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THE DEBT OVERHANG AND THE U.S. JOBS MALAISE

A House Budget Committee report demonstrating that economic hardships have been made worse by Washington's misguided interventions and the lack of a credible plan to lift the crushing debt burden.

July 7, 2011

Nothing is more critical to today's economy than restoring real job and business growth. Yet for almost three years, the U.S. economy has remained mired in a slow-growth, high-unemployment trap. The so-called "recovery" feels more like a malaise than a rebound. The incoming data in recent weeks paint a disappointing picture: job growth slowed dramatically in May while the unemployment rate ticked back up to 9.1 percent, consumer and business confidence has slipped, and the overall economy is on pace to register growth of less than 2 percent for the second consecutive quarter. That is dangerously close to the stall speed for an economy, prompting some analysts to warn that this temporary "soft patch" could turn into a renewed downturn.

The obvious question remains: "what is holding the economy back?" The truth is that there is more than one negative force at play. Some experts make the general point that recoveries from a financial crisis can be long and sluggish – more so than a "typical" recession – due to the painful deleveraging process that occurs in its wake. In addition, the U.S. housing market, itself the epicenter of the crisis is moribund, clogging one of the main channels of recovery from an economic downturn (i.e. residential investment, and related purchases, in response to lower interest rates). But another hallmark of this recession – the enormous build-up of government debt that hastened the unsustainable course of U.S. Federal finances – has emerged as one of the main factors weighing down the economy.

During the recession and its aftermath, the government took a variety of measures to try to boost economic activity. These various interventions – which ranged from direct government spending, to "cash-for clunkers" deals, to the new homebuyer tax credit – sought to provide short-term "pops" in economic activity, but failed to deliver sustained economic growth and job creation.

The Keynesian playbook has not only been exhausted, its results have been discredited. The Keynesian economic policy hinges on the notion that the potential short-term benefit to economic activity from debt-financed government spending can outweigh the longer-term cost of higher government debt. Keynes famously discounted these costs by remarking that "in the long run, we are all dead." There is a point, however, where the build-up in debt is so large that these longer-term fiscal concerns start to bleed into the present, impacting short-term economic activity. The extreme example is a sudden, full-blown debt crisis like the one that Greece is now experiencing. But there is also a more subtle stagnation that can grip a debt-burdened economy – it's a crisis of uncertainty and waning confidence in policymakers' willingness to deal with the government's unsustainable fiscal trajectory. Investors and businesses make decisions on a forward-looking basis. They know that today's large debt levels are simply tomorrow's tax hikes, interest rate increases, or inflation – and they act accordingly.

It is this debt overhang, and the uncertainty it generates, that is weighing on U.S. growth, investment and job creation today.

Prominent economists argue that the key to jump-starting U.S. economic growth and job creation is tangible action to rein in the growth of government spending with the aim of getting debt under control. Stanford University economists George Shultz and John Taylor, along with Nobel laureate Gary Becker of the University of Chicago, wrote recently: *"Credible actions that reduce the rapid growth of federal spending and debt will raise economic growth and lower the unemployment rate. Higher private investment, not more government purchases, is the surest way to increase prosperity."*[1] They make the case that such a plan would be an economic "game-changer." There is a contrasting opinion, however, that reducing government spending could be damaging to growth and job creation over the short term. Economists like Taylor counter this view with economic data, showing that lower government spending is not, in fact, associated with a higher rate of unemployment. Over the past 20 years, lower levels of government spending are associated with lower unemployment levels (see Chart 1).

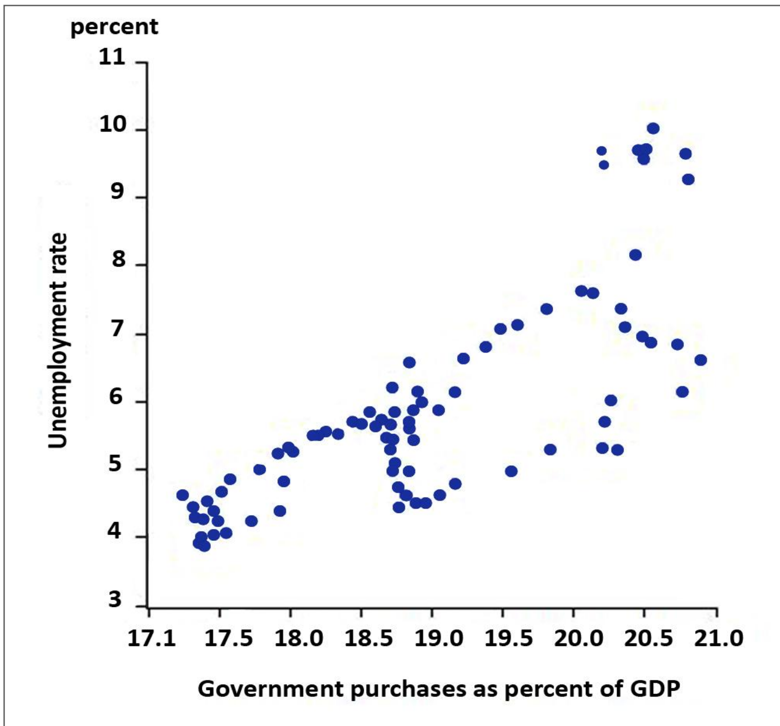

Chart 1 – Source: BLS and BEA
[Taylor, John. "Higher Investment Best Way to Reduce Unemployment, Recent Experience Shows," Economics One, 1/14/2011]

It turns out that the key economic variable that correlates remarkably well with unemployment is private investment. When investment as a share of the economy is high, unemployment tends to be low. When investment drops, as it has in the wake of the recent recession, unemployment tends to be high (see Chart 2). Taylor's view is that the economic data tell us that the government needs to encourage private investment, rather than keep its own spending high, in order to encourage job growth. He believes that vast uncertainty, linked to the prospect of higher future tax rates and interest rates, is having a chilling effect on private investment and therefore job creation.

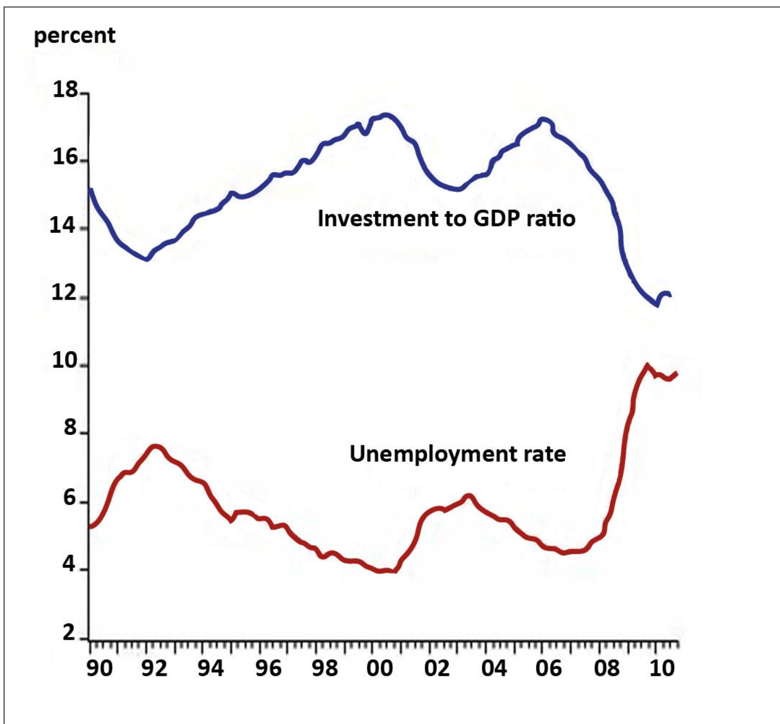

Chart 2 – Source: BLS and BEA
[Taylor, John. "Higher Investment Best Way to Reduce Unemployment, Recent Experience Shows," Economics One, 1/14/2011]

Reducing government spending now would "reduce the threats of higher taxes, higher interest rates and a fiscal crisis," and would therefore provide an immediate stimulus to the economy.[2] Fed Chairman Ben Bernanke echoed a similar sentiment in a recent speech, saying that putting in place a credible plan to reduce future deficits "would not only enhance economic performance in the long run, *but could*

[1] Becker, Gary, George Schultz, and John Taylor, "Time for a Budget Game-Changer", *Wall Street Journal*, April 4, 2011
http://online.wsj.com/article/SB10001424052748704471904576231010618488684.html

[2] *The Wall Street Journal*, "Time for a Budget Game-Changer," April 4, 2011

also yield near-term benefits by leading to lower long-term interest rates and increased consumer and business confidence."[3]

The issue of quantifying just how much uncertainty about future conditions might be impacting current business decisions and confidence levels is notoriously difficult, but not impossible. Former Fed Chairman Alan Greenspan conducted an econometric study earlier this year that aimed to quantify how much government policy uncertainty was impacting reported levels of business investment. Greenspan focused his attention on corporate illiquid long-term fixed asset investment (i.e. capital expenditures). As a percentage of corporate cash flow, these investment expenditures have recently fallen to their lowest level since 1940.

Greenspan's thesis was that a surge in government activism on a variety of fronts since the 2008 financial crisis, and the uncertainty it generated, was contributing to these low investment levels and "disappointingly tepid" growth and job creation. His study found that roughly half, to as much as three-quarters, of these depressed investment levels were due to "vastly greater uncertainties embedded in the competitive, regulatory and financial environments faced by businesses since the collapse of Lehman Brothers, deriving from the surge in government activism."[4] Greenspan argues that the government's continued efforts to boost, as well as guide, economic activity are actually hampering what should be a broad-based and robust recovery. This conclusion implies that curbing government spending would lift some of the uncertainty about the future now gripping private businesses and would lead to more expansion and job creation.

The links among debt, uncertainty and sluggish job growth are also readily apparent in anecdotal reports and business surveys. The NFIB Small Business Optimism Index declined for the third consecutive month in June as business owners ratcheted down hiring plans. Sentiment among small businesses is important because they account for roughly two-thirds of job creation in the U.S.

NFIB chief economist Bill Dunkelberg recently explained his view of the jobs malaise: "Washington is throwing misdirected policies at the problem, offering tax breaks for hiring and equipment investment, but acting surprised when they don't bear any fruit. The failure to understand why small-business owners are not hiring or investing has resulted in a set of policies that have not been very effective, and Main Street is suffering. The icing on the cake: the growing debt, large deficits, threats of higher taxes, regulations…and the uncertainty of the new health care law – is it any wonder that optimism is down?"[5]

These reports show that job creators do not see higher government spending and larger debt levels as some sort of "free lunch." Rising debt levels are tomorrow's tax increases or interest rate hikes, which adversely impacts hiring decisions today[6]. As debt levels continue to rise, businesses will think twice about hiring or buying new equipment because government will tax the returns on these investments at much higher rates. The result of such economic uncertainty is often a hiring freeze and delayed expansion plans.

It is clear that if policymakers are serious about encouraging robust job creation, they need to chart a more sustainable fiscal course. However, adherents of traditional Keynesian economics claim that immediate government spending reductions will likely lower demand and hamper short-term economic activity and job growth. This view assumes that a high level of government spending is one of the key props holding up the economy. It is far more likely that this level of government spending, and the record debt levels it has produced, is what is *weighing* on growth and job creation. A move to lower that spending could boost market confidence and lessen uncertainty, leading to a spark in expansion and job-creating investments.[7]

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[3] Bernanke Speech at CRFB Conference "Fiscal Accountability," June 14, 2011 (emphasis added)
[4] Greenspan, Alan. "Activism," International Finance 2011, March 4, 2011
[5] NFIB's Small Business Economic Trends, June 2011
[6] Economists refer to this as "Ricardian Equivalence."
[7] In some sense, this is the Ricardian rebuttal to traditional Keynesian economics.

At a recent Ways and Means Committee hearing on Impediments to Job Creation, American Enterprise Institute economist Andrew Biggs summarized this view: "Many economists now agree that these negative Keynesian effects can be partially or fully offset *if a large and credible fiscal consolidation generates confidence that more disruptive steps have been avoided down the road. Individuals, businesses or markets may quickly become more willing to spend, to invest or to lend if short-term steps avert a long-term crisis*."[8] In other words, a move to rein in government spending would likely lead to more, not less, economic activity and job creation.

The Path to Prosperity

In the face of annual deficits in excess of $1 trillion, a $14 trillion national debt, and tens of trillions of dollars in unfunded liabilities burdening our economy, it is incumbent upon leaders to offer solutions that address the fiscal imbalance, proving greater certainty for job creation and economic growth.

Exhausting the Keynesian playbook, the President's Fiscal Year 2012 budget calls for more deficit spending, imposes higher tax rates, and fails to chart a sustainable fiscal path. While the President failed to offer a budget that deals with the challenges before us, Senate Democrats have failed to pass *any* budget for the past 80X days.

In sharp contrast, the U.S. House of Representatives passed a budget resolution earlier this year that puts the budget on a path to balance and the economy on the path to prosperity. By clearing the debt's shadow of uncertainty and advancing pro-growth reforms, the House-passed budget fosters a better environment for private-sector job creation.

Many economists contend that the policy path outlined in the House-passed FY2012 budget resolution provides the critical ingredients for economic growth. Stanford economist John Taylor wrote: *"[T]he House budget plan… approximately balances the budget with no increase in taxes. This is good news for economic growth."*[9]

Washington's focus remains on the arbitrary debt ceiling threshold, with warnings of calamity and economic pain if Congress fails to allow the Treasury Department to borrow more money to finance higher government spending. President Obama has asked Congress to raise the statutory debt ceiling, and Congress is working to ensure that any increase in the debt ceiling is accompanied by serious spending cuts and controls.

This debt ceiling debate should not be confused with the bigger debt challenge before us. Americans are already experiencing sharp economic hardships as a result of the current debt overhang, and an unprecedented economic calamity remains on the horizon if the debt continues to spiral out of control.

Job and wage growth must be today's highest priority. To ensure a prosperous future for the next generation, it is incumbent on policymakers to chart a fiscally-sustainable course.

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[8] Biggs, Andrew. Statement at Ways and Means Hearing, March 30, 2011 (emphasis added)

[9] Taylor, John, "Obama's Permanent Spending Binge," *Wall Street Journal*, April 22, 2011. http://online.wsj.com/article/SB10001424052748704071704576276584062512382.html