Testimony before the Budget Committee "Challenges for the U.S. Economic Recovery"

February 3rd 2011

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Chairman Conrad, Ranking Member Sessions, and distinguished members of the Budget Committee, it is an honor to be with you today. Since the beginning of 2008, millions of individuals have lost their jobs through no fault of their own. Even though growth in domestic product has started to rise again, the situation in the labor market remains difficult. Measures of the rate of underemployment are still above 15%, and an unusually large number of job losers has been unemployed for over six months. Unless we see unprecedented job growth in the near future, available estimates suggest the process of reintegrating these workers into employment is going to be long-lasting and gradual.

During this process, many individuals are at risk of permanently leaving the labor force. Those most likely to drop out are older workers, partially disabled workers, and less educated workers. This development is potentially costly for society, since these workers, while able to work, do not pay income taxes, are more likely to draw Social Security benefits early, or enter costly programs such as disability insurance. In the process of searching for jobs, many workers are likely to exhaust unemployment insurance (UI) benefits. It is well known that upon exhaustion, families' consumption falls, and the incidence of poverty rises.2 This effect is particularly large for single earner families with children. On the other hand, only a limited fraction of individuals exhausting UI benefits actually find a job.³

Upon finding a job for those who do, experience from previous large recessions suggests that earnings of laid off workers are substantially lower. The average mature worker losing a stable

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 ¹ E.g., Congressional Budget Office (2010b).
² E.g., Gruber (1997), Congressional Budget Office (2004).

³ Card, Chetty, and Weber (2007).

job at a good employer will see earnings reductions of 20% lasting over 15-20 years.⁴ While these earnings losses vary somewhat among demographic groups or industries, no group in the labor market is exempt from significant and long lasting costs of job loss.⁵ A job loss is also typically followed by an extended period of instability of employment and earnings.⁶ During this period, job losers can also experience declines in health. In severe downturns, these health declines can lead to significant reductions in life expectancy of 1 to 1.5 years.⁷

The effects of unemployment and job loss are also felt by workers' children, who can suffer from the consequences even as adults, and by their families. At particular risk are those young adults entering college with lower financial support from their families. In the current labor market, these students also face fewer opportunities to finance their studies by part-time employment, and are thus at greater risk of dropping out of college.⁹

More generally, evidence from past recessions suggests that entering the labor market in a recession can have long-lasting consequences for young workers. Entering the labor market in a large recession such as the current one can lead to reduced earnings for up to 10 to 15 years. These effects differ by education group.¹⁰ In the short run, lower educated workers experience larger increases in unemployment than more educated labor market entrants. However, in the long run less educated individuals tend to recover faster, as do individuals at the top of the education distribution. It is workers in the middle of the education distribution can suffer near permanent earnings consequences from entering the labor market in a recession.

Large-scale layoffs and persistent unemployment have wide-reaching consequences for

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⁴ Jacobson, Lalonde, and Sullivan (1993) and von Wachter, Song, and Manchester (2009) show the long-term earnings losses of laid-off workers during the 1982 recession in Pennsylvania and the U.S., respectively. ⁵ Farber (2004) provides estimates of the short-term costs of job loss for the U.S. over the past two decades. Schoeni

⁵ Farber (2004) provides estimates of the short-term costs of job loss for the U.S. over the past two decades. Schoeni and Dardia (2003), von Wachter, Handwerker, and Hildreth (2008), Couch and Placzek (2010), and Kodrzycki (2007) show medium run estimates for California, California, Connecticut and Massachusetts in the 1990s.

⁶ See, e.g., Stevens (1997) and von Wachter, Song, and Manchester (2009).

⁷ Sullivan and von Wachter (2009) estimate the short- and long-term effects of lay-off on mortality. Burgard, Brand, and House (2007) give an overview of other health effects of job loss and unemployment.

⁸ Stevens and Schaller (2009) and Oreopoulos, Page, and Stevens (2008) provide evidence that layoff affects children's test scores and adult earnings, respectively. Del Bono, Weber, and Winter-Ebmer (2008) show that layoff affects fertility rates.

⁹ The fraction of workers working while in college has been increasing (e.g., Scott-Clayton 2007). However, there is no evidence that this work provides a return later in the labor market (Hotz, Xu, Tienda, and Ahituv 2002), suggesting that this work partly finances school attendance.

¹⁰ Oreopoulos, von Wachter, and Heisz (2008) and Kondo (2008).

affected workers and their families, but also for expenditures on many government programs. Government policies can help reduce the impact of extended joblessness on laid off workers and their families, as well as mitigate the potential impact on government finances. My recommendations fall in four areas, comprising extensions in durations of unemployment insurance benefits; development of an 'exit strategy' for the long-term unemployed as the labor market recovers; prevention of layoffs; and assistance to young labor market entrants.

My first policy recommendation is to extend and potentially reform unemployment insurance (UI) benefits. Extensions of unemployment insurance have been shown to prevent large consumption declines of laid off workers. Given the large fraction of UI recipients at risk of exhausting their benefits, this benefit accrues to a larger number of individuals in recessions. Thereby, UI extensions can also provide a degree of demand stabilization. On the other hand, recent research suggests that the effects of extending UI benefits on employment are likely to be smaller in recessions. Similarly, there is no evidence that individuals use UI extensions to take jobs with higher wages. For these reasons, our calculations suggest that benefits of raising UI are likely to substantially outweigh the costs. 12

Extensions in UI duration can also prevent individuals who are at risk of dropping out of the labor force to enter more costly government programs such as disability insurance or to claim Social Security benefits early. Thus, these extensions could imply cost savings for the Social Security trust fund that should be incorporated into calculations of the budgetary effect of UI extensions. The exact quantification of these mechanism is in principle possible, but the available data is current not accessible to researchers. Further extensions in UI should be made conditional on data sharing between concerned state and federal agencies.

Available approximations suggest cost savings from UI extensions through these channels could be substantial. For example, using unpublished data from the Department of Labor, the Joint Economic Committee (2010) provided estimates indicating that – absent further extensions in the duration of unemployment insurance benefits – the number of disabled unemployment

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¹¹ Congressional Budget Office (2008, 2010a,b) summarizes evidence that spending through unemployment insurance is an efficient means to provide economic stimulus

¹² Schmieder, von Wachter, and Bender (2011). These calculations do not take into account the potential beneficial effect on demand stabilization. As argued in Landais, Michaillat, and Saez (2010) we also assume that any adverse effect on job creation is negligible in a slack labor market.

insurance recipients who were likely to exhaust their unemployment insurance benefits in the latter half of 2010 is 290,000. Estimates of the value of average life-time benefits of Social Security Disability Insurance (SSDI) and the value of Medicare benefits accruing to SSDI recipients provided in von Wachter, Song, and Manchester (2010) imply large budgetary costs if even a fraction of these individuals apply and receive SSDI. Thus, if extensions in the duration of unemployment insurance benefits can prevent some of these individuals to apply to SSDI, this can imply substantial cost savings that partially offset the cost of benefit extensions.

At a monthly job finding rate of ten percent, ¹³ an extension of benefits by six month would imply that about half of these individuals find a job. Clearly, not all the 290,000 disabled individuals would apply for SSDI and, conditional on applying, not everyone is eligible. ¹⁴ Using estimates in von Wachter, Song, and Manchester (2010), the Joint Economic Committee (2010) reports that if two thirds of the 290,000 potentially eligible individuals apply for and receive SSDI, the potential cost would amount to \$24.2 billion. Given that a six month UI extension would lead to reemployment of approximately half (less if the job arrival rate is lower for disabled individuals, potentially more if the labor market continues to recover), the total cost saving is likely to be smaller than this number. However, these back-of-the-envelope calculations demonstrate that the magnitudes involved may be significant.

Recessions also tend lead to early retirement from the labor force, especially for lower educated men. My own estimates based on past recessions suggest that for a five point rise in state unemployment rates, the employment-population rate of 60-64 year old high-school graduates by 4-5 percentage points.¹⁵ One reason is likely to be that earnings of older workers are particularly hard hit by a layoff.¹⁶ The majority of these workers does not return to the labor force and is likely to claim Social Security benefits early. In the current recession, new monthly primary claims for both genders have risen steeply by about 25-30 percent from 2008 to 2010. Whereas annual primary claims where roughly constant from 2003 to 2007 at two million per year, they rose to 2.7 and 2.6 million in 2009 and 2010, respectively.¹⁷ Extensions in UI may

¹³ E.g., conforming with estimates for job finding rate by Hall (2005) at the through of the 1982 recession,

¹⁴ Bound and Burkhauser (1999) report that among non-working disabled individuals, about 70% receive some form of disability benefits, the majority of which is likely to be SSDI.

¹⁵ von Wachter (2007).

¹⁶ Chan and Stevens (2001), von Wachter (2007), von Wachter, Song, and Manchester (2009).

¹⁷ Social Security Beneficiary Data (http://www.socialsecurity.gov/OACT/ProgData/awards.html). The awards were

prevent some of these workers from dropping out of the labor force and claiming Social Security benefits early.

My second policy recommendation is the need to prepare an 'exit strategy' for UI recipients once the labor market shows signs of recovery. To help the long-term unemployed to find a job amidst an improving labor market, three types of programs have shown to be able to achieve lasting increases in employment while potentially saving money for the unemployment insurance system: Job Search Assistance, Retraining Programs, and Reemployment Bonuses.¹⁸

To find a new job, workers laid-off in a recession may need to reorient their career goals. Job search assistance can help with this uncertain and time consuming process by providing access to job listings, but also by providing information on occupations, industries, or regions with promising job prospects. Various types of job search assistance provided within the unemployment insurance system in the United States' and in other countries have been shown to be efficient and cost effective. Yet, research has also suggested that the current infrastructure of One-Stop Career centers could be improved and extended to provide more efficient and cost-effective services to unemployed job seekers. In particular, the provision of more intensive services – involving individual career-counseling and training courses – could be made more efficient and extended to a broader population. Thereby, it is worth considering a system that targets more costly services such as training are targeted to workers most likely to run out of UI benefits or be long-term unemployed.

To reorient or restart their careers and improve their job prospects, some unemployed workers will have to acquire new skills. Some training programs have been shown to be more efficient and cost-effective at raising employment of laid-off workers than others. For example, while completing technical courses at community colleges appears helpful for many workers, training in non-technical subjects is less promising.²⁰ Similarly, on-the-job training programs that provide on-the-job experience while matching unemployed workers with interested firms appear

^{2.3} million in 2008, consistent with the recession gaining strength in mid-year.

¹⁸ The following summary is based, among others, on surveys of the literature in Department of Labor (1995), Heckman, Lalonde, and Smith (1999), Kluve (2006), Card, Kluve, and Weber (2009).

¹⁹ See, e.g., Jacobson (2009).

²⁰ Jacobson, Lalonde, and Sullivan (2005).

promising.²¹ Thus, proper counseling of workers and subsidizing the right kind of training are likely to be important aspects in any effort to effectively retrain workers. In contrast to job search assistance, which has been shown to quickly reduce the number of workers receiving unemployment insurance benefits, the impact of training accrues over time.²² A combination of job search assistance and targeted training may thus lead to sustained job finding and employment rates.

For some workers, a long period of time may elapse before they find a new job. These workers may have lost motivation, hope, or a realistic view of what wages to expect in the labor market. If targeted to workers most likely to exhaust unemployment insurance benefits, bonuses that pay workers for finding a new job can reconnect long-term unemployed workers to the labor force can raise employment and reduce the cost for the unemployment insurance system.

An advantage of these policies is that they have been evaluated and implemented within the current unemployment insurance system. These policies cannot substitute for a rise in job creation; but such an 'exit strategy' represents a potentially important complement to help to make sure the long-term unemployed and the finances of the unemployment insurance system both benefit quickly from the onset of an economic expansion.

Combinations of these policies could also be implemented simultaneously for further effectiveness. For example, a combination of stricter job search requirements, intensive counseling and retraining, plus reemployment bonuses may keep workers attached to the labor force and willing to accept jobs as soon as job creation increases. An approach of this kind would raise the market value of some unemployed workers while at the same time bringing their wage expectations in line with the reality in the labor market. Such an "exit strategy" built into the unemployment insurance system may be particularly useful for older laid-off workers who face strong wage penalties and low employment rates. It may also help to address concerns regarding the effect of extending unemployment insurance benefits on the employment rate itself.

Current research suggests government policy is less effective in helping to alleviate the large and lasting reductions in wages that eventually follow a typical job loss during a recession.

See the discussion in Katz (2010).
See Card, Kluve, and Weber (2009).

While some training programs have been shown to raise earnings of laid-off workers, and may do so cost-effectively from a tax-payers point of view, the resulting increases are modest relative to the losses these workers have experienced.²³ The reason is that the main factors likely underlying long-term earnings losses are deeply rooted in the workings of the labor market. The majority of long-term losses are due to losses in the value of certain skills as industries decline; due to the loss of long-term career jobs; or due to slow wage-adjustment in the labor market.²⁴ None of these sources of wage loss are easily manipulated by government policy.

Given the difficulties of helping job losers and unemployed workers recover from long-term earnings losses after the fact, my third recommendation is to explore available options to reduce large-scale layoffs in the future. One way would be to avert some large-scale layoffs through 'work-sharing' arrangements (also termed 'short-time compensation'). This would prevent the decline in spending power associated with layoffs, avoid dislocation and long-lasting earnings losses of laid-off workers, and may be cost-effective from society's point of view.

For example, the cost of unemployment insurance benefits for a typical worker is a small fraction of the total earnings lost due to a layoff over the remainder of the individual's working life. If the same benefits were paid during employment to avoid job loss, this would substantially reduce the cost of recessions. An added advantage of such 'work-sharing' arrangement is that it may immediately raise employment during the current recovery by reducing ongoing job destruction.

Such a system of work-sharing has already been instituted in 17 states.²⁵ However, the current system may have to be extended and publicized to have a visible impact on ongoing job destruction and to have a substantial impact on employment.²⁶ More research is needed on the specific features of an extended work-sharing system;²⁷ however, by building on existing

implementation of a work sharing program (see Möller 2010 for a critical assessment). Vroman and Brusentsev (2009) provide an overview of short-time compensation in other European countries and Canada. ²⁷ Work-sharing bears some similarities to wage insurance (e.g., Kletzer and Litan 2001, Kling 2006) in that wages

²³ Non-experimental estimates in Jacobson, Lalonde, and Sullivan (2005) imply that one year of technical training at community college reduces the average earnings loss by about a third.

²⁴ See von Wachter, Song, and Manchester (2009) for additional discussion.

²⁵ See Department of Labor (1997) for an overview of short-time compensation programs in different states. ²⁶ Abraham and Houseman (2009) suggest regulatory uncertainty as one reason for a low take-up of short-time compensation among states. See the Department of Labor (1997) for reasons of low take-up among employers within states that allow short-time compensation. The German experience is the most cited example of a successful

programs work-sharing may be a way to start shifting away from the notion that large-scale and costly layoffs are unavoidable if firms need to cut their wage bills.²⁸

My fourth and final recommendation concerns assistance unlucky young individuals coming of age during the recession. First, the current system of financial aid for college could be used to help prevent children from low-income background or from families who experienced a job loss from dropping out of college. Research documents a robust relationship of parental income and the cost of college with college attendance especially of lower income individuals, and this relationship appears to have strengthened over time.²⁹ Financial aid can be an important buffer against labor market shocks affecting parental income or students' own ability to work while in school. However, students are often not aware of available programs, and thus even eligible students do not take up available aid. Current research suggests that this is partly driven by complexity of the student loan process.³⁰ Reducing the complexity of the financial aid process and informing and assisting students with applications would be helpful and relatively low-cost policy. Another concern is that many resources available for especially lower income students are currently provided at the state level, such as subsidized Community Colleges or merit scholarships. As states budgets are being cut, these resources are at risk. Since Community College resources and merit scholarships affect the incidence and quality of college education, federal assistance to maintain access to college for low income students would be helpful.

For those young individuals not bound for college, the recent increase in idleness can represent a risk but also an opportunity to take time to invest in skills. Recent research has shown sectoral training programs can be successful in raising the employment rate of participants.³¹ These programs cooperate with firms in structuring their training programs and in placing workers. Expanding support for participation in such programs is worth considering. An alternative is to further encourage the use of federal financial aid such as Pell grants to enroll

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are replaced while workers remain employed; it shares the feature with direct subsidies or tax breaks targeted to job creation that some jobs may be subsidized that may have been viable from the outset if firms game the system.

²⁸ Alternative options include the relocation and retraining of workers within firms (see, e.g., Koller 2010 for an example); reductions in salary among all employees (e.g., Akerlof, Dickens, and Perry 2000); or managed employment reductions, such as early retirement programs.

²⁹ See Demin and Dynarski (2009) for a summary.

³⁰ See Oreopoulos et al. (2009) for background information and suggested solutions to this problem.

³¹ See Maguire et al. (2009) for a summary.

young workers at vocational schools.³² However, very little is known about the actual rewards in the labor market of these schools. Mandating scientific evaluations of the returns to private programs receiving federal funding through financial aid and making the necessary data available to the academic community would be a useful policy.

³² See, e.g., Cellini (2010).

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