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THE CHALLENGE OF CREATING JOBS IN THE AFTERMATH OF "THE GREAT RECESSION"

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED ELEVENTH CONGRESS

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THE CHALLENGE OF CREATING JOBS IN THE AFTERMATH OF "THE GREAT RECESSION"

THURSDAY, DECEMBER 10, 2009

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, Pursuant to call, at 10:08 a.m., in Room 210, Cannon House Office Building, The Honorable Carolyn B. Maloney (Chair) presiding.

Representatives present: Maloney, Hinchey, Cummings, Snyder, Brady, Burgess, and Campbell.

Staff present: Paul Chen, Gail Cohen, Colleen Healy, Elisabeth Jacobs, Michael Neal, Barry Nolan, Annabelle Tamerjan, Andrew Tulloch, Andrew Wilson, Rachel Greszler, Lydia Mashburn, Jane McCullogh, Ted Boll, Gordon Brady, Dan Miller, and Robert O'Quinn.

OPENING STATEMENT OF THE HONORABLE CAROLYN B. MALONEY, CHAIR, A U.S. REPRESENTATIVE FROM NEW YORK

Chair Maloney. The committee will come to order.

I am Congresswoman Maloney, and I recognize myself for 5 minutes.

For the first time since the recession began 2 years ago, the labor market appears to have stabilized. After month after month of punishing losses, November's employment picture was relatively stable. Less than a year ago, job losses were growing more and more severe. Last November, the economy shed 600,000 jobs. Losses increased until January, when they hit a post-Great Depression record of 741,000 jobs lost, the last month President Bush was in office.

But we turned a corner. Job losses have steadily fallen for the last six months. Yet there is no escaping the cruel math of recoveries. The recovery of the job market lags behind the recovery of the broader economy. Businesses must have more customers before they add employees.

Although the labor market appears to be stabilizing, too many Americans remain out of work. More than 15 million workers are unemployed. While we have brought the economy back from the brink, we are not yet where we need to be in terms of job creation.

The mission is to create high-quality private-sector jobs. Congress has already done a great deal of work on this front. The $700 billion Recovery Act included a tax cut for 95 percent of American families and created jobs while investing in clean energy technologies, infrastructure, and education. We see those investments

paying off in the steadily improving labor market figures. The effect of the stimulus on job creation has been verified by the nonpartisan Congressional Budget Office.

Just last month, we extended the $8,000 first-time homebuyers credit that will spur construction jobs.

We extended tax relief to small businesses. We are boosting funding for small business loans via the Small Business Administration. These two initiatives should spur hiring.

Earlier this week, President Obama announced a new job creation agenda with three key initiatives to accelerate job growth. First, we need to focus on small businesses. Small businesses are the engine of the American economy. By helping small businesses expand investments and access credit, they can fuel job growth. Second, we need to invest in our future by rebuilding America's crumbling infrastructure. Finally, we need to focus on green jobs. Smart, targeted investments in energy efficiency can help create jobs while improving energy security and saving consumers money.

Congress and the President will work together to aggressively pursue a job creation agenda that speeds the labor market recovery. Of course, some of those initiatives will require new spending, and we are committed to transparency regarding the cost of our initiatives.

But let me be clear: While putting Americans back to work today may require deficit spending, the dangers of inaction are even more costly. If we do not invest in job creation, we will pay later in the form of higher payments to unemployment insurance, food stamps, welfare, and other entitlements for a ballooning number of out-of-work Americans and their very hard-hit suffering families.

Nearly 6 million Americans have been unemployed for 6 or more months. Over 3 million Americans have been unemployed for over a year. Research shows that the longer a worker is out of work, the harder it is for him or her to gain employment. We must invest in these workers with aggressive job creation policies, coupled with targeted job training initiatives. Otherwise, we face a long-term cost burden far more expensive than smart spending on job creation investments today.

Our challenge today is immense. While the economy may be on the road to recovery, the labor market remains on shaky footing. We Americans are a hard-working, resilient people, but the millions who have been battered by the economic storm need our help today in getting back to work, and I am confident that we are up to the task.

I am thrilled that we are joined today by Dr. Joseph Stiglitz, one of America's brightest economic minds, who is here to help us learn more ways to accomplish our goal of a rapid and complete labor market recovery. And I welcome also Dr. Roberts. Thank you both for being here.

I now recognize Mr. Brady for 5 minutes.

[The prepared statement of Representative Maloney appears in the Submissions for the Record on page 36.]

OPENING STATEMENT OF THE HONORABLE KEVIN BRADY, A U.S. REPRESENTATIVE FROM TEXAS

Representative Brady. Thank you, Madam Chair.

I would like to ask unanimous consent to insert the opening statement of Senator Brownback into the record.

Chair Maloney. Without objection.

[The prepared statement of Senator Brownback appears in the Submissions for the Record on page 36.]

Representative Brady. I join the chairwoman in welcoming Dr. Stiglitz and Dr. Roberts and look forward to hearing the views of these two distinguished economists.

The economy remains the number one issue for Americans and my constituents in Texas. They are apprehensive, in some cases frightened, about the direction the economic policy has taken in Washington.

A new Bloomberg survey of the American public reveals the vast majority of the Nation, 60 percent, believe the stimulus has had no effect or is actually hurting the economy. More troubling, nearly half say they feel less financially secure today than they did when President Obama first took office. And their pessimism grows about the willingness and the ability of the government to reduce the staggering deficit.

The recent hastily arranged job summit and calls by the President for Stimulus II are further signs that this administration's economic policies are failing the American public. Consumers are frightened by the debt and their job future and are understandably reluctant to spend. Businesses of all sizes are worried, reluctant to add new workers while Washington promotes higher health care costs, energy costs, more regulation, and new taxes.

The White House and this Congress have taken their eyes off the economic ball, opting instead to pursue ideological agendas that contribute nothing to our economic recovery and, in fact, fuel fear among job creators along our Main Streets. We need to stop "frightening the horses" if we hope for a stable and reliable economic recovery led by our local businesses, rather than the government.

The United States is at an economic crossroads. The road to the right is a free market economy in which the decisions of Americans acting as entrepreneurs, consumers, workers, investors, and savers are determinative, while the road to the left is a social market economy in which the Federal Government plays a controlling role.

To the right, Congress would gradually reduce Federal budget deficits by restraining the growth of Federal spending and pruning unnecessary or ineffective programs. Reforming health care on this path would focus on empowering patients and lowering costs.

To the left, Congress would continue its reckless spending. Reforming health care on this path would focus on empowering the Federal bureaucracy and expanding health care entitlement benefits with little consideration about long-term costs.

To the right, Congress would direct the Treasury to sell its shares in Chrysler, Citigroup, GMAC, and General Motors and to truly privatize Fannie Mae and Freddie Mac as quickly as possible. Once again, the market will determine which companies prosper or fail.

To the left, Congress would establish an industrial policy of the United States, determining winners such as green technologies and losers such as oil and natural gas production based on political criteria. Housing is one of the few sectors of the U.S. economy in

which the Federal Government has pursued an industrial policy. The collapse of the housing bubble and the insolvencies of Fannie and Freddie should warn us about the dangers of mixing public purpose and private profits.

To the right, necessary regulations would be as simple as possible and fairly enforced. Old regulations would be regularly reviewed, and regulations that have proved costly, ineffective, or unnecessary would be eliminated.

To the left, new regulations would multiply. The cost or effectiveness of regulation would matter little so long as their intent is good.

To the right, Congress would stabilize the Federal tax burden as a percent of GDP at its post-World War II average. Congress would reform the Federal income tax system to encourage both domestic and foreign investors to make job-creating investments in the United States, rather than forcing them abroad.

To the left, Congress would allow the Federal tax burden to rise as a percent of GDP. Congress would inevitably be forced to increase the income and payroll tax rates paid by nearly all Americans, not just the wealthy.

To the right, Congress would aggressively pursue new customers around the globe, tearing down barriers and creating U.S. jobs by approving the pending free trade agreements with Colombia, Panama, and South Korea and engaging in dynamic growing markets, such as the Asia Pacific region.

To the left, Congress would block these agreements, withdraw from the global marketplace, and impose protectionist measures that block access to the U.S. market at the behest of a few labor leaders and other activists.

History both here and abroad proves that the right road leads us to the same economic growth, rising personal income, and expanding job opportunities, while the left road leads to stagnation.

The question before our distinguished economists Dr. Stiglitz and Dr. Roberts today is which road would you choose?

I yield back.

[The prepared statement of Representative Brady appears in the Submissions for the Record on page 37.]

Chair Maloney. Thank you very much.

Congressman Snyder.

OPENING STATEMENT OF THE HONORABLE VIC SNYDER, A U.S. REPRESENTATIVE FROM ARKANSAS

Representative Snyder. Thank you, Madam Chair.

I don't normally do opening statements. But I have got to tell you, listening to some of my Republican colleagues in Washington here talk about deficits is a bit like listening to Bonnie and Clyde at a job interview to be a bank security guard.

Have we forgotten the history of the last couple decades? 1997, the Balanced Budget Act of 1997 under Bill Clinton's leadership? It was a bipartisan bill. Newt Gingrich was Speaker. I voted for it. It led to surpluses in fiscal years '98, '99, and 2000. Remember those days? Surpluses as far as the eye can see. Alan Greenspan testifying, gee, we may pay down the national debt too fast. That

was not a dream, was it, Dr. Stiglitz? That really happened. Testified we might pay down the national debt too fast.

Then what happened? A new team in town. President Bush comes in. An economic plan in April of 2001 that I did not vote for. I think it was one of the best votes I have made here. And instead of having budget surpluses as far as the eye can see, we are now back into the worst indebtedness that the United States has ever seen.

All of us are concerned about the indebtedness, but to hear folks talking about that somehow this has been created in the last 9 or 10 months of the Obama administration is just foolhardy. It just doesn't make any sense.

In order to solve problems we have to understand the cause of the problems, and the cause of the problems was a bad economic policy over the last 8 or 9 years.

I want to say just a word about the Stimulus Act. I just want to read, Madam Chair, if I might, from the CBO report that came out just in the last few weeks.

"CBO estimates that in the third quarter of calendar year 2009 an additional 600,000 to 1.6 million people were employed in the United States and real gross domestic product, GDP, was 1.2 percent to 3.2 percent higher than would have been the case in the absence of the Stimulus Act.

Now is that good enough? Hell, no, it is not good enough. But let's not pretend that somehow there have not been positive benefits. We have certainly seen that in Arkansas with some of the infrastructure projects that have gone on, the tax cuts for millions of Americans that have helped.

I just think that, as we look ahead, time does not start today. The history of this country started a couple of centuries ago, and we need to learn from what has happened in the past with regard to our policies. We have an opportunity I think to get this country going in the right direction, but it will be more difficult if we somehow reform history as we move forward.

Thank you, Madam Chair.

Chair Maloney. Thank you very much.

I understand Mr. Campbell is placing his opening comments in the record. All members have time to put that in the record.

Chair Maloney. Dr. Burgess.

OPENING STATEMENT OF THE HONORABLE MICHAEL C. BURGESS, M.D., A U.S. REPRESENTATIVE FROM TEXAS

Representative Burgess. Thank you, Madam Chair. I will be brief.

I am grateful for the witnesses we have today. I think this gets to one of the fundamental questions that needs to be answered and perhaps one of the fundamental differences we have between us on different sides of this dais up here: Who is the better person for creating jobs in this economy? Is it the government or is it the private sector?

The Federal Government currently employs over 1.8 million people. Wal-Mart, a similar number, and no one can doubt that Wal-Mart has been a profitable enterprise. The Federal Government, not so much, a debt of $12.1 trillion; and we will go up sometime

before the end of this month another $1.8 trillion on our debt limit. So if we were a business, we would clearly not be in business any longer.

Now the stimulus bill passed in the spring, the $787 billion stimulus bill. The academic conversation about who was the appropriate creator of jobs was one that was had at that time. With that vote, it was determined that the public sector was the appropriate creator of jobs. And once we crossed irrevocably that bridge—the belief that the government knows better than the private sector on how to create jobs—it doesn't matter how much money we spend. It is now expected that the Federal Government must spend the money.

However, the government can't continue to spend and spend our way into what might be described as a more normal unemployment number. Ben Bernanke said on Monday that he expects unemployment to stay between 9.3 and 9.7 percent over the next year. At that rate, we wouldn't get back to what many of us would like to see in an unemployment rate for 6 years. And today we hear that in just 1 week, 474,000 more Americans have filed for unemployment.

If we consider this, the Federal Government has spent $787 billion to create a number of jobs that we can't actually really determine. Not even the head of the stimulus board is willing to certify. But even assuming that nearly a million jobs have been saved or created, that is a cost of roughly $800,000 per job, if you believe that the government is the right person to do that. Then compare that with the certain fact that it costs the private sector somewhere between $55,000 and $90,000 to create a job, and that is a job with some benefits, perhaps health insurance, perhaps some retirement package. Now whether you are good at math or not, it doesn't matter. But that savings of nearly $700,000 if the private sector creates a job versus what the public sector spends is significant.

So as Congress, as a legislative body, we must consider what we can do to encourage the private sector to help create jobs.

The reauthorization of the highway infrastructure bill is one that we could consider. We put some money into the infrastructure in the stimulus bill. Some people would argue we didn't do enough in that regard. But we have been sitting on a reauthorization pretty much all year, and that is something that we could do. President Eisenhower, of course, led the way with the creation of the interstate system, and certainly that was a job creator when that program was begun.

Most importantly, we have got to stop damaging the environment for the small business and the entrepreneur that personally goes to work every day, trying to think of how to get ahead and how to grow their business. We spend so much time up here renaming post offices, but maybe that is a good thing. Because if we are renaming post offices at least we are not damaging the economic environment any further.

Well, let's stop making the environment hostile for businesses with things like cap-and-trade, our energy policy, the health care monstrosity, and now this latest TARP II bill that we will have on the floor today. It seems like that if we would do things to create

stability within the business environment and get out of the way that that might be a better trajectory to follow for job creation.

But I am anxious to hear from our witnesses today.

With that, I yield back the balance of my time.

Chair Maloney. Thank you.

Congressman Cummings is recognized.

OPENING STATEMENT OF THE HONORABLE ELIJAH E. CUMMINGS, A U.S. REPRESENTATIVE FROM MARYLAND

Representative Cummings. Good morning. Thank you, Madam Chair.

Today's hearing is yet another reminder why we must build upon the success of the American Recovery and Reinvestment Act or risk a backslide into conditions like those we saw earlier this year when we were losing over 700,000 jobs every month.

I, unfortunately, may have to leave, because I have got two other hearings going on. But I want to hear as much of this testimony as I possibly can.

There have been many such hearings held in the House Transportation and Infrastructure Committee, and we have been repeatedly briefed on the projects around the Nation that have produced immediate gains through long-term investments, and that is what we are doing now over there in the Transportation Committee. However, my colleagues on the right continue to argue that the money can be better spent by paying down the debt and reducing the deficit.

It is a tough position to argue against. Who doesn't want fiscal responsibility from their government? But abandoning the long-suffering and long-term-unemployed citizens in Baltimore and all over this country is a shortsighted world view and one I simply cannot endorse. Not only is abandoning these Americans a moral failing, but it is bad fiscal policy as well. The result would be higher future costs for unemployment insurance, food stamps, public health benefits, as well as lower property values and higher crime rates.

But I will stand steadfast by my original statement that it is a moral failing to continue to let our constituents lose their homes, their savings, and their health care in the name of supposed fiscal responsibility after 8 years of gross fiscal irresponsibility and blatant catering to the wealthiest among us.

That is why I wholeheartedly support President Obama's continued efforts to help the economy recover. In addition to the infrastructure investments, the proposal offers tremendous assistance to small businesses, the engine that drives our greater economy.

Since taking office in January, the President has not lost sight of the ultimate goal of helping all Americans recover. Last fall, when we were told that the sky was falling, we took action to bail out Wall Street and banks all over America. However, record bonuses now flow from those same bailed-out firms, and lobbyists tell us the increased consumer protections currently being debated on the floor will spell the end of business as we know it. I don't buy it. It only further entrenches me in the mindset that stronger consumer protections are exactly what we need.

Further, the financial regulatory reform bill being considered on the House floor this week will provide $3 billion for short-term

loans to unemployed homeowners nearing foreclosure. This is the kind of relief that can move us from trial modifications to permanent stability.

While we took the necessary action to stabilize the financial system last fall, the time has come to embrace consumer protection, job creation, and real foreclosure prevention in order to meet the larger goal of creating a recovery for not just Wall Street but for Main Street and for all of Americans.

I welcome the testimony of our witnesses this morning, and I look forward to a frank and productive discussion.

With that, Madam Chair, I yield back.

Chair Maloney. Thank you very much.

I would now like to introduce our distinguished panel.

Professor Joseph Stiglitz is a university professor at Columbia University in New York City and Chair of Columbia University's Committee on Global Thought. He is also the cofounder and executive director of the Initiative for Policy Dialogue at Columbia.

In 2001, he was awarded the Nobel Prize for Economics. Dr. Stiglitz was a member of the President's Council of Economic Advisers from 1993 to 1995 and served as its chairman from 1995 to 1997. He then became chief economist and senior vice president of the World Bank from '97 to 2000. He has received numerous awards and has been called the People's Professor.

Professor Russell Roberts is professor of economics at George Mason University, a distinguished scholar, and a research fellow at Stanford University's Hoover Institution. He is the author of a series of novels which discuss economic principles. His first novel, "The Choice: A Fable of Free Trade and Protectionism," was named one of the top 10 books of the year by *Business Week* and one of the best books of the year by the *Financial Times* when it was first published in 1994. Professor Roberts is the host of the weekly podcast series EconTalk and is a frequent commentator on NPR's Morning Edition and All Things Considered.

We welcome both of you and look forward to your testimony. Both of you will have 10 minutes for your testimony. We usually have 5 minutes, but this topic is critical to our country. We look forward to your thoughts.

Dr. Stiglitz and then Dr. Roberts. Thank you.

STATEMENT OF HONORABLE JOSEPH E. STIGLITZ, NOBEL LAUREATE, PROFESSOR, COLUMBIA UNIVERSITY, FORMER CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS, NEW YORK, NY

Dr. Stiglitz. Thank you very much. It is a pleasure to address you concerning the state of the economy and what needs to be done.

Though the economy today is far better than a year ago, it is no exaggeration to say the situation remains bleak. We are at a critical stage in our recovery. The banks have been rescued and are set to pay out large amounts in bonuses. Yet there remain severe problems in our financial markets, with mortgage foreclosures continuing apace and massive problems in commercial real estate on the horizon.

The suffering of homeowners who have lost much of their home equity, if not their homes, and workers who have lost their jobs is palpable. The divide between Wall Street on the one hand and the rest of the country, and even parts of the financial system that have received special favors from Washington and those that have not, has perhaps never been greater in recent memory. The fact that the stock market is up or credit markets are less frozen should not distract us from the problems ahead.

These are especially grave in the labor market. We should not be fooled by the fact that the unemployment rate this month dropped by .2 percent to 10 percent. More than one out of six workers who would like a full-time job still can't get one. Such an unemployment rate should be unacceptable.

In my written testimony, I describe how bad the situation in the labor market is and why I am pessimistic concerning a quick recovery, a view that I think is now shared by the Fed. We will be lucky if the unemployment rate returns to a normal level before 2012 or 2013, unless strong measures are taken soon; and, even then, the prognosis is not good.

I also explain why it would be shortsighted—even more shortsighted than those in the financial markets who got us into the mess—if we were to give in to deficit fetishism. We would be myopic in two senses: to focus on one side of the balance sheet rather than both sides (the assets that spending can create) is simply bad economics. These investments can yield returns far in excess of the cost of capital.

Investments in jobs can even help reduce the deficit in the long run. Unemployed workers lose their job skills. We are at risk of replicating a phenomenon observed in Europe in the 1980s called hysteresis. Those with extended periods of unemployment never return to the labor force or, if they do, it is in jobs with vastly lower wages and productivity.

Unless we manage this crisis well, we could be setting ourselves up for an extended period of high unemployment. What economists call the natural unemployment rate may be significantly increased. And if that happens, GDP and tax revenues for years to come will be lower than they otherwise would be, with the result that the national debt would be higher.

That does not mean that we should ignore the deficit. It does mean that we should be very careful in our spending, ensuring that we get value for our dollars.

My earlier book with Linda Bilmes highlighted the high cost of the Iraq and Afghanistan wars, including the future cost of providing disability payments and caring for the large number of injured and permanently disabled returning troops. At the time, we estimated, for instance, that those costs would be in the order of $500 billion or more. Evidence since the publication of our book suggests that those numbers were excessively conservative.

They also suggest that the costs in Afghanistan are markedly higher than in Iraq. Using the Administration's estimates of about $1 million per troop, which does not include future costs of disability and health care, the money spent on the 30,000 additional troop surge could have created more than 1 million jobs in America

that pay $30,000; and the jobs created in America would have higher multipliers. That is to say, second- and third-round effects.

It is also one of the reasons why I have been so critical of the manner in which the bank bailouts were conducted.

A congressional oversight panel has described how at the time that money was provided to the banks we got back 66 cents on the dollar in preferred shares and warrants. Not to put too fine a point on it, we, as taxpayers, were cheated. Had we gotten a fair deal, our national debt in the future would have been much lower.

As we approach the looming jobs problem, we should not repeat the mistakes we have repeatedly made responding to the crisis of too little, too late. There is in economics something akin to the Powell Doctrine in the military. One needs to attack the problem with overwhelming force. If things turn out better than the pessimistic prognosis given below, we can always scale back.

There are clear criteria for the form of stimulus: high multipliers, that is to say, large GDP bang for the buck; large job creation bang for the buck; creating assets with high returns, especially those directed at national needs like improving technology and public transportation systems; flexibility; automatic stabilizers which increase spending commensurate with the economy's needs; and meeting some of the economic and social exigencies created by economic crisis.

We need to take a portfolio approach. There is no single measure that will solve the problems of the magnitude that we face.

But I do want to emphasize the response to some of the discussion that has been raised that the stimulus has worked. It has not been enough. It could have been better designed, but there is absolutely no doubt that, had it not been for the stimulus, the job situation would be far worse than it is today.

Assessing alternative measures in terms of the criteria I have laid out gives some sense of priorities, which should include extending unemployment benefits, aid to States, government jobs programs, research and technology programs, and longer-term investments.

Here let me just make a couple of comments. In my written testimony, I elaborate on these.

First, we should take advantage of the fact that this is likely to be a long downturn. We should be drawing up plans now for higher-return public infrastructure projects that are not shovel ready but could be ready in 1 or 2 years' time. If it turns out that the economy recovers, which is unlikely, these can be undertaken eventually if funds become available. If the economy is still weak a year or two from now, we will have a portfolio of high-return projects from which we can choose.

Secondly, as we went about the rescue we had no vision of what kind of a financial sector, or what kind of economy we wanted to emerge after the crisis. We cannot and we should not go back to the world of 2007. Our financial sector was bloated and distorted. It will have to be downsized. But the question is, what parts should be downsized? We should be strengthening the venture capital firms and the banks that lend to small- and medium-sized firms.

A vision of the economy that we want after the crisis should also guide our spending. The economy of the future will require more

educated workers and will be based on high technology. That is why it is particularly disturbing for me to see universities furloughing teachers and other cutbacks in our education system.

In my written testimony, I discuss the special problems facing small- and medium-sized enterprises which are the source of job creation. They are facing increasing difficulties in getting access to credit, even as the banks seem to be recovering. More than a year ago, we were told that we needed to bail out the banks to maintain lending. But in giving huge sums to the banks, we put no conditions on how they used the money.

I also outline some bold actions that could be undertaken that would enhance the flow of funds to SMEs. Whatever benefits we give should be linked to job creation. A capital gains tax benefit for a small business engaged in real estate speculation is not exactly what the economy needs at this juncture. Many owners of SMEs rely on the use of their home or other real estate as collateral for lending; and with these prices plummeting, access to credit is being impaired.

This is only one of several complex linkages between the real estate sector and rest of the economy, explaining why it was such a mistake not to do more earlier about that sector; and this is only one of several channels through which problems in the real estate market are transmitted to the rest of the economy.

For instance, the weak housing market will contribute to high unemployment and lower productivity in another way. A distinguishing feature of America's labor market is its high mobility. But if individuals' mortgages are underwater or if home equity is significantly eroded, they will be unable to move, to reinvest in a new home, and this will really undermine what has been one of our great strengths.

Let me say a word about global imbalances. This is a global economic downturn. Well before the crisis there was a worry that there would be a disorderly unwinding of the global imbalances. This disorderly unwinding was not the cause of the current crisis, but it could be of the next.

It is important that something be done about these imbalances, which include America living beyond its means. But one of the things I emphasize is that we cannot rely on some international fix, a magic bullet that might result from correcting these imbalances for solving our problems.

While I have emphasized that it is premature to begin exiting from the extraordinary monetary and fiscal interventions, I thought it important to stress the special difficulties resulting from particular measures undertaken by the Fed as it puts on its balance sheet around $1 trillion of mortgages. We should recognize that, as it exits this program, mortgage interest rates will rise, and this will have an adverse effect on real estate prices and investment. At the same time, the Fed will experience a large capital loss on its holdings. Whether it recognizes that loss or not does not hide what has really happened. This is just another of the many costs that the failure of our financial system and the Fed's failure have imposed on our society.

These costs are one of the reasons that we have to have effective regulatory reform. Our financial system failed to perform its essen-

tial functions of managing risk, and allocating capital at low transaction costs. Private rewards were misaligned with social returns.

We are emerging from this crisis with a banking system that is more concentrated and less competitive, more able to extract rents from the rest of the economy, evidenced by usurious interest rates on credit cards. While the money will help recapitalize the banks, the higher interest rates will slow the recovery and a less competitive banking system will serve neither our citizens nor our economy well.

There is a simple test of the adequacy of reform of our financial system. If these reforms had been put in place say in 2003, would a crisis have occurred? And if it had occurred, would it have been less costly? My assessment of the reforms currently on the table is that they failed to meet this test.

Unless we pass an adequate regulatory reform, we can look forward to another crisis down the road. This is not good news either for our citizens or for our economy.

I am particularly concerned about our failure to deal effectively both with the too-big-to-fail institutions and with derivatives and credit default swaps. In my written testimony, I explain what we should be doing and why what is currently under discussion falls far short. Our regulations failed, but so did our regulatory institutions. Again, I explain why I think it would be a serious mistake to make the Federal Reserve system a system regulator.

Let me conclude with three general comments.

The first is that the agenda of our economic reform needs to be far broader. Our tax laws encouraged excessive leverage and risk taking. What kind of society says that speculation should be encouraged at the expense of hard work? But that is what we are saying when we tax earned income far higher than capital gains. Flawed bankruptcy laws and corporate governance, too, contributed to the crisis.

Secondly, we need to keep in mind that the real costs of an economic downturn caused by a bubble occur after the bubble breaks. Crises don't destroy the assets of an economy. The banks may be bankrupt, many firms and households may be bankrupt, but the real assets are as much as they were before, the same buildings, factories, and people, the same human, fiscal, and natural capital.

In the run-up to the crisis, resources were wasted by the private sector. This is water over the dam. The key question is, how will resources be used after the bubble is broken? This is typically when most of the losses occur as resources fail to be used efficiently and fully and as unemployment soars. This is the real market failure and one that is avoidable if the right policies are put into place.

What is striking is how often the right policies are not put into place, and the losses in the bubble are compounded by the losses after it bursts. Something is wrong when we simultaneously have homeless people and empty houses, unmet needs and yet firms and workers willing to produce more.

We are a rich country. We can afford to squander hundreds of billions of dollars, but there are limits for even a rich country. The combined effects of unbridled spending on unproductive wars, corporate welfare, and poorly designed bank bailouts inevitably will exert their toll, but when these effects are compounded by macro-

economic mismanagement, leading to an economy operating for years below its potential, the consequences are even more worrisome.

I know my time is up. Let me just conclude there and ask that you put into the record my full testimony.

[The prepared statement of Joseph E. Stiglitz appears in the Submissions for the Record on page 39.]

Chair Maloney. Without objection.

Dr. Roberts, you are recognized for 10 minutes. Thank you.

STATEMENT OF RUSSELL ROBERTS, PROFESSOR OF ECONOMICS, GEORGE MASON UNIVERSITY, AND THE J. FISH AND LILLIAN F. SMITH DISTINGUISHED SCHOLAR AT THE MERCATUS CENTER, AND A RESEARCH FELLOW AT STANFORD UNIVERSITY'S HOOVER INSTITUTION, FAIRFAX, VA

Dr. Roberts. Chairwoman Maloney and distinguished members of the committee, a man once asked his doctor how much weight he would lose if he skipped his daily breakfast of a bagel and butter, about 350 calories. The doctor said, if you do that every day for a month, you will lose 3 pounds. After 10 days of skipping breakfast, the man came in to see how he was doing. To the doctor's surprise, the man's weight was unchanged. The doctor said, Well, good thing you stopped eating breakfast. Otherwise, you would have gained a pound. When I made my prediction, I didn't realize how bad your weight situation was.

Unfortunately, the doctor's analysis was flawed. He didn't realize that because the man was skipping breakfast he was eating a bigger lunch.

Now I think about that doctor when I think about the CBO estimates of the impact of the American Recovery and Reinvestment Act of 2009, the stimulus package. The CBO estimates, as we have discussed, that there are about 600,000 to 1.6 million jobs in the economy extra compared to what would have happened in the absence of the stimulus. It is an embarrassingly imprecise estimate, but it is not really an estimate at all. It is just a repeat of the forecast that CBO made at the beginning of the process, like the doctor who predicts that skipping breakfast will reduce your weight.

It doesn't use the facts in the economy, as the CEO concedes, since the stimulus was passed. It is a fake estimate. We have no idea how many jobs have been created or lost because of the stimulus since the CBO admits to know the real impact we would have to know the path of the economy in the absence of the package and that is unknown, just as the lunch habits and metabolism of the patient might be unknown to a doctor making a forecast in advance.

What we do know is that we have lost millions of jobs since March when the stimulus was passed. We were told that, without it, unemployment would reach 8.8 percent. Well, with it, it is back at 10 now; and it was, of course, higher.

There is no way of knowing whether the stimulus averted a worse situation or whether it is part of the problem. And I am ashamed to say and embarrassed to say there is no consensus in the economics profession on this question and no empirical evi-

dence available to settle that. But it wouldn't be surprising to discover the stimulus has had little or no effect or made things worse.

Of the $235 billion spent to date, more than a third of that has been spent on temporary tax rebates, just as the Bush Administration temporary rebates of February 2008, had little or no impact and were mostly saved. That has been true of these tax rebates.

The direct spending component is about $145 billion of that. Eighty percent has been spent by the Departments of Health and Human Services, the Department of Labor, Education, and the Social Security Administration. Those agencies don't have very many shovels. Roughly one-half of the job losses since December of 2007 are in construction and manufacturing, and HHS spending doesn't do much for those folks.

Some argue it doesn't matter what the money is spent on. People will spend the money they receive. That creates jobs, puts more money in people's hands, and so on. Ironically, this Keynesian story works best when the economy is healthy. Consumer spending is down because people are rightfully worried about the future. When people are nervous or scared, they are going to save more and spend less compared to when they are confident and optimistic. So fiscal policy that counts on the multiplier doesn't work any better than monetary policy stuck in that liquidity trap.

This is particularly true of temporary increases in income. Both fiscal and monetary policy are constrained by the anxiety that people have about the future.

Unfortunately, policymakers have been doing a lot to create anxiety, rather than to dispel it. The deficit last year was $1.4 trillion. People know that tax increases are coming, but they don't know how big their share will be. The prospect of tax increases discourages spending and offsets some or all of the stimulus.

The size of the debt is creating worries about default or inflation. The government continues to intervene in ad hoc ways in the auto industry, the financial sector, and major changes are on the table for how the government regulates health and energy.

We need new businesses to start. We need old businesses to expand. Yet their owners can't be sure of what the rules of the game are, the tax rates they might face, the interest rates they might face, the inflation rate they might face, the health care mandates they might face, the emissions regulations they might face. And it is not surprising that businesses are likely to sit on their hands sitting on the sidelines to see how things will turn out.

In a recent survey of employers by Manpower Inc., 73 percent said they plan no change in staffing for the first quarter of 2010. That is the highest level of no change since 1962. Employers are waiting to see what the rules of the game are going to be.

So what is to be done? Well, everybody assumes there is something that has to be done. There has to be a solution, something to get people back to work faster.

That may not be the case. Government policy induced an unnatural expansion of the housing sector over the last decade. We built way too many houses. That naturally drew a lot of people into construction. Fully 25 percent of the losses in the job market have been in construction. The workers who no longer hold those jobs

have to find other things to do, and they are taking their time deciding on what that should be.

Unfortunately, it is natural that unemployment lingers. If you have to do something, please look for effective ways to spend money and reduce policy uncertainty. Stop giving away money to states with no strings attached.

Why has a major goal of policy so far been to preserve state employment while the private sector takes a beating? Let's let the states deal with their past recklessness rather than giving them an incentive to be reckless in the future. They are obligated to balance their budget. They can cut spending. They can even cut spending, if they would like, without laying workers off. I think that is a good incentive.

Don't treat unspent TARP funds as free money. They aren't free. Don't waste it the way the stimulus money has mostly been wasted.

Instead of spending randomly, let's cut the payroll tax. Cutting the payroll tax makes workers less expensive to employers. Cut it by 25 percent for the next 5 years, you will see an impact on job creation. It will reduce revenue by about $250 billion a year, but it will at least have a chance of creating jobs.

To reduce uncertainty and fears, stop fiddling with every aspect of the economy. Maybe it is not the best time to try to radically change the health care system and the energy market while propping up banks, the auto industry, and borrowing trillions of dollars.

Stop issuing such short-term debt. It is what got Wall Street in trouble. The government rescued Wall Street—mistakenly in my opinion. There is no one to rescue us. Reduce some aspect of government spending to show that grownups are in charge and that the government can act responsibly. Get rid of corporate welfare. Cut tariffs and quota which are a silent tax on the consumer.

Stop propping up losers. Let people who are reckless go out of business. Otherwise, we are throwing good money after bad and setting the stage for future recklessness.

F.A. Hayek said that, "the curious task of economics is to demonstrate to men how little they know about what they imagine they can design." It would be good to recognize our limits about what we imagine we can design. We cannot steer the economy, we cannot steer the labor market, and recognizing those limitations is a step in the right direction.

Thank you very much.

[The prepared statement of Russell Roberts appears in the Submissions for the Record on page 64.]

Chair Maloney. I thank both of you for your very thoughtful presentation.

Both of you mentioned the challenge that we have in creating private-sector jobs. This is a chart that we did on private-sector job loss; and it shows, since 1992—this top level is the jobs created and the bottom level is the jobs lost, and you see that in the recession of 2000 the jobs created never, never went back to the level under the Clinton years. In fact, the number of private-sector jobs created has fallen dramatically. The jobs lost have risen, which is not unexpected in a recession. But what is happening when the number of

private-sector jobs created has fallen so dramatically, particularly during the Bush administration?

And my question, Dr. Roberts and Dr. Stiglitz, is did the labor market fundamentals change or weaken in some way—the labor market fundamentals during the Bush administration? Has there been some fundamental change in our structure? Why are the number of private-sector jobs falling so dramatically?

[The chart titled "Current Recession Characterized by Precipitous Fall in Private Sector Job Creation" appears in the Submissions for the Record on page 69.]

Dr. Stiglitz. Actually, I would say things were even worse than those pictures depict, because much of the job creation in the private sector was artificial. That is to say there was a bubble, and a lot of the jobs created in the private sector were in real estate or based on consumption that was fueled by this artificially created bubble.

For instance, in one year alone, there were $950 billion of mortgage equity withdrawals that fueled consumption in the private sector. That was all artificial, so the true picture is worse than what you have depicted.

There is a change in the structure of our economy that has been going on for some time, partly having to do with globalization. That is to say that there is a shift of comparative advantage, in manufacturing in particular, to other parts of the world. Some countries, like Germany, have responded to that challenge by trying to create education systems that enable the sustenance of a competitive manufacturing sector based on high technology.

We decided not to take that course. We did not make the investments in people and technology that we should have, and that has put us at a competitive disadvantage.

I think, in some sense, it was a very difficult time. It would have been difficult for any administration. But the failure to take a proactive response has made things far worse. There are other countries like Sweden that did have a proactive policy and have succeeded much more impressively.

Chair Maloney. Thank you.

Dr. Roberts.

Dr. Roberts. Well, I think the other fact that is going on in that picture, that is, of course, a million factors, that people made all kinds of choices about education and training, whether it be in the job market or not.

Of course, the other factor going on in the background of that story is monetary policy. It is kind of ironic. Alan Greenspan was a genius; and then, all of a sudden, he wasn't a genius anymore. Around the 2001 period, he put interest rates at their lowest level of the past 40 years; and then he very precipitously increased them around 2004. I think that did a lot of damage to our economy, as Professor Stiglitz points out.

There was a lot of artificial investment in housing. That was partly due to bad monetary policy. It was also due I think in part probably to bad regulation and pressure put on various institutions to give low interest loans and low down payment loans. Caused an artificial expansion of the housing sector. We both agree on that. It was very destructive in foregone capital and wasted opportuni-

ties for better investment. So I think the monetary story is partly what is going on in those data.

I disagree a little bit with Professor Stiglitz on globalization. It is true we haven't made top-down investments in technology. We have a lot of bottom-up investments for individuals who have done training on their own through their own choices.

We have the most vibrant technology sector in the world, we have the most vibrant venture capital sector in the world, and those sectors are relatively unregulated, particularly venture capital, which is why I have hopes and optimism for the future, even though our financial system is a horrible mess as government has tried to steer it in I think very destructive ways.

I think the bright side of the story is productivity. Our competitiveness is helped tremendously by our incredible productivity, not so much in the recent recession, where productivity jumps artificially as workers are laid off, but rather through the fact that our skills and technology are rather spectacular.

A lot of our job losses since the recession are in manufacturing. Some of that is due to a reduction in the economy's strength, but some of it is due to productivity in manufacturing, a process that has been going on for 50 years as we have been able to substitute technology, which is really human knowledge embodied in machines, and made our workers more productive. So I am optimistic about our future and competing in the global marketplace.

Dr. Stiglitz. Can I just make one more comment? I agree very strongly that we have very vibrant technology, but it is a high-technology sector that has not created as many jobs and hasn't been as integrated into manufacturing as in some other countries.

But I wanted to really focus on one other point, which is that, normally, we think of a low price of factor inputs as a good thing, as stimulating the economy. The cost of capital that was made artificially low by the Fed should have been the basis of a large job creation, if our financial sector had been doing its job. The fact is, it could have directed that capital to productive uses. We could have had a real boom if things had gone the right way.

But, unfortunately, our private financial sector didn't do what it should have been doing. Combined with these other problems that I have described, the result was that what would have been an opportunity from low cost of capital to have a massive expansion of the productive powers of our economy wasn't taken advantage of.

Dr. Roberts. May I comment on that?

Chair Maloney. Certainly. Then we have to move to the next speaker, but, in fairness, you should have an opportunity to comment, too.

Dr. Roberts. Briefly, it is an excellent point that those low rates of interest normally would have stimulated all kinds of potentially productive activities. Unfortunately, in 1997, we made capital gains on housing tax free. That encouraged a lot of people to accumulate second homes and third homes as a way of investing, which is not particularly productive. So that was a terrible mistake.

But I think we also have to recognize that the government mandates pushed money explicitly into low interest, low down payment mortgages. Fannie and Freddie were pushed tremendously in this period, especially starting in 2001, to invest in a lot more low-in-

come housing. It is a lovely goal. But, as a result, a lot of those mortgages went underwater.

The private sector, the financial Wall Street side that Professor Stiglitz is referring to, also got into that, but that wasn't until about 2004 to 2006 when they did make a lot of bad bets. The question is, why did they do that? And I worry a lot that they were expecting to be bailed out by the government, which, of course, they were. They were gambling with my money and yours, not their own money. Until we fix that, we are not going to have a healthy financial sector. The too-big-to-fail problem which you mentioned earlier I think is the central problem that has to be solved.

Chair Maloney. Thank you very much.

Mr. Campbell.

Representative Campbell. Thank you, Madam Chair.

John Maynard Keynes said that the government could stimulate the economy by digging a hole, by paying someone to dig a hole and fill it back up again. Dr. Stiglitz, do you agree with that?

Dr. Stiglitz. Yes, but we have better ways of spending money than either going to war or filling holes.

Dr. Roberts. I don't agree with it. In fact, I want to emphasize one thing we do agree on is that money spent on war is wasted. It is not a stimulus package.

I think one of the most destructive and immoral economic doctrines of the last 75 years was the belief that World War II was good for our economy because it created a Keynesian multiplier. Even more effective than just digging ditches, it got people to buy tanks and airplanes. But tank and airplane purchases are good for tank and airplane manufacturers. They are not good for the rest of us. Private consumption in those times fell. It was very bad.

Representative Campbell. I got a letter—we all got a letter from Vice President Biden earlier this year saying, here is a list of the stimulus, that stimulus money that was put in your district. Interestingly, the very first thing on the list in my district was $2.3 million to put a green roof on a Federal building. What they didn't point out was that that Federal building is scheduled to be torn down. So we are spending $2.3 million to green roof a building in my district which will subsequently be torn down. Now that is clearly digging a hole and filling it back up again.

Now to your point, Dr. Stiglitz, yes, somebody got hired to put on that roof. But there is no multiplier. There is no downstream, no additional jobs.

I would think it sounds like you would both agree that if we were going to spend—through tax credits or any other way—Federal money that it would be much better spent, rather than digging a hole and filling it back up again, in something that creates a number of downstream jobs.

Let me just throw two ideas at you both and get your comments on them.

One, on infrastructure things, suppose the government put free broadband Internet, wireless Internet in the 250 largest markets in the country and then let the high-technology community do what they could with that capability. It actually wouldn't be that expensive to do that.

Or let me give you a second idea. What if we had a capital gains tax holiday but different than what has been talked about. You said that for 12 months or 9 months or 6 months—pick a period of time—that any investment made by someone would be free from capital gains tax whenever they sold it. If they sold it 5 years from now, 10 years from now, it didn't matter. It seems to me that one of the problems right now is the perception of risk out there and that people are not making investment, not hiring, not doing anything.

Dr. Stiglitz talked about the financial sector. I am on the Financial Services Committee. I agree with you on the war in Afghanistan, with both of you on all of that stuff. But I only have got 5 minutes. So we will stick with this particular topic right now.

But if we did something like that, we reduce the risk or increase the potential return in exchange for that increased risk that is out there and perhaps get some money off the fence and say, well, maybe I will invest in that business, maybe I will grow this particular business, maybe I will buy that piece of commercial real estate which is troubled.

So your views on those two thoughts, Dr. Stiglitz and then Dr. Roberts.

Dr. Stiglitz. I think both of them are good ideas as a broad concept. Let me speak to the first one.

The fact is that the margin of cost of using broadband is very close to zero, and that is the kind of facility where there is a particular role for government in the provision. The private sector could provide it, but it would charge. This would create a distortion, because the price exceeds the marginal cost of usage, so this is a particularly good example of something that the government could provide. It increases efficiency and then creates an environment. It is part of the infrastructure, which is particularly relevant for modern technology. So I think that is the kind of thing that one ought to very seriously consider.

The second point you raised has to do with how do we reduce the risk of investment? There is another problem that I want to also emphasize, and that is access to capital, which small- and medium-sized enterprises are particularly facing. So the problem is both the demand for investment but also the capability of making that investment.

One way of trying to attack both problems simultaneously, for instance, is to allow firms, and especially small firms, to write down immediately the cost of their investment. That is like the government paying a part of the cost up front, but it is effectively a loan. Now is a particularly good time for doing that because, while it reduces government revenue today, it will increase government revenue in the future, because the depreciation isn't there and the cost of capital to the government right now is close to zero. It is effectively a loan from the government to the firm at a time when the firm really values it, both reducing the uncertainty and giving them access to capital.

One should try to think about two general principles: First, when can you do that? And, second, what tax benefits ought to be linked to investment? It is not just lowering tax rates, giving tax benefits, but they have to be linked to job creation or to investment.

Representative Campbell. Dr. Roberts.

Dr. Roberts. I would love to have free broadband. There are a lot of free things I would like. One of the lessons we learn from economics is nothing is free; and one of the challenges you face in your jobs is trying to recognize what the costs are, especially in today's world where it appears that everything is a free lunch, that there is no cost to spending—in fact, "there is a benefit, because it is going to reduce unemployment!" I think that is sometimes an illusion that can actually make the situation worse.

I particularly worry about the precedent of using the government to decide where technology goes. It is going to lead to lots of lobbying and decisions made not necessarily on the basis of what is most productive but what is politically expedient.

Right now, for example, we are guaranteeing a loan to the Tesla Corporation which makes a very nice sports car. It is an electric sports car out of California. It is beautiful. It is very fast, and it is an electric car that is lovely.

They want to develop a sedan for families. Are they going to be able to do that? I would like to see them do that on their own two feet, convincing investors of the very risky proposition they are involved in, rather than being guaranteed that I am going to step in and make them whole if it doesn't work out. I think that is a terrible precedent not simply because the government has no incentive to make those investments wisely but, even worse, people start lobbying you for favors and goodies as, of course, they already do.

Again, the same thing is true with the tax holiday. It is always tempting. I just think it is important to remember it is not free. There is foregone income and opportunities that could be done with that money, and I would worry about tweaking the system here and there.

The reason I advocate—I have mentioned a 25 percent cut in the payroll tax. I would actually like to eliminate the payroll tax. Payroll tax is a regressive tax. It deceives people into what its real effects are. The people actually think that it goes to be set aside for their Social Security money instead of out the door to go fight the war in Afghanistan, pay for food stamps, and everything else the government does. So, right now, people have a very weird idea about what a dollar of government spending costs them.

So I would like to get rid of that and add a little bit to income taxes so that everybody can see with transparency what the effects of government spending are on their pocketbook. So that is politically difficult to do, and it is probably not the best thing to do right now because it is complicated. People are going to say, what is going to pass? What is going to happen? So every time a nice idea gets put on the table, people say, you know, maybe I will wait until that tax break comes through. So it is a dangerous game.

Again, I would argue for simplicity, transparency, and, ideally, efficiency, if you can find it.

Chair Maloney. Thank you very much.

And recognized in order of appearance Congressman Snyder.

Representative Snyder. Thank you, Madam Chair.

I thank y'all for being here and your different perspectives.

Dr. Roberts, I wanted to direct my question, if I might, to you. In your written statement you have this one—at the end you say,

reduce some aspect of government spending to show that the grownups are in charge and that someone can practice tough love with the American people. Say "no" to some special interests. Get rid of corporate welfare.

We have a situation regardless of what you think about the health care reform bill and the different variations. But we have this issue of Medicare Advantage. I don't know if you are familiar with it or not. But it was—well, I will go ahead and describe the situation.

We have a situation now where one out of five Medicare recipients gets 12 percent more money on average than the other four out of five and 80 percent. And it originally came about because some private insurance company said they can deliver Medicare more efficiently. The program was set up. But then at some point they said, actually, we want a little more money. So now they are getting 12 percent more on recipient.

Part of the—at least in the House bill—is to gradually eliminate that additional money, which I have heard somebody today say that is corporate welfare. They are getting more money to do what they said they could do more efficiently.

So what happened? I voted for the bill, as a lot of Members did. And we now have the U.S. Chamber running ads all over the country talking about these massive cuts to Medicare. Yet you go on the U.S. Chamber of Commerce's Web site and they're saying something like, where are the legislators with courage to stand up for entitlement reform?

So regardless of what you think about all aspects of this thing—but isn't that a good example? You have one program that most of us—regardless of the financing—would say it is very well-received by the American people. But you have taken one out of five Medicare recipients and are paying corporations 12 percent more money on the average than the other 80 percent. Is that a good example, as I have described to you, of what we should be doing away with?

Dr. Roberts. Well, I don't know the details of Medicare Advantage, and I have no interest in defending the U.S. Chamber of Commerce's strategies for provoking you to do what they think is in their interest.

I would say, quoting Friedman, that pro business is not the same as pro capitalist. I am pro capitalist. I am not pro business. Businesses don't like capitalism. It makes them compete. They would prefer to get special treatment. I want to get rid of all that.

That is why I want to get rid of those quotas on sugar which enrich about 10 families in the United States and make every American pay a higher price. It is outrageous. Especially now. It is a great time to do something for the American people at the expense of rich fat cats. Get rid of those quotas. They are unfair, and they are destructive.

Representative Snyder. In fact, I brought it up several times that there has been bipartisan interest, as you know, in doing something about our trade policy with Cuba. It seems like, if we are going to do something, this would be a wonderful time to help sell more stuff to Cuba.

I wanted to ask you another question, if I might. I forget how you phrased it, but, basically, you are saying, is this the right time to

create more uncertainty by—I think your word is—"fiddling" with different aspects of the American economy. Probably two biggest aspects of fiddling—I think maybe Dr. Burgess mentioned it—are health care and energy policy or climate change.

The question I have for you, though, is, even if we come up with some bill that Dr. Burgess and I would both support or you and I would support, given the nature of energy policy and energy and given the nature of health care, we will acknowledge I think that whatever we would do it would take several years to implement. I mean, how can we sit back and say, we will do nothing until we can look ahead and see several years of blissful peace and paradise economically and socially in the worldwide community and then we will act in these areas?

That is not going to happen when in fact—I mean, I have people coming to my office all the time from the business community, and they have been doing this for a couple of decades, saying we have to do something about health care costs. It hurts my ability to compete internationally, whether it is small- and medium-sized companies or from international corporations based in Arkansas coming and saying we have got to do something about this. It will add to our ability to compete.

So my question is, I can understand what you are saying about this uncertainty, but there is uncertainty, is there not, in doing nothing?

Dr. Roberts. Oh, absolutely.

Representative Snyder. Please respond to that.

Dr. Roberts. It is an interesting challenge. If you want to do something in health care—let's take a very narrow problem that everybody is worried about, which is that some Americans don't have health care coverage, right? Or, worse—it is often confused—have limited access to health care, which is what we really fundamentally care about.

We could create a program that would help those folks. It would cost a lot of tax dollars, right, but we could subsidize their insurance. We could create a larger entitlement program for Medicaid than we have now. We could fix ways to make sure that people are covered.

Well, why would we pass a 2,000-page piece of legislation that no one understands? I don't get it. Well, I do get it, actually. And people say, I don't mind that it takes a while, but people say, well, we will figure out how it works later. That is the mistake. Not that it takes a while but that we are passing legislation when we don't understand the consequences.

Representative Snyder. So you don't have a problem with tackling a problem today at the time of this economic downturn, like health care or like energy and climate change legislation. Your concern is your ability to understand the legislation or the ability of the American people. I need to be sure. Because I think that is an important point.

Dr. Roberts. I am saying two things. Transparency is extremely important in today's climate, right? So a 2,000-plus page bill that—I don't know—creates 80 new, 100 new—whatever it is—pieces of the health care puzzle, no one understands how they interact. Most

of us haven't read the whole bill. I think that is the wrong way to fix the problem.

The second thing I would say is that whatever you do to fix the problem you want to be pretty confident that it will make the problem better and not worse. I would say a lot of the stuff we are doing right now, we are really not quite sure, and that is the biggest problem we have. But if our goal as a Nation is to help coverage, let's pay for it. Just like, if our goal is to get more people in houses, let's subsidize housing. Let's not create a labyrinthine regulatory environment with Fannie and Freddie that no one understood, no one was on top of and is going to cost the American people hundreds of billions of dollars that at the time was said was going to be a free lunch. That is what we want to avoid.

Representative Snyder. I know my time is up. But what you are saying, though, is you do not have a problem with us acting today. It is the programs with regard to health care that you have a problem with, which is different I think than what I took from your testimony.

Dr. Roberts. Absolutely.

Chair Maloney. Thank you.

Dr. Burgess.

Representative Burgess. Dr. Snyder, it will be a cold day when you and I begin to agree on a lot of things. But I think you know, just like Dr. Snyder, through the summer, Dr. Roberts, I heard from angry people at home about what we were doing with this—at that time, it was a 1,000 page bill. They got madder when it went to 2,000 pages. Yet we weren't fixing the fundamental problem that most people were concerned about, and that is someone who, because of a tough medical diagnosis, because they find themselves between jobs and their COBRA benefits are something they can't keep up with because of the way COBRA is structured, they now end up with a tough medical diagnosis without health insurance.

It is very, very difficult then to claw your way back into the system. That is what has been so pernicious.

Interestingly enough, we had a Congressional Budget Office study that told us how much it would cost to fix that problem based loosely on what Senator McCain advocated in the fall of 2008 based on the stated high-risk pools and reinsurance programs, giving states some flexibility. It was about $25 billion over the 10-year budget window, which is, as you point out, a significant amount of money but nowhere near the $1 trillion price tag that we ended up with with this large bill.

Because of the things we are doing—and it is not just health care, because we have got a 1,400-page bill today on financial services, and we had 1,000-page bill on energy earlier in the year—the lack of job creation is something that has not been seen since—did you say since 1962? Did I understand that correctly?

Dr. Roberts. That was the expectation of employers that they are going to do nothing. That number is at its highest level since 1962 for the first quarter of 2010. Seventy-three percent say they don't expect to hire or reduce in the first quarter, which evidently is the largest since 1962. People are just waiting.

Representative Burgess. And what broke that? What caused that to change in 1962? I mean, I was alive, but I don't know that I was economically aware of my surroundings. What changed in 1962?

Dr. Roberts. I turned 8. I think that was the crucial event.

I don't know. There were a lot of things going on. I don't know. There were some tax cuts I am aware of, but I don't know if they were decisive or unimportant.

Representative Burgess. But the tax rate did come down significantly somewhere around that time, is that not correct?

Dr. Stiglitz. The big thing was the investment tax credit that stimulated the economy.

Representative Burgess. And it got people off the sidelines and created jobs?

Dr. Stiglitz. At least one of them.

Representative Burgess. Well, Dr. Roberts, you mentioned I think in your testimony the problem of the true unemployment rate. The people who have just given up and may not be looking for a job. I think we heard in this committee last Friday that that number is 17.2 percent of people who are—the actual number of unemployed are those people that have just stayed away from even seeking employment.

What is the right thing to do here? Do we continue to extend unemployment benefits to that group of people? Or are we creating more problems than we are helping at some point by indefinitely extending those benefits?

Dr. Roberts. Extending unemployment benefits are good for the people who get them. And we understandably feel bad for those who don't have a job. It will discourage them from looking more. The measured unemployment rate will be higher than it otherwise would be. Politically, that is tough for you guys, isn't it? That is a real tension that you have got to deal with.

Representative Burgess. Has anyone measured the job-searching activity that goes on toward the conclusion of those benefits? Do we have any data? Has any economist looked at that and said, okay, we have got 26 weeks of unemployment. People know what that 26 weeks is, and the last 6 weeks is there a change in behavior that might lead to finding a job or is the market just so bad that it doesn't matter what you do?

Dr. Roberts. Well, there have been a lot of studies of it. I think the crucial question here is how different, potentially, this particular leaving of unemployment is going to be for the Americans who are struggling right now.

We have a couple of sectors that are going to have to get smaller. We can artificially prop them up. I think that would be a terrible mistake. But, as I mentioned, a quarter of the people who have lost their jobs since 2007 were in the construction industry. You have specialized skills.

What would you do in that situation? You could say, well, maybe my sector will come back. And, of course, maybe it will. But maybe it won't, in which case maybe it is time for you, unfortunately, to leave those skills behind and retool. Those are very difficult decisions. People want to postpone them, and I don't blame them.

Representative Burgess. What about the demographic of the young individuals, 17 to 21, say that——

Dr. Roberts. Teenage unemployment rate is about 26 percent right now. It wasn't helped by the increase in the minimum wage. I think that was a mistake. Again, especially in a time of high unemployment, to make it more costly to hire low-income, low-skilled workers I think is a mistake.

Representative Burgess [continuing]. Should we look at revisiting what—we don't call it reduction of minimum wage but call it an entry-level wage for certain sections of that demographic?

Dr. Roberts. I would get rid of the minimum wage. I think it puts low-skilled workers at a terrible disadvantage. It creates an artificial pool of people who want to work and reduces the number of employers who want to hire them. We only look at the wage. We should look at the other aspects of the job, on-the-job training, how hard you have to work while you are on the job.

You raise that minimum wage, you make the life of a person—it is true—a bunch of people get a higher wage, which is great for them. But the other folks who have fewer opportunities than the people who do have a job are going to find the workplace a less friendly place because there is more competition with other folks.

Chair Maloney. Would you like to respond?

Dr. Stiglitz. Just a couple of points, very briefly.

First, although there have been studies about the effect of unemployment insurance on job search, most of those studies are not in the context of high unemployment in the particular situation we are today. The problem is there are no jobs, so having many more people looking for the same jobs isn't going to lead to more employment. It is not lack of search but lack of jobs. We ought to remember that this particular situation is not always the case. When the economy recovers, the search becomes a more relevant concern.

Secondly, the situation is much worse than what you have just described, because, in fact, large numbers of people are moving over to disability, and those do not appear in the unemployment numbers, even in the broader measure of discouraged workers. Discouraged workers do not include people who have applied for disability.

The estimates are that the increased number of people applying for disability—not all of them will get it—is about a million. About half of them will get it, and they will likely remain out of the labor market perhaps for the rest of their lives or at least for an extended period of time.

There is not any epidemic of a disease that is causing this. It is a lack of jobs. It is another part of what you might call our safety net. But what I am emphasizing is that the labor market situation right now is worse than even the one out of six number that I mentioned.

The third point, to reiterate what Dr. Roberts said, is that there is going to have to be a lot of structural change, with people moving from one industry to another. That is why what I think active labor market policies are required, and that requires education and training.

Chair Maloney. Thank you very much.

Mr. Cummings.

Representative Cummings. I want to just pick up exactly where we left off here.

So what are we training them for? In other words, if the jobs are not there—and we had testimony in this committee just a week or so ago, less than a week ago, where we were told that one of the areas that seemed to be increasing is health care or at least is staying pretty steady. It is not losing.

But, you know, when you think about people who are in a position right now where, if they lost their job, their job is pretty much going away—I think you talked about this, Dr. Stiglitz.

I guess the better question is, if the President called you today as soon as you walked out this door and said, you know, I just saw you on C–SPAN. I want you to tell me what you would do if you were me to deal with this jobs situation. What would you tell him? Both of you.

You know why I am asking this question is because, you know, we can go back and forth. This reminds me of a ping-pong game. We could go back and forth, back and forth. We could have our theories about all kinds of stuff.

But the fact is, is that when I go back to Baltimore, I have still got people who don't have a job. I have still got people who—it is about Christmastime. They are not able to buy presents. They are not trying to get to Disney World. They are just trying to get to the park. They are not trying to have filet mignon. They are trying to have hamburger. And they can't get there.

You all have said it, I think—I know you said it, Dr. Stiglitz. Not only are they losing their homes, they are losing the equity in their homes. They are looking at their stock portfolio and realizing that, almost overnight, they have been wiped out.

So I am trying to figure out, when we go to jobs, what is it that we can do? We have all this nay saying, oh, we can't do this. What can we do and how soon can we do it? Because the people that I am talking about are holding on by a thread; and the thread is getting very, very, very, very thin. So they don't want to hear a lot of, you know, theory. They want to know how they can get to work.

Dr. Stiglitz.

Dr. Stiglitz. Let me first say that there is no magic bullet. In my written testimony I gave a list of several things.

Representative Cummings. You are talking to the President. Tell him what you would do. Go ahead.

Mr. President——

Chair Maloney. We will send it to him.

Dr. Stiglitz. I would begin with aid to the states. They have balanced budget frameworks. Their revenues are plummeting, and their shortfall is over $200 billion a year. They have to either raise taxes or cut back expenditures, which means cutting back on jobs.

For instance, over the past year alone, state and local governments have reduced their employment by 96,000. Government is compounding the problem because of lack of revenue. It is not because they have mismanaged anything; it is a macroproblem that was imposed on them.

I would recommend what I call revenue sharing. If the economy turns up, you don't have to help them. If it turns down, you need to give them more money so they don't have to cut back. This is

really important, because the needs that you describe are getting worse and the ability of the States to respond is weakening.

Representative Cummings [continuing]. Anything else you would tell him?

Dr. Stiglitz. I would actually use investment tax credits, particularly marginal investment tax credits, to encourage the private sector and other kinds of things I mentioned before like accelerate depreciation for small businesses. That directly links to encouraging investment.

I also think that you need to have a government jobs program. You can create jobs. We have big public needs: creating parks, weatherizing public schools, lots of things like that that we might be doing in the future but accelerating them today.

I also think research and technology programs are important. The big advancements in our technology that have transformed our economy for the most part come from the government. They have been implemented by the private sector, but they come from the government. The Internet was financed by the U.S. Government.

You can go down a whole list of things where governments have played a transformative role, and yet now support for these activities is being undermined. This is particularly critical at this time because some of our big, major universities are suffering greatly, the private ones because of the reduction of their endowments, and the public ones because of cutbacks at the state level.

Finally, as I have described in my testimony, we focused in the first round of the stimulus on shovel ready projects. That created the problem of things that perhaps should not have been done. But this is a long-term downturn, and we should begin thinking about what we can do over the longer term. If it turns out that we are wrong and the downturn is shorter term, we can always cut back. But if we don't do the planning now, we won't have plans that we can put in place a year from now or 18 months from now.

On the credit side, credit is not flowing to small- and medium-sized enterprises. As Congresswoman Maloney pointed out, that is where the job creation is. There are a whole set of things we should do to fix this.

We ought to require all banks to allocate a certain fraction of their portfolio to small- and medium-sized enterprises, effectively extending CRA temporarily for small- and medium-sized enterprise.

I mentioned that with much of the TARP money, there was no thought to what kind of financial system we ought to have. It didn't go to the banks that were involved in lending to small- and medium-sized enterprises, which is where it should have gone.

The Fed is providing money at low interest rates, close to zero interest rates, to the banks without asking what they are using the money for. If the Fed is lending money to the banks at zero interest rates, there ought to be a link to job and investment creation in the United States.

The real problem right now is we are actually having a foreign policy problem, because our Fed is lending money to banks at close to zero interest rate, and they are worried abroad that we are creating bubbles in their country, which is actually undermining globalization. Brazil has put up barriers to the inflow of capital,

and other countries are discussing putting up inflow barriers of capital as well.

The conduct of our monetary policy is leading to a weakening of capital market globalization. It is counterproductive.

One other idea is using some of the TARP money, for instance, to help reduce some of the cyclical risks associated with SME lending. Much of the risk that they face today is they don't know the business cycle. We have talked about the risks associated with health care reform. We know about that. But the big risk facing most businesses is, where is the economy going? Small businesses can't control that. The downturn is a result of macroeconomic mismanagement, and we ought to help small- and medium-sized enterprises manage that risk. Big businesses can do it on their own.

Another provision is extending loss carry-back provisions for SMEs that engage in incremental investment or job creation. This is an example similar to immediate tax write-offs for investment. It has a cost to the Treasury in the short term but will make up for that in the long term. The year is not a natural unit.

There are a number of other suggestions in my written testimony. But I think there is actually a portfolio here. None of them by themselves is going to transform the economy, but, taken together as a package, I think it will make a dent in the unemployment rate.

Representative Cummings. Thank you very much. I see my time is long over.

Chair Maloney. Mr. Roberts, would you like to respond to what would you tell the President today?

Dr. Roberts. My phone call is briefer. I will make it short.

I would say, Mr. President, I really appreciate—I am deeply flattered that you think economists have something useful to tell you, particularly this economist. But I, as an economist, have become more humble in recent years. I will give you an example.

The economy is a complex system that we do not understand well as economists, and I mentioned earlier that we have Nobel laureates who want to see the stimulus be double what it was initially. We have equally illustrious economists who think it ought to be zero. That is embarrassing. That tells you that our field is in a little bit of turmoil. We don't understand the complex system called the economy. So maybe you are looking up the wrong tree when you are asking for me to make jobs for people on the streets of Baltimore.

Because that is not what presidents are good at. What presidents are good at is trying to make a policy environment that might make a difference. But, ultimately, those decisions are not going to be made by the President.

You know, airline crashes have fallen steadily over the last decades. We are much, much better at reducing the risk of crashing an airplane. Why aren't we better at reducing the risk of financial crashes? We have lots of data. We have lots of smart people thinking they can steer the financial system the way we steer the aircraft safety system.

But they are fundamentally different. We are not good at steering the financial system. I don't care how many pages are in the bill.

So I would—again, I would push for transparency. I would ask the President, let's try to learn from our mistakes and not repeat them.

And I would be skeptical about the ability of government to create technology, despite Dr. Stiglitz' encouragement. The government created DARPANet. The private sector created the Worldwide Web and the Internet as we know it today. They can work together, and it can be useful. Sometimes they are synergistic. But the ability of the government to pick winners I think is an extremely dangerous road to go down.

Chair Maloney. Thank you very much.

Mr. Brady.

Representative Brady. Thank you, Madam Chairman.

I did get a chance to read both of your testimonies last night while I kept an eye on that highbrow, intellectual economic news program I like to call SportsCenter. So I did get to read the testimonies and appreciate them. Both of them are very enlightening.

Right now, when it comes to jobs, the U.S. is recovering at a slower pace than any other major developed nation. When you look back, the Great Depression, while countries entered it about the same time, the speed of their recoveries also varied greatly. On one extreme, Sweden, 1934. On the other extreme, the U.S., 8 years later.

Dr. Al Felzenberg in his book, "The Leaders We Deserved (and a Few We Didn't): Rethinking the Presidential Rating Game," he identified in the sense that President Franklin Roosevelt had unintentionally retarded the U.S. recovery by vacillating between mutually contradictory economic policies, starting from reflation, breaking the gold standard and devaluing the dollar, and moving to price controls. Then there was a focus on balancing the budget, especially with higher taxes and tax experiments, increases in taxes on retained earnings. That led to a recession on top of the Depression. Then there was the trust busting where they broke up the price fixing that had been put in place before. And then, of course, the big spending, the WPA, the make work project.

While there has been a lot of effort to not repeat monetary mistakes from the Great Depression, it seems like we may well be repeating some of the fiscal and regulatory mistakes from the Great Depression. FDR's policy fluidity increased uncertainty and slowed private business investment and job creation in the 1930s, just as I hear from our local businesses back home who tell me their customers and clients are not making those key investment decisions because it is hard enough for them to predict the market. It is impossible for them to predict the market and Congress at the same time.

Dr. Roberts, in your testimony, you state that policy fluidity is once again exacerbating uncertainty and therefore retarding business investment and job creation. So the question is, in contrast to one of our former colleagues, now Chief of Staff Rahm Emanuel, who said, never let a crisis go to waste, should Congress put large, contentious issues such as health care, climate change, imposed tax increases aside to reduce uncertainty and encourage quicker business investment and job creation?

Dr. Roberts. You want a yes, don't you?

Well, I do think that is a good idea. I do think that is a good idea. I think it is the wrong time to be experimenting.

Again, if we had to fix something that we thought was desperately wrong that would be simple, transparent, and quick, I think it would be a good idea. But I think overhauling complex systems at this time is very difficult.

Just one comment on the Great Depression. It is 75 years later, and economists still can't agree on what caused it or how we got out of it. I think that is a warning sign, Mr. Cummings, to asking economists to solve, steer the economy. It is embarrassing, but it must be admitted. It is true.

Representative Brady. Thanks.

In all fairness, Dr. Stiglitz, please.

Dr. Stiglitz. Uncertainty is inherent, and there is uncertainty if we do something and uncertainty if we don't do something. I have talked to a lot of businessmen in the energy sector who say the real problem right now is they know that, at some time in the future, they are going to pay for the price of carbon. The equilibrium price of carbon is much higher than zero. If we don't do something, Europe is going to implement border taxes. We are going to have to do something.

And they want a response. They know something is going to have to be done, and they want something to be done sooner rather than later. So there is no way of getting out of this inherent uncertainty of the world that we live in.

The same thing is true about health care. That was one of the discussions that we had earlier. In my mind, I agree it would be a lot better if we could do something that was transparent and clear. But again there is no getting out of this inherent uncertainty.

Representative Brady. Doctor, I was just going to ask, there are real-life consequences to all this uncertainty. Yesterday, we had a company, Eastman, that had—that canceled a major chemical construction project in Beaumont. It cost us about 2,500 jobs. It was on the board because not just of global uncertainties, but there are uncertainties about climate change, global warming legislation and how it might affect their projects. So that uncertainty came home to roost for a community in our district with real negative consequences.

I agree, uncertainty exists in all climates, but I really think back home in all of our states it has changed the behavior and it is altering behavior and the ability for us to recover from this economy.

Dr. Stiglitz. As I said before, I know that a lot of, say, large electric power plants do not want to invest, knowing that sometime in the next 5 years or 10 years we will have to deal with this problem of climate change. They would rather have it dealt with sooner than later.

This is not going to go away. If we resolved it, hopefully in a good way, that would allow them to go ahead. In the meanwhile, they know there is a high likelihood that there will be some form of carbon charge. There will be taxes put on our exports if we don't, and we should recognize that we can't be the free rider on the global system. Our firms know that they will face these border taxes if we don't do something.

Chair Maloney. The gentleman's time has expired.

Representative Brady. Thank you both.

Chair Maloney. Mr. Hinchey.

Representative Hinchey. Thank you very much, Madam Chairman.

Thank you both, gentlemen. I am sorry I wasn't here to hear what you had to say, but, unfortunately, I had to be someplace else. But I am happy to be here at least for a few minutes to have an opportunity to see you and maybe ask you a question that I'm sure you have addressed before.

But the situation that is confronting us is this deep recession, and the deep recession has its primary results in the loss of employment. We have more people who have been unemployed than we have in a long, long time. The economic circumstances we are dealing with hearken back to the 1929 Depression.

The economic stimulus package that we have introduced, $787 billion, was, in the opinion of many of us, about half of what we should have put out. Unfortunately, only about 30 percent of that $787 billion has been put out so far. It has been awfully slow. A lot more needs to be done.

Could you give us some insight into what you think about the initiation of the stimulus bill and what needs to be done to get it out there more effectively? What is the focus of attention that it needs to have and what else we need to do to create and stimulate the much-needed jobs that are going to be essential to addressing this economic condition?

Dr. Stiglitz. I agree that the stimulus package that was passed was both too small and not as well designed as it could have been. We knew that the large part that went into household tax cuts was not going to lead to that much spending. Because with the overhang of debt, the uncertainties, households would tend to save a lot of that. The nature of a stimulus is that you have to stimulate. You have to have people spend. So that part was not very effective.

The tax cut should have been aimed at investment. An incremental investment tax credit, as I mentioned earlier, or other provisions encouraging investment would have been better. Some of the money went to help states and localities but not enough. The result of that is, while the Federal Government is expanding, states and localities are contracting, and that is undoing the stimulus. It is like a negative stimulus coming from the state and local level.

It is one of the lessons we should have learned from the Great Depression but didn't. Exactly the same thing happened during the Great Depression. The magnitude of the net stimulus is much smaller because it is being offset, and that is another thing I would have changed.

One of the discussions that we have been having this morning is that different economists disagree. That is always going to be the case. But I think that the overwhelming number of economists—and we will have a disagreement about this—know that we have had lots of experience of situations where there is an economic downturn, and the problem is a lack of aggregate demand. In those contexts, increasing aggregate demand, by and large, does lead to more output and more jobs. The situation is, as you said, serious.

The fact is, it is not just a lag. People say the problem is that employment always lags, but that is not the problem. We haven't had enough growth to create jobs, with or without lags.

Representative Hinchey. So, with regard to growth, one of the things we ought to be doing is stimulating the existing industry and maybe also coming up with new technology that is going to create new industries.

In connection with what you were saying just a few minutes ago, the energy situation, don't you think we should be putting more attention and more investments into the generation of alternative energy, solar energy to stimulate new technologies and new industry?

Dr. Stiglitz. Yes. Let me be clear regarding the discussion we have had earlier this morning about the issue of the role of government in stimulating technology. It is not just a question of picking winners. The real question is that there are huge spillovers, what we economists call externalities, benefits to all of society when you create new technologies.

We have all benefited enormously from inventions like the Internet or the laser. We could all list a whole set of things where the inventor got only a small percentage of the social benefit arising from his innovation. That kind of basic R&D that always necessarily needs to be supported by the government. That is even more true when we are talking about benefits that are societal in nature, like global warming. The answer is very much that those are exactly the kinds of things that we ought to be doing now, which would create the preconditions for more private-sector activity.

Chair Maloney. The gentleman's time has expired.

We have been called to a vote, but I want to briefly ask—maybe we have time for two brief questions.

In your testimony, Dr. Stiglitz, you pointed out that there were going to be severe shocks and problems with our financial markets due to the mortgage industry's foreclosures continuing and the looming problem of commercial real estate. Do you have any solutions or ideas of what we should do with these challenges that are before us?

Dr. Stiglitz. In the area of home foreclosure, the real problem is that the policies of the Administration so far have not been sufficient. The main deficiency is that we have not written down principal. A quarter of all homes are underwater. We know that once homes are underwater, the probability of a default and a foreclosure goes way up. Eventually, that leads to problems in our financial sector, in the ability of banks to lend. It leads to all kinds of consequences. So we need to restructure the value of those mortgages.

Unfortunately, we have made some mistakes in what we have done so far, two mistakes in particular. We allowed the banks to keep on their balance sheet these mortgages at face value, rather than writing them down to the reality. I call that marking to hope, not marking to market. That discourages them from dealing with these problems.

Secondly, it was a mistake in some of the bailouts when we decided to underwrite the banks' losses because that encourages them to, again, hope for a gain so that they get the upside and the gov-

ernment takes the downside. That in turn encourages them not to do anything.

I think we need a homeowners Chapter 11 that would provide a legal backdrop to encourage restructuring. We have Chapter 11 that allows for a rapid restructuring of corporate debts because we think it is important to keep jobs; keeping people in their homes is equally or more important. We need a homeowners Chapter 11 that treats homeowners at least as well as we treat corporations and homes at least as well as we treat debts associated with yachts and other things of indebtedness.

Chair Maloney. And commercial real estate which is a looming time bomb, what should we do about that?

Dr. Stiglitz. That is a problem with no easy solution, other than to recognize that it is a problem and that we ought to be demanding capital adequacy on the part of banks. If we don't, we are going to have a problem with our financial system in 1, 2, 3 years time all over again.

Dr. Roberts. But if we continue to give people a do-over for their mistakes, as compassionate as that sounds and its impact on the economy as a whole might be beneficial today, we are continuing to destroy the incentives that make our country productive and prosperous. So I think it is a terrible mistake to say to people, if you are in trouble, turn to us and we will extend your hand, where the "us" is the government. I think it is a bad precedent. It is a problem.

I think we will have a serious foreclosure problem next year. It is going to be very destructive. Unfortunately, we aren't going to have the budgetary leeway, I suspect, to do much about it.

But to say to people, whether it is on Wall Street or on Main Street, you don't have to take responsibilities for your actions; if you made a mistake, we will bail you out; that is going to be the end of our country as we know it. Down the road, we will pay a fierce price. It will destroy the mortgage market, and that is how we got into this mess, by assuming that we could tweak and control and steer the mortgage market the way we thought was socially desirable. It is an illusion to think that comes at no price.

So it does have a good short-run effect. I agree with Professor Stiglitz. But the long-run consequences are easy to ignore, and I think they have to be faced.

Chair Maloney. Thank you very much.

Mr. Brady.

Representative Brady. Dr. Stiglitz, in your testimony—and I am curious—you made a recommendation that to spur employment that we encourage people to retire early, lowering penalties to get on Social Security and lowering the eligibility for Medicare. Many European countries tried these in the 1980s and 1990s, and it ultimately reversed course because it actually took away Federal outlays and increased their entitlement costs.

Right now, as you know, everyone knows Social Security and Medicare are sinking ships. So the dual thought of adding more people onto those ships at the same time removing them as productive citizens at a time life expectancy is increasing, wouldn't that proposal actually reduce real GDP over time?

Dr. Stiglitz. I thought of that as mostly a short-term measure. I will agree with you that, over time, we ought to be increasing Social Security and Medicare. This is one of the older ideas in the Greenspan Commission, and I support that idea.

Representative Brady. Dr. Roberts, any thought?

Dr. Roberts. No, no comment.

Representative Brady. Thank you both. I appreciate it.

Chair Maloney. First of all, I would like to thank our distinguished panelists today. While putting Americans back to work today may require deficit spending, the dangers of inaction are even more costly. If we don't invest in job creation, we will pay later in the form of higher payments to unemployment insurance, food stamps, welfare, and other entitlements.

Thank you for your ideas to help us work in government to help the private sector create more jobs and to move our economy forward.

We have been called for a vote. I could listen to both of you all day. Thank you very much for being here. Thank you.

Dr. Roberts. Thank you.

[Whereupon, at 11:54 a.m., the committee was adjourned.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF CAROLYN MALONEY, CHAIR, JOINT ECONOMIC COMMITTEE

For the first time since the recession began two years ago, the labor market appears to have stabilized. After month after month of punishing losses, November's employment picture was relatively stable. Less than a year ago, job losses were growing more and more severe. Last November, the economy shed 600,000 jobs. Losses increased until January, when they hit a post-Great Depression record of 741,000 jobs lost, the last month that President Bush was in office.

But we turned a corner. Job losses have steadily fallen for the last six months. Yet there is no escaping the cruel math of recoveries. The recovery of the job market lags behind the recovery of the broader economy. Businesses must have more customers before they add employees.

Although the labor market appears to be stabilizing, too many Americans remain out of work. More than 15 million workers are unemployed. While we have brought the economy back from the brink, we are not yet where we need to be in terms of job creation.

The mission is to create high-quality private-sector jobs. Congress has already done a great deal of work on this front. The $700 billion Recovery Act included a tax cut for 95 percent of American families and created jobs while investing in clean energy technologies, infrastructure, and education—and we see those investments paying off in the steadily improving labor market figures. The effect of the stimulus on job creation has been verified by the non-partisan Congressional Budget Office.

Just last month, we extended the $8,000 first-time homebuyers credit that will spur construction jobs.

We extended tax relief to small businesses. We are boosting funding for small business loans via the Small Business Administration. These two initiatives should spur hiring.

Earlier this week, President Obama announced a new job creation agenda with three key initiatives to accelerate job growth. First, we need to focus on small businesses. Small businesses are the engine of the American economy. By helping small businesses expand investment and access credit, they can fuel job growth. Second, we need to invest in our future by rebuilding America's crumbling infrastructure. Finally, we need to focus on "green" jobs. Smart, targeted investments in energy efficiency can help create jobs while improving energy security and saving consumers money.

Congress and the President will work together to aggressively pursue a job creation agenda that speeds the labor market recovery. Of course, some of those initiatives will require new spending. We are committed to transparency regarding the cost of our initiatives.

But let me be clear: While putting Americans back to work today may require deficit spending, the dangers of inaction are even more costly. If we don't invest in job creation, we will pay later in the form of higher payments to unemployment insurance, food stamps, welfare, and other entitlements for a ballooning number of out-of-work Americans and their hard-hit families.

Nearly 6 million Americans have been unemployed for 6 or more months. Over 3 million Americans have been unemployed for over a year. Research shows that the longer a worker is out of work, the harder it is for him to find a new job. We must invest in these workers with aggressive job creation policies coupled with targeted job training initiatives. Otherwise, we face a long-term cost burden far more expensive than smart spending on job creation investments today.

Our challenge today is immense. While the economy may be on the road to recovery, the labor market remains on shaky footing. We Americans are a hard-working, resilient people. But the millions who have been battered by the economic storm need our help today in getting back to work. I am confident that we are up to the task.

And I am thrilled that we have with us today Dr. Joseph Stiglitz, one of America's brightest economic minds, to help us learn about the best ways to accomplish our goal of a rapid and complete labor market recovery.

PREPARED STATEMENT OF SENATOR SAM BROWNBACK, RANKING MINORITY

I want to thank the chair for scheduling today's hearing. The question of how to restore growth to the labor market is the single most important challenge facing the Administration and the Congress. In answering the question of "what should government do?," we need to be mindful of the equally important consideration of "what government should not do."

The only way that we are going to restore meaningful, long-term growth in employment and output is through the private sector. We need to once again unleash

the engine that powers our economy to create jobs and opportunity for our citizens. We need to make sure that our citizens are able to enjoy the fruits of THEIR labor instead of being asked to give more and more of those fruits to the government to distribute according to its wishes and desires.

Point is that instead of paving the way to economic recovery, the government is standing in the way.

The massive stimulus bill—$787 billion—that passed in February. The American people were told that this was necessary to prevent unemployment from rising above 8 percent. The last time I checked, 10 is greater than 8. The February stimulus has turned out to be no stimulus, so now the President and Democratic leadership are calling for more stimulus—even though the majority of the first stimulus hasn't been spent. This time they are talking about using unspent money from TARP. I opposed passage of TARP and I am even more opposed to the Administration and Congressional majority transforming this money into a perpetual slush fund. The legislation was specific. As money was paid back to the government, it was to be used to pay down the national debt, not to fund new programs or new spending.

What are the biggest threats to the future long-term prosperity of our nation? Plain and simple: it is our skyrocketing national debt, our unfunded entitlement promises and a government intent on getting bigger and bigger and controlling more and more of our nation's economy. Does the marketplace have imperfections? Yes it does. But those imperfections pale in comparison to the threat posed by a runaway government that believes it has better and more complete knowledge of how to allocate resources and determine the value of labor and capital.

The failure of "really smart people" on Wall Street to recognize and account for risk couple with excess leverage brought our entire economic system to the brink of collapse. The government is in the process of doing the same thing. For instance, instead of creating stability and reducing uncertainty, our government is introducing greater uncertainty and great risk into the private sector.

Let's take the current debate over the proposed takeover of the health care system by the federal government. If you are a small business the current debate and the ideologically driven path of current legislation offer little comfort and introduce even greater uncertainty into an already uncertain economic environment. What will it cost? What new mandates and penalties will I face? These are questions business owners and managers are concerned with. These uncertainties loom as a major obstacle to a decision to hire new workers or to postpone decisions to reduce compensation costs by reducing the number of employees.

Entrepreneurs see it for what it is—a giant government scheme to embark upon the greatest redistribution of economic resources in this history of this nation. The difference is that when an entrepreneur embarks on a new venture, the money at risk is usually his own. When the government embarks on a new scheme, it's other people's money.

We will hear that legislation passed in the House and in pending in the Senate will reduce the deficit. It's a mirage that relies on timing and inflation. The real point is that the legislation will permanently and significantly increase the size of government both in terms of what the government spends and what it takes from hard working citizens. At the end of the day, it will leave us less free, more deeply in debt, and less prosperous in the future.

I look forward to the testimony from our witnesses. Both are distinguished scholars. I will be interested to hear their thoughts on how to move the economy forward. For my part, I am convinced that government needs to cease being the obstacle to recovery. We need to stop increasing uncertainty and as I said earlier stop blocking the road to recovery.

PREPARED STATEMENT OF REPRESENTATIVE KEVIN BRADY

I join in welcoming Dr. Stiglitz and Dr. Roberts, and look forward to hearing the views of these two distinguished economists.

The economy remains the number one issue for Americans and my constituents in Texas. They are apprehensive—in some cases frightened—about the direction that economic policy has taken in Washington.

A new Bloomberg survey of the American public reveals that the vast majority of the Nation, 60 percent, believe the stimulus had no effect or is hurting the economy. More troubling, nearly half (48%) say they feel less financially secure today than they did when President Obama first took office. And their pessimism grows about the willingness and the ability of the government to reduce the staggering deficit.

The recent hastily-arranged jobs summit and calls by the President for Stimulus II are further signs this Administration's economic policies are failing the American public.

Consumers are frightened by the debt and their job future and understandably reluctant to spend. Businesses of all sizes are worried—reluctant to add new workers while Washington promotes higher health care costs, energy costs, more regulation and new taxes.

The White House and this Congress have taken their eyes off the economic ball, opting instead to pursue ideological agendas that contribute nothing to our economic recovery and, in fact, fuel fear among job creators along our Main Streets. We need to stop "frightening the horses" if we hope for a stable and reliable economic recovery led by our local businesses, rather than the government.

The United States is at an economic crossroads. The road to the right is a free market economy in which the decisions of Americans acting as entrepreneurs, consumers, workers, investors, and savers are determinative, while the road to left is a social market economy, in which the federal government plays a controlling role.

To the right, Congress would gradually reduce federal budget deficits by restraining the growth of federal spending and pruning unnecessary or ineffective programs. Reforming health care on this path would focus on empowering patients and lowering costs.

To the left, Congress would continue its reckless spending. Reforming health care on this path would focus on empowering the federal bureaucracy and expanding health-care entitlement benefits with little consideration about long-term costs.

To the right, Congress would direct the Treasury to sell its shares in Chrysler, Citigroup, GMAC, and General Motors and to truly privatize Fannie Mae and Freddie Mac as quickly as possible. Once again, the market would determine which companies prosper or fail.

To the left, Congress would establish an industrial policy for the United States, determining winners such as green technologies, and losers such as oil and natural gas production, based on political criteria. Housing is one of the few sectors of the U.S. economy in which the federal government has pursued an industrial policy. The collapse of the housing bubble and the insolvencies of Fannie Mae and Freddie Mac should warn us about the dangers of mixing public purpose and private profits.

To the right, necessary regulations would be as simple as possible and fairly enforced. Old regulations would be regularly reviewed, and regulations that proved costly, ineffective, or unnecessary would be eliminated.

To the left, new regulations would multiply. The cost or effectiveness of regulations would matter little so long as their intent is good.

To the right, Congress would stabilize the federal tax burden as a percent of GDP at its post-World War II average. Congress would reform the federal income tax system to encourage both domestic and foreign investors to make job-creating investments in the United States rather than forcing them abroad.

To the left, Congress would allow the federal tax burden to rise as a percent of GDP. Congress would inevitably be forced to increase the income and payroll tax rates paid by nearly all Americans, not just the wealthy.

To the right, Congress would aggressively pursue new customers around the globe, tearing down barriers and creating U.S. jobs by approving the pending free trade agreements with Colombia, Panama, and South Korea and engaging in dynamic growing markets—such as the Asia Pacific region.

To the left, Congress would block these agreements, withdraw from the global marketplace, and impose protectionist measures that block access to the U.S. market at the behest of a few labor leaders and other activists.

History both here and abroad proves that the right road leads to sustained economic growth, rising personal income, and expanding job opportunities while the left road leads to stagnation.

The question before Dr. Stiglitz and Dr. Roberts today, is which road would you choose?

The Challenge of Creating Jobs in the Aftermath of the "Great Recession"

Testimony by Joseph E. Stiglitz

Joint Economic Committee

December 10, 2009

It is a pleasure to address you concerning the State of the Economy and what needs to be done.

Though the situation today is far better than a year ago, it is no exaggeration to say that the situation remains bleak. We are at a critical stage in our recovery. The banks have been rescued and are set to pay out large amounts in bonuses. Yet there remain severe problems in our financial markets, with mortgages foreclosures continuing apace and massive problems in commercial real estate on the horizon. The suffering of those who have seen their life dreams vanish as their home equity—their major source of savings—disappear before their eyes, or the young people who, having knocked on door after door, see no job prospects in the immediate future, is palpable. We have an economic problem on our hands, but we also have a major social problem, with millions having lost their homes or about to do so. The divide between Wall Street, on the one hand, and the rest of the country, and even between the parts of the financial system that have received special favors from Washington and those that have not, has perhaps never been greater in recent memory. The fact that the stock market is up or that credit markets are less frozen should not distract us from the problems ahead.

These problems are especially grave in the labor market. We should not be fooled by the fact that the unemployment rate this month dropped by 0.2% to 10%. More than one out of six workers who would like a full time job still couldn't get one. But the unemployment rate is not lower because more jobs have been created but because more workers have become discouraged while looking for a job. According to the establishment data, the loss of jobs had slowed to 11,000 in October;

however, the loss in private sector jobs was large (18,000), and the loss of "regular jobs" (excluding temporary help services) in the private sector was 70,000. The fact that hours increased slightly, albeit from record low levels, is positive, but one should not read too much into one month's data.

Adjusted for changes in the structure of the economy, unemployment is the worst since the Great Depression. Other indicators suggest how bad things are: For instance, the duration of unemployment (the percentage of those in long-term unemployment) has reached another high. Weekly wages are essentially stagnating. When we look at particular groups and particular locations, the data is even bleaker. The numbers cited are averages for the whole country. Unemployment among males ages 16 to 19 stands at 30.3%, among those with less than a high school diploma at 14.5%, and among African-Americans ages 16 to 19 at 49.4%. And these numbers do not include those who have become so discouraged that they have stopped looking for a job or who have accepted a part time job because there is no full time job available.

We have been told that employment lags output. There are lags. Many firms won't start hiring until the shortened workweek, just over 33 hours, is extended. But these grim statistics are not just a matter of lags. Growth in private demand (i.e. without government action) is likely to be insufficient to restore employment to normal levels any time soon. The mathematics are simple: unless growth is greater than the sum of productivity increases and labor force growth, the number of unemployed, now standing at some 15.4 million, compared to 7.5 million at the start of the recession, will grow. Normally, the labor force grows around 1% per year and productivity around 2.2%, so that unless growth exceeds 3.2%, unemployment will grow. To bring the unemployment rate down rapidly requires growth in excess of that number for a considerable period of time—or by a considerable amount over a short period of time. Recent data suggests the problem *may* be even worse. Productivity has been growing faster than "normal" (recently at 8%), and that means that the break-even growth rate is far higher. There is little reason to believe

that it will be sustained at such levels, but there is also little reason to believe that it will fall to below longer-run trends. (And, of course, if it should, it would not portend well for the economy's long-run prospects.)

It is imperative that something should be done about this. The stimulus package passed in February has been working. It was, however, not large enough and was not designed to maximize job creation. It was not up to the task required by the rapidly deteriorating economy. Unless action is taken, we risk facing a vicious cycle—unemployment contributing to a weak economy, more mortgage foreclosures, more bad debts, lower demand, and possibly more—but certainly not less—unemployment.

As we approach the looming jobs problem, we should not repeat the mistakes we have continually made in responding to this crisis—too little, too late. There is, in economics, something akin to the Powell doctrine in the military: one needs to attack the problem with overwhelming force. Australia did this, with its carefully designed but large stimulus package. It was the first OECD country to emerge from recession. If things should turn out better than the pessimistic prognosis given below, one can always scale back.

The basic economics of the situation is simple: what sustained the U.S. economy prior to the crisis was an unsustainable housing bubble, which fed a consumption boom. Household savings rates fell to an unsustainable level of zero. We might, through a variety of gimmicks, try to push the savings rate back down to near zero. That would be a mistake for the long-run strength of the economy. Households could get away with zero savings because they had an asset, a house, whose value seemed to increase without bounds. Their home equity has been greatly reduced, if not destroyed.

We had a bubble which has broken. The Fed was wrong in saying that one couldn't ascertain whether there was (likely) a bubble before it broke. It was very wrong not

to have taken preventive actions. We have all paid a very high price for its flawed ideology. But it would be even worse for us now not to recognize that and to encourage households to consume as if house prices and asset values will once again be restored to bubble levels. That is why consumption, representing some 70% of GDP, will almost inevitably be weaker than before the crisis. Measures designed to "smooth" the adjustment will at the same time prolong the adjustment.
This is a synchronous global meltdown, and it is impossible for every country to export its way out of the crisis. We can try to export our way out through competitive devaluation, a form of beggar-thy-neighbor policy. But such policies will hurt our trading partners, and in the end, if their economies are weak, it will be difficult to sustain exports. But even if exports do well, they are unlikely to compensate for weaknesses in consumption.

With consumption weak, it will be difficult for investment to be strong, though eventually, because of the rapid pace of innovation in some sectors, obsolescence will necessitate new investments. But the overhang of residential and commercial real estate will mean that these will not resume to pre-crisis levels any time soon (though growth rates may look impressive, given the current low base).

I should say a brief word about my assessment of the economy's prospects over the next year or two. This crisis has been complex—a mixture of a financial and an economic crisis. The economic crisis, in turn, has at least three components: (a) an inventory adjustment; (b) a real estate "adjustment"; and (c) a longer-term restructuring from manufacturing to a service sector economy. The current rebound is largely a response to an excessive depletion of inventories, combined with the impact of the stimulus programs. It will be a long time before real estate recovers; indeed, some believe that the problems in commercial real estate are just beginning to surface. And many of the jobs lost in manufacturing are not likely to return; indeed, another 41,000 jobs were lost in manufacturing in November. In short, the economic crisis is far from over.

While the financial sector has been brought back from the brink, there are likely to be many bumps on the road ahead. Mortgage foreclosures are likely to continue, with one out of four homes underwater. There is a broad consensus among economists that what has been done so far has been inadequate; what is needed is a write-down of principle, not just lowering payments. At best, the current program will help a little; at worst, it will push the problems out into the future. (I will return to these issues later in my testimony.)

The effects of the stimulus will provide some strength to the economy through 2010, but there are two other looming problems (besides the uncertainties already noted in the financial sector): the substantial shortfall of revenues at the state level and the withdrawal of the stimulus spending in 2011. States have balanced budget frameworks, and thus if their revenues decline, they have to either increase taxes or cut back spending—a strong negative stimulus to the economy. Property taxes are an important source of revenue, and the decline in property values will hit them hard. The full impacts are just beginning to be felt. The effect of the shortfalls has been softened by the stimulus package; the end of the stimulus will heighten the problems. Those dependent on public services are likely to be especially hard hit, but so too will the macro-economy.

There is a third looming problem—the "exit" of monetary policy from its current stance—which I discuss below.

In short, there is no alternative to strong government expenditure and job creation programs. Today, the worry in some quarters is the resulting impact on the deficit. We need to be careful not to succumb to deficit fetishism. The government's debt is only one side of its balance sheet. No one would assess the state of a firm by looking only at what it owes. One needs to look at the assets too. If assets increase in tandem with liabilities, then the balance sheet can remain in good shape. If money is spent on infrastructure, education, and technology, the long-run productivity of the economy is increased at the same time that jobs are created today, in the short

run. Numerous studies have shown that such investments can yield high returns, far higher than the government's cost of capital.

Deficits unaccompanied with increases in assets do matter, and that is one of the reasons why I have been so concerned about spending that creates deficits (including deficits in the future) but does not create a productive asset. Spending on the war is an example.[1] My earlier book with Linda Bilmes highlighted the huge costs of the Iraq and Afghanistan wars, including the future costs of providing disability payments and caring for the large number of injured and permanently disabled returning troops. At the time, we estimated, for instance, those costs to be in the order of half a trillion dollars. Evidence since the publication of our book suggests that those numbers were excessively conservative. They also suggest that the costs in Afghanistan are markedly higher than in Iraq. Using the Administration's estimates of about $1 million per troop (which does not include future costs of disability and health care, which, over time, will add substantially to the national debt), the money spent on the 30,000 additional troops surge could have created more than 1 million jobs in America that pay $30,000—and the jobs created in America would have higher multipliers (second and third round effects).

It is also one of the reasons why I have been so critical of the manner in which the bank bailouts were conducted. The Congressional Oversight Panel has described how at the time we got back 66 cents on the dollar in preferred shares and warrants. Not to put too fine a point on it, we as taxpayers were cheated. Had we gotten a fair deal, our national debt would in the future be that much lower. We should not be misled by the fact that some of those to whom we have given money have paid us back with interest. No oil company drilling wells would say, "Look, this oil well has more than paid back my investment." Yes, the good wells pay off; but they have to

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[1] The critique of this spending on the wars in Iraq and Afghanistan go deeper: the concern is that they are unlikely to increase our security and that there are huge human costs that go well beyond the economic costs. See Linda Bilmes and J. E. Stiglitz, *The Three Trillion Dollar War,* New York: WW Norton, 2008.

pay enough to compensate for the dry holes. There is little prospect that we will ever recover the money put into AIG, with interest sufficient to justify the risks borne. We as a country have paid a very high price for not following the normal rules of capitalism, which require that a firm that cannot pay back its creditors should be put into receivership and that a bank that is undercapitalized should be put into conservatorship.

Investments in jobs can even help reduce the deficit in the long run. Unemployed workers lose their job skills. We are at risk of replicating a phenomenon observed in Europe in the 80s, called hysteresis: those with extended periods of unemployment never return to the labor force, or if they do, it is in a job with vastly lower wages and productivity. Unless we manage this crisis well, we could be setting ourselves up for an extended period of high unemployment. What economists call the "natural unemployment rate" may be significantly increased. And if that happens, GDP and tax revenues for years to come will be lower than they otherwise would be—with the result that the national debt will be higher.

Our financial markets have been unbelievably short-sighted, which has brought us to the brink of ruin. Their short-sightedness led them to pay out bonuses and dividends with money intended to recapitalize them. It would be a mistake now if we replicated this short-sightedness by focusing on the deficit.

There are clear criteria for the form of stimulus: (a) high multipliers—large GDP "bang for the buck"; (b) large job creation bang for the buck; (c) creating assets with high returns, especially those directed at national needs, like improving technology and improving public transportation systems; (d) flexibility—automatic stabilizers which increase spending commensurate with the economy's needs; and (e) meeting some of the economic and social exigencies created by the economic crisis.

Assessing alternative measures in these terms gives the following priorities:

(i) *Extending unemployment benefits.* Such benefits have high multipliers, and in the absence of these benefits, there can be enormous suffering. Mortgage defaults are also likely to increase, exacerbating the problems in the financial sector.

(ii) *Aid to states.* We should make up for the shortfall of their revenues arising from the economic recession.[2] State governments have reduced employment by 8,000 over the past year, and local governments have reduced their employment by another 96,000. Governments at the state and local levels are compounding the problem of the jobs deficit and weak economy; they are engaged in pro-cyclical policies, exacerbating the downturn. But unless they have help, they have no choice. To be sure, matters would be worse without the stimulus. They will get worse when the stimulus is removed.

(iii) *Tax credits.* Giving tax credits for weatherizing homes helps provide jobs for those who have lost jobs in the construction industry, while at the same time they help meet the challenge of global warming.

(iv) *Government job programs.* Labor intensive government job programs can create large numbers of jobs at relatively low cost

(v) *Research and technology programs.* We have been underinvesting in this area for a long time, but the problems have become more acute as private universities face declining endowments and public universities face declining support. Some universities are furloughing teachers; others are cutting back on hiring.

(vi) *Longer-term investments.* It was natural to begin with "shovel ready" projects. But the downturn is likely to be a long-term downturn, and we should use this to our advantage. We should begin drawing up plans *now* for high return public infrastructure projects that are not shovel ready—but

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[2] The assistance should be open ended, with as few strings as possible except that states and localities should maintain their tax effort; the federal government should fill the budget gap (what revenues would have been had growth been "normal") for the duration of the crisis. Given the difficulties states currently face in borrowing, the Federal government should also extend credit to them, passing on the advantage of the low interest rates at which it can borrow and taking as effective collateral payments that the Federal government makes to the States under a variety of programs.

could be ready in one or two years time. If it turns out that the economy recovers (unlikely), these can be undertaken eventually, as funds come available; if the economy is still weak a year or two from now, we will have a portfolio of high return projects from which we can choose.

Small and Medium Sized Enterprises

I want to spend a minute talking about small and medium sized enterprises (SMEs), which are the source of job creation. They are facing increasing difficulties in getting access to credit, even as the banks seem to be recovering. This is understandable. Banks and their supervisors are raising lending standards. Competition has been reduced. Many borrow on the basis of real estate collateral, and the value of that collateral has declined. Credit card companies have been raising their already high interest rates, and many very small businesses rely, at least partially, on credit cards.

More than a year ago we were told that we needed to bail out the banks to maintain lending. But in giving huge sums to the banks, we put no conditions on how they used the money. They used it in ways that were predictable, reflecting that the private incentives of bank executives differ from the social returns. Much of the money didn't go to recapitalize the banks, as we were promised, but to pay bonuses and dividends. And even with recapitalization and access to low interest funds, the banks are not increasing lending to SMEs, though there is a concern that in the successful emerging markets the money is fueling new bubbles.

The following seven point program may help alleviate the problems:

(a) Requiring all banks to allocate a certain fraction of their portfolio to SMEs (along the lines of CRA requirements); and restricting lending which directly or indirectly might contribute to the formation of bubbles.

(b) Directing more of TARP moneys into banks that are committed to lending to SMEs.

(c) Using TARP money to help establish new financial institutions committed to providing support for SMEs.

(d) Using TARP money to help lay off some of the cyclical risks associated with SME lending.

(e) Extending tax loss carry-back provisions for SMEs that engage in incremental investments or job creation.

(f) Restricting lending by banks for speculative purposes (especially banks making use of access to Federal Reserve money at low interest rates), which would encourage them to direct more of their lending towards the creation of new jobs.

(g) Carefully expanding SBA programs, recognizing not only the high risks that small businesses face in an extended economic downturn but also the difficulties that they currently face in getting access to credit.

Whatever benefits we give (access to credit, taxes, etc.) should be linked to job creation. A capital gains tax benefit for a small business engaged in real estate speculation is not exactly what the economy needs at this juncture. More generally, tax preferences have contributed to our country's current problems, and we must be more thoughtful about extending them.

Mortgages

I have long argued that doing nothing about mortgages while we were pouring money into the banks was akin to giving a mass transfusion to a patient suffering from internal hemorrhaging. It was a mistake not to have taken measures in the fall of 2008. It is now recognized that the measures taken in February 2009 were totally inadequate. Something must be done about writing down principle.[3]

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[3] Elsewhere, I have argued for a homeowners' Chapter 11 that would enable a smooth and orderly write-down of principle. There are other proposals that would have a similar effect, involving "equitization" of the debt and "right to rent," allowing individuals to stay in their homes as tenants, at market rates, with an option to repurchase. Such programs would protect the housing stock and communities and at the same time would provide service providers a powerful incentive to

Otherwise, foreclosures will continue at an unacceptable rate, and real estate prices will be unnecessarily depressed. This affects the rest of the economy through a variety of channels. First, as more mortgages are underwater, defaults and foreclosures rise, exacerbating the downward vicious circle we have already seen. The resulting losses of banks impact their ability and willingness to lend. But the declining prices also play into the problems in the labor market. As I noted, small businesses depend on asset-backed loans. Many small-business owners borrow on the basis of their homes. As home prices decline, access to credit declines. And that means jobs get destroyed.

But the weak housing market will contribute to high unemployment and lower productivity in another way: a distinguishing feature of America's labor market is its high mobility. But if individuals' mortgages are underwater or if home equity is significantly eroded, they will be unable to reinvest in a new home.

Supply side policies

The problem of unemployment in coming years may be worse than in a "normal" cycle for another reason (in addition to those already recounted). Many approaching retirement have lost a substantial part of their retirement savings and are considering postponing retirement. This will lead to a shortfall in vacancies, implying fewer jobs for new entrants into the labor force. Reducing the age of eligibility for Medicare and the penalties for early retirement under Social Security might help alleviate this problem.

Global imbalances

This is a global economic downturn. Well before the crisis, there was a worry that there would be a "disorderly unwinding" of the global imbalances. This disorderly unwinding was not the cause of the current crisis, but it could be of the next. It is

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renegotiate. Unfortunately, some of the accounting rule changes and some of the bailout programs undermined incentives to renegotiate, exacerbating the problems of mortgage restructuring.

important that something be done about these imbalances, which include America living beyond its means. Unfortunately, while household savings rates have increased, government deficits have increased in tandem, so the national savings rate remains low. The decreasing trade deficit (reflecting the narrowing gap between national savings and investment) is largely due to lower investment.

China has been put under a great deal of pressure to increase its exchange rate and its consumption. We should, however, be aware that it will have only a limited effect on our trade balance or exports. We are more likely to simply switch the source of our imports, to buy textiles and apparel from some other developing country rather than China.[4] From the global perspective, we should not be encouraging others to imitate our profligate consumption patterns. There are huge needs for investment, for instance in response to the threat of global warming or to improve the livelihoods of the 40% of the world living on less than $2 a day. The challenge is to recycle the savings to where they are needed.

In any case, as China increases its consumption (and it has been increasing at a rapid pace in recent years, though not as rapidly as GDP), some of it will be directed at improving education and health. We cannot expect much of it to show up as imports from the U.S. In short, we have to focus our attention in putting our own house in order, if we want a resumption of robust growth here. We cannot rely on some international fix, some magic that might result from correcting global imbalances.

Exit from Current Monetary Policies

By now, it should be clear that I think it is premature to begin to think of an exit from current strong actions on the part of government to stimulate the economy. The monetary authorities are now talking about an end of the extraordinary

[4] Moreover, in some cases, prices will adjust; in that case, the major impact of the revaluation will be a profit squeeze for some Chinese exporters.

measures that they have undertaken, and especially the quantitative easing. I want to highlight the dangers ahead, both for our economy and our national debt.

First, though, I want to comment briefly on the performance of the Fed. While everyone is thankful that we have been brought back from the brink, we should recognize the role of the Fed in creating the crisis in the first place. It was front and center. There is a broad consensus that its actions, guided by a flawed economic philosophy, led to the crisis. It believed that one could not tell a bubble before it broke, that it did not have the instruments with which to deflate the bubble, that the cost of cleaning up the mess after the bubble broke would be less than any costs incurred in early action. On each of these points it was wrong, very wrong, and we have paid a high price. Of course, one cannot be sure that there is a bubble before it breaks—but one can make strong probabilistic statements, and the role of any policymaker is to make judgments under uncertainty and to manage the risks.[5] The dereliction of its regulatory responsibilities provided full scope for the excesses of the years before the crisis.

I emphasize this because one of the issues before this Congress is reform of our regulatory structure. Giving more power to an institution which has failed so miserably, with results that have imposed such costs on all of us, cannot be the right solution—unless there are deep and fundamental reforms in the institution, of a kind that are beyond those currently being discussed. To do so would send a message to our own citizens and the world that we have no system of political accountability. To be sure, those on the board of the Fed today may (or may not) have learned a lesson, though economic philosophies often do not change that quickly. But even if they have, we have a country that is supposed to be governed by laws; the success of our system should not depend on the fact that those in charge have had their fingers burnt. If we take that approach, then in five years, or fifteen

[5] One can't be sure about the rate of inflation before it occurs, either, yet the fact that there is uncertainty does not impede it from acting.

years, we will have someone else in charge, someone who has not learned these lessons at such cost, and our country risks suffering again.[6]

Traditionally, the Fed intervenes only by affecting the short-term interest rate, and it only takes T-bills as collateral. Other rates are left to the market. In the extraordinary steps taken by the Fed in response to this crisis, it has entered into other markets, taking other assets as collateral. It seems to have *temporarily* lowered long-term mortgage rates, and this has facilitated the refinancing of mortgages. But any private party buying such mortgages knows that, when the program ends, mortgage rates will rise, and those holding the mortgage will take a substantial capital loss. It is no surprise then that the government program has, in effect, crowded out the private market—the Fed is on target to hold a trillion dollars of mortgages, on which it will suffer a large capital loss. The fact that the Fed won't recognize this loss does not mean it is not there. The reason that the private sector won't buy these assets is that they know the returns are lower than they will be able to get on new mortgages issued after the Fed exits. There is an opportunity cost. The loss in the value of the assets measures the (present discounted value) of that opportunity cost. It measures, in other words, how much higher the national debt will be as a result of the government program.

The fact that the Federal Reserve might not *recognize* the losses doesn't mean that the losses have not occurred.[7] Our banks got into trouble partly because of their funny accounting—they tried to deceive the regulators, their investors, and the tax authorities, and they wound up in part deceiving themselves. We should be clear why markets froze beginning in August 2007: each bank knew that it didn't know

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[6] The problems of governance of the Federal Reserve system are well known. The regional banks, for instance, can, and often do, have on their boards representatives of the systemically dangerous institutions. Capture is built into the governance structure. Moreover, even if old leadership and institutions were admirable, it is useful, after a crisis such as this, to have new leadership that can assess with dispassion what went wrong.

[7] It is important to have accounting frameworks that recognize such losses, and proposals to force the Fed to do so should be encouraged. Otherwise, behavior will be distorted in attempts to hide them. Examples are given below.

its own balance sheet, so it couldn't trust that of any other. One of the criticisms of the manner in which we have handled the bailout is the lack of transparency.

There are proposals that the Fed keep these mortgages on their balance sheets *in order to avoid recognizing the losses*, and, when the time comes to rein in lending, to do so by inducing banks to hold more money at the Fed by offering higher interest rates. That too comes at a high cost—money paid on deposits at the Fed is money that may help the banks' balance sheets but that is not available to help the government's balance sheet. There are other regulatory instruments that may be far less costly to the taxpayer and far more certain in their impacts on lending.

Regulatory Reform

Finally, I want to say a few words about reform of the regulations affecting our financial system. We should have begun both regulatory reform and bailouts with a conception of what kind of a financial system we wanted—and what was wrong with the financial system of the past. Our financial system failed to perform its critical social functions of allocating capital and managing risk with low transaction costs. Instead, it created risk and misallocated capital, all with high transaction costs. That some 40% of corporate profits were garnered by the financial system should have been a sign that something was awry. A financial system is a means to an end, not an end in itself. Our financial system has engaged in predatory lending. It has resisted the creation of an efficient electronic payment mechanism that modern technology could have provided. Instead of the pennies that it should cost to transfer money from one account to another, charges of 1%, 2%, or more of the sales are imposed. It is like a tax—a tax that dampens business, especially hurting small and medium sized businesses and competitive industries operating at low margins. But the revenues from this tax do not go to public purposes but to pay outsized bonuses to those in the banks.

We are emerging from this crisis with a banking system that is more concentrated and less competitive and able to extract more rents from the rest of the economy,

evidenced by usurious interest rates on credit cards. While the money will help recapitalize the banks, the higher interest rates will slow the recovery, and a less competitive banking system will neither serve our citizens nor our economy well.

There is a simple test of the adequacy of "reform" (regulatory and structural reforms) of our financial system: if these reforms had been in place, say in 2003, would the crisis have occurred, and if it had occurred, would it have been less costly? My assessment of the reforms currently on the table is that they fail to meet this test. Unless we pass an adequate regulatory reform, we can look forward to another crisis some years down the road. This is not good news either for our citizens or for our economy.

Take the issue of incentives. The one subject on which economists agree is that incentives matter. Bankers' incentive structures encouraged short-sighted behavior and excessive risk taking. They acted in a manner totally consistent with their incentives. Why should we be surprised at what resulted? Excessive risk taking might not matter, were it not for the large externalities: the failures of our banks have imposed large costs on all of us, on homeowners, on workers, and on taxpayers. That is the reason that we need regulation, and especially for systemically significant institutions.

I remain unconvinced that we have done enough to deal with the institutions that are too big to fail or institutions that are even too big to be financially resolved. The Governor of the Bank of England has recognized how critical it is to fix the problem that they pose. Fixing this problem is not the only issue—there is no such simple solution. It is necessary, but not sufficient. The reason that something has to be done should be obvious: too big to fail institutions have perverse incentives. If they gamble and win, they walk off with the winnings; if they fail, we pick up the losses. The way we have addressed this crisis has made these problems worse. Concentration in the financial sector has increased, and so has moral hazard. I

testified to this committee on this issue earlier, and I will not repeat what I—and all the other witnesses at that hearing—said then.[8]

Steps taken so far are moves in the right direction, but they don't go far enough. Creating a $150 billion fund to finance the next bailout is desirable if we fail in preventive action, but $150 billion is clearly insufficient: we have spent $180 billion on the AIG bailout alone. But the fund itself is an admission of defeat: if we had a well-functioning regulatory structure, it would close down banks before the losses had mounted to the size that they could not or would not be borne by bondholders and shareholders.

Having plans for an orderly resolution—living wills—is also a step in the right direction; but in the context of a crisis, it is unlikely that anything will go as planned. Giving additional resolution powers too is a move in the right direction; but the issue is not so much having the powers but a willingness to use them, as large and powerful financial institutions in a crisis will use the same kind of scare tactics that they used in the current crisis. Existing powers were not fully used either before or after the current crisis. Authorities will worry about the turmoil that will result if bondholders and shareholders are let go.

We cannot let institutions grow to the size where they are too big to fail. We must prevent them from becoming so intertwined that they represent systemic risk, and we must restrict risk taking activities of any institution that is sufficiently large that it might be bailed out. It is a matter of fairness and a matter of efficiency. These too big to fail institutions have an advantage not based on superior banking skills but on the implicit subsidy provided by the U.S. taxpayer. This distorts the financial sector, not only tilting the playing field towards the large banks but also encouraging

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[8] Joseph E. Stiglitz, "Too Big to Fail or Too Big to Save? Examining the Systemic Threats of Large Financial Institutions," testimony before the Joint Economic Committee, April 21, 2009.

excessive investment in the financial sector.[9] A dynamic can be set in motion with increasing concentration, decreasing competition, and increasing risk borne by the taxpayer.

Large institutions must, in addition, be restricted in their risk taking, e.g. in their leverage and in their trading. They should not be allowed to engage in proprietary trading—including speculation underwritten by the U.S. government. What is required is not changing the name of proprietary trading but instead changing the rules that allow them to make investments on their own account, with part of the downside risks implicitly being borne by the taxpayers.

But of even more concern is the role of the big banks in credit default swaps and other derivatives. We must remember how much these have cost us. The AIG bailout alone has amounted to $180 billion. Whatever benefits may have accrued to our economy, I know of no evidence that suggests that those benefits exceed the costs. We have had exchange traded risk management tools—such as futures markets—well before CDS's. While the new products may have lowered transactions costs, they have also enabled shifting risk to taxpayers, and this may be their primary advantage to those who make use of them and the banks that sell them. But this is also the reason that we must restrict them. If they are risk management products that can survive on their own merit, then other institutions will find it desirable to issue them, though even then they will have to be regulated.. CDS's are either insurance instruments, in which case they should be regulated as insurance; or they are gambling instruments, in which case they should be treated

[9] The financial sector has imposed large costs (both financial costs through bailouts, as well as the more general economic externalities associated with the economic disruptions which they have caused) on the rest of the economy, and repeatedly so, distorting our economy's structure. There is a general principle in economics called the "polluter pays" principle: those who impose costs on others should be forced to bear those costs. If they do not, the economy is distorted. It is a matter of fairness and efficiency. More generally, taxes should be imposed on activities generating negative externalities. This suggests the imposition of taxes on the financial sector. One tax gaining increasing support around the world is a financial services transactions tax. Taxes on short term capital gains might even serve to stabilize markets. Tax policy could also be used to encourage better compensation structures.

as such. But when they are underwritten by the too big to fail institutions—as almost all of them are—they are effectively underwritten by the US taxpayer. And yet, we treat them more favorably than either insurance or gambling, for no justifiable reason other than that they are written by these powerful institutions. Indeed, by giving them seniority in bankruptcy, we treat them more favorably than any other securities. In this way, they impose negative externalities on others. The economic consequences—besides the huge risks to which the taxpayer is exposed, so evident in this last crisis—are serious: they are underpriced, and anything that is underpriced is oversold. It is understandable why big businesses who benefit from the current arrangement in their hedging strategies might complain about any change that could eliminate this underpricing: anyone would complain about a loss of a subsidy, but as in so many cases, they are misguided, since they probably receive little of the benefit of the subsidy—most accrues to the issuers. But even if their costs were to increase, that is as it should be. Even when these derivatives are being used as legitimate instruments of private insurance, there is no reason that the government should be subsidizing that insurance and no reason that it should be subsidizing one form of insurance over others.

The administration is right that transactions should be encouraged to go to standardized products traded over exchanges or clearing housing. It is again understandable why the issuers would prefer to keep their non-transparent OTC products. The lower the transparency, the less perfect competition, the higher prices and profits; and OTC derivatives have become an important profit center for some institutions. But as a matter of public policy we should be trying to make markets work better. Our financial markets failed us, and we should not forget that. They can and will fail us again unless we correct the underlying problems. We need to make markets as transparent and competitive as we can if markets are to perform as they should. Capital markets are supposed to provide discipline, but they cannot provide discipline if they do not have the requisite information. If the banks' balance sheets can change as rapidly as, for instance, AIG's seemed to in October 2008, how can any investor know how to assess a firm's prospects?

Without knowledge of the counterparty risks, how can there be market discipline? In short, with opaqueness, we are converting financial markets into a crap shot. I have seen no evidence that the risks covered could not be reasonably adequately covered by standardized products. In most cases, costs would actually be lowered, but even in the few instances in which that would not be the case, I can see no benefit commensurate with the costs, including those borne by taxpayers and the rest of the economy.

"Encouraging" movement to standardized products does not go far enough. The devil is in the details, and we should have little confidence that our regulators will get it right, unless we spell out what that means. Those who love opacity—and profit from it—will put pressure to keep that opacity.[10]

But demanding that they be traded on exchanges is not enough either. We must be sure that the exchanges are adequately capitalized, lest the taxpayer be forced to pick up the losses when the exchange collapses. There is a simple remedy: making all those trading on the exchanges (or trading in CDS's in non-exchange traded transactions with any institution) being jointly and severally liable for all losses in the market. Let those who allegedly benefit from the market absorb the downside risk—rather than imposing the costs on taxpayers, or by giving these instruments seniority in bankruptcy, forcing legitimate businesses to bear the costs. I suspect that were we to make the participants in the market bear these losses, there would be greater transparency and less trade, and prices would begin to better reflect the real risks.

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[10] Those who love opacity also love it in legislation. It appears that a small alteration to legislation intended to force trading into standardized products traded on clearing houses and exchanges has been gutted by the insertion of language that broadens acceptable trading platforms to include "any electronic trade execution or voice brokerage facility"—which might seem to include any telephone call. If such a provision were to pass, it would make a laughing stock of regulatory reform and subject the whole effort to derision.

While I commend the House for moving to create a Financial Products Safety Commission, the exemptions have effectively gutted its effectiveness. There is in this area a kind of Gresham's law. Bad products can drive out good ones. We should have learned that lesson from this crisis. Homeowners didn't have to succumb to predatory lending.[11] They didn't have to buy the explosive and toxic mortgages. But many Americans are not able to assess risk—not a surprise, given that our financial wizards failed so miserably. And they can be encouraged to use products that are unsuitable for their circumstances. They can, and are, being preyed upon. Allowing such predatory activities might generate more profits for the banks. But this is not the way to recapitalize our banking system.

Reforming the regulatory processes and institutions

Three comments on regulatory processes: We have seen the risks of regulatory capture. We know the pressures under which regulators are placed. Those pressures are present in booms—no one wants to be a party pooper—and they are even stronger in a crisis: no one wants to be blamed for exacerbating its depth. There is always hope that a little bit of forbearance will go a long way. That is why we have to hardwire much of the regulatory framework; discretion can and has been abused.

Secondly, we have to make sure that the regulators are drawn disproportionately from those who will be harmed by bad behavior of those in the financial sector, not helped. That is one of the reasons for the Financial Product Safety Commission—a regulatory body focusing on potential adverse impacts of the products being sold.

Thirdly, we should recognize that our regulators, including the Federal Reserve, performed far more poorly than central banks in other countries. We like to be

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[11] Some of the predatory lending is linked with fraudulent behavior on the part of certain lenders. In 2004, the FBI warned publicly of an epidemic of mortgage fraud, but the part of the FBI responsible remained vastly understaffed. Strong enforcement of anti-fraud laws is essential for the maintenance of the integrity of our financial system.

proud of our institutions, believing that we are setting an example for others to follow. In this case, our institutions were far from the head of the class. Canada, Australia, India, Brazil, and Spain all had central banks that thought far more deeply about the common issues confronting their economies and what actions might protect them. Their central bankers had a different regulatory philosophy, and they had different institutional structures and different systems of accountability. They all performed far better, some in even more adverse situations. Before the crisis, experts in regulation had, for instance, praised some of the practices of these other central banks; their superior performance was predictable and predicted. It was not just an accident.

One aspect of the institutional structure of several of these banks is worth noting: they were not as independent. Independence of central banks has been treated by some as essential for a well-performing central bank. Central banks are public institutions, and they should be held accountable and subject to public scrutiny. They should not be exempt from the Freedom of Information Act, though there may need to be narrow exceptions carved out. The world did not fall apart when it was disclosed who got the AIG bailout money; as is so often the case, secrecy appeared more part of a cover-up. Transparency provided the beginning of a meaningful discussion of what went on. Whatever one might say about the necessity of central bank independence in setting interest rates, when they are engaged in effectively spending public money—as ours was—lack of transparency and accountability should be viewed as totally unacceptable.

Today, everyone talks about the importance of accountability. Accountability means that there have to be consequences for one's actions. The Fed failed to regulate our banks and our financial system. We should not forget the cost of this failure. It is not just the cost to our budget, deficits that have reached unheard of levels, actions necessary because of the failure of the Fed. The higher level of debt will have an impact for years to come—investments in human capital, infrastructure, and technology will be squeezed, not to mention cutbacks in basic services. Ten years

from now, our GDP will be substantially lower than it would have been had the Fed done its job. The loss in GDP from what it would have been had the Fed done its job even over a narrower time frame—say just 2008 to 2011—is literally in the trillions of dollars. It would seem strange to respond to such failure simply by giving more power to the Fed, which failed to use the powers that it had. As I testified earlier, I believe that it is essential to create a new Systemic Regulator.

Concluding Comments

I want to conclude with three general comments. The first is that the agenda of economic reform needs to be far broader. Our tax laws encouraged excessive leverage and risk taking. What kind of society says that speculation should be encouraged at the expense of hard work? That is what we are saying when we tax earned income far higher that capital gains. Flawed bankruptcy laws and corporate governance too contributed to the crisis.

Secondly, we need to keep in mind that the real cost of an economic downturn caused by a bubble—an economic downturn of the kind that we are now experiencing—occurs after the bubble breaks. Crises don't destroy the assets of an economy. The banks may be bankrupt. Many firms and households may be bankrupt. But the *real* assets are much as they were before—the same buildings, factories, and people; the same human, physical, and natural capital. In the run-up to a crisis, resources are wasted—putting money into building houses, for instance, rather than to more productive uses. But this is water over the dam—bygones are bygones. The key question is, how will resources be used after the bubble is broken? This is typically when most of the losses occur, as resources fail to be used efficiently and fully and as unemployment soars. This is the real market failure, and one that is avoidable if the right policies are put into place.

What is striking is how often the right policies are not put into place, and the losses during the bubble are compounded by the losses after it bursts. Something is

wrong when we simultaneously have homeless people and empty houses and when we have unmet needs and firms and workers willing to produce more.

We are a rich country. We can afford to squander hundreds of billions of dollars. But there are limits for even a rich country. The combined effects of unbridled spending on unproductive wars, on corporate welfare, and on poorly designed bank bailouts inevitably will exert their toll. But when these effects are compounded by macro-economic mismanagement, leading to an economy operating for years below its potential, the consequences are even more worrisome.

This crisis has put to the test our economy and our political system. Financial institutions are essential to the well-functioning of any economy. Our financial system didn't function as it should have, and we have all suffered. But this is not the first time that our banks have had to be bailed out. It has happened repeatedly. The S&L bailout was the last large bailout of American banks because of bad lending here at home, but the myriad of bailouts abroad, with names like the Mexican, Indonesian, Korean, Thai, Brazilian, Argentinean, Russian bailouts, were all bailouts of American banks arising from their failure to assess creditworthiness. We should not forget that. The only period in history when there were no banking crises was the short period after the Great Depression, before the deregulatory movement that began in the late 70s and early 80s.

We have seen how important trust is to the functioning of a financial system. Financial institutions lost trust in each other, and our credit system froze. We all understand the basic reasons for the failures, including lack of transparency, excessive leverage and risk taking, and a misalignment of private rewards and social returns. Unfortunately, to too large an extent the rescue has been marked by much of the same. There has been a lack of transparency and a socializing of losses and risk, combined with privatizing of returns and profits, what I call ersatz capitalism. I am a strong believer in the virtues of a market economy; I know of no economist who believes that this new ersatz capitalism is likely to produce an efficient,

dynamic, or fair economy. As we went about the rescue, we had no vision of what kind of a financial sector or what kind of economy we wanted to emerge after the crisis. We cannot and we should not go back to the world of 2007. Our financial sector was bloated and distorted. It will have to be downsized. But the question is, what parts should be downsized? We should be strengthening the venture capital firms and the banks that lend to small and medium sized banks.

Many in the public have sensed that something went awry in the rescue. They have seen their jobs and wealth destroyed while some in the financial sector walk away with huge bonuses. The financial sector has lost the trust of the American people, but now, there is a risk that government too will lose that trust. Active programs to promote jobs and to regulate effectively the financial sector are important steps in restoring that trust.

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The Job Market and the Great Recession

TESTIMONY

by

Russell Roberts
Professor of Economics
George Mason University

Congress of the United States Joint Economic Committee hearing entitled
"The Challenge of Creating Jobs in the Aftermath of 'The Great Recession'"
Thursday, December 10, 2009, 10:00 a.m.
210 Cannon House Office Building

Russell Roberts is a professor of economics at George Mason University, the J. Fish and Lillian F. Smith Distinguished Scholar at the University's Mercatus Center, and a research scholar at Stanford University's Hoover Institution.

He is the author of three books on how markets work. A member of the Mercatus Center's Financial Markets Working Group, he is finishing a monograph on the financial crisis. He is also the host of the weekly award-winning podcast, EconTalk. He holds a Ph. D in economics from the University of Chicago.

Chairwoman Maloney, Vice Chairman Schumer, Ranking Members Brady and Brownback, and Distinguished Members of the Committee:

We are in the middle of what is likely to be the worst economy since the Great Depression. Since the recession began in December of 2007, the economy has lost 7.2 million jobs. We all want to see an expansion of opportunities that would allow people to get back to work. It is easy to create jobs. The challenge is to create genuine opportunity—productive jobs, not make-work jobs.

The American Recovery and Reinvestment Act of 2009 (ARRA) has been in place for more than nine months. While GDP growth is now positive, the job market remains deeply troubled. Unemployment is unacceptably high. And the economy continues to lose jobs.

What went wrong? Why didn't the $787 billion stimulus of ARRA get the job done? What might be done that could improve job opportunities? These are the questions I address here.

The stimulus package has been disappointing. Even proponents concede that the spending side of the stimulus has been very slow to reach the economy—only $235 billion has been spent as of December 1, 2009. More importantly, the structure of the stimulus package was not designed to stimulate. More than a third of what has been spent was in the form of a temporary tax rebate. Just as with the Bush Administration tax rebates in early 2008, most of the money was saved rather than spent.

The direct spending component has been $145 billion. Of that $145 billion, the four government agencies receiving the most money—the Departments of Health and Human Services, Department of Labor, Department of Education, and the Social Security Administration, account for over 80 percent of the spending.

Those agencies don't have many shovels.

The money has gone to increase funding for Alzheimer's Research, to bolster the tax revenues of states so that teachers can continue to be paid, to digitize medical records and to continue paying unemployment benefits. Some of the money went to give raises to workers. Pleasant for them, but not so helpful for job creation.

Roughly one half of the job losses since December of 2007 are in construction and manufacturing. A better understanding of Alzheimers and more efficient medical record-keeping are good things. But they do little or nothing for the bulk of the workers looking for work.

I did manage to find a $1 million program in the Department of Education for re-training laid-off manufacturing workers. But overwhelmingly the money spent by these agencies was not targeted at the problem.

The Department of Transportation has spent only $6.5 billion.

Is it surprising that unemployment remains in double digits?

Some argue that it doesn't matter what we spend the money on. The main thing is to get the money in circulation. People will then spend it, creating demand for products, which creates jobs and puts more money in people's hands and so on. Ironically, this Keynesian story works best when the economy is healthy.

But consumer spending is down because people are rightfully worried about the future. The future of the economy is highly uncertain. Prudence is a good idea. But when people are scared of the future, they are going to save more and spend less compared to when they are optimistic about the future. So fiscal policy that counts on the multiplier doesn't work any better than monetary policy in that famous liquidity trap. This is particularly true of temporary increases in income. So both fiscal and monetary policies are constrained by the anxiety people have about the future.

Unfortunately, policymakers aren't very good at dispelling anxiety or creating confidence. Politicians like to show how active they are. That very activity creates uncertainty about the future. So spending an extra $235 billion in the face of a $1.4 trillion deficit or an additional proposal to spend $200 billion may actually make things worse.

There is no reliable way of knowing whether the stimulus package has averted a worse situation or whether it's part of the problem. There is no consensus in the economics profession on this question and no empirical evidence that can settle the dispute.

People know that tax increases are coming but they do not know how big their share will be. There is also the once-unthinkable possibility of a default by the United States on its fiduciary obligations. These possibilities do not encourage confidence.

While politicians may not be good at creating confidence, they can be very good at creating increased uncertainty. Right now, the government is either intervening in numerous parts of the economy or considering expanded intervention in major ways. These sectors include the auto industry, the financial sector, health care, carbon dioxide emissions, and the role of unions. In the areas where the government has already intervened, the timing and nature of the exit strategy is up in the air. In the areas where the government is considering major intervention, the timing and entrance strategy are equally uncertain.

This uncertainty discourages the risk-taking needed to get the economy going. We need new businesses to start and old businesses to expand. But if their owners can't be sure of what the rules of the game are going to be—the tax rates they might face, the interest rates they might face, the inflation rate they might face, the health care mandates they might face, the emissions requirements they might face—then it's not surprising that business (and investors and consumers) are likely to sit on the sidelines to see how things will turn out.

In a recent survey of employers released this week by Manpower, Inc., 73 percent said they plan no change in staffing for the first quarter of 2010. That is the highest level of "no change" since 1962. Employers are sitting on the sidelines waiting to see what the rules of the game are going to be.

And some changes in the incentives facing employers go in the wrong direction and have reduced the incentive for job creation. The recent increase in the minimum wage has made low-skill workers more expensive to employers and by creating a shortage of opportunities, reduced the bargaining power of employees in the employer-employee relationship.

The recent CBO study of the effects of the stimulus seems to contradict these claims about the impact of the stimulus. That study found that the stimulus had saved or created between 600,000 and 1.6 million jobs. That estimate is embarrassingly imprecise. And it's not really an estimate of jobs saved or created. It's a mechanical application of past estimates of the fiscal multiplier. It is actually the same estimate the CBO made before the stimulus was passed. It remains nothing more than that—a guess of what might be the impact.

Here is the delicate way the CBO explains it:

> Estimating the law's overall effects on employment requires a more comprehensive analysis than the recipients' reports provide. Therefore, looking at the actual amounts spent so far (where identifiable) and estimates of the other effects of ARRA on spending and revenues, CBO has estimated the law's impact on employment and economic output using evidence about how previous similar policies have affected the economy and various mathematical models that represent the workings of the economy.

Those mathematical models don't reach a consensus. Nor is there any reason to think that the relationships embedded in those models remain applicable in the current set of circumstances.

So what is to be done?

Most people presume that there is something that can be done, something to get people back to work faster. That may not be possible. Government policy induced an unnatural expansion of the housing sector. We built way too many houses. That naturally drew a lot of people into construction. Fully 25 percent of the job losses have been in construction. The workers who no longer hold those jobs need to find other things to do. They will want to take time deciding what they should do instead. Unfortunately, it is natural that unemployment lingers.

The current trend suggests it may take another two years or more before employment returns to its old level. That time period is guaranteed to get the attention of every member of the House and at least a third of the Senate. Is there anything that might speed things up?

Given the lack of success so far and the role uncertainty plays in the decision-making of entrepreneurs, investors and consumers, doing less might, paradoxically, be more successful than doing more, especially if the "more" that is done works in the wrong direction.

So if you must do something, the goal would be to get the most bang for your buck (or

actually our buck, since we, the people, are paying for it). Stop giving away money to states with no strings attached. Don't treat the unspent TARP funds of $200 billion of our money, as if it were free money. It isn't. Don't waste it the way the stimulus money was wasted.

If you must spend it, spend it in ways that encourage employers to create jobs. The obvious way to do that is to cut the payroll tax. Cut it by 25 percent for the next five years. That will reduce revenue by about $250 billion per year, but at least it has a chance to create jobs.

It doesn't solve the uncertainty problem. To do that, you need to stop fiddling with every aspect of the economy.

- Leave something, anything, alone and admit that not every problem has a solution.

- Start acting responsibly. Stop selling free lunches. Stop pretending you can add to the demand for health care and cut costs at the same time.

- Stop issuing short-term debt. The government is playing with fire. That's what got Wall Street in trouble. The government rescued Wall Street. There is no one to rescue us.

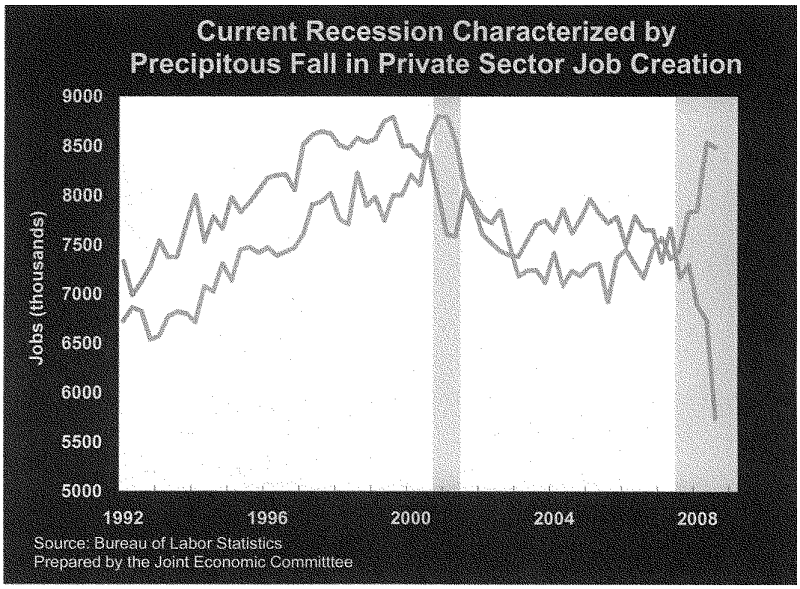
- Reduce some aspect of government spending to show that the grown-ups are in charge and that someone can practice tough love with the American people. Say no to some special interest. Get rid of corporate welfare. Cut tariffs and quotas which are a silent tax on the consumer.

- Stop ad hoc interventions and get us back to the rule of law.

- Stop propping up losers. Let people who were reckless go out of business.

- Let the economy heal.

F. A. Hayek said that "the curious task of economics is to demonstrate to men how little they really know about what they imagine they can design." It would be good to recognize our limits about what we imagine we can design. We cannot steer the economy. Or the labor market. Recognizing our limitations is a step in the right direction.


Current Recession Characterized by
Precipitous Fall in Private Sector Job Creation
Jobs (thousands)
9000
8500
8000
7500
7000
6500
6000
5500
5000
1992
1996
2000
2004
2008
Source: Bureau of Labor Statistics
Prepared by the Joint Economic Committtee

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