

Statement of Justin Wolfers

**Fellow, Peterson Institute for International Economics, and
Professor of Economics and Public Policy, University of Michigan**

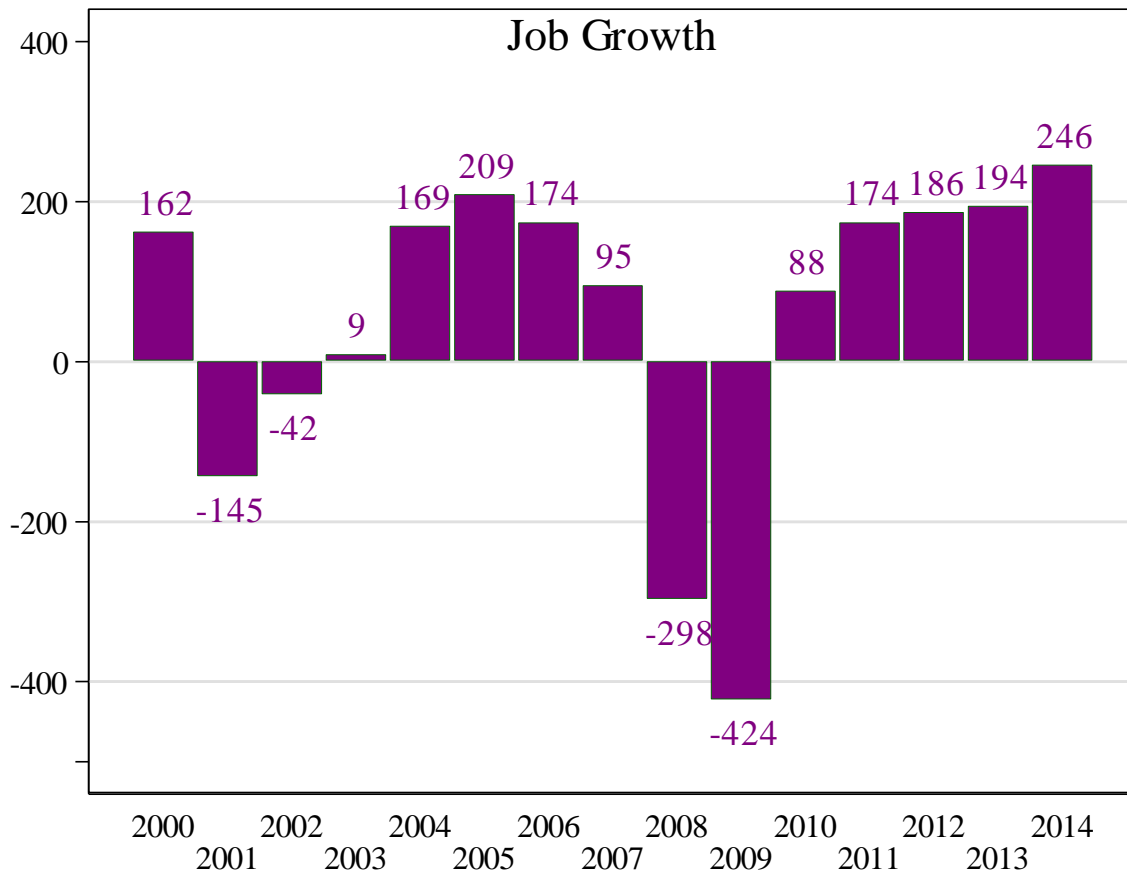
Before the Senate Committee on Finance

Hearings on “Job Creation and a Healthy Economy”, January 22 2015

Chairman Hatch, Ranking Member Wyden, and Members of the Committee, thank you for inviting me to speak with you today on the important issues of job creation and a healthy economy. Before continuing, let me add the obvious disclaimer that I am only speaking for myself.

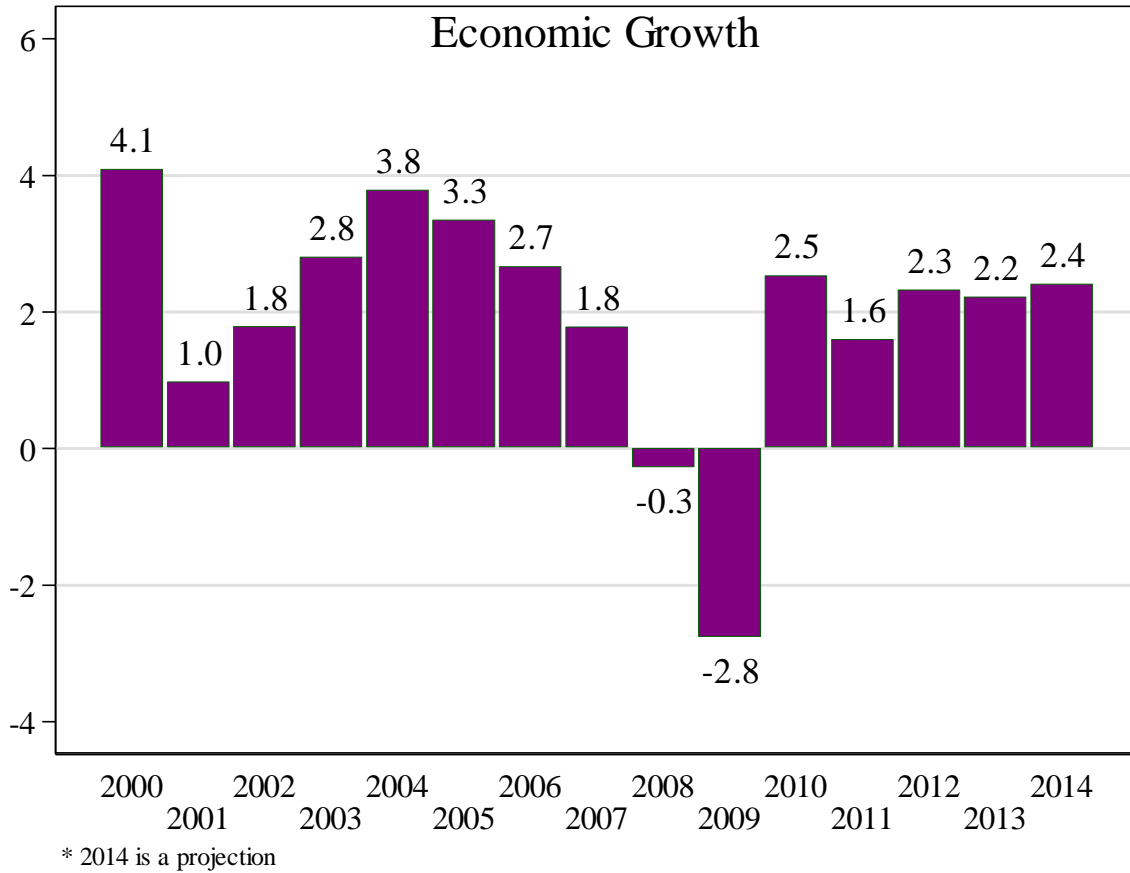
An Improving Economy

From a macroeconomic perspective, the labor market recovery is robust. In 2014, non-farm payrolls grew by an average of 246,000 jobs per month, the fastest rate not only through this recovery, but also the fastest rate since 1999.

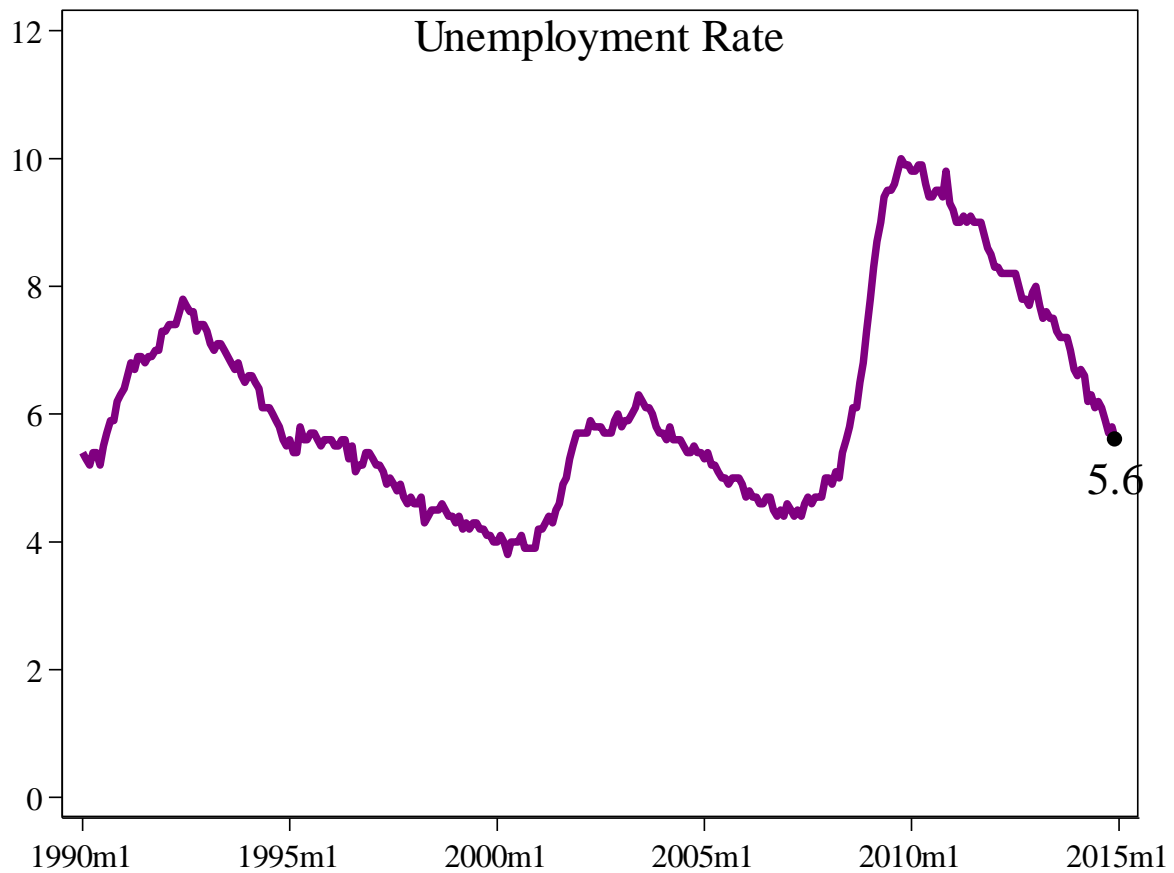


It finally appears that the recovery has developed reliable momentum. Aggregate GDP statistics also bear this out, although they suggest that rates of economic growth through the recovery are better

described as moderate – typically in the 2-2½ percent range. The juxtaposition of moderate GDP growth and robust employment growth reflects the fact that productivity growth has been a bit slow through the recovery.



Even so, robust job growth has led the unemployment rate to fall from nearly 10 percent through most of 2010, to 5.6 percent at the end of 2014. This means that over the past four years, the unemployment rate has fallen by about one percentage points per year, a rate far faster than most economists had envisioned and faster than has historically been typical for an economic recovery.

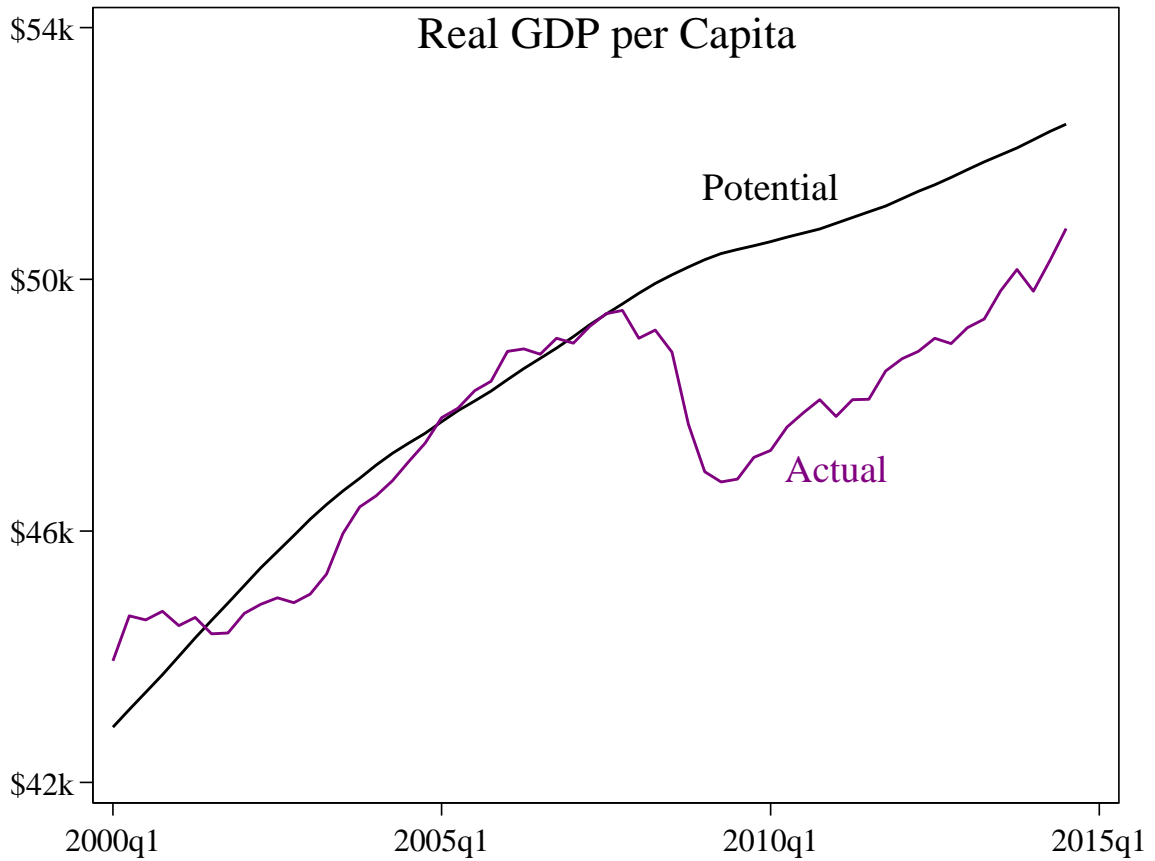


If unemployment continues on its current trajectory, unemployment will have fallen to around 5 percent by the middle of this year, which is a rate that many economists consider to be “normal.”

Unfinished Business

As much as there is good news about the direction and rate of *change* of our broad macroeconomic aggregates, we should not confuse this with the fact that the *level* of activity remains below potential. The economy is *improving*, but it is not yet doing *well*.

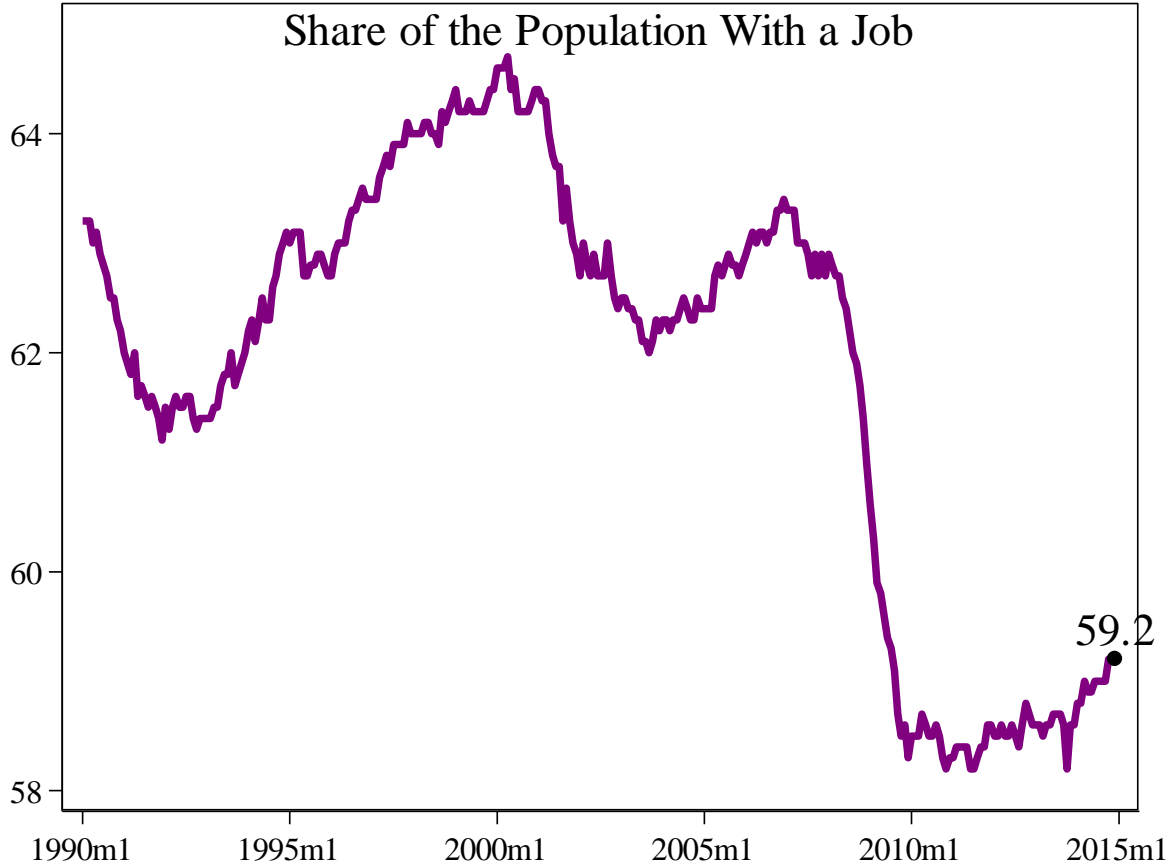
For instance, the level of output remains substantially below the economy’s long-run potential.



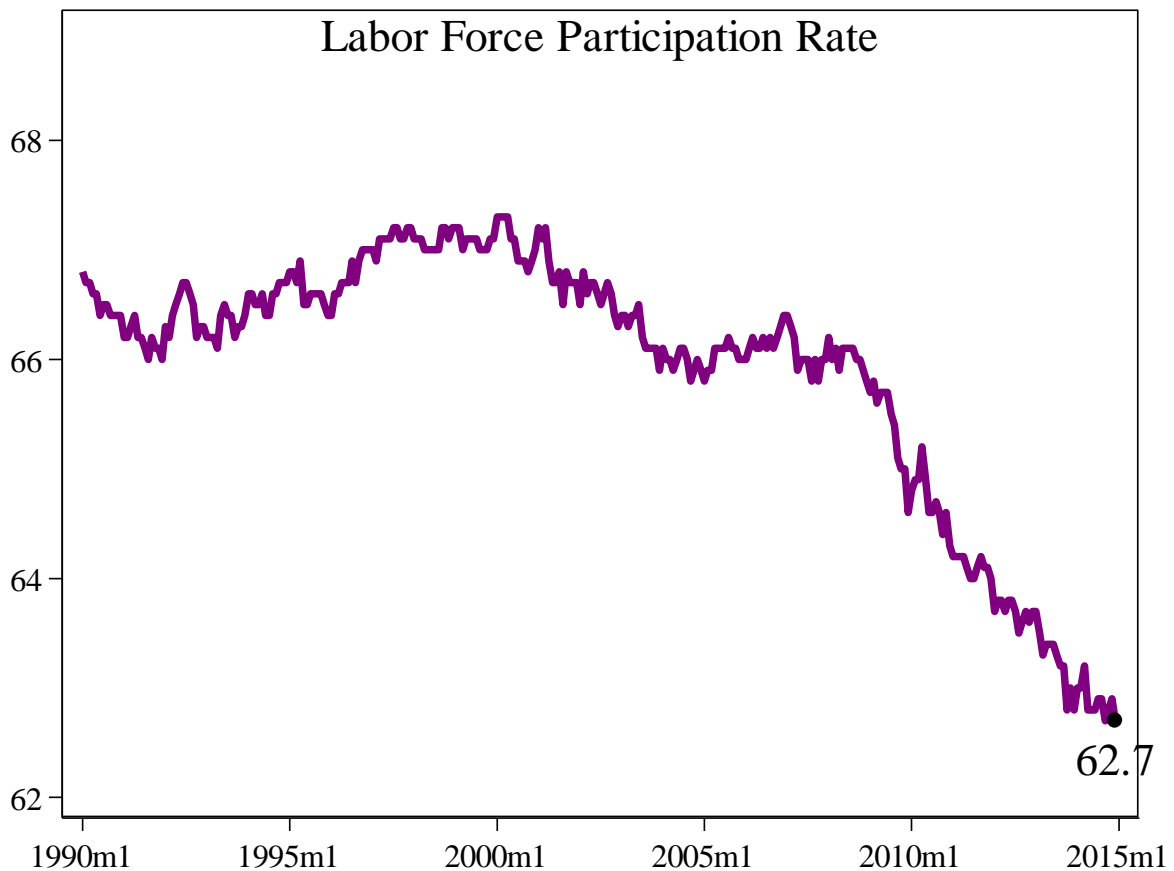
And while the current level of unemployment at 5.6 percent is far better than it was a few years ago, this is not the sort of outcome that has historically been regarded as cause for celebration. Indeed, today's 5.6 percent unemployment rate is roughly the same as its average throughout the post-war period (5.8 percent).

Even as unemployment has fallen toward the sorts of levels that many economists regard as effectively being "full employment," I would caution against declaring "Mission Accomplished" too early. While unemployment has fallen sharply, the proportion of the population with a job – which is sometimes

called the employment-to-population ratio—has not risen much at all.



Should we feel buoyed by the almost-complete recovery in the unemployment rate, or depressed by the minimal recovery in the employment-to-population ratio? Mechanically, the different patterns shown by these two indicators reflect a decline in the labor force participation. In turn, this suggests that the extent to which you consider the recovery unfinished business depends on the extent to which those who left the labor force in recent years would be willing to work if sufficient opportunities for meaningful work were available.



The decline in labor force participation since 2000 – and its steepening decline since 2008 – is rather remarkable, coming as it does after decades of a rising participation. That rising participation had reflected the entry of women into the workforce, a phenomena which slowed in the 2000s and will likely require policy action such as adopting paid parental leave and other family-friendly policies in order to see further large gains.

The more recent decline in participation reflects both cyclical and structural factors. Most economists agree that at least half of the decline in labor force participation since 2007 is due to population aging, and this has become a particularly important force as the leading edge of the Baby Boom cohort hit age 62 in 2008. This is just the beginning of a longer-run demographic shift that will continue to push the participation rate down over the next fifteen years as the rest of the Baby Boomers enter prime retirement age.

While demographics explains half of the decline in participation, the factors responsible for the other half remains unclear, as this remains a contested issue, and there is no shortage of economists with their own preferred explanations.

It remains possible that much of this may reflect the ongoing effects of the recent recession which led many discouraged workers to simply stop looking for a job. If this interpretation is correct, then today's

depressed labor force participation rate disguises a “reserve army” of unemployed, who will return to the workforce when jobs become plentiful. By this view, the recovery still has a long way to run, and policy should be focused on ensuring that the recovery is long and strong enough to get these folks back to work.

The view that today’s low participation rates partly reflect hidden unemployment is consistent with my own preferred interpretation, which is based on the evidence that cyclical downturns continue to depress labor force participation for several years after the ensuing recovery. By this view, today’s weak participation partly reflects the weak economy two, three, four or even five years ago. If this view is correct – and there is evidence from state business cycles to support it – then we are still some distance from full employment, and an ongoing economic recovery will lead participation rates to rise moderately over the next year or two.

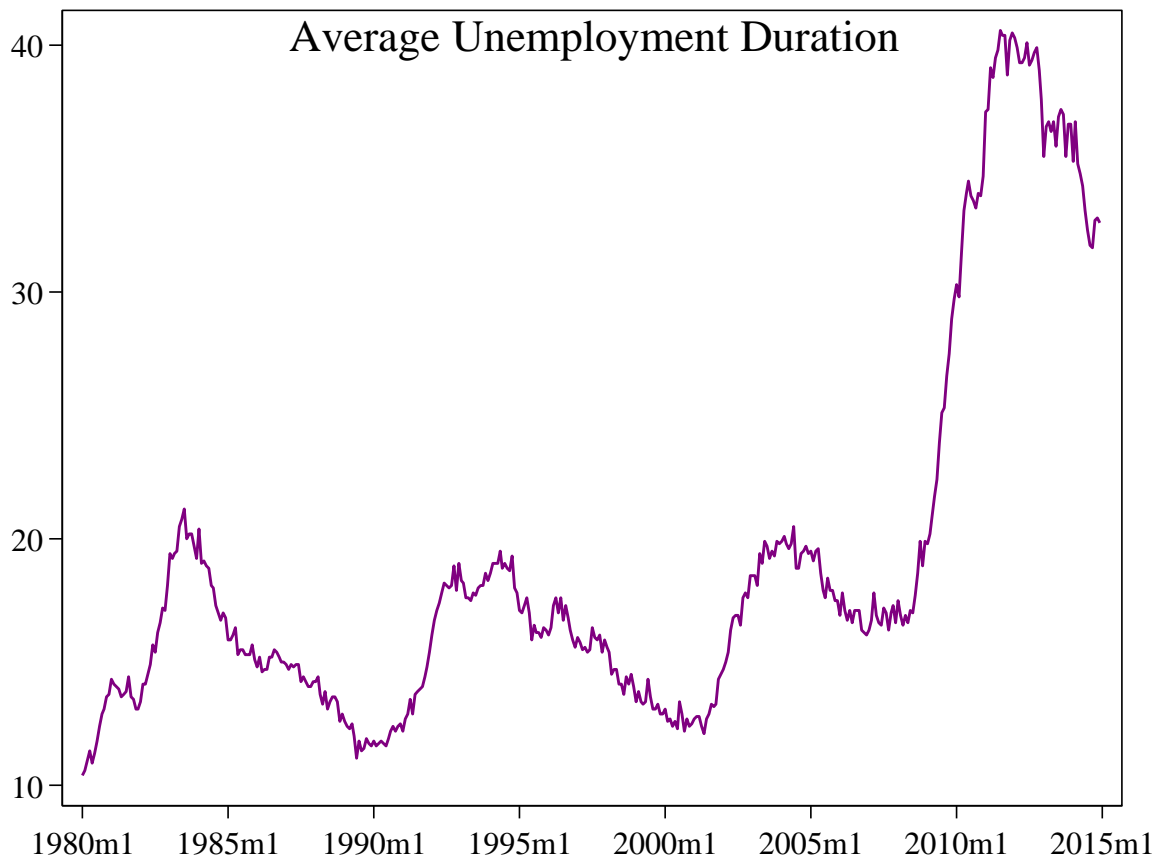
Beyond this specific view, the more important point is that the understanding of economists about what constitutes full employment remains quite imprecise, and there is substantial uncertainty about how much farther this recovery can continue without igniting inflationary pressures. If the recovery continues, we may end up learning that the economy can sustain not only higher labor force participation, but also an unemployment rate of four-point-something percent, rather than five-point-something. Certainly, the 1990s suggests that this may be achievable. If there is uncertainty about what the economy can achieve, policy should err on the side of exploring whether better outcomes are possible.

Let me now shift my focus from the relative short run, and move to raising some longer-run issues.

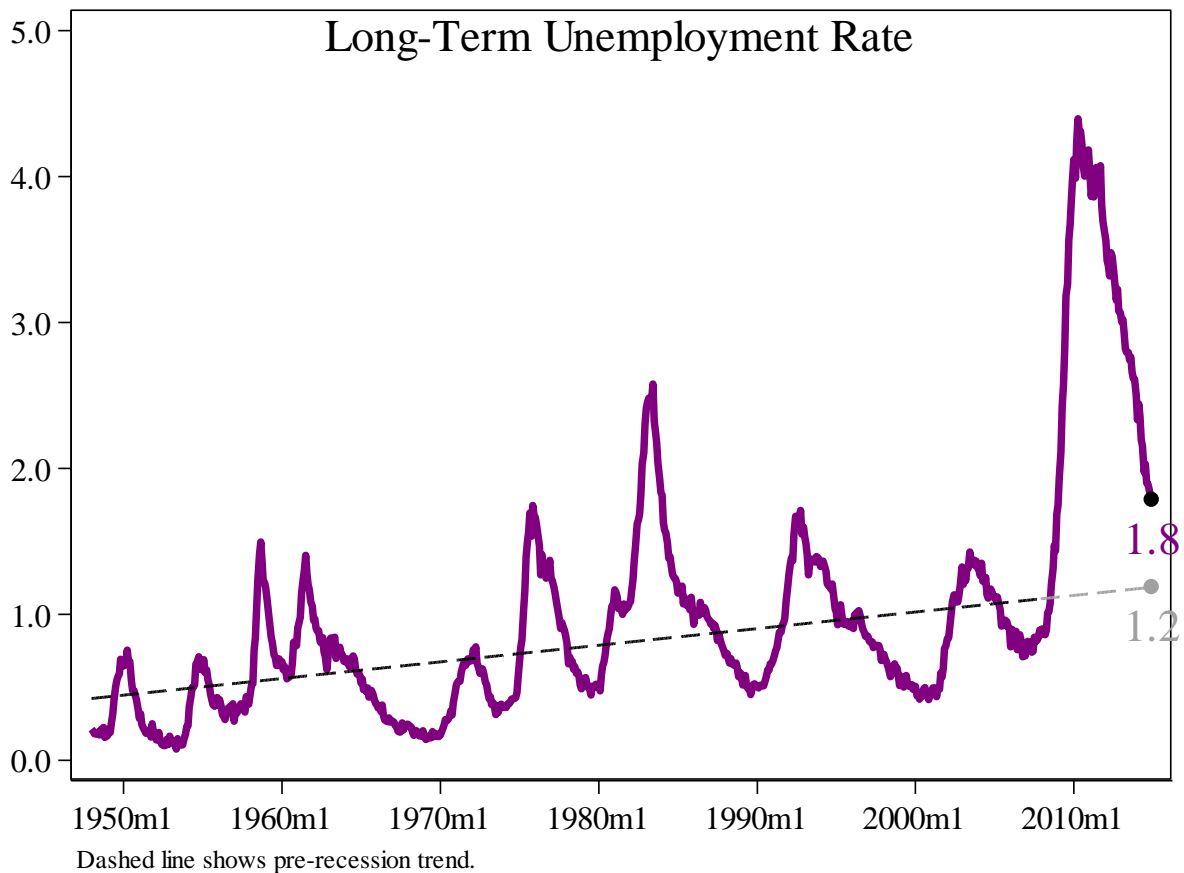
Long-Term Unemployment

Historically, the United States had a highly fluid labor market, in which millions of people were hired and fired each month. The result was that losing your job was not a catastrophe, as there were plenty of new opportunities. Accordingly, so a typical spell of unemployment would only last a matter of weeks, before a motivated worker could find another job. In turn, this meant that the burden of unemployment on any individual was not too great, as even a five percent unemployment rate meant that many people were each spending just a few weeks or months unemployed.

Yet following the Great Recession, the burden of unemployment became a lot more concentrated, as the average duration of unemployment rose sharply. Today we measure unemployment spells in months or years, rather than in weeks. Instead of many people sharing the burden of short unemployment spells, today’s unemployment is due to far fewer people each bearing the burden of many months or years of unemployment. Beyond the strains on their own lives, this may also have long-term macroeconomic consequences, as a long spell of unemployment leads people to lose skills, connections and hope, leading to the possibility that there will be a group that may never work again – at least without intensive assistance. This raises the likelihood that a complete recovery from this recession will require much more intensive job assistance in order to help the very long-term unemployed return to work.



The good news is that much of the rise in long-term unemployment (defined as having been jobless for at least six months) has declined as the recovery has progressed. But beyond the business cycle ups and downs, there has been a slow-moving trend over many decades toward rising levels of long-term unemployment. Even if current rates of long-term unemployment return to their pre-recession trend, it will still comprise 1.2 percent of the labor force.



Given that widespread long-term unemployment is so new, it is little surprise that our labor market and training programs are not well-adapted to dealing with this issue.

Following the financial crisis, Congress passed Emergency Unemployment Compensation, extending the number of weeks for which jobless workers could claim unemployment insurance. Subsequent research has shown that this actually helped the long-term unemployed remain in the labor force and supported their job search.

Congress should consider making this process of extending benefits automatic for future downturns of sufficient severity. Such a move would both remove the need for specific congressional action (which often comes with a lag), and a well-crafted formula would also offer Congress the assurance that such extensions would disappear when business cycle conditions returned to normal.

Indeed, let me expand on this theme a bit, by raising the possibility of using such automatic stabilizers more aggressively.

Preventing Future Recessions and an Increasing Role for Automatic Stabilizers

The most recent recession has highlighted an important shortcoming in relying on the Federal Reserve to manage the business cycle: When interest rates hit zero, there is limited scope for further monetary action to stimulate the economy. Indeed, we now understand that in a low inflation environment, it is very difficult for the Fed to engineer the sorts of sufficiently low real interest rates that may be required to offset adverse economic shocks.

This suggests that it may be important to build more automatic stabilizers into our economy. We already have some automatic stabilizers built in, such as a progressive tax system, which means that when income falls, so too will tax rates. Likewise, some federal programs, like the Unemployment Insurance Extended Benefits provide needed income that lead to increased spending during periods of high unemployment.

This idea of building in a counter-cyclical spending pattern is one which Congress could expand substantially, building formulae into an array of federal programs that would raise spending during periods of slow economic activity, and lower spending during periods of stronger activity. I have already raised the idea that the Emergency Unemployment Compensation program could be put in place so that it is automatically triggered whenever long-term unemployment rises again in the future. But the idea is far more broadly applicable, and similar triggers could be built into programs ranging from federal highway and infrastructure spending, to Pell grants, to making block grants to states for TANF responsive to economic conditions.

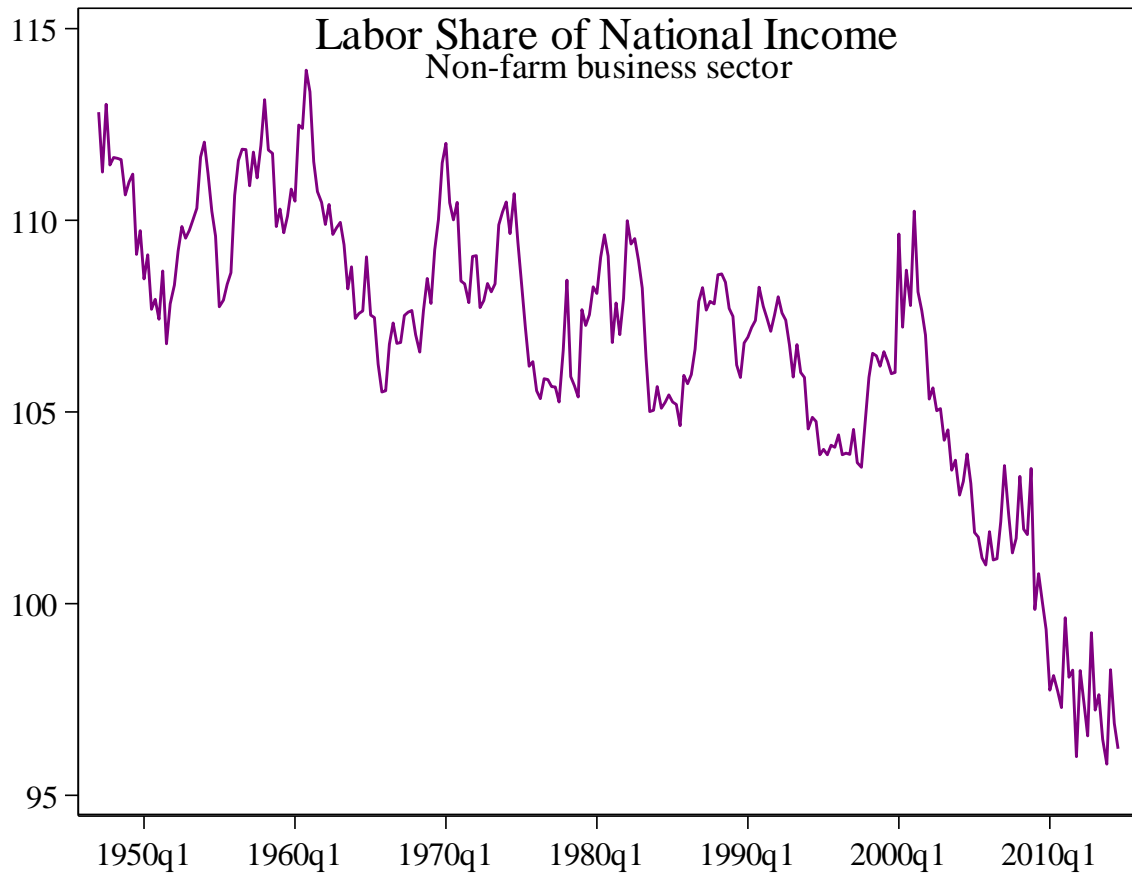
Not only would the automaticity of these mechanisms minimize the legislative lags that often undermine fiscal stimulus, but they would increase spending precisely when the value of that spending was highest and curtail spending as the value falls. And the use of formulae would allow the debate about how best to respond to cyclical changes to be divorced from the very different debate about how much should be spent on each of these programs.

Automatic stabilizers also have important benefits beyond the role they play in taming the business cycle. By concentrating federal spending during periods when the economy is weak, the federal government will be hiring precisely when there is the greatest amount most slack resources, meaning that it competes less with the private sector for scarce resources. The result is that federal spending would be targeted for those times when the cost of hiring workers is lowest.

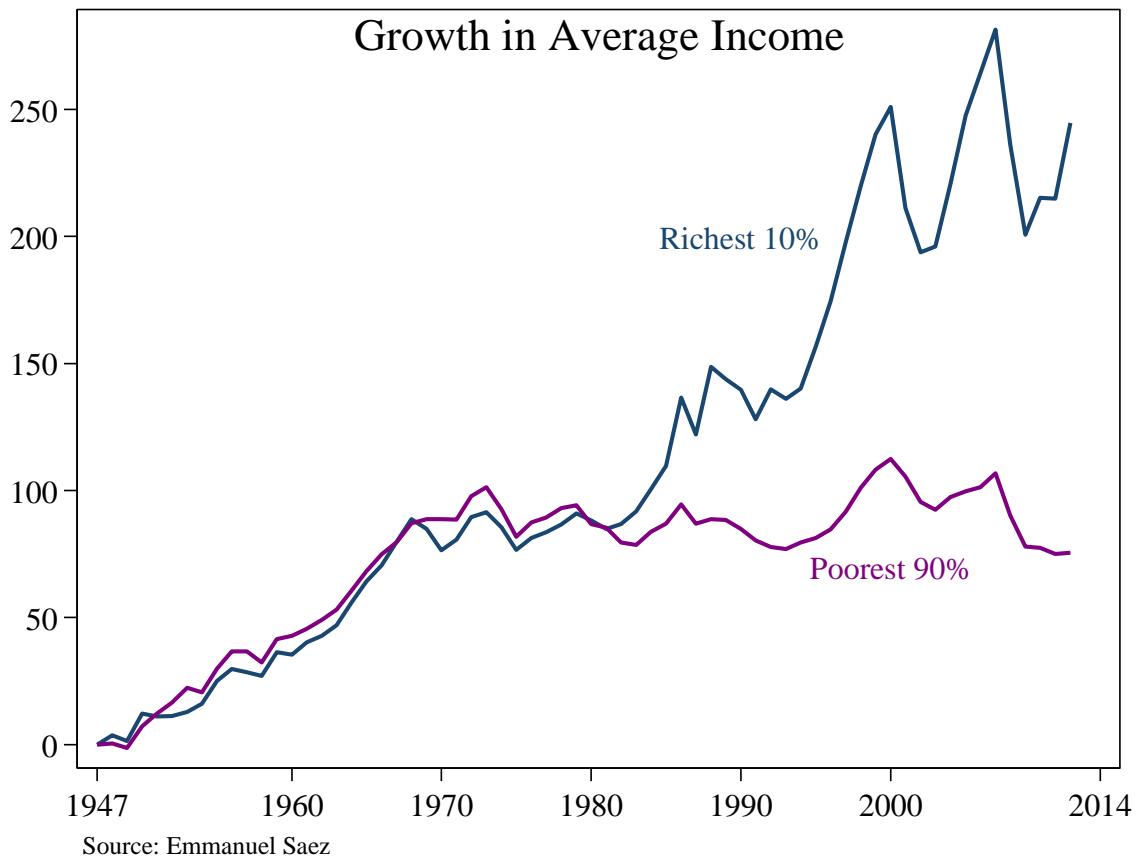
Rising Inequality and the Role of the Tax System

For much of U.S. history, the presumption was that economic growth would deliver rising well-being for a broad swathe of the population. Yet two important trends have undermined that view.

First, real wages have not risen by much, even as productivity continues to grow. The result is that labor's share of national income – the proportion of our economic pie that goes to workers in the form of wages – has declined sharply over recent decades, suggesting that firm owners, rather than workers, are enjoying the fruits of economic growth.



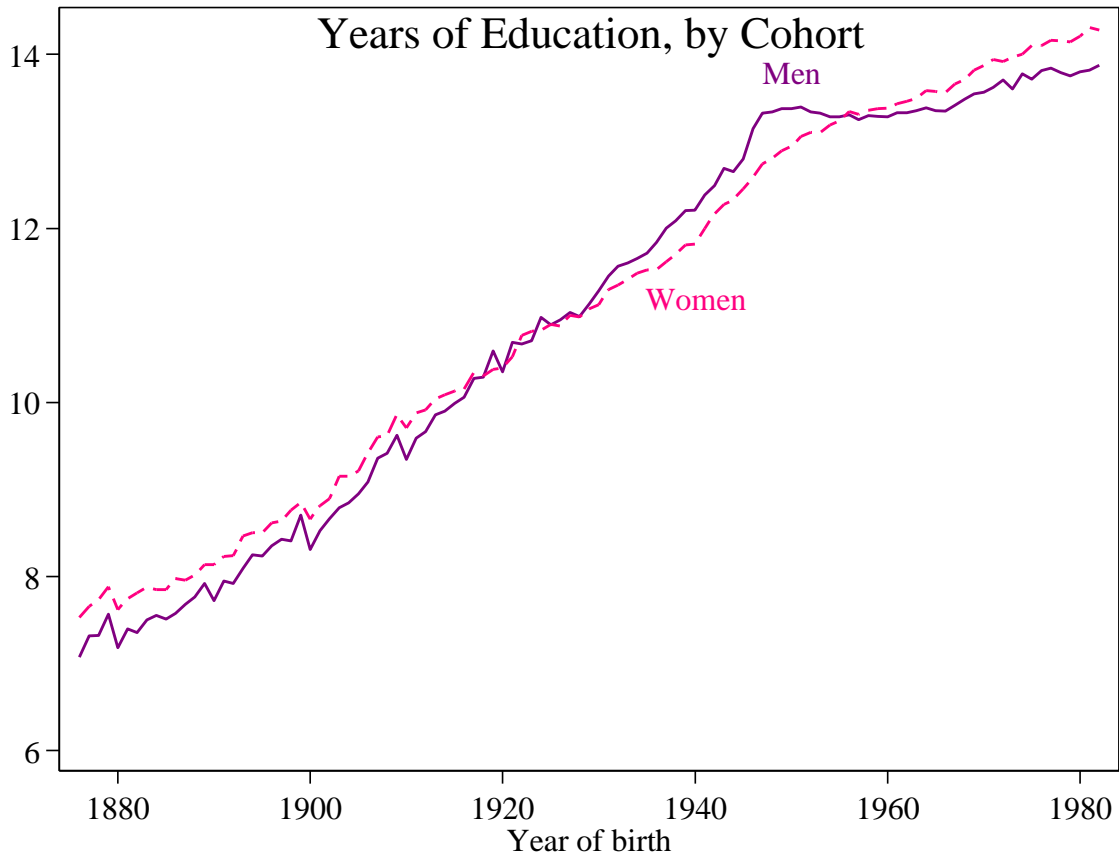
And second, beyond the shift in the functional distribution of income between labor and capital, there has been a sharp rise in overall income inequality, even within labor or capital earnings. As the following chart shows, economic growth raised incomes in roughly equal measure for both rich and non-rich from 1947 through to 1979. But since 1980, economic growth has delivered large average rises in income for the top 10% (and much of that was concentrated in the top 1%), but it has yielded very little for the remaining 90%.



If these are the outcomes that our current market system is delivering, it suggests a potential role for the tax system in ensuring that the fruits of economic growth are more broadly shared. While the two major political parties are locked in a debate about the optimal size of government, and how large aggregate tax collections should be, this raises a conceptually distinct question, which is how best to distribute that tax burden. This is a debate that can occur even without shifting the overall tax burden. Higher taxes on the few who have enjoyed unusually strong returns, if it leads to lower taxes on many other workers, may even enhance overall incentives for productive activity, while also reducing inequality.

Investing in Education

For much of the past century, economic growth and opportunity in the United States have been supported by rising levels of education. Typically, each generation of Americans got around two more years of education than their parents. Yet in the past few decades, this trend has slowed dramatically, and virtually halted for men. Indeed, the current crop of 30-year old men are barely more educated than their parents were.



The “high school movement” in the early twentieth century led to a substantial expansion of secondary education. And while I recognize that these issues lie largely outside the committee’s jurisdiction, I think it nonetheless important to make the case that now is the time for a broader “college movement,” which makes both two-year and four-year colleges more widely available.

The President’s proposal to expand access to community college seems like a natural first step in this agenda. But this is an agenda that would also benefit from four complementary reforms. First, college readiness remains an important barrier for many students, and an emerging body of evidence suggests that the roots of these gaps arise in early childhood. This suggests that investments in pre-K education may help also yield better long-run outcomes. Second, while there are some excellent tertiary institutions, far too many of them – and far too many in the community college sector – yield low-quality education, and result only in students dropping out from colleges. The sector needs to be reformed, with an emphasis on raising the quality of community college education, providing more support for struggling students, and the federal government should stop funding under-performing tertiary institutions. Third, a variety of innovative education programs have shown that even very small low-cost nudges – such as help in navigating FASFA, a text message to remind you of your deadlines, a personalized letter letting you know that a high-quality college education may actually be affordable given the array of funding opportunities available – can have very large effects. Successful programs

should be scaled up, and federal grants should be made for ongoing innovation in simplifying the college application process, and making the relatively low cost of college substantially more transparent. And fourth, the expensive big-ticket items, like the Hope Tax Credit, the Credit for Lifelong Learning, and the American Opportunity Tax Credit, are potentially useful, but should be tightly tailored to families most in need, both because that is where the college attendance gap is the largest, and also because this is where extra federal dollars are most likely to have their largest affect. Moreover, these credits are most likely to be effective if coupled with the sorts of information campaigns and nudges I just mentioned.

Labor markets and a healthy economy are of paramount importance to the health, happiness and well-being of all Americans, and I appreciate the opportunity to share my assessment with you today.