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Before the Joint Economic Committee

"Bolstering the Economy: Helping American Families by Reauthorizing the Payroll Tax Cut and UI Benefits"

February 7, 2012

The U.S. economy is improving. Manufacturing is strengthening, construction has turned the corner, vehicle sales are posting healthy gains, and, most importantly, the job market is gaining traction. Two million payroll jobs were added on net during the past year, and the unemployment rate is falling quickly. A self-sustaining economic expansion appears to be finally taking hold.

Yet it is premature to conclude that the economy is off and running. The economy was performing similarly at this time last year, only to be derailed by a surge in oil and other commodity prices, the Japanese earthquake, the European sovereign debt crisis, and political brinksmanship around the Treasury's debt ceiling.[1] The collective psyche remains fragile; it would not take much to unnerve households and businesses once again, thwarting the economy's full revival.

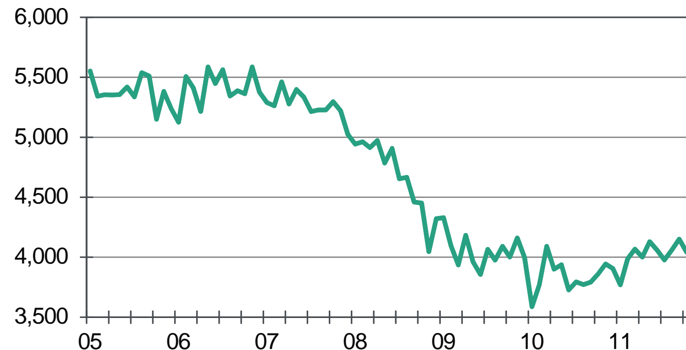
The immediate threats are familiar. Europe's economic problems, while less pressing given recent aggressive action by the European Central Bank, remain significant. The U.S. foreclosure crisis is pulling house prices lower, adding pressure on stretched homeowners, on small businesses looking for credit, and on local governments struggling to fund schools and other important services. A further risk is another misstep by U.S. policymakers, who will soon face a significant test over extending the current payroll tax holiday and the emergency unemployment insurance program.

Missing link

The missing link in the current economic recovery has been businesses' reluctance to step up hiring. Firms have done an excellent job of reducing costs, increasing profitability, and restructuring their balance sheets. While larger companies are in better shape than smaller ones, in aggregate, the financial condition of American businesses is arguably as good as it has ever been. Across nearly every industry, profits are at record highs and cash has never been more abundant.

Their healthy finances have enabled businesses to increase investment and curtail layoffs. Equipment and software purchases have been sturdy, and layoff rates have never been lower. Unfortunately, the rate of hiring has also been moribund (see Chart 1). The pace of new business formation has been exceptionally weak, and existing businesses have lacked the confidence necessary to expand and add workers. The nightmare of the

Great Recession still conditions their thinking, and uncertainty about changes in the regulatory and legal environment has not helped.



The recent jobs data may be signaling that businesses are finally getting their groove back. Discounting the effects of mild winter weather and other technical factors, payrolls appear to be adding close to 200,000 jobs per month. Moreover, the job gains are increasingly broad-based across industries, occupations, and regions of the country. Employment as measured by the household survey—the basis for the calculation of the unemployment rate—has grown even more strongly in recent months. The household survey is better at picking up employment at new and smaller establishments, particularly at turning points in the business cycle. All of this is consistent with faster hiring.

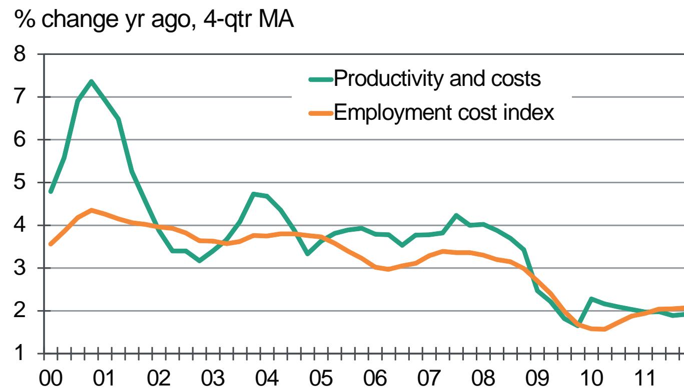
The real thing

The recent rapid drop in the unemployment rate is thus real, resulting primarily from more jobs and not from a declining labor force.[ii] It would not be particularly encouraging if unemployment had declined because discouraged workers were leaving the workforce or if those who had left the job market earlier felt it was still too tough to come back. But this is not the case, because the unemployment rate has declined even as the labor force showed a meaningful increase.

Nonetheless, labor force growth is likely to remain soft in coming months, suggesting that even with only modest job growth, the unemployment rate will fall further and more quickly. An unemployment rate below 8% by the end of 2012 and closer to 7% by the end of 2013 now appears possible.

Not until unemployment falls meaningfully below 7% will wage growth pick up enough to draw more potential workers back into the labor force. Supply and demand conditions in the labor market have kept annual compensation growth stuck close to 2% since the Great Recession (see Chart 2).[iii] This is at best keeping pace with inflation. For

many households, a job may not make financial sense, given commuting and child care costs. This may be why female labor force participation rates are declining while male participation rates have held up recently.



Low after-inflation wages may also help explain unusually weak growth in foreign immigration, historically a vital source of U.S. labor force growth. Stiffer border controls and enforcement of immigration laws are likely also contributing, but many potential immigrants probably believe that their chance of finding an adequately paying job in the U.S. is too low to make the costly trek.

European turmoil

While the economy began 2012 on a more solid footing, it remains vulnerable, facing many serious threats. The ongoing European sovereign debt crisis is especially worrisome. Europe is in recession; and while the U.S. economy can tolerate a mild and short European downturn, anything more severe would be difficult to shrug off. The severity of Europe's recession depends on policymakers there.

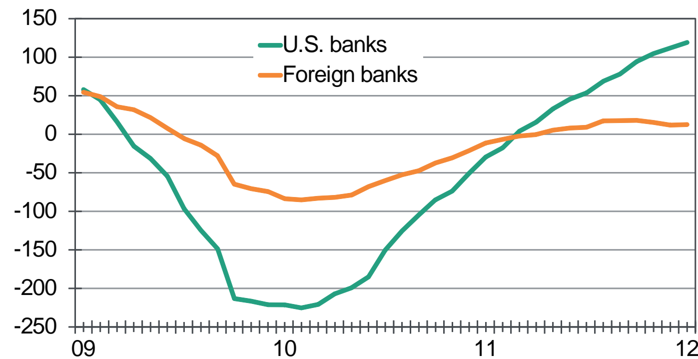
Events in Europe affect the U.S. economy most immediately through the stock market. Movements in U.S. share prices have been closely tied to Europe's crisis since it erupted in early 2010. This is not surprising; U.S. multinationals are deeply involved in Europe, as they are across the globe. Although stock values are little changed over the past two years, prices have swung up and down in the interim. Wealthier U.S. households have had difficulty determining their net worth, which weighs on their willingness to spend. Such spending counts for a lot; households in the top 20% of the income distribution are responsible for almost 60% of consumer purchasing.

Europe's crisis may also impair the availability of credit, putting pressure on financial systems on both sides of the Atlantic. European banks make approximately a fifth of all U.S. commercial and industrial loans and are tied to big U.S. banks through a number of

business channels. According to the Federal Reserve, foreign banks have tightened their commercial and industrial lending standards, and their volumes of outstanding loans have begun to decline (see Chart 3). U.S. banks have been able to fill the void so far, but this deserves close attention.

Chart 3: European Banks Pull-Back

Yr-over-yr change in C&I loans at foreign banks, $ bil



Source: Federal Reserve Board

A European recession will further weaken global trade, hurting U.S. export growth. One-fourth of U.S. exports go to Europe, but exports to the rest of the world are hurting as well, as all economies struggle with the effects of Europe's downturn. Asia seems particularly vulnerable. Exacerbating this threat is a rising U.S. dollar. The greenback has strengthened significantly against the euro since the summer and is also up strongly against the currencies of most emerging economies. Even the Chinese yuan appears to have slowed its appreciation against the dollar.

Europe's downturn is expected to be mild, lasting through the middle of 2012, with real GDP in the euro zone falling no more than 1%. However, this depends on how quickly policymakers can stabilize financial markets. It is encouraging that the European Central Bank has teamed up with the Federal Reserve and other key central banks to provide cheap funds to the stressed banking system. The ECB is also providing longer-term financing and easing collateral requirements for banks seeking loans. To the relief of financial markets, this signals clearly that monetary policymakers will not allow a major bank to fail because of a lack of liquidity.

Financial markets should also be cheered by the increasing commitment of European policymakers to fiscal discipline. The most profligate nations have replaced their governments and appear to be implementing serious austerity programs. Collectively, European Union governments have agreed to stiffer fiscal rules, more stringent oversight, and harsher penalties for violations. Officials also say they will enlarge the European bailout fund and the International Monetary Fund to help fiscally troubled governments. This should allow the ECB to continue buying enough debt to keep these governments' borrowing costs from spiraling out of control.

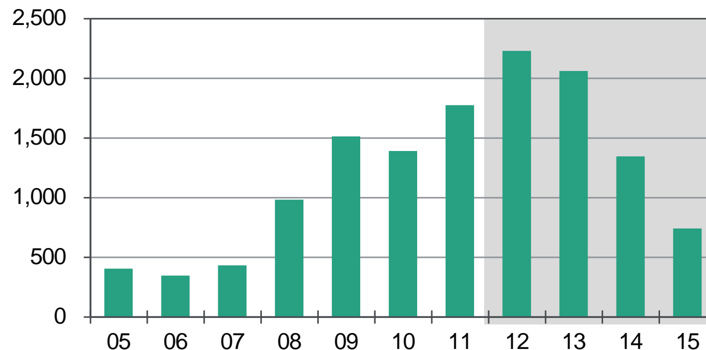
Nonetheless, it is not hard to construct darker scenarios in which Europe loses the political will to keep the euro zone together in its current form, and its economy enters a deep downturn, with serious repercussions for the U.S.

Falling house prices

The six-year housing crash is easing, but it is not over, and it remains a problem for the economy. Home sales and construction have hit bottom, and multifamily construction is picking up, but prices continue to slump. Average nationwide prices are down by about a third from their peak, falling almost 4% in 2011, and have further to go before they turn upward.

Behind this pessimism is the expectation that the share of distress sales, including foreclosures and short sales, will increase this year (see Chart 4). Distress sales occur at a large price discount; as they grow in proportion to the overall housing market, prices decline. The volume of distress sales was constrained last year because of the robo-signing scandal and other foreclosure process issues, which prompted regulatory and legal action against large mortgage servicers. The largest of these still outstanding is a suit filed by state attorneys general against the servicers. Once it is settled—most likely early this year—the foreclosure process will ramp up again, the number of distress sales will rise, and house prices will fall further.

Chart 4: More Distress Sales, More House Price Declines



Sources: FDIC, Equifax, RealtyTrac, Moody's Analytics

Prices are expected to fall only modestly from here, another 5% at most. Limiting the downside is sturdy investor demand for distressed properties; prices have fallen enough and rents are strong enough for investors to cover their costs while they wait for markets to firm. Unlike the house flippers who infected the market during the housing bubble, today's investors have longer horizons. Prices for nondistressed properties are also holding up well, suggesting the market for these has its own separate dynamic.

Nonetheless, the economy's prospects remain questionable as long as house prices are falling. A house remains the most important asset for most middle-income Americans; small business owners tap home equity for seed money and collateral, and property taxes fund most local governments. Most worrisome is the chance of another vicious cycle in house prices, similar to that during the depths of the Great Recession: As prices fell, more homeowners were pushed under water, producing more mortgage defaults, foreclosures and distress sales, and thus more price declines. With nearly 15 million home loans estimated to be under water, this is a serious threat.[iv] Worse, policymakers are unlikely to respond to a new downturn, given the lack of funds and political will.

Payroll tax holiday and UI

The U.S. economy's performance also depends on what Congress and the administration do about the temporary 2% payroll tax cut and emergency unemployment insurance program. Policymakers bought time late in December when they agreed to extend these programs through February, and an extension through the rest of 2012 is widely expected and necessary. Extending the payroll tax holiday through the remainder of 2012 will put approximately $100 billion in workers' pockets, while extending the emergency UI program will provide $45 billion to the unemployed. Together, the benefit of these programs to American households is equal to almost 1% of GDP.

The near-term bang for the buck—the additional economic activity generated within one year of the temporary tax cut and spending increase—is also meaningful. There was arguably no more effective form of government support during the recession than the emergency UI benefits provided to workers (see Table).[v] Emergency UI provides an especially large economic boost, as financially stressed unemployed workers spend any benefits they receive quickly. With few other resources, UI benefits are spent and not saved. The multiplier from a payroll tax cut, while sizable, is smaller since some of the benefit is saved or not spent quickly, particularly the portion going to higher-income households. More detailed analysis of spending by consumers indicates that approximately two-thirds of the tax cut is spent within six months.[vi]

The importance of extending the payroll tax holiday and emergency UI program is evident in the support these measures provided to the economy in 2011. Given the decline in the personal saving rate last year—from closer to 5% in January to 4% by year's end—it is clear that the bulk of the tax cut and increase in UI was spent. Indeed, the money not collected in payroll taxes last year largely covered the surge in gasoline, food and apparel costs. The higher costs for these necessary goods is one of the key reasons why the economy struggled in 2011; without the payroll tax cut and emergency UI, it is possible the economy would have experienced another recession.

Fiscal Stimulus Multipliers *As of 2011Q3*	Bang for the Buck
Tax Cuts	
Refundable Lump-Sum Tax Rebate	1.22
Nonrefundable Lump-Sum Tax Rebate	1.01
Temporary Tax Cuts	
Child Tax Credit, ARRA parameters	1.38
Payroll Tax Holiday for Employees	1.27
Earned Income Tax Credit, ARRA parameters	1.24
Job Tax Credit	1.20
Making Work Pay	1.19
Payroll Tax Holiday for Employers	1.05
Across-the-Board Tax Cut	0.98
Housing Tax Credit	0.82
Accelerated Depreciation	0.29
Loss Carryback	0.25
Permanent Tax Cuts	
Extend Alternative Minimum Tax Patch	0.53
Make Dividend and Capital Gains Tax Cuts Permanent	0.39
Make Bush Income Tax Cuts Permanent	0.35
Cut in Corporate Tax Rate	0.32
Spending Increases	
Temporary Increase in Food Stamps	1.71
Temporary Federal Financing of Work-Share Programs	1.64
Extending Unemployment Insurance Benefits	1.55
Increase Defense Spending	1.53
Increase Infrastructure Spending	1.44
General Aid to State Governments	1.34
Low Income Home Energy Assistance Program (LIHEAP)	1.13

Note: The bang for the buck is estimated by the one-year $ change in GDP for a given $ reduction in federal tax revenue or increase in spending.
Source: Moody's Analytics

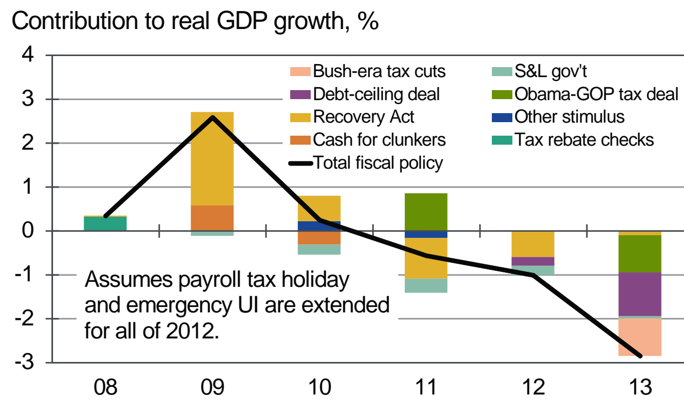
Not extending these programs would deliver a significant blow to the still-tentative economy. Based on the Moody's Analytics model of the U.S. economy, failure to extend the payroll tax holiday will reduce real GDP in 2012 by 0.4 percentage point, while not extending emergency UI will reduce real GDP by 0.3 percentage point. Real GDP is expected to grow 2.6% this year under the assumption that these programs will be extended, but not doing so would result in real GDP growth of less than 2%. The impact on the job market will also be meaningful, costing the economy more than half a million

jobs and raising the unemployment rate by at least 0.3 percentage point by the end of 2012.

Extending the payroll tax holiday and emergency UI programs thus makes the difference between an economy that is expanding at close to its long-run potential rate and an economy growing below potential.[vii] While odds are the recovery will continue even if these programs are not extended, the economy will be vulnerable to anything else that may go wrong. The risks will be greatest this spring and summer when the economy is struggling most with the fallout from the European debt crisis and further house price declines.

It is also important to consider that even if these programs are extended, federal fiscal policy will be a significant drag on the economy this year. As the remaining fiscal stimulus from the 2009 Recovery Act fades, and as spending cuts agreed to in the August debt-ceiling deal kick in, the changes will shave 0.8 percentage point from 2012 real GDP growth. Spending cuts by local governments will trim another 0.3 percentage point from growth (see Chart 5).

Chart 5: Federal Fiscal Drag Intensifies

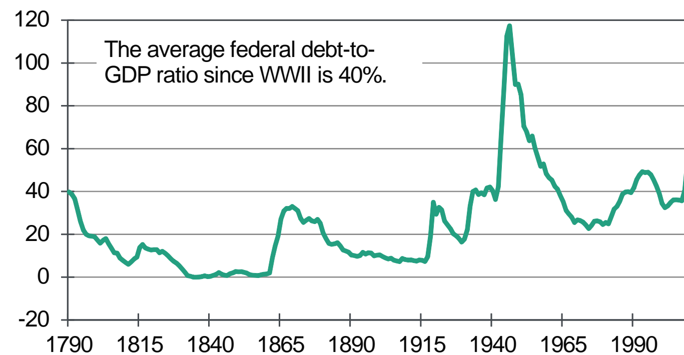


Source: Moody's Analytics

Fiscal considerations

The cost of extending the payroll tax holiday and emergency UI program should be offset by future government spending cuts and tax increases. The nation's fiscal situation has become more tenuous, as the federal government's debt-to-GDP ratio has risen by 30 percentage points during the past four years. At close to 70%, it is the highest debt load since just after World War II (see Chart 6).

Chart 6: Any Additional Fiscal Support Must Be Paid For



Sources: Treasury, Moody's Analytics

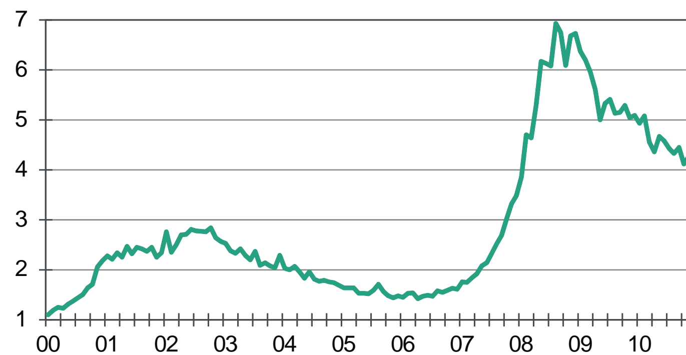
The deterioration in the government's fiscal condition largely reflects the impact of the Great Recession on tax revenues and government spending and the policy response to the recession. Policymakers aggressively used government resources to fill the hole created by the collapse in private sector demand, putting more than $1.3 trillion into fiscal stimulus programs during the past four years. While not responding to the recession would have cost taxpayers even more, given what would have arguably otherwise been a depression, the government's actions have been extraordinarily costly.[viii] And the costs continue to mount, as this fiscal year's federal budget deficit will again equal 8% of GDP.

When determining how to pay for these programs, policymakers should consider that under current law, the fiscal drag will intensify substantially in 2013. If policymakers make no other legislative changes, not only will the payroll tax holiday and emergency UI program expire, but spending cuts that were part of the debt-ceiling deal will take effect as well. Marginal tax rates for individuals will also rise as the Bush-era tax cuts end. Fiscal policy will thus slash nearly 3 percentage points from 2013 real GDP growth. This would be very difficult for even a fast-growing economy to withstand.

Other considerations

There are reasonable concerns that some recipients of emergency UI are taking advantage of the program, particularly given that as many as 99 weeks of benefits are available in economically hard-hit states. For instance, some of the unemployed may be slow to take jobs, preferring to collect UI. Some older workers may also be delaying retirement, but rather than take a job they remain unemployed and claim UI, retiring after their benefits are exhausted. There is increasing anecdotal and statistical evidence of these and other kinds of abuses in the UI system. Indeed, research on the topic suggests that the current unemployment rate is approximately half a percentage point higher than it would otherwise be, due to the disincentive effects of emergency UI benefits.[ix]

But while there are disincentive effects from emergency UI, the vast majority of UI beneficiaries are not taking advantage of the system. They clearly need the help. The most telling statistic supporting this perspective is the large ratio of unemployed workers per job opening, which according to the BLS is near 4-to-1. (see Chart 7). This is down from about 6-to-1 during the worst of the recession, but it remains more than double the level consistent with a well-functioning job market. Moreover, it would be undesirable for the unemployed to take jobs that were not suitable. It may very well be better for them, their employer, and the broader economy for them to search longer for work to find a more appropriate job.



After considering all the effects of the emergency UI program, including the disincentive effects and the benefits to aggregate demand, ending or scaling back the program would be a significant macroeconomic mistake.[x]

There has also been some debate among policymakers over whether UI benefits should be denied to any worker who lacks a high school diploma or GED and is not enrolled in classes to get one or the other. This would unnecessarily complicate and perhaps significantly delay the provision of UI benefits to hard-pressed unemployed workers at a critical time for the economy. Any such restriction would also undermine a key principle of the UI system since its inception during the Great Depression, namely that workers who paid insurance premiums to the UI system when they were on the job should be able to collect on that insurance when they lose their job.

Policymakers should also consider extending the period over which states are able to borrow interest-free from the federal government to meet their UI obligations. According to National Conference of State Legislators, 27 states have outstanding loans totaling $38 billion from the federal government to pay state unemployment compensation. The largest debts are owed by California, New York, Pennsylvania, North Carolina, Illinois, Ohio, Indiana, Florida and New Jersey. It would also be helpful if penalties on states that are borrowing to pay unemployment compensation are also waived for a longer period.

Without such relief, states are beginning to raise payroll taxes at a still-difficult time for the economy.

Work share

This is not to say the unemployment insurance program does not need significant reform; it does. While there are a number of ways to improve the UI system, one of the most promising would be the wider adoption of work-share programs, also called short-term compensation. Work-share programs in a number of states have successfully limited layoffs.

Work share was effectively used by Germany during the recession. German real GDP declined almost 6% peak to trough, but unemployment rose only modestly, to around 8%. U.S. real GDP declined closer to 5%, yet unemployment rose by more than 5 percentage points to 10%. There are a number of reasons for the difference, but the wider use of work share in Germany is an important one.

Work share allows employers to reduce employees' hours for a time and for the workers to receive proportionate unemployment benefits for those reduced hours to lessen the financial impact. Employers are generally required to submit a plan describing the program. 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 promotes employee morale, allowing workers to maintain their health insurance and retirement benefits.

A number of features can make work-share programs more effective. Most important is to have employers administer work-share payments as part of their regular payroll process rather than have employees file claims with unemployment agencies. The rules should also allow employers to determine the appropriate reduction in hours for individual employees rather than impose a uniform reduction for all affected workers. Employers should also be allowed to adjust their plans as circumstances change, which they will in an economic downturn. It is also important that experience under work share count in determining workers' eligibility for full unemployment benefits. Work share would also be more effective if combined with training requirements to ensure that workers use the additional downtime effectively.

Conclusions

The U.S. economy has performed much better in recent months. Most encouraging are the recent revival in job growth and the substantial decline in the unemployment rate. There are nascent signs that businesses are hiring more, which is necessary for a much stronger economy.

But while prospects are looking up, the economy still faces formidable hurdles, the most obvious of these being the troubles in Europe and falling house prices at home. It would not take much to undermine confidence, which remains on edge after the

nightmare of the Great Recession and amid Washington's partisan acrimony. Given that 2012 is an election year, policy uncertainty will only intensify. The economy is not yet home free.

It is thus important for fiscal policymakers to be judicious about how they withdraw support from the economy. Fiscal policy has already become a drag as various tax cuts and spending initiatives implemented during the recession fade. This is on top of the economic drag created by cuts in state and local government budgets.

Given this, Congress and the Obama administration should agree to extend the current payroll tax holiday and emergency UI program through the end of 2012. This will ensure that fiscal policy does not become even more of a weight this spring and summer, when the economy will still be vulnerable.

Policymakers have worked very hard and used tremendous financial resources to end the Great Recession and support the subsequent recovery. It has been an extraordinarily trying time, but it would have been measurably more difficult if not for policymakers' unprecedented efforts. A self-sustaining economic expansion is close at hand, but only if policymakers do not pull their support from the economy too quickly.

[i] There was a significant amount of optimism regarding the economy's prospects in early 2011. According to Consensus Economics, the consensus of economists as of January 2011 was for real U.S. GDP to grow 3.4% in 2011. It actually grew only 1.7%.

[ii] From 9.1% in August, the unemployment rate has fallen to 8.3% in January. During this period, the BLS household survey has recorded an employment increase of 1.9 million jobs and a gain of more than 700,000 in the U.S. labor force.

[iii] The chart shows two broad measures of labor compensation growth. Compensation as measured by the employment cost index is the most comprehensive and consistent measure; it controls for the shifting mix of jobs across industries and occupations. Compensation as measured in the productivity and cost report is significantly influenced by the value of stock options granted as compensation.

[iv] The Moody's Analytics estimate of the number of underwater homeowners is based on actual mortgage debt outstanding from Equifax credit files. It differs from estimates by CoreLogic, which put the number of underwater homeowners at closer to 11 million households. The Moody's estimate is nearly the same as CoreLogic's in California, much lower in Florida, and higher almost everywhere else. The difference in estimates may be due in part to CoreLogic's estimate of current debt outstanding, which is based on the amount of debt outstanding at origination. CoreLogic may have some difficulty measuring debt outstanding in rural or exurban areas, where homeowners generally have little equity even in good times (since house prices never rise much) and go into small negative-equity positions in difficult times. The Moody's estimate is much higher in Texas, for example. CoreLogic data are also unavailable for a half-dozen states.

[v] The bang-for-the-buck estimates are based on simulations of the Moody's Analytics econometric model of the U.S. economy.

[vi] See "Consumer Spending and the Economic Stimulus Payments of 2008," Parker et al, January 2011. http://finance.wharton.upenn.edu/~souleles/research/papers/PSJM2011.pdf. Also see "Household Expenditure and the Income Tax Rebates of 2011," Johnson et. al, *American Economic Review*, December, 2006. http://www.aeaweb.org/articles.php?doi=10.1257/aer.96.5.1589.

[vii] The economy's potential rate of growth is defined as a rate at which jobs are being added fast enough to maintain a stable rate of unemployment. The U.S. economy's long-run potential growth rate is estimated to be 2.6%.

[viii] See Blinder and Zandi, "How the Great Recession Was Brought to an End," Moody's Analytics Special Study, July 2010. http://www.economy.com/mark-zandi/documents/End-of-Great-Recession.pdf.

[ix] See Mazumder, "How Did Unemployment Insurance Extensions Affect the Unemployment Rate in 2008-10," Federal Reserve Bank of Chicago, Essays on Issues No. 285, April 2011; Rothstein, "Unemployment Insurance and Job Search in the Great Recession," NBER Working Paper No. 17534, October 2011; and Valletta and Kuang, "Extended Unemployment and UI Benefits," Federal Reserve Bank of San Francisco Economic Letter 2010-12, April 19, 2010.

[x] See Valletta and Kuang, "Why is Unemployment Duration So Long," Federal Reserve Bank of San Francisco Economic Letter 2012-03, January 12, 2012.