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STIMULUS FUNDS: Texas Gov. Rick Perry right to question accepting unemployment money

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One of the cornerstones of good economic analysis is the realization that, in the words of my former colleague Milton Friedman, "there ain't no such thing as a free lunch."

What Friedman's quote means is simply that fiscal policy cannot create wealth, it can only redistribute wealth. For everyone who gets federal funds, there is someone who loses those funds.

Yet when it comes to federal money for the states, this fundamental truth is lost. People falsely believe that federal funds to the states actually come without costs.

People equate federal dollars to the states to supplement state unemployment insurance (UI) programs with a free meal that should be enjoyed for as long, and often, as possible. The reaction to governors who question the efficacy of the recent stimulus package — most notably Texas Gov. Rick Perry — is simply the latest example of this mistaken belief.

Every additional dollar the government spends to supplement state unemployment benefits must be removed from someone's pocket — through higher taxes today or higher borrowing today, which is the same as higher taxes tomorrow. Either way, this form of government spending crowds out private sector investment, diminishing the private economy's rate of growth. In other words, increasing this form of government spending makes citizens poorer because it takes their money now and reduces their income later.

Everyone sympathizes with the needs of those who are unemployed through no fault of their own. But increasing taxes on people who work and paying more to people who don't work will cause output to fall and the number of people who don't work to rise.

Finding the right policy balance is tough — just how much income support is appropriate? This fact is at the heart of the debate about the extent to which Texas should accept federal stimulus money.

The UI program is generally funded by state taxes levied on wages paid to employees by employers. During good times, state revenues far exceed unemployment insurance costs, and state unemployment insurance funds run a surplus.

Recessions reverse the arithmetic. During bad economic times, unemployment rates surge, and state UI costs exceed current revenues as states extend their unemployment compensation beyond the amounts contributed to the Federal Unemployment Trust Fund.

Historically, the federal government often stepped in to cover the increased costs, but with strings attached. During the last recession, for example, the federal government provided the states with additional revenues to cover holes in their unemployment compensation funds. But in order to receive these funds, the states had to loosen unemployment insurance eligibility requirements.

Following the federal revenue help between 2002 and 2004, total state unemployment tax collections — including tax collections in Texas — permanently increased in order to cover the new federal mandates. A similar experience can be expected this time once the temporary federal money runs dry in 2011.

Even proponents of making the policy changes required to be eligible for the UI stimulus funds agree that the new federal programs will increase taxes on employers' payroll — albeit in their estimate by less than $80 million per year. It is undisputed, however, that accepting more federal money now will permanently increase costs on employers of Texas later once the one-time federal funds run out.

Perhaps more importantly, the unemployment insurance supplement and more generally the whole stimulus package will lead to job losses in the Lone Star State.

In a recent research paper my firm produced for the Texas Public Policy Foundation, we illustrated how increased government spending crowds out private business activity. In the case of the federal stimulus package, the surge in federal spending is so dramatic that we estimated it would reduce private sector business output by 2.5 percent, which translates into between 131,400 and 171,900 incremental jobs lost in Texas.

Texas can't insulate itself from these impacts. Due to the unavoidable negative impact, Texas needs to carefully scrutinize all federal programs to ensure that the additional expenditures do not create even more negative effects on the Texas economy. The history of federal unemployment insurance aid leading to even greater government expenditures in the future warrants particular caution as legislators consider whether to accept these additional funds.

To ignore the collateral damage higher benefits for the unemployed and higher taxes on employers have on employment and output is just plain bad economics and bad politics. A big heart needs a clear eye and vice versa.