54, the U.S. economy has restored less than one fifth of the jobs lost during the recession of 2007–2009. Long-term unemployed and discouraged workers now make up 5 percent of the U.S. workforce. Long-term unemployed people who are 50 or older have a less than one in ten chance of finding work in the next three months. The longer they remain unemployed the less likely they will ever be employed again.

The employment situation in the United States is a human crisis. Unemployed people face the stigma of unemployment and the erosion of job skills in addition to loss of income. And unemployment affects almost every part of the population. Older workers are being forced into early retirement for which they do not have adequate financial resources or health insurance. People unemployed mid-career see death rates increase by 10 to 15 percent and divorce rates by 13 to 18 percent. Minor children of parents who lose jobs suffer a 9 percent reduction in their future earnings. Young workers either remain unemployed or accept lower-level jobs and lower wages, indefinitely delaying household formation, marriage and childbearing. Those who graduate from college during a period of low employment can expect a permanent 1 to 20 percent reduction in earnings.

These statistics should be a wake-up call. But the Obama administration, Congress and the Federal Reserve have all responded largely as though unemployment is solely the responsibility of the unemployed. Earlier this year, Congress reduced extended unemployment benefits from 99 to 79 weeks. The chairman of Obama's Council of Economic Advisers, Alan Krueger, even went so far as to suggest that high unemployment figures were the result of unemployment benefits. Despite an endless supply of rhetoric about jobs, all levels of the federal government have moved slowly or not at all to bring about actual changes in monetary and fiscal policies that would stimulate the economy.

In fact, there are tools available to policy makers in this situation. Not all government spending qualifies as fiscal stimulus. It has to meet four criteria to be effective in stimulating domestic economic growth. First, the spending should be on domestic wages, not capital goods or foreign goods and services. Second, those employed by a stimulus program should be people who will spend the money on consumption, not save or invest it. A higher share of income is spent by those with lower and middle incomes than by those with higher incomes. Third, the spending should be deficit financed. Raising taxes or cutting other spending at the same time as the new spending counteracts the stimulus effect of the new spending. Fourth, the spending should be countercyclical. That is, it should continue only as long as the economy remains significantly below a full-employment level of economic output.

One example of an effective fiscal stimulus would be for the federal government to give grants to the states to provide funds to municipalities to hire teachers, police officers and firefighters. This would directly target domestic employment among persons who will spend most of their wages on consumption. Many of these municipal employees were laid off to balance budgets during the recession and have been forced to defer household expenses. This program would be deficit financed and conditioned on employment remaining depressed. That is, it should be phased out on a state-by-state basis when the state unemployment rate drops below a reference level of 6 or 6.5 percent.

Another step could be taken by the Federal Reserve, which has already lowered short-term interest rates to near zero. It could provide additional monetary stimulus by resuming its "quantitative easing" program. Quantitative easing is the technique by which the Federal Reserve purchases long-term bonds and adds them to the Federal Reserve's balance sheet, thereby lowering long-term interest rates and increasing the money supply. This would free up credit for businesses to hire workers.

Most mainstream economists on both sides of the political spectrum agree that some federal stimulus would be helpful. The most plausible argument against these kinds of expansionary policies is that they threaten price stability. Price stability is a part of economic policy that isn't well understood, especially in relation to job growth. Governments that overstimulate their economies can cause inflation, and the price of their bonds can collapse from fears of this overspending. The price of government bonds can also be undermined by a decline in the value of a nation's currency or by the perceived risk that a government could default on its loans. When bond prices fall, interest rates rise. This increases the cost of private and public borrowing and the cost of servicing existing debts, both of which act to restrict growth. Thus, policy makers should be careful not to promote growth in a way that undermines price stability because this will ultimately be counterproductive.

Such is the argument—in a vastly simplified form—that is most often made against a stimulus by the Republicans in Congress. Debt could prove destabilizing. At the same time, this argument ignores a key fact: our economy has reached what economists consider an equilibrium far below full employment. We need faster economic growth to address the unemployment crisis directly. Faster growth means higher employment, wages and business earnings. We can promote additional growth without undermining price stability and raising the cost of borrowing.

Fear of inflation is vastly overstated now. When there are tens of millions of unemployed, underemployed and discouraged workers available to fill jobs, workers cannot negotiate wage increases that could produce inflation. With poor economic conditions in Japan and Europe, expansionary policies are unlikely to produce a substantial decline in the value of the dollar. The bond markets currently judge the default risk of U.S. bonds to be extremely low. Long-term interest rates are at record lows. In fact, the only concern that rating agencies have expressed with U.S. bonds relates to the political risk, revealed during last year's ill-considered budget brinksmanship.

Balanced-budget conservatives argue that deficit spending will risk inflation and eventual default, but they have little evidence to back that up. The major economic contraction that we've experienced means that our economy differs qualitatively from the postwar U.S. economy in which full-employment could be assumed. Inflation fears don't take this qualitative difference into account. Historically, recessions following banking crises have taken an average of nearly five years to return to prerecession employment levels, but the current recovery is going to take far longer. Meanwhile, Greece, Ireland and Spain are demonstrating what austerity measures do during a widespread economic downturn: they make bill paying less likely and default more likely. Deficits actually grow.

The economics of these trade-offs are complex, but the moral imperative is clear. The government needs to adopt more expansionary monetary and fiscal policies. Whenever it is possible to promote growth and raise employment and wages without significantly undermining price stability, we must do so. This is the most basic Christian moral imperative to serve the well-being of our neighbors in need. Our nation does not lack the means to address this situation; we lack the will. Collectively, our elected representatives are showing an unconscionable complacency toward the human suffering caused by the current economy.