Fiscal Policy in the Obama White House: Reasoning, Results, and Challenges Going Forward

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It is a pleasure and an honor to be here today. One of the joys of being back to my old job as a professor is that I get to spend time with bright college students again. I am delighted to get to visit Reed for a day.

This is a lecture series in public policy. In my talk today, I thought I would discuss one main area of economic policymaking—fiscal policy. Fiscal policy refers to the decisions the President and Congress make concerning taxes, spending, and the federal budget. It encompasses some of the Administration's most important actions over the past two years: the Recovery Act, health reform, and the debate over the budget deficit. It also represents some of the biggest decisions that will have to be made over the coming year: what actions can we take to encourage growth and to bring our budget deficit down?

I want to discuss many things about fiscal policy. First, why did the Administration do what it did? What was the logic of our various fiscal policy choices? Second, how the policies worked out. Were they successful and what we could have done better? And most importantly, where do we go from here? What are some of the most promising policy options going forward?

I. FISCAL STIMULUS

Let me start with fiscal stimulus, which is using fiscal policy—tax cuts and spending increases—to help counteract the recession.

I first met with the President-Elect shortly after the election. Obviously, by this time, we had had the collapse of Lehman Brothers and the economy was clearly in decline. He began the conversation by saying: "There is not much more the Federal Reserve can do, so we need to be thinking about fiscal stimulus." Now, I had written a paper on how monetary policy had been very helpful in the recovery from the Great Depression, even though interest rates were very low in the 1930s, as they were by November 2008.[1] So, I start talking excitedly about what more the Federal Reserve could do. Only afterward did my husband point out that the very first thing I did upon meeting the President-Elect was to contradict him.

Despite my belief that monetary policy was not yet powerless, I was a strong supporter of the need for fiscal stimulus. The need for aggressive action of all types was clear. Everything I knew from economic history and the empirical evidence suggested that fiscal stimulus would be very effective.

***The Recovery Act*.** The economics team was announced just before Thanksgiving in 2008. By the Monday after, we were in Washington working on what would become the American Recovery and Reinvestment Act.

The first and most basic question that had to be answered was how big it should be. At the time we began our discussions, most people were thinking of fiscal stimulus in the $400 to $500 billion range. We started looking at forecasts of what was likely to happen in the absence of stimulus from the Federal Reserve and private sector analysts. As has been pointed out to me very frequently over the past two years, the forecast we came up with turned out to be less severe than what actually happened. We, like all of the forecasters we were consulting, failed to foresee just how terrible the recession would be, particularly in terms of unemployment.

But even so, conditions were grim enough that we pushed for a much larger stimulus than most had been contemplating. We had a meeting with the President-Elect in Chicago in mid-December where we made our case.

Before the President joined us, we had a discussion with David Axelrod about some of his polling results. He told us that the American people had not yet had their "holy shit moment." By which he meant they had not yet realized that the crisis and the recession were going to be terrible. With that as background, I began my discussion by saying, "Mr. President, this is your holy shit moment. The recession is terrible and we need to hit it with everything we've got."

At the urging of the economic team, the stimulus grew to $800 billion, with the understanding that if we thought we could get more from Congress, we should do so. For example, when the House at one point pushed it up to $950 billion, we were very happy and would gladly have gone along. But it was dialed back by both the House and the Senate, and ended up at $787 billion.

A second issue involved design. Many, including the President, found the idea of making it a "moon shot" attractive. If we are doing all of this spending, let's accomplish something big—the equivalent of going to the moon. For example, let's build a nationwide smarter electrical grid.

Unfortunately, that desire ran into conflict with a second goal, which was to get the aid to the economy quickly. The things you could do fast were often less transformational. They were things like more aid to state and local governments and tax cuts for working families. It also ran into the phenomenon of diminishing returns. We have so many needs in our country—infrastructure, education, scientific research, taking care of people hurt by the recession. Putting all of the funds into one thing means that the last dollar spent on that one thing is probably has less payoff than a dollar spent on something else.

We ended up in what I think was a good middle ground. We had many things that went out quickly, such as the tax cut for working families, aid to state and local governments, and increased unemployment benefits. But we also made big investments in things with long-run payoffs, such as education, clean energy, and infrastructure. For example, more than $90 billion, or one-eighth of the spending, went to clean energy, an area the President had identified as a top priority.

We are now nearing the end of the Recovery Act. About 70% of the funds have been spent. The rest will spend out over the next couple of years. The obvious question is, did it work?

In a fundamental sense, absolutely. Most obviously, an economy in free fall started to grow again. After declining at an annual rate of 6.8% in the fourth quarter of 2008 and 4.9% in the first quarter of 2009, the economy stabilized and began to grow again in the third quarter of 2009.

A range of analysts, including private forecasters at Goldman Sachs and Economy.com and the nonpartisan Congressional Budget Office, say that employment is higher by 3 million or more, relative to what it otherwise would have been.[2] This is what the Administration estimated the Act would do.

There have also been some innovative studies that have identified a causal link between the Recovery Act and the recovery. A new paper looks at the state fiscal relief portion of the Recovery Act.[3] Some of the funds distributed by that program were relatively exogenous to state economic conditions; the amounts depended on Medicaid funding in the year before the crisis. The researchers find that employment is higher, relative to predicted, in states that got more of the relatively exogenous portion of the state fiscal relief funds.

So all of this suggests that the Recovery Act has been incredibly helpful.

What the Act has not done, however, is to repair anywhere near all of the damage that was done by the recession. It has filled in part of the hole, but not nearly all. As a result, employment is still some 7½ million below where it was before the recession started.

Given where we are now, it is clear that it would have been good if the Recovery Act could have been substantially larger. However, at the time, I seriously doubt we could have gotten more from Congress. But, we would be in a better place today if we had.

<u>Additional Actions</u>. By the summer and fall of 2009, when it had become clear how severe the recession was, the economics team began discussing additional fiscal stimulus measures.

There was a fair amount of debate about the relative merits of more action to reduce unemployment versus concern about the deficit. There was a genuine split in opinion over whether it was wise to do substantially more fiscal stimulus.

We also debated the correct form of additional measures. Almost everyone agreed that we needed to continue emergency unemployment benefits and more state fiscal relief. But what else? Should we do more infrastructure spending, which was a sure bet in terms of job creation, but tends to be expensive and somewhat slow? Or should we do something like a new jobs tax credit, where you give firms a tax break if they hire more workers? This would cost less, but its impact was more uncertain.

The result of this debate was that we never quite threw ourselves into a full-throated, do-or-die push for more fiscal action. We came out in favor of some targeted measures and got some of them through Congress. For example, we did get essential continuations of unemployment insurance and $26 billion of additional state fiscal relief, including help particularly to prevent teacher layoffs. We also passed the HIRE Act, which was slimmed down version of a new jobs tax credit. And in late September of this year, the President finally signed a small business jobs bill that cut taxes for small businesses and made it easier for them to get credit. But we never got the extra substantial jolt of fiscal stimulus that the economy needed.

It wasn't just our internal debate that prevented more assertive action. Two other forces were also important. One was the loss of confidence in stimulus by the public. The same forces that made us need additional action, made people think the Recovery Act hadn't worked. We were very confident that the stimulus was working as expected, and that what had changed was that the downward trajectory of the economy in late 2008 and early 2009 was stronger than we had been able to see at the time. But, ordinary families who were suffering just saw that things weren't getting better and so assumed that the stimulus didn't work.

The second factor working against additional action was the Greek fiscal crisis. When investors lost confidence in Greek government bonds in April of 2010, it sent shock waves throughout the world. Suddenly there was greater concern about deficits and fear that other countries could follow Greece into a fiscal tailspin. Congress and the American people lost much of their interest in additional deficit spending. Whatever the reason, the result was that few additional jobs measures got passed after the Recovery Act. And that is deeply unfortunate.

II. DEFICIT REDUCTION

This discussion of why we failed to pass additional fiscal stimulus leads naturally to the second major fiscal issue that the Administration was grappling with—the budget deficit.

When the President took office, the deficit was already terrible in at least two ways. First, the medium-run and long-run deficits were very large. Several factors had caused the deficit outlook to deteriorate over the previous decade: the 2001 and 2003 tax cuts greatly reduced revenues; the Social Security prescription drug plan was not paid for when it was passed; we were fighting two wars. As a result, even before the recession hit, the Congressional Budget Office was projecting deficits of more than 5% of GDP per year over the next decade, or about $750 billion each year in today's dollars.[4]

The long-run situation was, and still is, even worse. The retirement of the baby-boomers and rising health care costs come together to cause projected spending to rise dramatically over the next 20 to 30 years. In its last report before President Obama took office, CBO projected deficits of 15% or more of GDP by 2035.

Second, the immediate deficit was enormous because of the recession. It was about $1 trillion dollars (or about 8% of GDP) on inauguration day.

How to approach these high and persistent deficits was one of the things the Administration struggled with.

***Health Care Reform*.** The most constructive thing that we did was health care reform. Many people talk about health care reform as taking our focus away from jobs and the deficit. But it was, in part, a way to make progress in both these areas, while expanding insurance coverage to millions of Americans. Health reform that genuinely slowed the growth rate of costs was a way to make progress on the long-run deficit, without hurting the recovery. It could free up fiscal space so that we could do more short-run stimulus for jobs.

The economics team played a central role in keeping the focus of health reform on cost containment. One of the first things we did at the CEA was to write a report on the economic case for reform.[5] We paid particular attention to the less-analyzed macroeconomic consequences of reform. We analyzed the benefits of cost containment on standards of living, the deficit, and unemployment in the short run. I became a true believer in the incredible benefits of cost control.

I will tell you one Larry Summers story today, because it shows how he could, indeed, be a tad annoying but also ultimately a good guy. In the summer of 2009 we were agonizing about the deficit and, since we were in the middle of health reform, I argued we should push harder on cost control. Larry kept coming back with, “I am sure our legislative folks are pushing as hard as they can on costs.”

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 tends to lead 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 united in the belief that limiting the amount of health insurance benefits that are not taxed would help contain cost growth.

Larry looked like he 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 limited 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, and 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.[6]

***Institutional Reforms*.** Besides health reform, the other thing we accomplished on the deficit were two institutional reforms.

The first is that we worked with Congress to reinstate a pay-as-you-go rule. This is just a rule that says that anything Congress does that would worsen the deficit has to be paid for. Such a rule was in place in the 1990s, but was abandoned in the 2ooos. Since its reinstatement, PAYGO has been helping us to hold even and not take any measures, other than emergency ones, that increase the deficit.

The other institution that we set up was the bipartisan National Commission on Fiscal Responsibility and Reform, otherwise known as the deficit commission. This is something you are going to be hearing a lot about in the next few weeks. It is scheduled to report in early December.

The commission was created by the President because he felt it was the best way to forge a consensus on solutions to the deficit. It has eighteen members, six appointed by the President, six by Republicans in Congress, and six by Democrats in Congress. The President made it very clear that everything was to be on the table. He carefully refused to make anything off limits, in hope of giving the commission the room it needed to succeed.

III. WHERE DO WE GO FROM HERE?

So far, I have discussed what we did and why on fiscal stimulus and the deficit. Summarizing where we have been in fiscal policy, however, is the easy part. The much harder question is, where do we go from here? What is the right fiscal policy strategy to restore growth and deal with the budget deficit?

I won't pretend to have all of the answers, but let me try to offer some suggestions for moving in the right direction.

***Additional Fiscal Stimulus*.** First, we need more fiscal stimulus in the short run, not less. I am as concerned about the deficit as anyone; as I will discuss in a minute, I am wildly in favor of passing a serious plan to get it down over time. But, a key point is that in the short run, the economy is still very weak and needs more assistance. The unemployment rate is still 9.6%. That number is devastating. Getting the unemployment rate down quickly is essential to ending the suffering of millions of American families.

Purely from a deficit point of view, getting the unemployment rate down quickly should be a priority. Right now, unemployment is high because total demand in the economy is still very low. When people aren't buying things, firms don't produce and they don't hire workers. We are suffering largely cyclical unemployment. But what can happen over time is that cyclical unemployment can become structural or long-lasting.

As people stay out of work for years, their skills deteriorate, firms become reluctant to hire them, and they drop out of the labor force. This can cause unemployment to be permanently higher. Nothing would be worse for people or for the budget deficit than for some of our currently high unemployment to become permanent. Thus, for both the short-run and long-run health of the economy and all of our citizens, we need to undertake policies to bring the unemployment rate down quickly.

Despite what many claim, it is not the case that deficit reduction is good for unemployment. Some economists and policymakers (such as George Osborne, the Chancellor of the Exchequer in Britain) argue that fiscal austerity is good for growth even in the short run. There are a few examples of countries that have grown after passing fiscal consolidation plans. But these are cases where the country was in a fiscal crisis and facing crippling interest rates. In such a case, taking action on the deficit can improve confidence and lower interest rates. But that is unlikely to be the case in the United States, where our long-term interest rates are at historic lows.

The much more normal pattern is that fiscal consolidations reduce growth in the short run. They are painful. This is the conclusion of an excellent new study from the International Monetary Fund that looks at the experience of 15 countries over the past 30 years.[7] We need to attack the deficit, but it is not a short-run jobs strategy.

For that we need some additional short-run stimulus. In fact, we need a fair amount of additional stimulus. The Recovery Act begins to wind down in a serious way in the first quarter of 2011. Without doing anything, we will be taking off about $250 billion of stimulus in 2011. That is a lot of fiscal contraction.

The theory, of course, was that by the time the stimulus wound down, the private sector would be growing robustly on its own. It would more than compensate for the decline in government spending and tax increases. Unfortunately, it is pretty clear that this is not yet the case. Private demand is growing, but not robustly. For this reason, we need some serious additional help in 2011.

What kind of additional fiscal stimulus could possibly pass the new Congress? I admit it will be a tough sell, but there are areas where there might be bipartisan agreement.

The most obvious would be payroll tax holiday of some kind. Employers and employees pay hundreds of billions of dollars of Social Security and Medicare taxes each year. We could just declare that firms pay no payroll taxes in 2011. I have heard a number of Republican members of Congress speak favorably of such a holiday. It could give firms the cash and confidence they need to invest and hire more workers. Or, we could cut payroll tax rates for both employers and employees, so that both investment and consumer spending rise.

If I could choose, I would do something less costly and more focused on marginal payrolls. For example, we could say that firms pay no taxes on any increase in their wage bill in 2011. Such a marginal payroll tax holiday lowers the price of additional workers and encourages firms to do just exactly what we would like them to do—hire new employees. The CBO has identified this as a stimulus measure with one of the highest bang for the buck.

There also ought to be room for agreement on more infrastructure spending. Each year, the American Society of Civil Engineers issues a report card on the state of our infrastructure—in 2009 the overall grade was a D.[8] There is surely need for more infrastructure spending. Traditionally both parties have supported spending for roads, bridges, tunnels, and airports.

If ever there was a time we ought to be doing more infrastructure spending, it is when unemployment in construction over 17% and construction costs are low as a result. One overlooked fact is that project after project under the Recovery Act has come in below budget because construction costs have fallen substantially.

Finally, there should be bipartisan support for extending unemployment insurance, perhaps while also phasing down exceptional benefits. With so many people unemployed for so long, we have had to extend unemployment compensation to last far longer than its usual 26 weeks. In some states, workers get as many as 99 weeks.

On November 28, the federal support for these longer benefits will run out. What this means is that people who are not yet on the emergency benefit rolls could get as little as 26 weeks. Those who are currently receiving the lengthened benefits would get to continue for a while, but eventually, they would all run out too. Cutting off emergency and extended benefits would be devastating for families struggling with unemployment and take away one of the most effective sources of stimulus.

One proposal that might get bipartisan agreement is to pass a full extension that say lasts for another six months, and then more limited extensions for the rest of the year. Such an agreement would guarantee another year of extended help. But it would also reassure more conservative policymakers that the extended benefits would not become permanent.

***Deficit Reduction*.** These are they kind of policies that we need to get people back to work. Now, what about the deficit?

Any such additional fiscal stimulus should be done in the context of a serious plan to get the deficit down. That is a political reality. After the election, where voters clearly expressed their concern about the deficit, I cannot see either the Congress or the

President adopting much more fiscal stimulus unless there were other measures that eventually lowered the deficit.

It is also an economic reality. The deficit truly is a terrible problem and it has to be dealt with. Good policy requires that we make progress on both jobs and the deficit.

The first part of dealing with the deficit is to not make it any worse. There are two things looming that make me nervous.

One is the extension of the Bush tax cuts for high-income earners. While you can justify extending the tax cuts for those earning less than $250,000 on stimulus grounds, that is a very hard case to make for the high-income tax cuts. Economic studies suggest that tax cuts for high-income earners do not have big aggregate demand effects. But, extending the high-income tax cuts for even one year greatly increases the chance that it becomes permanent. And over the next decade it would cost $700 billion. This is the very first place to show that we can actually make a tough decision that has a dramatic impact on the deficit.

The second thing that is making me nervous is Republicans' vow to get rid of the unpopular portions of the health reform legislation. The trouble is, the things people don't like are the things that save money.

Take, for example, reducing payments to Medicare Advantage plans. Medicare Advantage plans are private HMOs that seniors can sign up for in place of traditional Medicare. The Affordable Care Act cut the payments for Medicare Advantage because they currently cost substantially more than traditional Medicare. This saves more than $100 billion over the next decade.

Some think the cuts are terribly unfair. But, a recent study shows that the same people, when they were on traditional Medicare, were dramatically less costly than when they moved to Medicare Advantage.[9] The truth is, Medicare Advantage plans provide extra benefits for enrollees and nice returns for the insurance companies, and the people involved don't want to lose those extra benefits. But in tough budget times, they are the most sensible place to cut our government health expenditures.

It is also the case that you can't leave things that people like in the Act without leaving some of the things they don't. One of the most popular components of the legislation is the fact that it prevents insurance companies from denying coverage for people with pre-existing conditions. But that component only works in a system where everyone is required to have health insurance. Otherwise, some people would not buy health insurance until they became sick, and our private insurance system would go bankrupt. But mandatory coverage, even when there are generous subsidies for low and middle-income families, is not very popular.

I am all in favor of fixing some of the things that are not great about the health reform bill. And, there is lots that we could do to make cost containment even stronger. But, getting rid of the hard-won cost saving measures that we achieved would be a disaster for our future fiscal health.

Beyond doing no further harm to the deficit, what should we actually do to get it down?

Here, I think our best hope is the deficit commission's recommendation. The two co-chairs, Erskine Bowles and Alan Simpson, have put out a preliminary proposal. It has generated a strong reaction. Nancy Pelosi declared it "simply unacceptable." Some Republicans hate the fact that it calls for increased revenues.

I think it could be the basis for a bipartisan agreement. Now we don't have a fully fleshed out recommendation and there are clearly problems with the co-chairs' proposal. But, it makes a number of good suggestions and does something fundamental. It shows that real deficit reduction is both painful and possible. Both of these are incredibly important for everyone to hear.

We need to realize that true deficit control will involve real sacrifice. Too many politicians try to make it sound like just getting rid of waste and foreign aid will do the trick. If Americans really don't like big government, we are going to have to face lower Medicare and Social Security benefits. And even with cuts to spending, it will also take additional revenue to make things balance. No one has proposed a plausible plan that would solve the problem purely by doing things on the spending side.

At the same time that the co-chairs' report showed that deficit reduction will be painful, it did show that it isn't hopeless. For everybody who wants to say it is just too hard, here is a users' guide that shows you how to do it. Indeed, the proposal achieves more deficit reduction than the President asked for, so we can do away with some of the least popular provisions and still have a credible plan.

As a side note, I very much like the fact that the co-chairs' proposal explicitly says no deficit reduction measures should happen in 2011 because the economy is too weak. That shows a wise understanding that what we need to do now is pass a plan. The actual reductions can wait until the economy is stronger.

Finally, since getting a comprehensive plan will likely take a substantial amount of time, it would be wise to pass pieces of it quickly with the immediate fiscal stimulus measures.

For example, the betting is that the Commission is most likely to reach consensus on a proposal for ensuring the solvency of Social Security. It would be natural to pass a temporary payroll tax holiday to stimulate the economy as part of the Social Security piece of the deficit proposal. We could ensure that we are both paying for the stimulus measure and dealing with the deficit in Social Security.

Likewise, the co-chairs' proposal calls for gradually raising the gas tax by 15 cents. An increase in the gas tax, starting in say 2013, is a natural thing to include with a temporary increase in infrastructure spending. It would be good policy for short-run job creation, long-run growth, deficit reduction, and breaking our dependence on fossil fuels.

The important point is that we should be taking immediate measures to deal with jobs and the deficit, even as we continue the hard work of a more comprehensive deficit reduction plan.

IV. CONCLUSIONS

This description of what needs to be done is certainly sobering. I thought it was hard being a policymaker in the first two years of the Obama administration. We were dealing with a terrible economic crisis, a fragile financial system, and a health care system that was leaving millions without insurance coverage and slowly bankrupting us.

But it is going to be even harder in the coming two years. Policymakers are terribly divided. The choices that have to be made about the deficit will be unpopular and potentially politically suicidal. And it will require deft management to balance the needs for continued growth measures with a sensible deficit reduction plan.

However, the same things that make me worry about our success, also give me hope. The stakes are so very high. The choices that we make in the next two years may well determine whether we remain a great country or begin the process of steady decline. Whether we put people back to work or whether we languish in high unemployment and ever increasing debt.

Fortunately, at the most difficult moments in our history, dedicated public servants have had a way of stepping up when the American people needed them to the most. Every one of us is counting on the new Congress and the President to do just that in the coming months. Our future depends upon it.

Notes

[1] Christina D. Romer, "What Ended the Great Depression?" *Journal of Economic History*, December 1992, pp. 757-784.

[2] Congressional Budget Office, "Estimated Impact of the American Recovery and Reinvestment Act on Employment and Economic Output from July 2010 Through September 2010," November 2010. Other estimates are summarized in Council of Economic Advisers, "The Economic Impact of the American Recovery and Reinvestment Act of 2009: Fourth Quarterly Report," July 14, 2010.

[3] Gabriel Chodorow-Reich, Laura Feiveson, Zachary Liscow, and William Gui Woolston, "Does State Fiscal Relief During Recessions Increase Employment? Evidence from the American Recovery and Reinvestment Act," working paper, September 2010.

[4] See "Addressing the Long-Run Fiscal Challenge," Chapter 5 of the *Economic Report of the President*, February 2010, for an analysis of and citations for the CBO deficit projections.

[5] Council of Economic Advisers, "The Economic Case for Health Care Reform," June 2009.

[6] Congressional Budget Office, "Letter to the Honorable Nancy Pelosi," March 20, 2010, and "Letter to the Honorable Harry Reid," March 11, 2010.

[7] International Monetary Fund, "Will It Hurt? Macroeconomic Effects of Fiscal Consolidation," Chapter 3 of the *World Economic Outlook*: *Recovery, Risk, and Rebalancing*, October 2010.

[8] American Society of Civil Engineers, *2009 Report Card for America's Infrastructure*, March 25, 2009.

[9] Jason Brown, Mark Duggan, Ilyana Kuziemko, and William Woolston, "Can Risk Adjustment Reduce Selection in the Private Health Insurance Market? New Evidence from the Medicare Advantage Program," working paper, July 26, 2010.