UNEMPLOYMENT OR INSOLVENCY: 
STRATEGIES FOR A TROUBLED ECONOMY

Christina D. Romer 
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This lovely day brings to mind one of those random happy memories from my time in the White House. On a day like today, some bold undergraduate usually asks “Hey professor, can we have class outside?” Well one beautiful spring day a small group of us were walking into the Oval Office for the daily economic briefing. Jared Bernstein, the Vice President’s economic adviser, said to the President, “We should have the briefing outside today.” Much to our surprise the President said “OK,” and we were soon all traipsing across the Rose Garden. The gardener watering the flowers was quite startled when the President tapped him on the shoulder to ask if we could use the patio.

Quite frankly, most days were not that bucolic. We were far more often working late into the night in a dreary conference room than in a beautiful garden with lovely sunshine. Indeed, one of the questions that I used to dread the most from friends and acquaintances was, “So, are you having fun?” I usually said something cryptic like “I am sure I will have had fun in retrospect.” But the truth is, every inch of me wanted to yell “Are you out of your mind? The economy is in freefall, I haven’t had a full night’s sleep since the President nominated me, and, believe it or not, dealing with Larry Summers is the easy part of my job.”

But now that I safely back at Berkeley, I am finding that my more diplomatic answer was strangely true. I will never call the nearly two years that I spent in Washington fun, but it was the most important and rewarding thing I have ever done. It
was an honor above any I could have imagined to be asked to help formulate economic policy during the financial crisis and the subsequent terrible recession. And, the people that I worked with at the Council of Economic Advisers and in the White House—including, I should say, Larry Summers—are the closest thing I will probably ever have to army buddies.

This afternoon, I want discuss what I consider the two most important economic issues facing the United State today: continuing high unemployment and a terrible long-run budget outlook. Where do we stand on both these issues? What has already been accomplished? More importantly, what can be done going forward? Do we have to choose between tackling our unemployment problem and addressing the threat of government insolvency? Or can we make progress on both?

In the process, I will try to give you a feel for what working in the White House was like, and some of the challenges of economic policymaking in the first two years of the Obama administration.

**Dealing with Unemployment**

Let me start with continued high unemployment. This has obviously been a terrible recession. The collapse of the housing bubble and the resulting financial crisis set in motion a horrible decline in spending and employment.

**Problem.** The past two and a half years have been simply wretched for many American families. At its worst, employment was down some 8½ million from its peak. Unemployment hit 10.1%. This truly has been the worst recession in the United States since the Great Depression.

Now we started growing again the third quarter of 2009. Employment started
expanding about a year later. So far, we have added about 1.5 million jobs. And the unemployment rate has fallen just over a percentage point.

That is certainly an improvement, but it is not nearly good enough. The unemployment rate is still 8.8%. More than 13 million Americans are without a job. Six million of them have been out of work for more than six months.

There is a lot of talk about whether this is a jobless recovery. The truth is, this has been a somewhat “growthless” recovery. Job growth is weak because GDP growth is weak. Aside from just a few quarters, GDP growth has been at or below its trend rate of growth of about 2½ percent. We just learned last week that GDP grew at only 1.8% in the first quarter of this year.

To bring the unemployment rate down quickly, GDP growth needs to be much more rapid. To repair the damage from this recession, we need to be adding not 100 to 200 thousand jobs a month, but more like 400 or even 500 thousand per month. Unfortunately, virtually no one is predicting growth like that in the coming quarters. We will get another unemployment report tomorrow morning. Most forecasters are expecting only modest improvement.

I have to say that I still tense up on the day before an employment report. One of the jobs of the CEA chair is to get key data reports the night before they are going to be released to the public. My job was to let the Fed Chair and Secretary of the Treasury know if the report could cause financial market instability. It was also my job to brief the President about the numbers.

When the economy is in the grip of a terrible recession, the employment report in particular is the source of tremendous interest. This gave rise to a few awkward situations. Once, I got an email from the President’s body man, Reggie Love, saying that
President wanted me to call him in his limo to tell him the report. So, I dialed the number and I hear a very familiar “Hello.” But I couldn’t say “Are you really the president?” I proceeded to give him the numbers. After I hung up, I suddenly had this terrible fear that I had just played into a wonderful scam. I quickly emailed Reggie, who assured me that it was the President I had been talking to.

So, where we are is that the economy remains severely troubled and unemployment is painfully high.

**Actions Taken.** The actions that were taken during the crisis were incredibly helpful in generating the recovery we are now having. Our recovery may be tepid, but had it not been for those actions, we might well have had no recovery at all.

I give the Federal Reserve a lot of credit for preventing the financial crisis from spiraling out of control. They took a number of incredibly creative and aggressive actions to unfreeze financial markets and keep credit flowing in the fall of 2008. In early 2009, they did a round of quantitative easing that helped to reduce mortgage rates and stabilize the housing market.

My main criticism is that they took their eye off the ball in late 2009 and 2010. They started to think more about exit than about the fact that the economy was still operating far below capacity. The second round of quantitative easing, which started last November has been helpful, but it came about a year too late.

On the fiscal side, the Recovery Act, which was passed just a month after the President took office, was the largest countercyclical fiscal stimulus in American history. It totaled $787 billion dollars, divided roughly into one-third tax cuts, one-third government spending, and one-third payments to states and people directly hurt by the recession, such as the unemployed.
Studies by everyone from the Congressional Budget Office to private forecasters to the Council of Economic Advisers have shown that the Recovery Act helped to increase output and employment, relative to what otherwise would have happened. Employment would have been between $2\frac{1}{2}$ and $3\frac{1}{2}$ million jobs lower had it not been for the fiscal stimulus.

We are just starting to see the detailed academic studies that document that particular pieces of the Recovery Act were effective. One of my favorites grew out of work that was done at the Council of Economic Advisers.

In the summer of 2009, we got a group of new staff economists at the CEA. Staff economists are econ Ph.D. students partway through graduate school. I called a group of four of them into my office and asked them to turn their brilliant young minds to the question of whether the Recovery Act worked. This is obviously a very hard question because it is just one episode. And, the Recovery Act was clearly taken because the economy was plummeting. So disentangling the deterioration in the baseline from the effect of policy was very difficult.

What the four economists realized is that the distribution of the fiscal relief to the states spending across states had a somewhat independent element. Some of the aid was based on a formula unrelated to the health of each state’s economy. They then looked at what happened to employment in states that got more of this aid for exogenous reasons. Their finding is that employment growth was significantly stronger in the states that received more fiscal relief. This turned out to be such a strong study that the students have gone on to write a serious academic paper that is making its way toward publication in a top journal.

The main problem with the Recovery Act is that, big as it was, it wasn’t big
enough. Raising employment by 3 million or so relative to what would have happened is good. But, we were losing jobs so quickly, that even with that help, employment continued to fall for more than a year after the act was passed.

Like the Federal Reserve, the Administration and Congress should have done more in the fall of 2009 and early 2010 to aid the recovery. I remember that fall of 2009 as a very frustrating one. It was very clear to me that the economy was still struggling, but the will to do more to help it had died.

There was a definite split among the economics team about whether we should push for more fiscal stimulus, or switch our focus to the deficit. A number of us tried to make the case that more action was desperately needed and would be effective. Normally, meetings with the President were very friendly and free-wheeling. He likes to hear both sides of an issue argued passionately. But, about the fourth time we had the same argument over more stimulus in front of him, he had clearly had enough. As luck would have it, the next day, a reporter asked him if he ever lost his temper. He replied, “Yes, I let my economics team have it just yesterday.”

As frustrating and stressful as this period was, it also provides a good window into policymaking in the Obama White House. It was a remarkably intellectual process. You won arguments not by being political or vying for face time with the President, but by having the best evidence.

In the fall of 2009, those of us at the Council of Economic Advisers, together with a number of other economists in the administration, got very excited about a new jobs tax credit. This is essentially a payroll tax cut for firms, but limited only to new hires. This seemed to us a sensible way to encourage substantial hiring at a moderate cost.

It was a very tough sell to Congress and, frankly, to the President. The one
experiment with such a credit in the 1970s was widely viewed as a flop. Few firms even knew about the 1977 jobs tax credit, much less took advantage of it. And when the President asked the heads of a few large corporations about a jobs tax credit today, they casually asserted that such a credit would not affect their hiring behavior.

Our passionate band tried to make the case that a new jobs tax credit could be very effective. CEA economists obtained data on the fraction of firms that might be eligible, and used plausible response parameters to show that such a credit could have a very high bang for the buck. Alan Krueger at Treasury worked with outside economists to survey a representative sample of human resource managers, the people who actually make hiring decisions, to see how many thought their companies would respond. A surprisingly large fraction said it would affect their hiring behavior.

In the end, the President endorsed this measure. In early December 2009, he announced a package of additional stimulus actions to aid the economy. I remember that day as the happiest of my entire time in the White House. (Even better than a briefing in the Rose Garden.) We were finally taking more actions to strengthen the recovery.

Unfortunately, only a few of the additional measures were adopted. We got a version of our new jobs tax credit in the HIRE act. But, it was much smaller than what we had proposed, and had some of the complexities that plagued the 1970s version. Most of the other proposed measures died on the floor of the U.S. Senate.

**What More Needs to Be Done?** That is where we have been. What should we be doing now to deal with continued high unemployment?

First, I feel strongly that the cause of our high unemployment today is still the recession and low demand. Firms are not hiring workers because there isn’t enough
demand for the output those unemployed workers could produce. Consumers are still cautious; firms are not investing particularly heavily; and our net exports have not grown enough to fill the shortfall.

As I described in a recent *New York Times* column, it is not the case that high unemployment is just our new normal rate of unemployment. The problem is not that workers are in the wrong place or have the wrong skills for the jobs that are available. The problem is that there are just not enough jobs—period.

The answer to low overall demand is to try to get it up. The best solution would obviously be for private sector demand to come bounding back on its own. So far that has not happened and doesn’t look like it is about to.

I feel there is certainly more that the Fed could be doing. The second round of quantitative easing is set to end in June. Ben Bernanke at his press conference last week made it clear that the Fed was unlikely to do much more in the way of stimulus. I think that is very wrong. Inflation is still well below the Fed’s target and unemployment is certainly above normal.

Chairman Bernanke has stressed that the Fed still has things it could do, and I agree. The evidence is compelling that the first two rounds of quantitative easing have been at least moderately helpful. They ought to be using the tools they have aggressively.

More fiscal stimulus would also be helpful. I know that all the talk in Washington these days is about budget cutting; and, as I will discuss in a minute, I agree that we need to be passing a plan to get our deficit under control over time. But more short-run fiscal stimulus could be a part of a comprehensive plan.

The President has talked about the need for increased public investment. In his
State of the Union Address, he urged increased investment in infrastructure, education, and innovation. These are all sensible measures that would increase employment today and raise incomes and productivity in the future.

More aid to state and local governments would also be sensible. There is no question that some states will need to be making important long-run adjustments to get their budget deficits under control. California is surely at the top of the list. But, it is also true that the recession has taken a particularly terrible toll on state revenues, and state balanced budget requirements make it hard for states to weather such temporary fluctuations. The state fiscal relief included in the Recovery Act was particularly effective in stemming job losses and doing more of it in the short run would be helpful to the recovery. It would also maintain state and local services, and be a way to do some of that education investment the President was encouraging.

My particular favorite additional short-run stimulus would be a cut in the employer side of the payroll tax. Congress cut the payroll tax for employees in the budget compromise last December. A similar cut in what firms have to contribute for payroll taxes would make hiring workers cheaper and would therefore likely be particularly helpful for employment growth. This is just a broader and simpler version of the new jobs tax credit that I thought would be a very good idea back in 2009. And, it has the virtue of being something that I suspect policymakers on both sides of the aisle could support.

I frankly do not understand why policymakers are not feeling more urgency to get unemployment down. People are clearly suffering greatly. Moreover, continued high unemployment is potentially very destructive. Even though I don’t think our normal rate of unemployment has risen much so far, it certainly could.
Evidence from a number of European countries in the 1980s suggests that a prolonged period of high unemployment can permanently damage workers prospects and raise normal unemployment. We are seeing today that some firms are putting up ads saying “Only employed people will be considered.” This suggests that there is starting to be a stigma associated with being out of work for a long period.

A rise in the normal rate of unemployment would not only be a disaster for the people affected, but for the government budget. Fewer people working means permanently lower tax revenues. The surest way to prevent such an outcome is to get the unemployment rate down more quickly. We should be using every tool we have to accomplish this.

**Dealing with the Deficit**

Now before you decide that I am some old-fashioned Keynesian nut who doesn’t understand that we have a terrible budget deficit, let me turn to that.

**Problem.** There is no question that we have a terrible budget problem. But its nature is often misunderstood. The deficit is large today—about 10% of GDP—primarily because of the recession. The deficit is expected to fall substantially over the next few years as the economy recovers. So, the immediate deficit is not the real concern.

It is the long-run deficit that is truly terrifying. CBO projects that the federal deficit starts rising again after 2014. By 2035, if we don’t make changes, it will be almost 16% of GDP. By 2050, it will be 26% of GDP.

The source of these terrible projections is largely rising government health care expenditures: spending on Medicare, Medicaid, and S-CHIP (the government health program for children). Some of the rise is due to demographics—the retirement of the
baby-boom generation means that there will be more people qualifying for Medicare. But even more important than demographics is rising spending per person.

Whatever the cause, the projected long-run deficits are clearly unsustainable. No country has ever managed to run deficits like these for an extended period. We would surely face a fiscal crisis at some point if we stayed on this trajectory. The consequences of such a crisis would likely make the troubles we have just been through look tame.

**Actions Taken.** Let me turn now to the Obama Administration’s approach to the deficit during the first two years. Early on, the deficit was obviously of secondary importance. The President was concerned about the long-run deficit and had discussed it frequently during the campaign. But, we all understood that dealing with the financial crisis and the collapsing economy was the top priority. When the house is burning down, repairing the foundation can wait for a bit.

But as 2009 went on and the economy began to stabilize, we tried to make progress on the long-run deficit in two ways. One was through health care reform.

Many people think of the Affordable Care Act as something that just expanded coverage and put new regulations on the insurance industry. And it certainly did do that. When it is fully implemented a few years from now, the Act will expand coverage to about 32 million Americans who currently don’t have health insurance. And many of the consumer protections have already gone into effect.

But a key focus of the reform legislation was cost control. We were very aware that the major source of the long-run budget deficit was rising government health care spending. So we worked very hard to reform the system in a way that would help to control cost growth.

I will tell you one Larry Summers story, because it is exactly on this topic. It
shows how he could, indeed, be slightly annoying, but also ultimately a good guy.

In the summer of 2009 we were beginning to worry about the deficit and the 2011 budget. Since we were in the middle of health reform, I argued that the right way to make progress on the deficit was to push harder on cost control. Larry kept coming back with, “I am sure our legislative folks are pushing as hard as they can.” About the fifth time I said we should do more, he got quite exasperated and said, “Fine, what do you propose we do that we aren’t currently doing?” I answered, “How about capping the tax exclusion?”

Health insurance benefits provided by your employer are currently not taxed. This leads to more generous health insurance plans with things like low co-payments, which make people not realize how much they are spending on health care. Health economists are incredibly united in the belief that limiting the amount of health insurance benefits that are not taxed would help contain cost growth.

Larry was just about to brush me off again when he paused and said, “That’s a good idea.” The economists came out strongly for a version of capping the exclusion, the excise tax on high-priced insurance plans, and the President and Vice President were convinced to go along. It was an incredibly tough decision and not popular, but very good policy.

The resulting Affordable Care Act has a number of important cost-containment mechanisms. Besides the excise tax, it included many reforms and pilot programs to identify more efficient ways to organize medical care. Even more important, it set up an Independent Payment Advisory Board to suggest continuing cost control measures in Medicare and Medicaid. CBO says that, despite the costs associated with the increase in coverage, the Act will save the government more than $1 trillion over the next two
decades.

Besides health reform, the other very important thing that the President did about the long-run deficit was to set up the Bipartisan Commission on Fiscal Responsibility and Reform, otherwise known as the deficit commission. The idea was to get a bipartisan group of members of Congress and a few outsiders to make recommendations on the deficit. It was a way to start building consensus around the actions that will be necessary to really deal with the deficit.

The Commission reported back in December. The final recommendation received 11 of 18 votes—a clear majority. The majority included both Republicans and Democrats. Perhaps just as telling, the opposition was split between Republicans and Democrats. This was a centrist proposal with genuine bipartisan appeal and bipartisan opposition.

**What More Needs to Be Done?** Again, that is where we have been. What should be done about the deficit going forward?

One way not to deal with it is what happened in February. There was a knock-down drag-out fight over the 2011 budget. We brought the government to the edge of a shut-down over a very minor part of the total budget problem. We ended up with significant immediate cuts in discretionary spending. Such one-time cuts do very little to deal with our long-run deficit problem. But, they could reduce demand today and take a toll on the already fragile recovery.

A much better approach is to pass a comprehensive long-run plan for the deficit. It should genuinely solve the problem. That means it needs to figure out how we either slow the growth rate of entitlement spending over the next 50 years or how we pay for it. Most likely, a mixture of the two will be needed.
It should deal with the deficit gradually over time. Spending cuts and tax increases should wait until the recovery is further along.

Many policymakers want to claim that getting the deficit under control will be good for the economy in the short run. The idea is that the positive confidence effects will outweigh the direct negative consequences of higher taxes and lower spending.

A very nice study published by the IMF last fall showed that this was not the case. Using careful analysis of deliberate fiscal consolidations in 15 advanced countries over the past 30 years, it found that the net effects are clearly negative. So, a country like the United States, which is still struggling with high unemployment, needs to move cautiously on reducing its deficit.

But, by making the hard decisions now, we would reassure everyone—markets, businesses, and consumers. We could get any positive confidence effects, without the immediate negative impact of higher taxes or lower spending.

I was thrilled that the President finally spoke about the long-run deficit and presented a comprehensive plan for dealing with it. I was listening to the speech in the car and found myself clapping when I should have been driving. It comes after both the report of the bipartisan commission and the proposal of the House Budget Committee, chaired by Rep. Paul Ryan. Reaching an agreement will obviously be incredibly difficult. The President’s leadership is likely to be essential.

What is a possible deficit compromise likely to look like? It is very hard to say, but I will give you a mixture of predictions and hopes.

Spending will certainly be trimmed substantially. I suspect that the spending cuts will be more extreme than the President proposed, but not nearly as extreme as Representative Ryan wants. According to projections by the Congressional Budget
Office, the Ryan plan takes discretionary spending (including defense) and non-health mandatory spending down to levels not seen since the 1920s. I don’t believe the American people actually want to go back to a government the size it was when Calvin Coolidge was president.

The Bipartisan Commission proposed substantial cuts to just about everything. I suspect that any final deal will look a lot like that. It will include a cut in farm subsidies, a less generous social safety net, and a serious cut in security spending.

Health care spending is obviously going to be a huge issue. The Ryan plan cuts health spending by changing Medicaid to a block grant to states and Medicare from an entitlement to a voucher program. Rather than promising to pay for health care for the poor and elderly, it gives states and seniors a certain amount of money.

It controls government spending because the amount that goes to seniors, for example, would only grow with the rate of inflation. The government would not promise to keep up with health care costs. The idea is that giving seniors money to buy private insurance will make them more vigilant consumers and this will contain costs. But if it doesn’t, the extra would come from seniors, not from the government.

I can’t imagine that voters will go for this. Medicare is one of the most popular government programs. One of the main stumbling blocks to passing the health reform legislation last year was the fight over some very sensible cuts in Medicare. I would guess that where we will end up is with some more defined cuts to Medicare and some kind of a mechanism for enforcing slower cost growth.

Both the President and the commission called for strengthening the IPAB. That would be very sensible in my view. But the Republicans really hate it, so it is very hard to know how this will play out.
Revenues are going to be another huge issue. Additional revenues are going to be needed if we do not make draconian changes to popular entitlement programs. Right now, neither the President nor Representative Ryan is in a very likely place.

The Ryan plan actually cuts taxes substantially, especially at the top of the income distribution. It achieves deficit reduction by the extreme cuts I described in health and other spending.

The President has supported raising taxes on those earning more than $250,000 in a variety of ways. I certainly support that. But it is unlikely to be enough. There just aren’t that many high-income households. So even large tax increases do not generate enough additional revenue. Therefore, some tax increase on middle-class families is likely to be necessary.

The recommendations of the bipartisan commission are perhaps the answer. It would cut a large number of tax expenditures. Tax expenditures are the various deductions, credits, and loopholes in the tax code. They are called tax expenditures because, say, giving people a tax credit when they have children in college is really not any different from the government sending you a check to help pay for college.

This change would obviously raise a substantial amount of revenue. Especially if it significantly limited the deduction for the interest people pay on their mortgages. The commission proposed using some of the additional revenue to lower tax rates and some to lower the deficit.

This is a change that is popular with just about every economist I know. Tax expenditures make the tax system much more complicated. If we actually got rid of some of them, this would make tax forms much simpler. Tax expenditures also skew behavior in potentially undesirable directions. For example, as I discussed before, the
deductibility of employer provided health insurance probably encourages more spending on health insurance. So limiting them and lowering marginal rates is good for simplicity and for giving people better incentives.

Another virtue of this change is that it could possibly garner bipartisan support. A number of Republican economists have pointed out that limiting tax expenditures can be viewed as a spending cut. Marty Feldstein just had an op-ed in the *New York Times* today making this point. If Republicans in Congress felt the same way, this has the making of a good compromise.

One thing that I dearly hope is that any comprehensive plan includes some help for the economy today. The President made a very compelling case for including some increases in investment spending in his deficit plan. He pointed out that cutting education spending and spending on basic scientific research is short-sighted. It might help the budget for a while. But, it would also very likely make us a less productive and innovative economy over the longer run. Even within an overall plan for fiscal austerity, we should continue to spend on things that are essential to our long-run growth. And, to the degree that we can do a chunk of that investment spending in the short run, that would be helpful to the recovery.

I would put other measures to strengthen the recovery in the same category. Something like a payroll tax cut for employers may not sound like an investment. But if it helps to prevent high unemployment from becoming permanent, it would be an excellent forward-looking policy.

Indeed, one of the alternative fiscal commissions had exactly this kind of short-run stimulus as part of a comprehensive plan. The commission chaired by former Republican senator Pete Domenici and former CBO director Alice Rivlin. It had a $600
billion payroll tax holiday in 2011, and then a comprehensive plan that gets the deficit under control over 10 years. So a responsible fiscal plan that invests in the future and in job creation is most certainly possible.

**CONCLUSION**

The bottom line is that we don’t have to choose between unemployment and insolvency. There is a way to navigate through these two pressing problems. We should take responsible monetary and fiscal actions today to stimulate demand and hasten the recovery. That is the only way to get unemployment down quickly. But, any additional fiscal stimulus should only be done in the context of a comprehensive package of serious long-run deficit reduction. We absolutely have to put in place a plan soon for how we get our deficit down over time.

Unfortunately, all of the needed actions are politically treacherous. Congress is afraid to take any action that might be seen as expansionary, even though unemployment is so high. The Fed is frequently criticized for being irresponsible when it contemplates further monetary expansion. And the changes needed in spending and revenues to actually deal with our long-run budget problem will affect nearly every American in some way. Congress and the President are going to have to touch not one, but about a half-dozen “third rails”: everything from Social Security, to Medicare, to farm supports, to defense spending, to raising taxes.

Early on, I got pegged as the optimistic member of the economics team. I still haven’t forgiven the *San Francisco Chronicle* for toping and otherwise very nice profile with the headline “Obama’s Sunny Economic Forecaster.” It’s not that I don’t see the difficulties that lie ahead—of course I do. I have talked about many of them today. It is
that I have great faith in the ability of sensible policy to help deal with those difficulties. And great faith that our political leaders, despite their many differences, can find a way to do what needs to be done for the country.

Dealing with both unemployment and the deficit will be an economic and political challenge that tests even my optimism. Policymakers are going to have to sacrifice their short-run political interests for the long-run good of the country.

The only thing that gives me hope is that the stakes are so large. Throughout our history, policymakers have stepped up when they had to. This is another one of those times. Let’s pray that our political leaders rise to the challenge once again.