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Before the Senate Finance Committee

*"Using Unemployment Insurance to Help Americans Get Back to Work:
Creating Opportunities and Overcoming Challenges"*

April 14, 2010

The Great Recession is over, and the economy is again gaining traction, but the job market continues to lag. Businesses are no longer cutting payrolls, but they have yet to resume hiring in a significant way. Unemployment and underemployment, which surged during the recession, remain extraordinarily high and are unlikely to fall meaningfully soon. With continued aggressive monetary and fiscal policy support, the economy and job market should improve further; by this time next year, a self-reinforcing expansion will take hold. Still, it will take three to four years to make up the number of jobs lost during the recession, and four to five years to return to full employment. The unemployment insurance system should remain a key part of the policy response, helping facilitate the return to full employment.

Recession, recovery, expansion

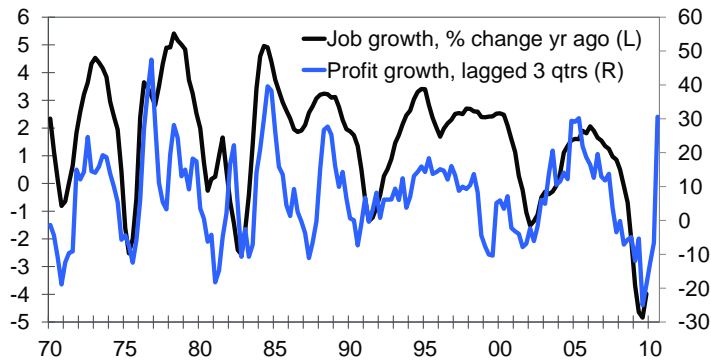
That the Great Recession has given way to an economic recovery is evident in real GDP growth. GDP, the value of all goods and services produced in the economy, expanded at a strong 4% average annualized rate during the second half of 2009 and appears to have risen close to 3% in the first three months of 2010.

The catalyst for the transition from recession to recovery was the unprecedented monetary and fiscal stimulus provided by government policymakers. A wide range of policies helped end the financial panic and stabilize the financial system, a necessary precondition for recovery. Among the most notable of these are the Federal Reserve's various credit facilities, its zero interest rate policy and credit-easing efforts, the Treasury Department's stress tests of the nation's largest bank holding companies and Troubled Asset Relief Program, and the FDIC's increase in deposit insurance limits and guarantees of bank debt. It is also no coincidence that the recession ended last summer, when the fiscal stimulus passed by Congress, the American Recovery and Reinvestment Act of 2009, was providing its maximum boost to GDP. The recovery act's expanded unemployment insurance benefits, financial aid to state governments, tax cuts for households and businesses, and tax credits for home purchases all contributed to the turn in the economy.

The recovery has gained traction in recent months as the sources of GDP growth have broadened to include consumer spending, business investment and exports. The job market has also stabilized. After declining by some 8.4 million jobs between December 2007 and February 2010, payroll employment expanded by 162,000 in March.¹ While this gain was fueled in part by temporary census hiring and a bounce back from unusually bad winter weather, underlying job growth appears to be running near 50,000 per month. Job growth has also spread to more industries, including manufacturing, mining, distribution, transportation, retailing, leisure and hospitality, healthcare, and educational services.

The preconditions for even stronger underlying job growth in the months ahead are falling into place. Most important is the rebound in corporate profits, which has occurred as businesses have successfully lowered their costs. Unit labor costs are falling at their fastest pace on record, fueled by surging productivity and tepid compensation growth. Interest expenses are declining, given corporate deleveraging and low borrowing rates. And rents are down as commercial real estate markets find themselves awash in vacant space. Although firms are constrained in their ability to raise prices, margins have widened; combined with better sales, this has juiced up profits—a necessary precursor to private sector job growth. Historically, the trend in corporate profits has led the trend in U.S. employment by six to 12 months (see Chart 1).

Profits Surge, Jobs Should Follow

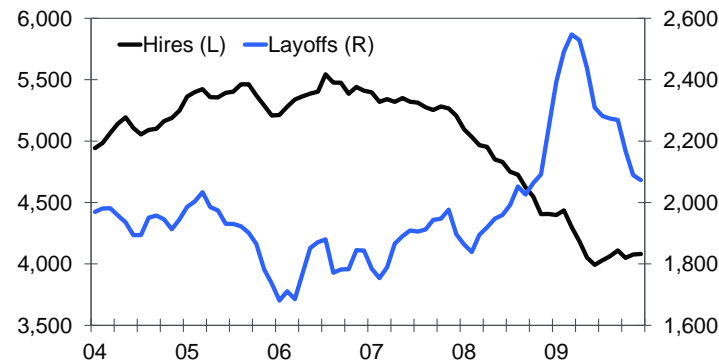


Sources: BLS, BEA

Despite these encouraging signs, until businesses resume hiring in earnest and unemployment moves definitively lower, it is premature to conclude that a self-sustaining economic expansion is under way. Indeed, hiring remains dormant. In the first quarter of this year, firms hired an average of nearly 4 million workers per month, down from nearly 5.5 million per month prior to the recession (see Chart 2).ⁱⁱ Without a pickup in hiring, underlying job growth will not accelerate, and unemployment is likely to resume drifting higher. U.S. payrolls need to grow by 125,000 jobs per month simply to stabilize unemployment, given the growth in the population and labor force. Even stronger job growth may be needed in coming months to keep unemployment from rising, since some of the millions of workers who stepped out of the labor force over the past two years will step back in as prospects improve.ⁱⁱⁱ

Hiring Remains Dormant

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Source: BLS

There are good reasons to believe hiring will be slow to revive. A lack of credit appears to be short-circuiting job growth, particularly for small and midsize firms that rely on credit cards and small banks for loans. Credit card companies and small banks remain under financial pressure and are pulling back. Lending standards have been tightened significantly, contributing to a sharp decline in the number of credit cards and commercial loans outstanding.^{iv} Smaller businesses account for a surprisingly large share of the nation's job base, and if they are unable to obtain credit to expand, the job machine will not function properly.

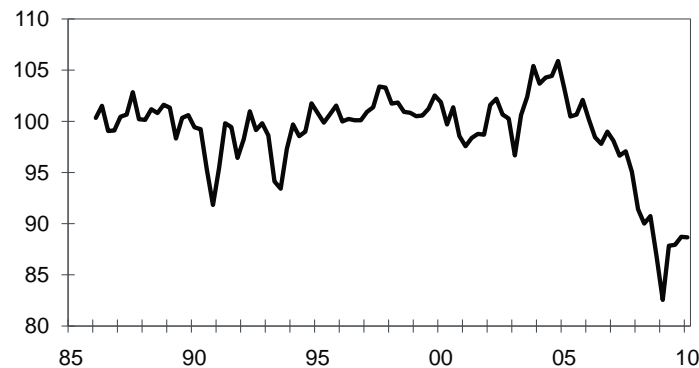
It is unlikely that credit conditions for small businesses will improve soon. Hundreds of the small banks so important to small business lending, particularly in smaller communities, have failed or will fail in the

next couple of years. Some 700 banks are now on the FDIC's troubled list; in many cases, defaulting commercial mortgage loans are overwhelming banks' capital. Credit card lenders are also adjusting to new regulations and have decided to take on less risk. Small business borrowers are also being hampered by the collapse in housing and commercial real estate prices. Real estate is often used by small business owners as collateral for borrowing. With the value of that collateral less certain, lenders are less willing to make loans.

Unusually weak business confidence may also be impeding hiring (see Chart 3). Many businesses suffered near-death experiences during the financial panic and Great Recession, and their managers are not convinced that conditions are strong enough yet to justify expansion. It will take more time than in past business cycles for those risk-taking spirits to return. While major changes to the healthcare system, financial institutions and markets, energy policy, and the tax code are essential, businesses may also be grappling with the uncertainty created by these policy initiatives.

A Dour Mood

Small business optimism index, 1986=100



Sources: NFIB, Moody's Economy.com

Assessing the damage

Even if hiring improves and an expansion takes hold in coming months as anticipated, the Great Recession has severely damaged the nation's labor market. Considering the magnitude and breadth of job losses and rise in unemployment, conditions are arguably as bad as they have been since the Great Depression.^v

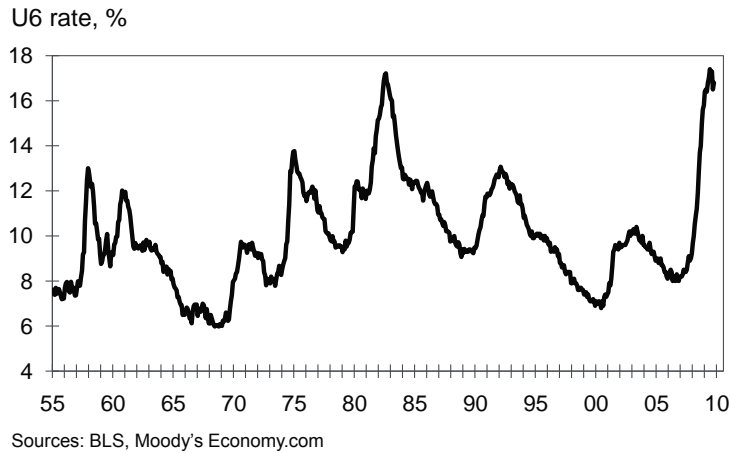
The 8.4 million decline in jobs represents over 6% of the prerecession job base, and the nearly double-digit unemployment rate means some 15 million Americans are looking for jobs. There are nearly five unemployed workers for each available position; normally the ratio is at most one unemployed worker per open position.

For anyone losing a job, moreover, it is extraordinarily difficult to find another. The average length of unemployment is closing in on eight months, and nearly half of those unemployed have been out of work more than the 26 weeks normally covered by unemployment insurance. Even in the early 1980s—the last time unemployment hit double digits—only a fourth of the unemployed were out of work that long. During the worst recession of the 1950s, closer to a tenth of workers were in this difficult position.

The unemployment statistics are bad, but they still understate the stress in the job market. Including those working part-time because they cannot find full-time work, and those who want to work but are not counted as unemployed because they have not looked for jobs in the past month, the so-called underemployment rate jumps to almost 17% (see Chart 4). This represents an astounding 26 million

Americans. On top of that are those whose hours have been cut back; the average number of hours worked per week remains just above record lows.

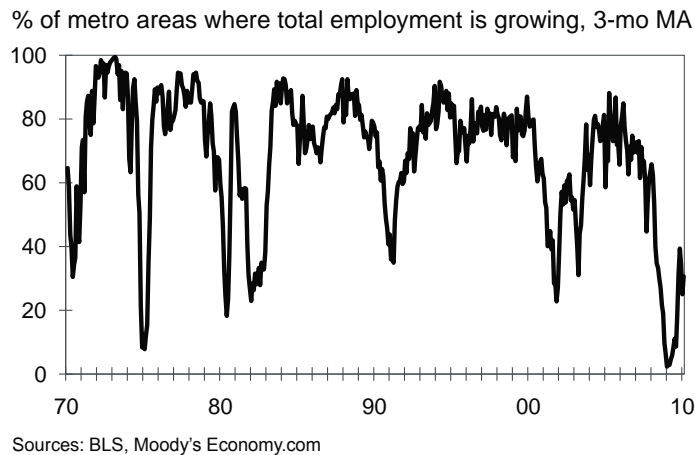
Unprecedented Underemployment



Unemployment remains painfully high across all demographic groups. Shockingly, more than a fourth of teenagers are unemployed, as are 16% of black Americans and more than 12% of Hispanics. The unemployment rate for males between 45 and 54 years old, historically the most stable group in the job market, remains well above 8%. At the worst of the early-1980s downturn, this group briefly suffered a 7% unemployment rate.

The job market also remains difficult from coast to coast. This time last year, meaningful job losses were occurring in more than 90% of the nation's metropolitan areas. Even now, two-thirds of the nation's metro areas are experiencing losses (see Chart 5). In most past recessions, one or two regions avoided the downturn; this time no area of the country has been spared. This has undermined one of the nation's historical strengths: workers' willingness and ability to move.^{vi} In the past, a laid-off auto worker from Michigan might relocate to Florida, and a displaced aerospace worker in Southern California could move to Las Vegas. That does not work today; the unemployment rates in Florida and Las Vegas are in the double digits.

Three-month Employment Diffusion Index



The recession's severe job losses erased a decade of U.S. employment growth; not until 2013 are payrolls expected to regain their previous peak. Even this less than sanguine outlook assumes the economy will find other sources of growth, most likely exports of both goods and services. This includes financial and healthcare services, management consulting, architectural and engineering services, and even professional services such as legal and accounting. Making these services globally competitive requires a highly educated and skilled workforce, this nation's comparative advantage.

It will take even longer for unemployment to decline to its full-employment rate—a benchmark that is rising as lengthy unemployment erodes the skills and marketability of more American workers. Those in their late 40s and 50s face particular difficulty getting back into the workforce. The estimated full-employment unemployment rate has already risen from below 5% prior to the Great Recession to nearly 5.5% now and could go even higher unless unemployment begins to decline soon. Assuming job growth performs as expected, unemployment will not fall back to a rate consistent with full employment until 2014.

Given the considerable risks remaining and prospects that unemployment will remain high for years, it is appropriate for policymakers to remain focused on further steps to support the job market. The recently passed job tax credit should prove helpful later this year.^{vii} Additional financial aid to hard-pressed state governments facing large budget shortfalls would also mitigate some of the job cuts that have already begun to occur. Empowering the Small Business Administration to extend more support to small-business lending would help to jump-start hiring.

Extend unemployment insurance

It is also important that policymakers provide emergency benefits to those who will lose their jobs this year. No form of the fiscal stimulus has proved more effective during the past two years than emergency UI benefits, providing a bang for the buck of 1.61—that is, for every \$1 in UI benefits, GDP one year later is increased by an estimated \$1.61 (see Table 1).^{viii}

| Fiscal Stimulus Bang for the Buck | |
|---|--------------------------|
| <i>Source: Moody's Economy.com</i> | |
| | Bang for the Buck |
| Tax Cuts | |
| Nonrefundable Lump-Sum Tax Rebate | 1.01 |
| Refundable Lump-Sum Tax Rebate | 1.22 |
| Temporary Tax Cuts | |
| Payroll Tax Holiday | 1.24 |
| Job Tax Credit | 1.30 |
| Across-the-Board Tax Cut | 1.02 |
| Accelerated Depreciation | 0.25 |
| Loss Carryback | 0.22 |
| Housing Tax Credit | 0.90 |
| Permanent Tax Cuts | |
| Extend Alternative Minimum Tax Patch | 0.51 |
| Make Bush Income Tax Cuts Permanent | 0.32 |
| Make Dividend and Capital Gains Tax Cuts Permanent | 0.37 |
| Cut in Corporate Tax Rate | 0.32 |
| Spending Increases | |
| Extending Unemployment Insurance Benefits | 1.61 |
| Temporary Federal Financing of Work-Share Programs | 1.69 |
| Temporary Increase in Food Stamps | 1.74 |
| General Aid to State Governments | 1.41 |
| Increased Infrastructure Spending | 1.57 |
| Low-Income Home Energy Assistance Program (LIHEAP) | 1.13 |
| <i>Note: The bang for the buck is estimated by the one-year dollar change in GDP for a given dollar reduction in federal tax revenue or increase in spending.</i> | |

This economic boost is large because financially stressed unemployed workers spend benefits quickly, as opposed to saving them. This was particularly important during the depths of the recession when consumers had aggressively cut spending. While consumer spending has since notably improved, it remains fragile and would likely weaken again if emergency UI benefits are not extended. The recovery would struggle to evolve into an expansion as anticipated.

Consumers' dour moods reinforce this concern. While surveys of consumer confidence show improvement over the past year, they are not much higher today than in the depths of the past recent recessions. If large numbers of unemployed workers begin running out of UI benefits this spring and summer, consumer sentiment could sink further. Attitudes would sour not only among the unemployed but also among their relatives, friends and neighbors, as they worry more about their own situations.

Policymakers should also consider extending states' ability to borrow interest-free from the federal government to meet their UI obligations. More than 30 states and local jurisdictions have together borrowed more than \$35 billion from the federal government to pay state unemployment compensation. The largest of these debts are owed by California, Michigan, New York, Pennsylvania, Ohio, North Carolina, Illinois, Texas, Indiana and New Jersey. The Labor department projects that 40 states will need to borrow from the federal government before the end of this year. It would also be helpful to waive penalties for the non repayment of these loans for a longer period. Without such relief, states will be forced to raise payroll taxes at just the wrong time for the economy.

TANF emergency fund

Policymakers should also consider extending and providing additional funds for the TANF Emergency Fund. Created by the Recovery Act, this fund is set to expire on September 30, 2010. The timing is particularly inopportune given that unemployment will likely still be in or near double digits, and more workers will have exhausted their benefits. Extending the program for another year until unemployment is clearly moving lower seems appropriate.

Over half of the nation's states have used the TANF emergency fund to establish new, or expand, subsidized employment programs, and some 39 states are using the fund to provide either basic cash support or short-term assistance to poor families with children. A range of jobs are being subsidized, including summer jobs for low-income youth and transitional jobs to help new or returning workers gain experience and establish relationships with employers.

The states' ability to use the fund to create jobs has been somewhat impaired, however, by a requirement that states put up 20% of any job subsidy. Given their own daunting fiscal problems, states have difficulty coming up with even a 20% contribution. Increasing the federal contribution to 90% or even 100% would significantly increase the use of the fund to support job creation.

Without congressional action soon on the TANF emergency fund, many states will begin to significantly scale back their job subsidy programs this spring. Fiscal 2011 state budget shortfalls are likely to be as severe as last year, when states received substantial federal aid. States are thus in no financial position to continue these programs. Many will likely also be forced to make TANF cuts soon.

Disincentives for intermittent work

Under current law, workers receiving federal emergency benefits are required to turn back to state benefits if they take temporary or part-time work, even if the state benefits are less. This is a significant disincentive to work, and it should be addressed by allowing unemployed workers to maximize their benefits even if they take temporary or part-time jobs. In most cases, workers would first exhaust their federal benefits and then their state benefits. This change would provide incentives for more work, ensure that workers receive maximum benefits, and provide relief to hard-pressed state UI trust funds.

Work-share programs

The wider adoption of work-share programs, also called short-term compensation, would help address persistent stresses in the job market. The 17 states that have work-share programs have successfully averted many layoffs, saving more than 165,000 jobs, up from 58,000 in 2008.

Work share programs have mitigated unemployment in a number of European countries. A good example is Germany, where real GDP declined almost 6% peak to trough during the recession, but unemployment rose only modestly to near 8%. U.S. real GDP declined about 4%, yet unemployment has risen by over 5 percentage points to nearly 10%. A number of factors explain the differences, but the wider use of work share in Germany is an important one.

Work share allows employers to reduce employees' hours for a period of time, with prorated unemployment benefits lessening the financial impact on workers' incomes. Work share is especially helpful for firms that expect workforce reductions to be temporary, allowing them to avoid the cost of severance, rehiring and training. It also helps maintain employee morale, allowing workers to keep health insurance and retirement benefits. For these reasons, the estimated bang for the buck from work share is \$1.69, even higher than emergency UI benefits.

To encourage the wider use of work share in the U.S., federal policymakers should consider startup grants for programs in states that do not currently have them, funding additional administrative costs and letting the Labor Department provide technical assistance to states that develop such programs. Providing temporary financing to states to fund work-share benefits, perhaps up to 26 weeks, would also jump-start broader adoption.

Successful work-share programs have developed a number of practices that increase their effectiveness. One key is letting employers include work-share payments in workers' regular paychecks, rather than making workers file separate claims with unemployment insurance offices. Another is allowing employers to set the appropriate reduction in hours for individual employees, rather than imposing blanket cuts across a workforce. Still another is letting employers adjust their work-share arrangements as circumstances change, as they inevitably do. It is also important that work experience under work share be counted in determining workers' eligibility for full unemployment benefits. Work share can also be more effective if combined with training to ensure workers are using their additional down time effectively.

Self-employment assistance

The unemployment insurance system can also be used to promote entrepreneurship, by expanding self-employment assistance programs. Currently, only seven states participate in such programs, which help unemployed workers create their own new jobs by paying them a self-employment allowance instead of regular UI benefits. Participants receive weekly allowances while they get their businesses going. Recipients must be eligible for regular UI, permanently laid off from their previous job, and identified through a state profiling system as likely to exhaust their UI benefits. Individuals can receive benefits even if they are engaged full-time in self-employment activities such as entrepreneurial training, business counseling and technical assistance.

Cost considerations

The cost to the federal government of providing the additional UI benefits outlined here are substantial, totaling as much as \$70 billion this year. The largest cost involves the extension of emergency unemployment insurance benefits, though the exact amount will depend on the severity and average length of joblessness over the coming months.

These costs will add to what will likely be another record budget deficit this fiscal year of close to \$1.5 trillion. The nation's debt-to-GDP ratio will rise to approximately 65%; the highest debt load since just after World War II. Given this disconcerting fiscal situation, it would be desirable if the costs of the UI benefits were paid for, not now but in the future once the economic expansion is in full swing. This would

send a strong signal to the buyers of U.S. Treasury debt that we are serious about addressing our fiscal problems, and thus help keep long-term interest rates from rising significantly near term. Continued low interest rates are important to ensure that an economic expansion takes hold.

Having said this, the greater immediate risk is not that long-term interest rates will rise too high, but that hiring and job growth will fail to revive as anticipated.^{ix} Costs to taxpayers will be measurably greater if the economy does not turn the corner to expansion but instead retreats back into recession. With the unemployment rate already near double digits, a deflationary cycle of falling wages begetting falling prices, leading to more wage cuts, could well take hold. At that point, policymakers will have no good response, given the 0% federal funds rate and the federal government's rapidly eroding balance sheet.

The economy has made significant strides in the last year. Just about a year ago, major financial firms were disappearing and the economy was in free fall. Yet the proverbial coast is not clear. The Great Recession has given way to recovery, but with firms still reluctant to add to their payrolls and unemployment so high, it will take more policy help to ensure a self-sustaining economic expansion takes root.

ⁱ Based on more recent unemployment insurance records, forthcoming revisions to the payroll employment data will likely show that closer to 9 million jobs were lost peak to trough during the recession.

ⁱⁱ This is based on the BLS's job openings and labor turnover survey. Net job growth equals the number of workers hired less the number of layoffs, quits and other separations.

ⁱⁱⁱ Economic conditions were of course much worse in the 1930s, when unemployment topped 25%.

^{iv} The tightening in lending standards is evident from the Federal Reserve's quarterly survey of senior loan officers at major financial institutions. The Fed asks respondents whether they have tightened their underwriting or increased their loan spreads in the last quarter. Recent responses indicate that fewer lenders are tightening further, but there is no indication they have eased after the extreme tightening that occurred during the past two years.

^v According to the household survey, some 2.8 million unemployed workers left the labor force altogether in March. In March 2007, prior to the recession, less than 1.8 million workers made the same move. Some will never seek active employment again, but others will return to the labor force as their own financial needs grow or as new job opportunities arise.

^{vi} Also curtailing labor mobility is the situation of an estimated 15 million homeowners whose equity in their homes is negative. To move, someone whose mortgage debt exceeds their home's value must either raise cash, persuade the lender to accept a short sale, or default.

^{vii} An assessment of the job tax credit and other similar proposals is provided in "Jump-Starting the Job Market: How Well Will a Job Tax Credit Work," Mark Zandi, *Regional Financial Review*, February 2010.

^{viii} The bang-for-the-buck estimates are based on simulations of the Moody's Analytics econometric model of the U.S. economy.

^{ix} Long-term rates are unlikely to rise significantly as long as the private sector continues to deleverage. According to the Federal Reserve's Flow of Funds, total economy-wide borrowing, including record federal government and municipal borrowing, is essential zero.