Senate Democratic Policy Committee

"Putting Americans Back to Work: Competing Visions for Job Creation"

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Chairman Dorgan and Members of the Committee, thank you for the opportunity to appear today to discuss the state of the United State labor market and policy options to improve economic performance.

The United States is in the midst of the most severe economic downturn since the Great Depression. While Gross Domestic Product (GDP) is estimated to have grown 2.8 percent in the 3rd quarter of this year, GDP remains $400 billion (3 percent) below its peak in the 4th quarter of 2007. Similarly, payroll employment in November was 131 million, 7.2 million below its peak in December 2007. The unemployment rate remains high at 10 percent, with particularly troubling pockets among teenagers (26.7 percent) and young adults (16 percent for those 20 to 24, and 10.4 percent for those 25 to 34).

Despite this, there are signs of improvement. GDP appears set to grow for a second straight quarter, and the traditional mechanics of economic recovery are beginning to come into play. This recession has included enormous inventory liquidation. As firms rebuild their inventories, this will translate into additional orders and output, thereby adding to upward momentum. Similarly, during the long downturn firms have cut back on capital outlays, with the result that they are facing the resurgence of growth with equipment that is dated, having experienced wear and tear, and in need of replacement. In some cases, their plants and other structures are in similar condition. Accordingly, even before firms begin to expand their productive capacity, economic growth will benefit from the mere replacement of obsolete capital.

These shifts are part and parcel of the normal dynamics of economic recovery that will ultimately lead to full employment. A key step in recovery occurred when financial markets stabilized in late 2008. Financial conditions have not yet fully normalized and credit tightness continues, but the fear of financial collapse that was at the core of the downturn has diminished. With the removal of the largest part of credit constraints, GDP growth can be built upon natural forces. Most importantly, with the recovery in output growth, employment growth will follow.

Policy Considerations

In light of the elevated level of unemployment, there is a natural desire to speed the process of return to full employment. Importantly, any such policy action will not "create" jobs – the forces of economic recovery will generate those jobs eventually – but rather accelerate jobs that would otherwise be generated.

Keynesian Stimulus. Much of the popular discussion focuses on Keynesian approaches that involve federal spending programs or tax reductions. Such approaches do not pass a benefit-cost test at this juncture. Taxes and spending are not the only source of policy impetus for recovery. Indeed, given the well-documented failures of legislative attempts at fiscal fine-tuning being enacted and implemented in a timely fashion, there is a presumption that monetary policy is better situated to undertake such efforts. Current Federal Reserve policy is extremely accommodative, providing a pipeline of monetary stimulus that will benefit the economy in the year to come.

In addition, Keynesian policies are fundamentally short-sighted, focusing on the current cash flows of households and firms. As noted above, the mechanics for improved cash flows appear to be in place. However, even in the face of adequate incomes and profits, households and businesses will be loathe to undertake purchases and hiring if they expect undesirable economic conditions in the future or are simply too uncertain to be able to judge the outlook.

At the moment, even with the pre-conditions for sustained growth in place, excessive policy uncertainty is itself likely an impediment to the rapid restoration of employment growth. In particular, it is difficult for a small business to commit to hiring new employees when faced with the expectation of higher taxes (such as raising the top two marginal income tax rates), potentially intrusive regulation from the Environmental Protection Agency's attempt to limit carbon emissions, the threat of protectionism that reduces trade opportunities, the possibility of easier unionization and associated higher labor costs, and potentially costly mandates in health care reform. At any point in time, each of these issues might raise concerns that would be surmountable; taken collectively they constitute a severe impediment to confidence that cannot be ameliorated by Keynesian stimulus.

Finally, Keynesian policies are not without cost – they will raise the budget deficit and increase further the national debt. Any consideration of further such efforts must confront the fact that the federal government ran a 2009 deficit of $1.4 trillion – the highest since World War II – as spending reached nearly 25 percent of GDP and receipts fell below 15 percent of GDP. These budgetary difficulties are unlike those experienced in over 50 years.

Going forward, there is no relief in sight. Each year the federal budget is projected to be in enormous deficit. By 2019, according to the CBO's analysis of the President's budget, the deficit will be 5.7 percent of GDP, even though the economy will have long-since been projected to reach full employment and revenues will rise above the norm to reach 19 percent of GDP. The deficit will be roughly $1 trillion, of which about $800 billion will be devoted to servicing debt on previous borrowing.

Deficits have economic consequences that impact both fairness and growth. At the most basic level, they force our children and grandchildren to pay the bill for our over-consumption. Often it is argued that it is "fair" to do so because the debt-financed spending confers a corresponding benefit to those generations, but the debts contemplated in the near future cannot pass any reasonable test of equity.

Federal deficits can crowd out domestic investment in physical capital, human capital, and technologies that increase potential GDP and the standard of living. Financing deficits may require net capital inflows that crowd out exports and harm our international competitiveness. We should worry about large borrowing from competitors like China limiting the United States' range of economic and diplomatic options.

In addition to these continued, corrosive effects of budget deficits, analysts have long worried about more dramatic fallout from the budgetary outlook. At what point do rating agencies downgrade the United States? When do lenders price additional risk and charge higher interest rates to federal borrowing, leading to a damaging spike in interest rates? How quickly will international investors flee the dollar for a new reserve currency? If so, how will the resulting higher interest rates, diminished dollar, higher inflation, and economic distress manifest itself? How quickly could such a tsunami of debt-related economic weakness arise? And when could it happen?

In thinking about these risks, it is useful to note that we are in an era unlike the past. While there have been nations whose debt approached or exceeded U.S. levels, it has never been in a situation in which nearly every part of the developed world faces a debt problem comparable (or worse) to that of the United States.

In short, a repeated propensity to attempt Keynesian "jobs bills" will not produce sufficient benefit to overcome policy uncertainty or outweigh the costs associated with ever-increasing national debt.

Other Options. There are ways to improve incentives and labor market performance. To begin, Congress should give serious consideration to repealing the recent legislated increases in the minimum wage. In 2007, Congress raised the minimum wage, which was then $5.15 per hour, to $7.25 per hour. The minimum

wage is not the only factor in labor markets, but it has a disproportionate impact on teenagers and other relatively low-skilled, young workers. In light of the extreme duress in these segments of the labor market, permitting additional hiring far outweighs the benefits of a higher floor.

In addition, Congress should move quickly to pass existing trade agreements with Colombia, Panama, and South Korea. Net exports must be a central driver of a successful, sustained recovery and these agreements would be an important step in their own right, and a strong signal for the future, for this sector of the economy.

Finally, the Administration and Congress should provide a clear roadmap to restore control over federal spending and budget deficits in the future. Such an exit strategy from the current situation would permit firms and households to reduce any anxiety over crippling interest rate spikes or sharp tax increases over the next decade, thereby improving the climate for economic recovery and employment growth.

Thank you for the opportunity to appear today. I look forward to answering any questions that you might have.