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RELIEF FOR STATES AND STRUGGLING FAMILIES PROVIDES SUBSTANTIAL BOOST TO EMPLOYMENT

By Chad Stone

The economy is in a very deep hole and faces a long climb back to full employment. Policymakers can make that climb easier by extending or bolstering key provisions of the American Recovery and Reinvestment Act (ARRA) enacted at the start of the year — particularly those related to unemployment insurance and state fiscal relief, whose scheduled expiration would otherwise exert a job-killing drag on the economy. Unfortunately, it is all too easy for policymakers and pundits to overlook the critical importance of these policies in boosting employment because these policies also serve other purposes and because the jobs that would not be there without them cannot be readily identified through surveys or other direct means.

Policies That Boost Employment in a Weak Economy

The economy is in a deep hole right now because there is not enough demand for the goods and services that businesses already have the capacity to produce. To stop the destruction of jobs and begin to put people back to work, it is critical to stimulate the demand for goods and services. Businesses that face stronger demand for their products are more apt both to hire and to retain employees and to maintain or increase orders from their suppliers. The initial boost in spending thus gets multiplied through the economy.

Financial Relief for Those Struggling to Make Ends Meet

One of the best ways to boost demand and hence employment is to target financial relief on low- and moderate-income individuals and unemployed workers who need a replacement for lost income. People whose income is disrupted in a recession and who lack the savings to tide them over and maintain their normal consumption, and people whose incomes are so low to start with that they have difficulty making ends meet, are the people most likely to spend quickly any added income they receive.

Understandably, lawmakers think of policies like a temporary increase in food stamp or unemployment benefits first and foremost as policies that relieve distress for the individuals receiving them and for their families. But these are also policies that score highest in “bang-for-the-buck" calculations of their economic impact as stimulus. The money gets spent fast, and its effects then spread through the economy. As a result of such policies, local retailers are less apt to lay off workers and cut back on orders from their suppliers during a downturn; and in the early stages of a recovery, they are more apt to hire additional workers and step up their orders from suppliers.

These job-preserving and job-creating effects are powerful, but their impact is diffuse through the economy and it is impossible to report on and count up specific jobs that would not be there without these policies. That diffuseness, however, should not lead lawmakers to devalue the importance of policies that help struggling families when they look for ways to boost employment. Helping struggling families isn't an *alternative* to preserving and creating jobs; it's one of the *most effective ways* to preserve and create jobs and should be a prime focus of any job-creation package. That is why it is so important that the unemployment insurance (UI) provisions in ARRA that are scheduled to expire at the end of this year be renewed so that they continue to provide a boost to demand and job creation in 2010.

Fiscal Relief for States

The employment-boosting effects of fiscal relief measures for cash-strapped states are similarly underappreciated or misunderstood. Faced with an unprecedented decline in revenues in this recession, states have been forced to implement deep and broad cutbacks in education, health care, and most other areas of state expenditures. The cuts have affected vulnerable children, seniors, and people with disabilities, among others. The role of federal assistance in avoiding even more draconian cuts has been important in protecting valuable state and local government services, but it has also provided an important boost to employment.

Unlike the federal government, states have balanced-budget requirements for their operating budgets. As budget deficits begin to emerge in a recession, states must take actions to cut existing programs or raise new revenues. Those actions translate into layoffs of state workers, cancellation of contracts with vendors, and a diminished response to the hardship that beneficiaries of safety-net programs experience. Those effects reverberate through the economy, adding to the job losses and further weakening economic activity. Federal fiscal assistance to states makes these job losses smaller than they otherwise would be.

One of the main provisions for providing fiscal relief to states is a temporary increase in the Federal Medical Assistance Percentage (FMAP), which increases the share of state Medicaid expenses that the federal government pays. Some critics may have this in mind when they describe this as increasing entitlement spending rather than providing "real" stimulus. But that criticism is misplaced and reflects a misunderstanding of how the provision works. By temporarily assuming more of the cost of Medicaid, the federal government allows states to continue to meet their Medicaid obligations without cutting other programs more deeply, avoiding the job losses and other adverse economic effects that would entail.

States continue to face a serious fiscal problem that will force them to institute additional deep budget cuts and tax increases in 2010. The federal assistance that states receive for their Medicaid programs under this year's economic recovery legislation is scheduled to end with a "cliff" on December 31, 2010, and the assistance states received for education and other services also will be largely exhausted by then. Although that date is more than a year away, the problem is coming to a head now. That's because states — which continue to face huge budget shortfalls that they must close — will be developing and adopting budgets in coming months for state fiscal year 2011, which starts on July 1, 2010 in most states. We estimate that states will have to find ways to close a gap of $180 billion between expected revenues and expected outlays in those budgets, and federal fiscal assistance will run out part way into the year.[1] By taking action now to extend ARRA assistance to states into 2011, lawmakers can reduce the drag that very large state budget cuts and tax increases would otherwise impose on economic activity and jobs and thereby give the recovery a better chance of gathering strength.

Jobs Impact Is Substantial But Diffuse

Properly understood, the bulk of the provisions in the recovery legislation enacted earlier this year contribute to job creation and preservation, but not all of them contribute to *readily identifiable* job creation and preservation. In the case of financial relief for states or hard-pressed households, it is not meaningful to try to trace a link between specific measures and specific jobs created or saved. Money that is spent by food stamp or unemployment insurance recipients, by state employees who keep their jobs because of state fiscal relief, or by employees of firms doing business with the state who keep their jobs for the same reason similarly creates additional demand for a wide variety of goods and services that preserves and creates jobs broadly through the economy. None of these jobs will be reflected, however, in surveys of recipients of government funds. The need to rely on statistical techniques to estimate the jobs impact of these measures does not mean they are any less effective at job creation than measures that are more amenable to direct measurement. What matters is how effective a measure is at stimulating new demand for goods and services that encourages employers to hire more workers or retain workers whom they would otherwise let go.

Other Policies May Not Be as Timely or Effective

Measures like temporary increases in UI and food stamp benefits and fiscal relief for states are among the quickest-acting and most potent measures for boosting aggregate demand and creating jobs. A variety of other measures are not as quick-acting and/or not as effective.

Infrastructure investment, for example, can be nearly as effective as the measures discussed in this paper once the money starts to flow, but it often takes time for the money to start flowing. Criticism of the infrastructure provisions in ARRA for taking too long to take effect was misplaced, because the economy was expected to remain weak into 2010 when the bulk of the infrastructure spending was expected to take place. With the economy still weak, infrastructure investments can still be helpful even if it takes time for the money to spend out, but they will not be as fast-acting as UI, food stamps, or state fiscal relief, which can be equally effective at boosting employment.

Tax cuts for individuals are only effective to the extent that they stimulate new demand for goods and services. Targeted, refundable tax cuts like the Making Work Pay tax cuts in ARRA have far more bang-for-the-buck than cuts in marginal income tax rates because a higher proportion of the benefit goes to low- and moderate-income taxpayers who will spend a high proportion of any additional after-tax income. Tax cuts for higher-income individuals, by contrast, are less effective at

[1] Elizabeth McNichol and Nicholas Johnson, "Recession Continues to Batter State Budgets; State Responses Could Slow Recovery," Center on Budget and Policy Priorities, updated November 19, 2009.

boosting aggregate demand and employment in a weak economy because those individuals save rather than spend a much larger fraction of any increase in after-tax income they receive. Such saving does not provide the needed boost to aggregate demand and employment.[2]

Tax cuts for businesses are generally ineffective at boosting employment because the primary problem employers face in a recession is a shortage of demand for their products, not a shortage of cash. In a recession, most firms would likely keep much or all of any tax windfall they receive — or pass it on to shareholders and business owners, two groups that tend to have higher incomes and thus to spend relatively little of any additional income they receive in the short term. Goldman Sachs made this point in a 2007 analysis, noting that "companies don't spend money just because it's there to spend. To justify outlays for new projects, the expected returns have to exceed the costs, and that usually requires growth in demand strong enough to put pressure on existing resources."[3]

For these same reasons, firms will not hire (or retain) more workers than it takes them to produce the goods and services they can sell. Simply giving them a general tax break is unlikely to affect their hiring in most cases. Consequently, the most promising strategy for boosting business production, investment, and hiring during an economic downturn is to boost demand so that people buy more of the products that firms produce. Business tax cuts are not effective at that.

Tax cuts targeted on job creation have some advantages compared with general business tax cuts but there are serious practical difficulties in designing such measures and their net impact on job creation is uncertain. How would one identify which jobs in expanding firms were created due to a jobs tax credit and which would have been created anyway? How would one identify jobs in contracting firms that would have been lost without the credit? The temptation for firms to game the system would be huge. Proposals that take these concerns seriously acknowledge that the large majority of jobs that receive such a tax credit would have been created anyway.[4] That means that a large percentage of the money spent is a business windfall that generates little new demand, as described above.

Econometric evidence suggests that even if they experience no increase in demand for their products, some firms will respond to such a tax credit by expanding employment. The wages supported by the credit will represent a net increase in demand, and the jobs will represent a net increase in employment. In terms of bang-for-the-buck, however, there is a real question whether a targeted jobs credit is as effective as the UI/food stamp/state fiscal relief measures discussed above.

Public-sector job creation that puts people who would otherwise be unemployed to work on worthwhile public projects that would otherwise not be undertaken (perhaps repairing schools or performing needed upkeep and maintenance in public parks and recreation areas) could boost demand and create jobs simultaneously. However, if the funding for such public-sector job creation

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[2] Saving is very important for long-term growth because a strong rate of saving is necessary to finance the capital investment needed to increase the economy's capacity to produce goods and services and raise future standards of living. But in a weak economy operating well below its existing capacity, the first priority is to boost aggregate demand (spending) in order to get back to a high rate of employment and capacity utilization.

[3] GS Weekly, September 21, 2007.

[4] See Timothy J. Bartik and John H. Bishop, "The Job Creation Tax Credit," Economic Policy Institute Briefing Paper #248, October 20, 2009.

comes at the expense of funding for effective measures like aid to states or struggling households and unemployed workers, the net impact on employment could be small. In addition, it would take time to get effective public-sector employment programs in place.

Conclusion

Some of the most effective measures to boost employment in a weak economy are those that provide financial relief to people struggling to make ends meet and to states facing large budget shortfalls. The importance of these programs in boosting employment is often overlooked or deprecated in debates over the best policies to create jobs, both because these policies also serve other purposes and because the jobs that would not be there without these policies cannot easily be identified through surveys or other direct means. Other policies that may be less effective can appear more promising because they seem to produce readily identifiable jobs. Some of those other measures could have a role to play in putting together an effective job-creation legislative package that can be enacted. However, federal lawmakers should be careful not to overlook measures that help struggling states or unemployed workers out of a misguided belief that these policies are not among the most effective job-creating policies available.