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Unemployment Short-Term and Long: Problems and Policy Proposals

Michael Reich*

Testimony

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*Professor of Economics and Director, Institute for Research on Labor and Employment,
University of California, Berkeley CA 94720-5555. mreich@econ.berkeley.edu

Introduction

In April 2010, a record 45.9 percent of the unemployed were counted by the Bureau of Labor Statistics as long-term unemployed—defined as durations of six months or more. Those who were unemployed for more than a year, whom I shall call the *very-long-term unemployed*, numbered 23 percent of all the unemployed. We know that long-term unemployment and very-long-term unemployment generate serious and long-lasting harm to millions of individuals and to the economy. The scarring effects upon the economic, mental and physical health of long-term unemployed workers and their families are well-documented (von Wachter 2010). We also know that many of the very long-term unemployed eventually leave the labor force permanently, and some of those end up on the disability rolls. Very-long-term unemployment consequently generates adverse effects upon the Treasury and upon the capacity of the economy to grow in the long-run.¹

In the past two years the proportion of the unemployed who have been out of work six months or longer has grown to levels not seen since the Great Depression (Chart 1). In the recession phase-- from the fourth quarter of 2007 to the end of the second quarter of 2009, when GDP growth resumed—the unemployment rate rose very rapidly and to a level higher than had been forecast. Given the length of the recession phase—over 18 months—it is not too surprising the number of long-term unemployed grew at about the same rate as the number of all the unemployed (Chart 2).

In the recovery phase that began in April or May of 2009, what went up quickly did not come down quickly. Thus far the overall unemployment rate has remained within a narrow range—hovering during the past year first a bit below 10 percent, then rising to a bit above 10 percent, and more recently, remaining a bit below 10 percent. But in the same period the long-term unemployment rate has continued to skyrocket as rapidly as during the recession phase. By April 2010, the proportion of the unemployed with jobless durations of six months or more had

¹ Chetty 2010, Rothstein 2010, Shierholz 2010, von Wachter 2010.

reached 45.9 percent.² By comparison, in the 1957-59 recession this proportion peaked at about 10 percent; in 1982-83, it peaked at about 26 percent.

The surprising and continuing growth of long-term and very-long-term unemployment well into the economic recovery and in the face of repeated extensions of emergency benefits, up to 99 weeks in some states, poses important questions for employment policy. Have these unprecedented benefit extensions themselves kept very-long-term unemployed workers from searching for and accepting job offers? Will the economic recovery eventually reduce the number of very-long-term unemployed without further interventions?

According to the best credible research studies, the answer to the first question is a very clear no. In previous recessions, when extensions of time limits on UI benefits were more modest, unemployed workers receiving UI benefits on average stayed out of work only one or two more weeks.³ Then, as now, well under half of the unemployed were receiving any UI benefits at all. In the current environment, with more than five job searchers for every job opening, the evidence suggests that such effects are even smaller (Valletta and Kuang 2010).

The adverse effects of extending benefit limits beyond 99 weeks are also likely to be small. Employers generally choose to hire new labor force entrants or unemployed workers with short unemployment spells over those with longer spells. The very-long-term-unemployed are thus the least likely to receive job offers. Moreover, the remaining financial assets of this group are especially meager (Chetty 2010). Consequently, they are the least likely group among the unemployed to refuse job offers they do receive simply because they can continue to collect unemployment insurance benefits.⁴ The very-long-term unemployed will be the last group to benefit from an economic recovery.

Will the economic recovery nonetheless be strong enough to eventually help the very-long-term unemployed? The Council of Economic Advisors, the Congressional Budget Office

² The rate would be even higher if the long-term unemployed who have left the labor force or who stopped looking for several months were included.

³ Card and Levine 2000, Chetty 2010. Consensus estimates are much lower than in previous studies (Katz 2010).

⁴ Any extension of unemployment benefits time limits reduces the proportion of the long-term unemployed who would otherwise drop out of the labor force. This increase in the unemployment rate is generally regarded as quite small. It represents a gain to the beneficiaries and it does not indicate an unwillingness to accept job offers.

and many economists of all political stripes have forecast a very slow decline in the unemployment rate and argued that the continuing high level of unemployment is best combated by additional government-led increases in aggregate demand (Romer 2010; Zandi 2010). Programs such as relief for the states and relief for teachers facing layoffs are indeed called for, and on a large scale.⁵ Absent such policies, unemployment will decline only very slowly. Consequently, the argument for immediately renewing emergency unemployment benefits as well as extending recipient limits beyond 99 weeks in higher unemployment states is especially compelling. So, I would add, is the case for direct job creation programs, such as those proposed in Rep. George Miller's Jobs for America Act.

In the remainder of this testimony, I will address *why* unemployment rates, short-term and long-term, have risen substantially higher than public and private forecasters predicted. I will also propose needed policy changes that would reduce the ranks of the unemployed and that would improve the workings of our labor market. Most of my proposals do not add big-ticket items to the Federal budget, so their merits can be considered independently of the question of how large the federal deficit should be at this time.

Why did the overall unemployment rate increase so much more than was expected? I argue that employers' weakening attachment to their workers, a development that began in the 1980s, has heightened the labor market's response to economic downturns. Well-working labor markets must maintain a balance between flexibility and security. But the increase in labor market flexibility has undermined this balance, generating costs for employers and workers alike. Unfortunately, the UI system itself creates employer incentives that have reinforced the turn to greater flexibility. I suggest some reforms of the UI system that would reverse the incentives in the system and improve labor market behavior.

My discussion of the rise of long-term unemployment begins with a usual suspect: the disappearance of many jobs that may never return, in industries such as manufacturing, construction, and the finance, insurance and real estate sector. A usual argument is that unemployed workers are locked in to these industries because they do not have the skills to

⁵ As is well-known, such programs as well as unemployment benefits provide the highest aggregate demand multipliers (Elmendorf 2010).

transfer to industries that are or will be growing. My reading of the research literature suggests that the evidence for this argument is mixed. A more compelling explanation is based upon the long duration of the recession period and the weakness of the recovery, which keeps feeding the ranks of the very-long-term unemployed. The large numbers of workers who already have been unemployed for one year or more are going to be joined by many, many others. There are programs already in place to help workers weather difficult transitions. I suggest changes in some of the existing programs so that they can help the very-long-term unemployed more effectively.

The growth of unemployment in the Great Recession

Discussions of the high unemployment levels of the Great Recession correctly begin with the sharp reductions of consumption, investment and international trade that followed the collapse of the housing and financial markets in 2008. Okun's Law, which is based on the experience in previous recessions and recoveries, summarizes the responsiveness of the labor market to cyclical (de-trended) changes in GDP. Using this relationship, in early 2009 most prestigious economic forecasters expected that unemployment would peak at a bit above 8 percent and fall thereafter.

Okun's Law, however, did not appear to hold, as the unemployment rate peaked at above 10 percent in the second quarter of 2009.⁶ According to the econometric estimates of Gordon (2010), the responsiveness of unemployment to GDP changes has risen substantially since the mid-1980s. Okun's Law does need revision.⁷

Why did layoffs and unemployment (and involuntary part-time employment) increase at a more rapid rate than Okun's Law predicted? A common answer, presented for example by

⁶ Romer (2010) suggests that Okun's Law did hold, but that, based on GDI discrepancies with GDP, economic activity fell much more than was measured at the time. Krueger (2010) suggests that the financial crisis, marked by the collapse of Lehman Brothers, is to blame. While the financial crisis appears to have exacerbated the decline in output, Krueger's figures do not show a greater than usual decline in employment at the time of Lehman Brothers.

⁷ Another important part of Okun's Law refers to hours per employee. The trend of involuntary part-time employment has exhibited two upward breaks, one in 2001-2 and a much larger one in the current recession. This part of Okun's Law also needs revision.

Elsby et al. (2010), suggests that productivity growth that accelerated more than had been forecast. But since productivity increases by definition when employment falls more than output, pointing to productivity acceleration is to provide a tautology, not an explanation. Moreover, productivity growth during a downturn reflects a structural change in labor market behavior since the 1980s.

In postwar recessions through the early 1980s, productivity fell at the end of expansions and into the downturn, in part because firms held on to skilled workers even as demand for their products fell.⁸ The return of productivity growth then coincided with economic recovery. But in the three recessions since the early 1990s, this pattern reversed. Productivity growth increased in each downturn, and especially so during the Great Recession. Firms have become much quicker to lay off workers, and not only because of new technological possibilities to do more with less. Productivity grew because the denominator of the output per hour ratio was shrinking faster than the numerator, not because the numerator was expanding faster than the denominator.⁹

Why this change? I propose that the answer involves the weakening attachments of firms to their workers.¹⁰ Since the 1980s, employers increasingly have placed a smaller value on long-term employment relations, while also searching for ways to cut the costs of their short-term employees. This trend itself results from the extent to which managerial decisions have become driven by short-run share prices. The stock market does not valorize the firm-specific skills of long-term employees and increasingly reacts to layoff announcements as evidence of positive managerial decision-making.¹¹ When layoffs increase share prices, managers with short-term horizons are likely to overshoot the frequency and size of layoff announcements, even if they

⁸ Okun's Law also quantified this relationship: one-third of a 1 percent cyclical decline in output took the form of a decline in productivity.

⁹ The increase in productivity growth in the Great Recession was not the result of more rapid implementation of technological change. Among all the industrialized countries, only the U.S. and South Korea experienced productivity increases during the Great Recession.

¹⁰ Gordon (2010) examines other hypotheses also related to growing labor market flexibility.

¹¹ According to Farber and Hallock (2009), in the 1970s share prices of large companies reacted strongly and negatively to layoff announcements. This pattern began to reverse in the 1980s. By the 1990s layoff announcements were nearly as likely to generate positive effects on share prices as to generate negative ones. The changes in these responses were concentrated within manufacturing. Uchitelle (2007) suggests that the pattern turned positive in the 2000s.

destroy long-term assets embodied in their employees, and thereby lower the company's share prices in the longer-run.

A trend toward shorter job tenure suggests why temporary layoffs have declined relative to permanent layoffs and why firms have become quicker to reduce their work forces when economic conditions become softer. The growth of sporadic or intermittent employment, a corollary of the rise of short-term jobs, helps to explain the declining trend in the take-up of UI in the past 25 years. These trends have placed a greater burden on UI systems, which were designed for a different era. The UI system is not working as well as it could.

Evidence on the growth of sporadic and short-term jobs

Trends in job tenure indicate how attachments between firms and their workers have evolved. Farber (2008) provides the most thorough and most up-to-date study of trends in job tenure; his data cover the period from 1973 to 2006. Farber finds a substantial and steady reduction from the early 1980s to 2006 in the proportion of male private-sector workers who hold a job with the same employer for more than ten years, confirming the familiar narrative that lifetime jobs are much less common than before.¹² This pattern occurred among men in all age groups and especially for men over 40.

Farber also finds that the proportion of workers who remain with the same employer for less than one year increased in the same time period. The proportion of workers in new jobs rose in all age groups, and especially among workers aged 30-39.¹³ In 2006 these short-term jobs accounted for one-fifth of total private sector employment.¹⁴ Equally important, in 2006 half of all new jobs ended within the first year, implying that that about a fourth of all new jobs end within six months.

¹² The trends for women were stable, in large part because increases in the long-term attachment of women to the labor force and to their jobs have offset occupational declines in job duration.

¹³ Farber uses less than one year as his cutoff because information on the distribution of job tenure by months is not available for many of the years in his dataset.

¹⁴ As Farber notes, over this period job duration in the public sector increased, especially but not solely among women.

Some of the decline in long-term jobs reflects the decline of industries, such as manufacturing, that had above-average job tenure levels. Similarly, some of the increase in short-term jobs reflects the rise of industries, such as retail and accommodations and food services, that long had lower levels of job tenure. But the shift to shorter job tenure is also visible within these industries.

Excess churning in the U.S. labor market

The growth of short-term and sporadic jobs is closely related to another key characteristic of the U.S. labor market: excess churning, which can be defined as hiring and separations above the level needed to a) accommodate cyclical changes in labor demand and supply, b) reallocate labor from declining to expanding sectors, and c) absorb life-cycle related labor force entries, re-entries and exits.¹⁵ The BLS JOLTS data on monthly hiring and separations are usually used to observe business cycle dynamics, but they are also useful to observe churning levels.

JOLTS data indicate that in November 2007—just before the Great Recession began—private sector firms made 4.9 million new hires and experienced about the same number of separations.¹⁶ The number of hires then fell substantially, bottoming out at 3.3 million in June 2009 and then increasing to 3.9 million in April 2010. Separations (primarily quits, layoffs and discharges and retirements) remained flat at about 4.6 million through June 2009 and then fell steadily to 3.7 million in April 2010. Among separations, a rapid decline in voluntary quits offset increases in layoffs and discharges. Layoffs and discharges numbered 1.8 million in December 2007, rose sharply to a peak of 2.65 million in January of 2009, and then fell to 1.8 million by March 2010.¹⁷

These figures tell the story of labor market adjustments over the business cycle. Hiring fell substantially in the recession, stayed flat for some time and began to turn upward only

¹⁵ The term turbulence is interchangeable with excess churning. For an extended discussion, see Brown, Haltiwanger and Lane 2006.

¹⁶ Numbers refer to seasonally adjusted data.

¹⁷ In comparison, weekly initial UI claims have numbered approximately 450,000, equivalent to 1.8 million claims per month.

recently. Separations increased moderately in the recession and then fell substantially during the recovery.

But cyclical changes are only part of the story. Even at the depth of the Great Recession, employers made 3.3 million hires per month. Consider also the *annual* turnover rate, which represent the average of the hiring and separation rates over a year. Over the twelve-month period ending in March 2010, when total employment numbered nearly 139 million (as measured by the household series), employers made a remarkable 48.6 million hires. Over the 12-month period ending March 2010, the number of separations totaled 50.9 million. The turnover rate for the year ending March 2010 thus amounted to 36 percent, very close to turnover rates for much of the previous decade (Davis, Faberman and Haltiwanger 2006, Figure 4).

To some observers, such as Davis, Faberman and Haltiwanger, these turnover rates indicate a fluid labor market that is working well to reallocate jobs and workers to more productive activities. But the annual turnover rates, taken together with what we know about employee replacement costs, also suggest a highly inefficient labor market, in which each firm's annual turnover costs can be quite substantial (Dube, Freeman and Reich 2010). In my view, the labor market is too fluid; the problem is not that firms are unable to fill their job openings with workers who would make lasting matches, but rather that firms face incentives to make shorter-term matches. The same facts seem consistent with these two very different interpretations because each interpretation takes a different view of the underlying public and private policy incentives.¹⁸ As I discuss below, although the UI system has contributed to this pattern, policy reforms could improve outcomes for both employers and workers and thereby for economic recovery and growth as well.

Reforming employer incentives in the Unemployment Insurance system

The UI system was designed for workers who have jobs most of the time, even if they change employers frequently (as in construction and entertainment). UI does not work as well,

¹⁸ Dube, Lester and Reich (2010) provide credible evidence that minimum wage increases reduce employee turnover.

however, for the increasing number of low-paid workers who are employed sporadically and part-time, who move frequently from one employer to another because their jobs offer few advancement opportunities, and who often experience more than a few weeks of unemployment spells between jobs.

The incentives in the UI system have increasingly reinforced a pattern of sporadic or intermittent employment. Employers have an incentive to hire workers and to retain them for only a few quarters. They know that many workers with short-term jobs (or without documentation) will not apply for UI as it is difficult to do so when earnings are from multiple employers and sporadic, and because it may not be worth the trouble when benefits will be low. Moreover, these workers can obtain food stamps and EITC benefits (if they file income tax forms). Employers do not bear any costs for these programs as they do for UI.

The experience rating property of the UI tax is designed to counteract these effects. Experience rating penalizes employers with higher layoff rates by raising their tax rate, thereby also reducing the subsidy that employers with more stable employment policies provide to those with policies that favor less stability. In practice, however, this incentive is incomplete, as it is limited by two features of the tax. It is common when a recession is underway for employers to reach the maximum tax rate, after which the marginal tax cost to the employer is zero. Second, the maximum wage on which the tax falls has long been very low: \$7,000 to 14,000 in two-thirds of the states in 2006.¹⁹ As a result, even when it is positive, the marginal cost of a layoff to an employer is well below the marginal UI benefits received by the laid-off worker. The good news, though, is that these incentives can be reversed. Empirical research (Anderson and Meyer 2000) based upon the effects of reforms made by Washington State in the 1980s, suggests that a fully experience-rated system would reduce layoffs by as much as one-third.

Proposals to reverse the adverse effects of the UI system on employment durations

¹⁹ Some states have now begun to increase this ceiling substantially, especially with the incentives provided in ARRA. The ceiling should be increased in all states and indexed to wage inflation.

Proposal 1 Accelerate dramatically the modernization of the UI system along the lines in ARRA.²⁰ The current UI system for too long has made it difficult or impossible for many unemployed low-wage workers to receive UI. Expanding UI eligibility in all 50 states should be a federal priority, to be achieved perhaps by providing greater financial incentives. More rapid implementation of these reforms should be a continuing priority.

Proposal 2 The experience rating system should be modernized by standardizing it among the states or transferring it to the Federal government. It should be reformed to a complete experience rating model, by adopting and going beyond the Washington State model. The marginal cost to employers should be made equal to the marginal UI benefits paid by the UI system. This will entail expanding the wage base substantially and indexing it as well. Such reforms would end current inequities, in which many employers are in effect subsidizing the firms that excessively churn their workforce.

Moreover, experience rating formulas should weight more heavily layoffs to workers with job tenure of less than one year. This would help to reduce the incidence of excess churning, thereby saving firms considerable turnover costs that labor market conditions impose upon them. It would also reduce taxpayers' cost of the EITC and food stamp programs.

Moving to an improved experience rating system does not mean that all employers will face higher payroll tax

Proposal 3 Expand radically the short-time compensation component of the UI system by federalizing this program and making it available in all 50 states. This program reduces layoffs by providing furloughs that are partly compensated via UI benefits. Short-time compensation is highly popular among employers and workers who have used it.²¹ But it remains scandalously under utilized because few even know of its existence and it is available in only 17 states. To publicize the program, UI agencies should be mandated to provide information about the program quarterly to employers of workers filing initial UI claims.

²⁰ Modernization includes using the most recent job quarter in the "base period" to determine benefits, raising the wage ceiling on the payroll tax, and making it easier for part-timers to receive UI benefits.

²¹ See, for example, Berkeley Policy Associates 1997 and Vroman and Brusentsev 2009.

Expanding short-time compensation as a substitute for UI benefits for laid-off workers may not directly reduce costs for the UI system. But it provides economic benefits by encouraging firms and workers to maintain, to invest in and to benefit from longer-term employment relations.

Proposal 3a A related proposal—job-sharing-- involves combining the short-time compensation program with a federal tax credit. This proposal, advanced by Dean Baker, encourages job creation. Baker (2009) estimates that a modest tax credit to businesses would reduce layoffs, generate substantial numbers of jobs, while reducing working hours modestly and leaving compensation unchanged.

Structural changes and the growth of long-term unemployment

I turn next to the question of high and persistent long-term unemployment. It is well-known that long-term unemployment rates decline in economic recoveries, although more slowly than declines in short-term unemployment. Long-term rates lag because employers prefer to hire new labor force entrants or to hire unemployed workers with short durations. Elsby et al. (2010) confirm this relationship and suggest that it has not changed during the Great Recession.²² Romer (2010) draws the further implication that long-term unemployment today is mostly cyclical, not the result of structural changes specific to this recession, and therefore it will fall once again as aggregate demand recovers.

The trend toward longer-lasting unemployment indeed predates the current recession, as Elsby et al. suggest. Since the 1980s, a higher proportion of layoffs have been permanent, rather than temporary. Burtless (2009) shows that the average duration of unemployment has been growing in recent recessions, as have the proportion of the unemployed who have exhausted all their unemployment insurance benefits. Allegretto and Lynch (2010) show that the successive reduction of peak unemployment rates in 1983, 1992 and 2003 were accompanied by

²² They make the important caveat that labor market adjustments since 2009q2 do depart from previous patterns.

successively smaller reductions in long-term unemployment. The growth and persistence of long-term unemployment thus need not be traced solely to the Great Recession.

Can structural decline in some industries explain the growth and persistence of long-term unemployment? The likely candidates for such structural change include manufacturing, construction and the finance, insurance and real estate (FIRE) sector, construction, and manufacturing. The evidence is mixed.²³ Employment in manufacturing declined precipitously during the 2001 recession and then did not rebound in the subsequent recovery. It experienced another rapid decline during the Great Recession. Construction employment went into free fall after the housing market collapse but may be stimulated by the growth of green economic standards, which affect construction more than any other sector. Workers in FIRE generally are well-educated and likely to find jobs in other industries.

The problem facing the locked-into-a-declining industry argument is that worker mobility across industries has been robust in recent decades. For some, the transitions have been to lower-paying jobs in industries such as building services and accommodation and food services. For others, especially those with at least some community college certification, industries such as health care will provide job opportunities that pay better. Aggregate demand policies to stimulate growth would increase these opportunities, but as already mentioned, by themselves they may not benefit the very long term unemployed for some time.

A stronger argument about the rise and persistence of long-term employment refers to the reduction of what used to be historically-high geographical labor mobility rates (Katz 2010). In the current recession, higher unemployment rates -- and plausibly also higher long-term unemployment rates-- are concentrated in areas that have had high foreclosure rates. Families who might want to move to areas with more job opportunities are constrained by the large asset losses they might occur if they sold their home. Moreover, the growth of unemployment is more widespread than ever before—as measured by the diffusion of higher unemployment in all regions-- so the benefits of mobility are also lower. Reduced labor mobility implies that,

²³ Brown, Haltiwanger and Lane 2006.. Rissman 2009 provides a literature review and the most careful examination of these issues.

compared to previous recessions, long-term unemployment will persist longer even when overall unemployment begins to fall.

A final argument concerns the adverse effects of very-long-term unemployment on future employability. We know that bouts of one year of unemployment can seriously affect not only the depreciation of skills, but also good work habits, on personal self-esteem, support from family and friends, and physical health itself. In the absence of targeted programs for this group, we are likely to have large groups of workers experience unemployment for two years and considerably longer. The adverse effects are then surely going to be more serious. This consideration in itself is sufficient to justify targeted programs.

Targeted policies to combat very long-term unemployment

Proposal 1 *UI benefits limits should be extended beyond 99 weeks-- for at least 13 additional weeks in those states that continue to have double-digit unemployment rates.*

Proposal 2 *Redirect half of the ARRA/WIA training funds to the very long-term unemployed to provide stipends for attending community colleges.*

Through ARRA and the Workforce Investment Act many states have received very large increases in workforce development funds. In California, for example, the Workforce Investment Boards have been allocated approximately twice the amount they received in recent years. After a long period of deliberation the California state WIB has decided to allocate most of the money to the community colleges for job-related education, especially to train workers for green jobs.

This is admirable, both because the state's community colleges funds have been cut sharply in the state budget, and because the demand for job-related training grows in a period of rising unemployment. Moreover, the coming expansion of the health care sector will generate many middle-skill jobs, such as imaging technicians, who can be trained by community colleges. It is not clear, however, when the California construction unemployment rate is likely over 20 percent, that many green jobs will be available for many of the new community college graduates.

I suggest that the state workforce development agencies be directed to allocate some portion of these funds, perhaps half, *toward education stipends for the very-long-term unemployed*. This group has the least amount of resources to invest in their education, so the payoff would be greater. Stipend-recipients should be required to demonstrate that their educational plan builds upon their existing skill base in a manner that will prepare them for jobs once the labor market improves.

Proposal 3 Renew and expand the subsidized jobs program in the \$5 billion TANF emergency fund.

Much of the TANF emergency money has been allocated for a 100 percent wage (but not benefit) subsidy to employers who hire the poor or unemployed. These funds are available in about 30 states, but if California's experience is typical, they are vastly underutilized. Moreover, employers who do utilize the program have a strong incentive to hire those who have been recently unemployed and who are more likely to obtain jobs anyway.

The program's funding should be renewed and expanded to all 50 states and publicity for the program should be vastly increased. *The program should target hiring of those who have been unemployed the longest*. This would include workers who received and are about to exhaust their UI benefits as well as those who did not receive UI benefits but can document the length of their period of unemployment.

The unprecedented high wage subsidy in this program calls for some tradeoffs from employers. For example, employers could be nudged to enhance the on-the-job-training they provide to their workers. Most such training in the U.S. is informal. It would have more payoff both to employers and workers if were made more structured and rewarded.²⁴ This can be initiated by asking employers to document the amount of training they provided and the set of skills imparted.

²⁴ For more on this issue, see Brown et al. 1997.

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Chart 1 Of total unemployment, the share unemployed for 27 or more weeks and the unemployment rate

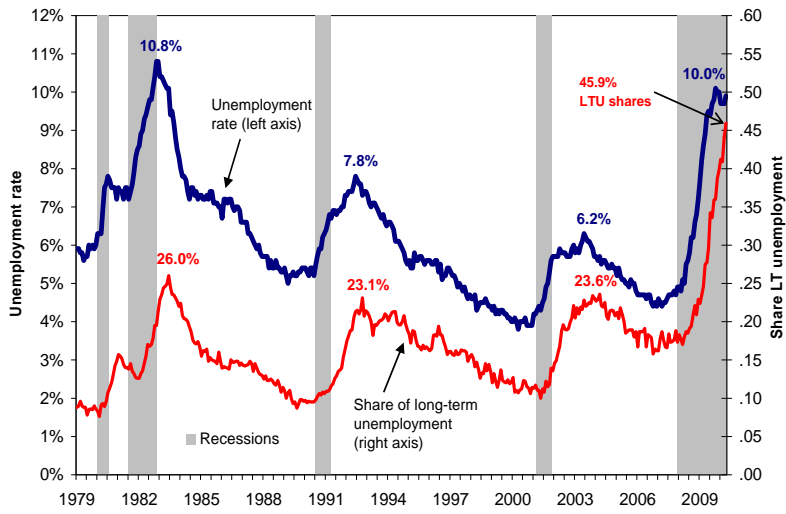


Chart 2 Of total unemployment, the share unemployed for 27 or more weeks and the unemployment rate: Jan-07 to April-10

