Testimony before the House Committee on Financial Services on

"Prospects for Employment Growth: Is Additional Stimulus Needed?"

Kevin A. Hassett

Director of Economic Policy Studies

American Enterprise Institute

February 23, 2010

The views expressed in this testimony are those of the author alone and do not necessarily represent the views of the American Enterprise Institute.

Chairman Frank, Ranking Member Bachus and members of the Committee, it is an honor to appear before you today to discuss the employment outlook and what can be done to address current challenges in the U.S. labor market. I also look forward to addressing the question of whether additional stimulus is needed to facilitate employment growth.

Your invitation asked me to specifically address four questions. Given the current state of the labor market, I must commend you for asking precisely the correct questions. In my testimony, I will address them each in turn.

1. What is your current forecast for employment growth?

Unlike my fellow panelist, Mark Zandi, I am not a professional forecaster. Indeed, given Mr. Zandi's impressive record, I would even stipulate that the best available forecast is whatever Mr. Zandi says. Instead of providing a competing forecast, I will focus my attention on the risks. Currently, the CBO and Blue Chip are both calling for the unemployment rate to hover around 10 percent throughout this year, and only drop to 9.3 to 9.5 percent in 2011.[1] These forecasts are based on the observation that employment recoveries have generally lagged behind the overall recovery.

I think the risks of such a forecast are, thankfully, on the upside.

The basic idea behind this observation is a simple one. Economist became convinced that the economy had undergone a "Great Moderation." This meant that they thought that deep recessions were a thing of the past, of course, but swings moderated under this view in both directions. It may be that rejecting the idea of a Great Moderation opens the door for the possibility of a more rapid recovery.

It may be that the employment recoveries that followed more severe recessions would be a better guide in this episode, specifically, what happened at the ends of the recessions in 1975 and 1982. In those cases, the first decline in the unemployment rate signaled the good news that a sustained jobs recovery had begun.

In 1975, the unemployment rate peaked two months after the end of the recession at 9 percent, and then began a steady decline that lasted almost five years. In 1982, the unemployment rate peaked at 10.8 percent one month after the end of the recession, and plummeted from there at a rate of about 1.5 percentage points per year. Those two recessions are the only ones since World War II that rival the current one in severity.

[1] "The Budget and Economic Outlook: Fiscal Years 2010 to 2020." Congressional Budget Office. January, 2010. Available at http://www.cbo.gov/ftpdocs/108xx/doc10871/01-26-Outlook.pdf.

Even looking beyond those two, it is interesting to note that unemployment does appear to have turned the corner. One way to look at how employment can be expected to recover is to examine the historical trend once employment stabilized in the aftermath of recessions. We have not seen an uptick in the last three months of unemployment numbers (November and December 2009 and January 2010). If we look at the first instance following each recession in which the unemployment rate did not see an increase in a three month period, and examine what happened over the following 11 months, we can get a good sense for what may happen in the near future. Using this model, and including each of the recessions since 1950, we calculate an average unemployment rate decline over the following 11 months to be .67 percent. This suggests that we should expect a December 2010 unemployment rate of just over 9 percent.

Putting the two together, it seems possible that the unemployment rate may drop into the high 8 percent range by the end of this year. That is hardly an acceptable level of unemployment, of course, but it is better than the baseline forecasts, and better than the 9.4 percent that would follow from averaging the recovery of the last two recessions.

2. Why has job growth not accelerated six months into recovery?

As just mentioned, it is typical for job growth to lag a bit. One reason this is true is that firms tend to hold on to workers and maintain excess capacity in downturns, in part because this will reduce search and hiring costs once the recovery eventually begins. This means that firms will tend to have excess capacity at the beginning of a recovery, and will be able to ratchet up output by increasing the activity of people who are already employed. Real hiring only begins when capacity constraints start to bind.

It is worth noting, however, that underneath that lagging job growth, there is a tremendous amount of flux. For example, using the BLS data on job creation and destruction for late last year as a guide, it is likely that the small loss of 20,000 jobs in January masked an enormous amount of job creation and destruction. I will return to this point below.

As we begin to look forward to policies to address high unemployment, it will be important to remember the fact that there are pockets of the economy where massive job creation is under way, and pockets that are still hemorrhaging jobs.

3. Do employment conditions today differ from previous recoveries, including the so-called "jobless" recoveries that followed recessions in 1990-1991 and 2001? If so, please describe.

The current unemployment rate is 9.7 percent. This is a bit higher than the 9.4 percent registered last July at what will likely be viewed as the business cycle trough. The recent recession and the two "jobless" recoveries are the only three recessions since 1950 that have had a higher unemployment rate 6 months after the trough. One other recession (1969-1970) had no change after six months. In the nine recessions immediately prior to the 2007-2009 recession, the average decrease in unemployment six months after the trough was .26 percent.

While the short-term trajectory mentioned previously provides some sign of hope, there is no way to sugar coat the description of the labor market. In the post-war period, unemployment has only reached our current level once, peaking at 10.8 percent in November and December 1982. As bad as the current number is, there are indicators below the top line that are truly horrifying. In particular, it is astounding the extent to which black Americans have born the brunt of this recession. For black Americans, the rate at trough was 14.7 percent, and has now risen all the way to 16.5 percent.

The disappointing six months aligns well with the previous recession, but the levels are much, much worse. The 2001 recession reached its trough in November of that year with an unemployment rate of 5.5 percent, while the rate for black Americans was 9.8 percent. Six months later, the overall rate was 5.8, and the rate for blacks was 10.2 percent.

The recovery following the 1990-1991 recession was actually a bit better for workers (in terms of changes). It ended in March of 1991, when overall unemployment was 6.8 percent and black unemployment was 12.5 percent. Six months later the overall rate was 6.9 percent and the rate for black Americans was 12.3 percent.

It is important to look closer at the data for blacks, as this has received far too little attention. While white unemployment has been declining since last November, unemployment among blacks has steadily increased. The picture among less educated African Americans is far worse. This month, the BLS reported 21.3 percent of African Americans without a high school diploma were unemployed.[2]

It is sadly a statistical regularity that unemployment has been far worse for black Americans. Since 1972, the earliest year the BLS reports unemployment data for "African Americans and Blacks", the white unemployment rate has averaged roughly 5.5 percent while black Americans have experienced an average rate of 12.1 percent. In bad economic times, racial differences in employment are magnified. Since 1972, the monthly unemployment rate for black Americans has risen has high as 21.2 percent, nearly two times the highest rate for the overall population during the same period.

Why are the effects of a recession exacerbated for blacks? Economists from the University of Connecticut and the University of California examined what is known as the "last-hired, first-fired" hypothesis, which speculates that blacks are the last to be hired during an expansion and the first to be let go during an economic contraction. They examine labor market transitions for black and white men during the business cycle and find blacks are usually the first to be let go as

[2] "African American History Month" Bureau of Labor Statistics. February, 2010. Available at: http://www.bls.gov/spotlight/2010/african_american_history/.

the business cycle deteriorates, but, contrary to the hypothesis, they are usually hired back early in the recovery phase.[3]

Thus, it is likely that the gross job flow data would, if available for the current moment, indicate that black Americans are flowing into the new jobs created at about the same rate as everyone else, but are disproportionately bearing the job destruction.

4. Is additional economic stimulus needed to spur job growth, and if so what form should it take?

Given the terrible state of the labor market, it is clear that more must be done. I would add that we should look especially to policies that are most likely to help black Americans, who have suffered the worst of the recession's job destruction.

As we look for ideas, there really is no productive reason to re-litigate last year's stimulus debate. In that regard, allow me to make just one point. Even if we accept the most optimistic assessments of last year's stimulus, the cost to taxpayers per job created is in the neighborhood of $100,000 per job. Given our budget situation, it seems to me that everyone should be willing to stipulate that we have to do something, and it has to be much more cost effective than that.

The good news is that there are a number of proposals out there that would be extremely valuable at this time.

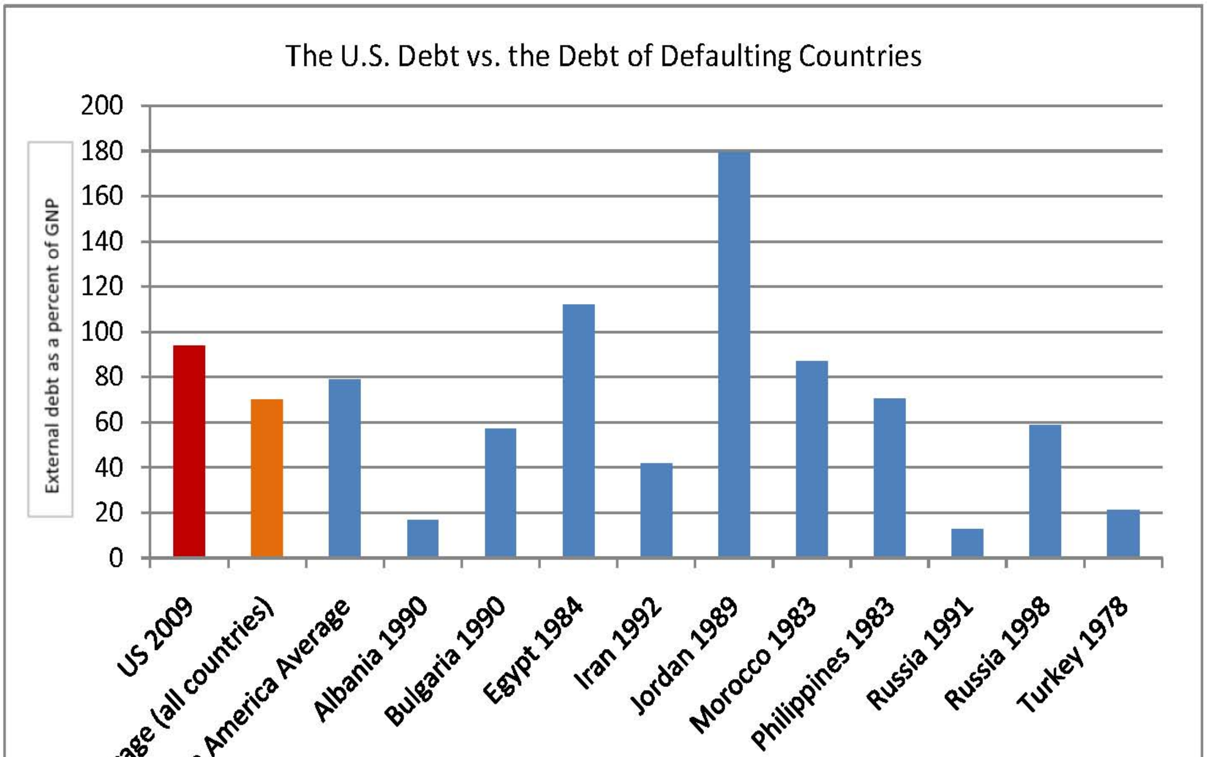
Fiscal Consoloidation

As we look to new policies, we must keep in mind the current fiscal situation, and the risks that the situation imposes. Many Americans probably think that it is impossible for the U.S. government to reach the point where its checks start to bounce. The massive expansion of U.S borrowing, both public and private, that has occurred in the past year suggests otherwise.

The nagging problem is that interest payments to our overseas creditors subtract from our ability to consume and invest. Periodically, this debt must be rolled over, with the government and citizens alike borrowing from new lenders to pay off the old. As a nation gets overextended, red flags go up, and lenders take their business elsewhere, and default becomes a real risk. Figure 1 compares the external debt (debt held by foreigners) of the U.S. to the external debt of

[3] Couch, Kenneth A. and Robert Fairlie. 2008 "Last Hired, First Fired? Black-White Unemployment and the Business Cycle," IZA Discussion Paper No. 3713, September. Available at: http://www.iza.org/index_html?lang=en&mainframe=http%3A//www.iza.org/en/webcontent/publications/papers/viewAbstract%3Fdp_id%3D3713&topSelect=publications&subSelect=papers

middle-income countries that experienced default (or restructuring) between 1970 and 2001. U.S. debt is now higher relative to our national income than it was for the typical middle-income country that defaulted on its debt in the 31 years of this sample. This year, our total external debt has reached 94 percent of GNP. There were so many Latin American defaults in our sample (Argentina twice, Brazil, Chile twice, Ecuador twice, etc.) that the chart aggregates all Latin American countries into a single category. The shocking news is that the U.S. is now in worse shape than was the typical Latin American country that defaulted.



Sources: US Treasury, the St. Louis Federal Reserve and Reinhart, Rogoff and Savastano: "Debt Intolerance," NBER, 2003.
Notes: Latin America average includes Caribbean countries. Data is for external debt to GNP in year of default or restructu ring, for middle income countires with sufficient data from 1970-2001.

And yet it is important to note that even with our unsustainable fiscal situation, default is not necessarily imminent. Countries with deficits this high have historically proceeded down three divergent paths. Some have chosen fiscal consolidation, others have chosen to attempt to inflate away the debt, and others have simply defaulted, if not intentionally, because of the failure to pursue either of the first two strategies.

In a recent paper with my AEI colleagues Aparna Mathur and Desmond Lachman, we find that the most successful policy responses to high deficits have mimicked that adopted by the U.S. following World War II. That is, successful consolidations have generally reduced spending. Failure to do so exposes the U.S. government to significant default risk that could, if history is a guide, emerge as a factor in financial markets without significant notice. It is my belief that there will be increasing pressure on the U.S. to engage in a fiscal consolidation. It is likely that many firms share that belief, creating an enormous amount of uncertainty regarding future policy. This uncertainty doubtlessly is undermining current activity.

Giavazzi and Pagano (1990) began an enormous literature when they studied the impact of fiscal contractions. They found that in some cases--the first identified were Ireland and Denmark--a country can have a dramatic reversal in economic growth when it achieves a successful fiscal consolidation; that is, when it cuts rather than increases government spending, and raises rather than lowers taxes.[4] Similar results have been found for other countries by Alesina and Perotti (1997), Alesina and Ardagna (1998), and Alesina, Perotti, and Tavares (1998).[5]

Reading through the literature, it is clear that fiscal consolidations can be stimulative. We should also not underestimate the possible current gains from phasing in long run changes that restore fiscal sanity to our budgetary outlook. We could do so either with a specific bill, or by appointing a commission to make the difficult choices for us.

Job Sharing

I encourage Congress to consider a specific economic policy that has been adopted by German policymakers, known as “Kurzabeit” or “short work.”

That policy enables firms that face a temporary decrease in demand to avoid shedding employees by cutting hours instead. If hours and wages are reduced by 10 percent or more, the government pays workers 60 percent of their lost salary. This encourages firms to use across-the-board reductions of hours instead of layoffs.

The economic argument in favor of such a policy is powerful. When a recession strikes, firms are faced with a dilemma: sales and profits are down, and many workers are idle. But finding skilled workers is costly and time-consuming, involving large fixed costs. If a firm fires workers, it may incur large hiring and training costs when the recession ends and sales turn back up. Thus, a firm would prefer, all else equal, to hoard labor during a recession.

Firms might well prefer to respond to a 20 percent cut in sales by reducing everyone’s work by 20 percent. That way, employees remain part of the firm, and ramping up production is less costly down the road.

---

[4] Giavazzi, Francesco, and Marco Pagano. 1990. Can Severe Fiscal Contractions Be Expansionary? Tales of Two Small European Countries. CEPR Discussion Paper 417, May.

[5] Alesina, Alberto, and Roberto Perotti. 1997. Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects. *IMF Staff Papers* 44 (2): 297-329; Alesina, Alberto, and Silvia Ardagna. 1998. Tales of Fiscal Adjustments. *Economic Policy* 27:489-545; and Alesina, Alberto, Roberto Perotti, and Jose Tavares. 1998. The Political Economy of Fiscal Adjustments. *Brookings Papers on Economic Activity* vol. 1998 (1): 197-266.

[5] Clausing, K. A. (2007). “Corporate Tax Revenues in OECD Countries,” *International Tax and Public Finance* 14:115-133.

A number of factors discourage American firms from making that choice. The biggest is government policy. If a firm lays off workers, the government mails the unemployed a check. If the firm reduces work-hours, there is no government assistance, and employees are left to face the entire decrease in wages on their own.

A U.S. program based on Germany's would be attractive to firms, workers and taxpayers.

It would subsidize firms as they hoard labor, enabling them to keep the best parts of their team even when sales dip. As the economy expands, firms will then be able to expand rapidly too, without sinking tons of time and resources into costly search.

In the U.S., this sort of hour-trimming is most commonly known as work-sharing, and 17 states utilize it in some form to make up part of employees' reduced wages. But few companies are participating because the government's contribution is not large enough to make work-sharing attractive. If the U.S. is to share in the labor-market success of its German friends, it needs a significant expansion of subsidies for work-sharing. Compared with the $787 billion economic stimulus, the costs would be low.

In work in progress, Economist Dean Baker co-director of the Center for Economic and Policy Research and I are working on quantifying the possible benefits of such a program in the U.S. Even at this late stage, the potential benefits seem quite impressive.

For example, the 20,000 job-loss figure for the economy in January was a net number. Every month there is a huge amount of churning with firms adding and subtracting millions of jobs. We don't have data yet for January, but for November the Labor Department reported that a total of 4,176,000 jobs were "created," while 4,340,000 jobs were "destroyed." Roughly half of the lost jobs were due to people voluntarily leaving their jobs. The other half, almost 2 million lost jobs, were cases where people were either laid off or fired.

The November data are typical. The net monthly job gain or loss conceals a huge amount of churning that produces this figure. This is an important policy opportunity, because there is already a massive amount of job creation out there. If we can slow job destruction even a little bit, then we will have set the stage for big increases in net job creation. If the rate of involuntary job loss can be reduced by 10 percent, then it would have the same effect on employment as if the economy generated an additional 200,000 jobs a month. Given the astonishing performance of German labor markets, such a change is not beyond the realm of the possible.

Work-sharing bills have been introduced in both the House and the Senate (H.R. 4135 and S. 2831) based on the programs in the several states. It is my opinion that these bills should be made stronger, with increased incentives for employers and employees to utilize the program. Support for this program comes from both sides of the aisle and we should move forward with it immediately.

For me, the strongest argument for work sharing is that blacks bear a disproportionate share of layoffs, so slowing layoffs through expanded work sharing will benefit them the most.

Create Jobs Directly

The literature is clear. Someone separated from the labor force runs the real risk of permanently separating from the normal economy. It is crucial that we reconnect as many people as possible before it is too late. The good news is that a lifeline now could easily start a worker back on a positive career track, making the lifeline a much more cost effective policy than years of welfare support.

Direct jobs programs could be a much more powerful way to get this process going than last year's stimulus. If the economic stimulus moneys were spent directly hiring individuals, they would have created 21 million jobs.

The Emergency Contingency Fund (ECF) provides funding for states to temporarily cover a portion of workers' wages in both public and private sector jobs. I believe that Republicans and Democrats should be able to come together and accept a major expansion of this program if it focuses as much as possible on private sector jobs.

Here is how it would work. If a firm sends out a lifeline to a currently unemployed worker, government funds help cover some of the costs. Through the program, federal funds reimburse states 80 cents for each additional dollar they spend getting people back to work. Over time, as the worker's reattachment to the labor force becomes stronger, the federal monies are gradually taken away.

As many as 29 states have or are developing employment programs funded through the ECF, and some estimates show as many as 120,000 subsidized jobs could be created at a cost of only $10,000 to $20,00 per job.

House Democrats have correctly judged this program positively. H.R. 4564, would make funds available for an additional year and presumably provide the publicity needed to increase the reliance of states on direct hiring incentives. Republicans should support such a program too, especially if the program is redesigned to send most of the money to workers employed in the private sector.

After all, a worker participating in the program gets a job. A firm gets an extended period of production from the worker at a heavily subsidized cost. This low cost input should increase the firm's profits, and increase the chances that they will lift their capital investments. It is like an indirect tax cut from the perspective of the firm.

Reduce Corporate Tax Rates

If we want firms to create jobs again in the U.S on net, then we should not underestimate the importance of creating an attractive climate in which firms can operate. The sad fact is, the U.S. is about the least hospitable climate for corporate investment on earth, with the second highest corporate tax rate among developed nations. We should not be surprised that such a statistic accompanies disappointing wage and job growth. The U.S. is increasingly becoming a radical outlier in this dimension. Congress must act to address this before we wake up one day to find that every business that could has decided to locate itself offshore.

The good news is that there are a number of recent studies that have suggested that the U.S. rate is so out of line with the rest of the world that we are on the wrong side of the corporate tax Laffer curve. A phased in reduction of the corporate tax rate, perhaps to something like the OECD average rate of around 25 percent, would likely cost very little revenue, and likely would induce an investment and hiring boom of the first order immediately.

The alternative, continuing to tax firms heavily, but then contriving special provisions that return monies to firms if they create a job, is foolishly complex, and likely counterproductive. Occam's razor applies in this case.[6] If we want firms to create jobs, we should give them a reason to want to expand their U.S. operations.

[6] Clausing, K. A. (2007). "Corporate Tax Revenues in OECD Countries," *International Tax and Public Finance* 14:115-133.