

**WHAT'S AT STAKE?
ECONOMIC ISSUES IN THE 2012 PRESIDENTIAL ELECTION**

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I. INTRODUCTION

History has it that back in the 1992 presidential election, there was a handwritten sign hanging in the Clinton campaign headquarters that read: “It’s the economy, stupid.” Back then, the slogan was a political judgment about what the Clinton campaign should focus on. In this year’s campaign, the slogan is just as relevant, but now it describes what voters should be thinking about.

In 2012, the most fundamental questions have to do with economics:

- How do we get the unemployment rate down quickly?
- How do we rein in the government budget deficit before it bankrupts us?
- How do we make sure that the economy is more productive and resilient over the long haul?

What I want to do this evening is talk about each of these fundamental economic issues – jobs, the deficit, and long-run growth. I’ll try to explain the nature and causes of these challenges, and what I think economic analysis and evidence suggests are possible solutions. I’ll also sketch out where the candidates stand, and the questions I think voters should be asking them.

Before I jump in, I want to say a word about partiality. This is a friendly community event, and I want to be very sensitive to the fact that people have different political opinions.

In today's discussion, I will try to be frank about things I think President Obama should be supporting and isn't. And I will try my best to be fair to Governor Romney. (Believe me, I've been to the Romney website so often in the last few months to learn about his positions, they now think I'm a prime target for a donation.)

Even so, it is bound to come through that I am a strong supporter of President Obama, and usually think he has a better position on the issues. Some things are just too essential a part of a person not to show through. But just so you know, I don't agree with President Obama because I worked for him. It's the other way around: I was honored to work for him precisely because I agreed with most of what he believed, and I shared his values.

But please, feel free to push back and disagree with me during the question and answer part of the evening. One of the things I believe very strongly is that we all need to be able to talk about economic issues respectfully, even when we have different views.

II. JOBS

With that as prelude, let me start with what is surely the most pressing economic issue the country is facing – a profound lack of jobs.

Issue and Diagnosis

My teenage son is a big fan of the “rent is too damn high” guy. Well, I think our much bigger problem is that unemployment is too damn high.

Now, the situation has improved markedly from what it was in the dark days of early 2009. Figure 1 shows a graph of the level of employment (the blue line) and the unemployment rate (the red bars). In late 2008 and early 2009, we were losing three-

quarters of a million jobs every month, and the unemployment rate was climbing toward 10%. We have been adding jobs slowly but surely since the start of 2010. Employment has risen by more than 4 million from its low. And the unemployment rate has fallen by about 2 percentage points.

But you can also see that things have not improved as much as anyone would like. Employment is still almost 5 million jobs below what it was at the beginning of 2008. And unemployment is still too damn high – at 7.8%.

So why are things still so bad? As the person who had the misfortune (some would say, the stupidity) to predict that the unemployment rate would be below 6% by now, I have thought about this a lot.

The fundamental reason is a lack of demand. Consumer spending is still anemic; business investment, though stronger, is not booming; exports are weak; and not that many people are building houses. When people and businesses don't buy things, firms don't produce and they don't hire. It's as simple as that.

I think there is pretty widespread agreement with this diagnosis. Some politicians try to blame the problem on more structural factors, like outsourcing or a mismatch between worker skills and the jobs available. But those same structural problems were also with us five years ago, when the unemployment rate was below 5%.¹ Almost all of the experts, including most recently, Edward Lazear, who was chair of the Council of Economic Advisers under President Bush, say that demand is the much more important factor.²

Where there is more debate is about why demand has not recovered more forcefully. Republican policymakers tend to emphasize low confidence and feelings of uncertainty. And they tend to blame American policy for that uncertainty. For example,

Governor Romney's economic advisers argue that businesses are nervous about all of the new regulations on the financial industry and about the effects of the health reform legislation.³

I actually agree that low confidence and high uncertainty are important. But I see little evidence that these problems are related to policy here at home. Figure 2 shows a graph of the measures of stock price volatility, a common indicator of uncertainty, for the United States and Germany. If our uncertainty were being driven by the Dodd-Frank financial reform bill or other American policies, you would expect to see stock price volatility moving differently in the U.S. and Europe. And yet, the two series have moved almost in lockstep over the last two years.⁴

What this evidence suggests, and what I believe, is that the meltdown in Europe is a big source of uncertainty here in the U.S. Consumers and businesses watching the slow-moving train wreck across the Atlantic are rightly nervous, and so we put off buying and investing. And, of course, the high unemployment in Europe is directly lowering demand in the United States because Europeans aren't buying as many of our exports.

Besides Europe, another big factor holding back demand in the U.S. is high consumer debt loads. During the run-up of house prices in the early and mid-2000s, American families took on large amounts of debt. When house prices crashed and unemployment rose, household debt-to-wealth and debt-to-income ratios went sky-high. In response, consumers have been scrambling to pay off debt and have become more cautious.

We now have some compelling evidence that high debt loads are depressing consumer spending. Economists Atif Mian and Amir Sufi got data from one of the

credit reporting bureaus on the growth in household debt before the crisis for each county in the U.S. They then got auto sales growth, also by county. Figure 3 shows their results. They found that when the recovery started, purchases of autos were much lower in highly indebted counties.⁵

A final factor depressing demand today is more prosaic: we just built an awful lot of houses in the mid-2000s. Figure 4 shows a picture of the home vacancy rate in the U.S. This is just a measure of how many homes are sitting empty. What you see is that home vacancies are still at a historic high. The result is that we are unlikely to need to do much residential construction for a while still.

OK, we all know we have a problem with jobs, and now you have a sense of the causes. What is the answer? How do we get demand and job creation up?

Possible Solutions

There are only a handful of tools that the government has to increase demand quickly.

One is fiscal stimulus. Fiscal stimulus just refers to tax cuts or increases in government spending. The Recovery Act passed just a month after President Obama came into office was about \$800 billion dollars of fiscal stimulus. It had tax cuts for working families; a big shot of infrastructure spending; and money for troubled state and local governments so that they didn't have to lay off as many teachers and other workers. Some like to say it didn't work and that fiscal stimulus is, in general, useless. But that is just not true.

The only silver lining that has come out of the terrible recession has been renewed interest and research about the effects of fiscal policy. That new research has

shown very strongly that increases in government spending and tax cuts generally raise output and reduce unemployment. And the studies looking explicitly at the Recovery Act conclude that it probably raised employment by about 3 million jobs, relative to what otherwise would have happened.⁶ The main problem with the Recovery Act was that it was just too small relative to the problems we were facing.

So, something that would help get demand up and unemployment down quickly would be another significant round of fiscal stimulus.

The second tool the government has to get demand up is expansionary monetary policy. When the financial crisis hit in 2008, the Federal Reserve lowered the main interest rate it controls, the federal funds rate, to near zero. That, combined with other actions the Fed took to keep credit flowing, is widely acknowledged to have helped prevent an even more devastating recession.

Even when the Fed has lowered short-term interest rates to near zero, there is still more it can do to help the economy. Unconventional policies, such as quantitative easing or guidance about future policy, can lower longer-term interest rates and affect people's expectations of future growth and inflation.⁷ This can absolutely encourage spending by businesses and households, and help lower unemployment. Last month, the Federal Reserve announced that it was embarking on another round of expansionary policy – which I think is a wonderful development.

The third tool that might help to get demand up is an aggressive housing policy. The new evidence on the importance of household debt has convinced me that we are likely to need to help homeowners who are underwater on their mortgages. Nearly 11 million people owe more on their mortgages than their homes are worth.⁸ This makes them particularly hesitant to spend and puts them at high risk for foreclosure.

I suspect that many of these troubled loans will need to be renegotiated and the principal reduced, if we are going to truly stabilize house prices and get a robust recovery going. Now I can't bear the thought of the government just paying for such principal reduction. It would be enormously expensive, and we have already bailed out the banks once. Rather, it would be great if regulators and the big housing agencies encouraged banks to do the write-downs on their own dime.

Or we may need to rewrite the personal bankruptcy law. Right now, bankruptcy judges can alter most loan contracts – except for the mortgage on a primary residence. Giving judges the ability to write down principal on home loans would be a smart thing to do – and a brave thing to run on.

Those are the tools we have for getting demand up in the near term. I think we should be using all of them. The economy is still very far below its normal level of production and employment. We need to do all that we can to get demand and hiring up until we are back to full employment.

The Candidates' Positions

So where do the two candidates stand on these various tools to spur near-term recovery?

President Obama is certainly in favor of more fiscal stimulus. Just about a year ago, he proposed the American Jobs Act, which would have provided about another \$400 billion of immediate job creating measures.⁹ It had another chunk of infrastructure spending. And it had a tax cut for firms that increased employment – exactly what we want firms to be doing. It also provided more money to state and local governments to help stop the hemorrhaging of teacher jobs and government services.

The measure didn't get anywhere in Congress, but it would still be very good policy.

Now on monetary stimulus, the President would never say what he supports. There is a very strong unwritten rule that the administration respects the independence of the Federal Reserve and does not comment on monetary policy. However, what is clear is that some of the President's appointees to the Federal Reserve Board – Chairman Bernanke (who was originally appointed by President Bush), Vice Chair Janet Yellen, and Governor Sarah Bloom Raskin – have been strong proponents of additional monetary actions.

Finally, on housing, President Obama is not proposing much that is new. His administration has been trying to get the big housing agencies – Freddie Mac and Fannie Mae – to participate in a principal reduction program the Treasury has devised. But so far, they have not been able to get them to budge.

What about Governor Romney? I think it is fair to say that he is not in favor of any of the tools for short-run demand creation that I mentioned. He is adamantly opposed to more fiscal stimulus. Indeed, he is prominent among those saying that the Recovery Act didn't work.

He is also deeply opposed to monetary stimulus. Mr. Romney has said that the Fed has done too much already. He has even gone so far as to declare that he would not reappoint Chairman Bernanke to run the Fed when his term expires a year from January – because his policies have been too expansionary.

Finally, Governor Romney has a decidedly minimalist housing plan.¹⁰ Basically, his hope is that growth in the rest of the economy will cause housing to take care of itself.

As far as I can tell, the main thing Governor Romney has for short-run demand

stimulus is the belief that his election and policy actions aimed at other objectives will improve confidence. He has said that as soon as possible after his election, he would overturn the Affordable Care Act and the Dodd-Frank financial reform legislation. And he would do tax reform that would cut tax rates but broaden the base so revenue stayed the same. His advisors argue that these policies will make businesses want to invest and people want to spend.¹¹

I have to say that I am skeptical. It may well be that businesses would view a President Romney as more pro-business, and so would be a little more confident. But that won't magically make the fear related to Europe and slowing world growth go away. And I find it hard to imagine that going back to the drawing board on health care and financial regulatory reform will lower uncertainty. The problems those pieces of legislation were meant to solve will still be there. We'll just be back to square one on the solutions.

III. THE DEFICIT

If jobs are big economic issue number one, the budget deficit is clearly big economic issue number two. We have a terrible problem and we can't wait much longer to tackle it.

Issue and Diagnosis

Thankfully, as with unemployment, there is relatively little debate over the cause of our deficit problem – just over what we should do about it.

First, about the cause. The deficit is large today – around 7% of a year's GDP – mainly because unemployment is still high.¹² When people are unemployed, they have

little income and so don't pay much in taxes.

But the current deficit is actually not the main problem. It is perfectly appropriate to run a deficit in bad economic times. And world bond markets are completely confident that we're good for it: the U.S. government is currently able to borrow at the lowest rates in our history. Moreover, the deficit is projected to shrink substantially as the economy recovers.

What keeps the experts up at night is the fact that the deficit is projected to start growing again about ten years from now. Figure 5 shows the projections for the federal budget surplus from the nonpartisan Congressional Budget Office. On the path we are on, the Federal budget will hit a deficit of 16% of GDP in 2035 – more than double what it is today – and be on its way to even higher numbers.¹³ No country has ever run deficits that large year after year and remained solvent.

The main source of these terrifying numbers is the projected rise in government health care spending. We are facing not one, but two tsunamis here. The first is the retirement of the baby-boom generation. This will swell the number of people eligible for Medicare. And it will do the same for Medicaid – because Medicaid is the program that pays for much of nursing home care for the elderly. The second tsunami is that health care spending per person is projected to keep rising much faster than total output. It has been doing that for that last twenty years and looks likely to keep doing so.

Together, these two phenomena – more retirees and more health spending per person – combine to raise projected government spending dramatically. Figure 6 shows that under two different ways of measuring it, the Congressional Budget Office expects government health care spending to rise from about 5% of a year's GDP today to 10% in

2025.¹⁴

That's the deficit problem and where it comes from. What should we do about it?

The Appropriate Pace of Deficit Reduction

The first thing to say has to do with timing. We should absolutely come up with a plan soon to deal with the deficit. But, we shouldn't swing immediately to extreme austerity. To reduce the deficit dramatically next year would cause unemployment to rise and the economy to slip back into recession.

Just as fiscal stimulus lowers unemployment, fiscal contraction raises it. Careful studies have shown this to be true in a wide range of countries over the past 25 years.¹⁵ And if you don't believe historical evidence, just look at Europe today. Many countries have moved strongly to fiscal contraction, and the result has been a dramatic rise in unemployment. Fiscal austerity is not the only reason – but it's a big one.

What we need instead is a bold two-part plan. Remember, the deficit is mainly a long-run issue. To deal with that, we should put in place a very serious plan that lowers those terrible long-run deficit projections. That is, we need to make the hard decisions now about what spending will be cut and whose taxes will be raised. And those changes will need to be with us not just for the next year or two, but for decades going forward. But such a deficit reduction plan should be paired with serious short-term job creation measures to get unemployment down immediately. The package would be both good for people and ultimately good for the deficit.

I have no doubt that President Obama agrees with what I just said. He has supported aggressive deficit reduction. He negotiated very hard for a grand bargain last summer during the fight over raising the debt ceiling. And he has supported a plan in

his budget very similar to the Bowles-Simpson bipartisan proposal. But he has urged that such a deficit-reduction plan be paired with something like his proposed American Jobs Act – so that we don't go too fast toward austerity.¹⁶

I am not really sure where Governor Romney stands on this issue of the appropriate timing of deficit reduction. He certainly does not support more near-term fiscal stimulus – which suggests that he might move to immediate austerity. But at other times, he talks about not getting the deficit down to zero until the end of his second term. So perhaps he would move gradually. This is an area where we could use more clarity from Mr. Romney.

Possible Solutions to the Long-Run Budget Problem

The timing of deficit reduction is clearly an important question. What about the even bigger one: What should we do to bring down those horrible long-run projections?

It is helpful to think of four components of the budget:

- Tax revenues.
- Defense spending.
- Government health care spending.
- All other spending.

Each piece plays a role in the deficit, and reforms in each could help to improve the outlook.

For example, tax revenues are how we pay for spending. Over the last 12 years, federal revenues have fallen sharply as a share of GDP.¹⁷ One way to reduce the deficit is obviously to raise some taxes. Similarly, defense and other security spending accounts for about one-quarter of federal spending. To get spending down, one margin to cut is

projected defense spending.

Today Medicare and Medicaid account for about 20% of the federal budget. But, as I mentioned, government health care spending is projected to grow very rapidly. So slowing spending growth is likely to be essential to dealing with the long-run deficit.

Finally, the catchall category of all other spending contains lots of things: Social Security, food stamps, Pell grants, funds for roads and bridges, air traffic controllers, and much more. None of these types of spending are projected to rise dramatically over time. But cutting this spending would clearly help the overall deficit.

Most experts will tell you that we need to use all four of these margins to actually deal with our deficit problem.¹⁸ The many bipartisan plans that have come out – Bowles-Simpson, Rivlin-Domenici, the Gang of Six – all recommend changes in each of these four areas. That just makes sense. The deficit problem is so large that it will be very hard to solve by only changing one or two of these areas. Or, to put it another way, if we did try to solve it with just revenues or just cutting non-health spending, the changes would be so large that they would likely be incredibly painful and too concentrated on certain groups or programs.

The Candidates' Positions on the Broad Parameters of Deficit Reduction

President Obama's plan works along all four margins I described. He has proposed a modest tax increase on high-income families.¹⁹ Working with his Secretary of Defense, the President also identified almost \$500 billion of defense cuts that can be made over the next decade without harming our national security.²⁰ And the President has committed to looking for additional defense savings.

The health reform legislation that the President passed included mechanisms

that are designed to encourage cost savings over time. And the President has urged strengthening those mechanisms. I will discuss health care spending plans in more detail in a minute. Finally, the President has supported cutting other spending. He agreed to a number of cuts in non-security discretionary spending in the Budget Control Act of 2011. And his budget proposes further cuts.²¹

So, the President's budget plan has all the pieces of a serious proposal. As a result, it is fairly well balanced – the costs of deficit reduction are spread widely across people. It's main failing, I would say, is that it is not bold enough. It contains less deficit reduction than was in the Bowles-Simpson bipartisan proposal. The President's plan reduces the deficit over the next decade by between \$3 and 4 trillion. That's a lot, but a fair amount less than is needed.

Governor Romney's proposals are very different from President Obama's. First, on tax revenues, he is not in favor of any increase. In fact, his main campaign pledge is to reduce tax rates.²² Governor Romney says that he will pay for the additional rate cut by trimming tax deductions and credits. But so far, the plan for a tax cut is very specific and the plans for reforms to pay for it are quite vague. So you have to worry that he could end up actually reducing revenues. Even in the best case scenario, Governor Romney does not plan to raise any additional revenue.

On defense, Governor Romney wants to increase spending. He has pledged to put a floor on core defense spending of 4% of GDP.²³ Press analyses suggest that this will involve spending about \$2 trillion more on defense over the next decade than is currently planned.²⁴

Given that he is opposed to additional revenue and wants to increase defense spending, you can see that Governor Romney has taken two key margins for solving the

deficit problem off the table. This clearly makes it harder to deal with the deficit. It also means that if he is going to succeed, he will need to make very large reductions in health care and other types of spending.

As I will discuss in a moment, Governor Romney is indeed proposing far-reaching changes in health care. He is also proposing very large cuts in other types of spending. During the primary, he expressed support for the Ryan budget, so it is perhaps a guide to what he would do. The Congressional Budget Office reports that the Ryan budget will shrink non-defense discretionary spending over the next four decades as a share of GDP to levels last seen in the 1920s.²⁵ If this came to pass, it would involve a radical change in the size and function of government.

The Candidates' Positions on Health Care Spending

Before we leave the discussion of the deficit, I want to talk more about one piece of the plans where Governor Romney and President Obama differ most dramatically – and that is on federal health care spending.

Governor Romney wants to essentially end Medicare and Medicaid as entitlements. Saying something is an entitlement means that the government promises certain groups in society health care, and then pays what it costs – without Congress having to approve the funding each year. Governor Romney and Congressman Ryan would change the government health care programs so that government spending is limited.

This change is easiest to see for Medicaid. Medicaid is a joint federal-state program that provides health care to the poor and disabled. Right now, the federal government is on the hook for a fixed share of what states pay for Medicaid. Governor

Romney wants to turn the federal contribution into a block grant: states would get a certain amount of money, regardless of how much they spend. And crucially, the size of those block grants would grow much more slowly than Medicaid spending is currently predicted to grow. So by construction, this plan would cut federal spending growth.

The way this plan is supposed to work is that states would be forced to come up with innovative new ways to provide health care to the poor and disabled at lower cost. If they can, great – we have solved part of the problem. But if they can't, what happens then? Either the state governments pay more, or they throw people off the rolls.

Governor Romney's proposal on Medicare is similar. For people under 55, he proposes replacing traditional Medicare with a premium-support or voucher plan. Seniors would be given a voucher of a certain amount that they could then use to buy private insurance. Importantly, at least in the most recent version of the Ryan budget, the growth in total Medicare spending (and hence in the growth of the size of the vouchers) is capped at a pretty low level.²⁶ Under that formulation, this plan would indeed slow government spending growth.

What proponents of this approach hope is that competition and consumer pressure will force private insurance companies to become more cost conscious and innovative. This is supposed to slow spending growth enough that the vouchers will pay for the same quality of care. Unfortunately, there are reasons to think that competition might not work in this market. The market for health insurance is complicated, with lots of market imperfections. And competition has not succeeded in controlling costs in the market for insurance for working age people over the last couple of decades. If competition doesn't slow spending growth, but the government has fixed the amount it spends, seniors would have to pay more or get less good coverage and care.

What is President Obama's alternative? Fundamentally, he has said let's leave Medicare and Medicaid as entitlement programs: seniors, the poor, and disabled Americans are guaranteed health care paid for by the government in the same way as it is today. But, and it's a big but, the government has to find ways to lower spending without lowering the quality of care.

The way the government would do that is to try to reform how health care is organized and paid for. The Affordable Care Act made an important start in this area. It includes a number of pilot programs to see if different ways of organizing doctors or paying for care improves outcomes and reduces costs. And it sets up a board to encourage the spread of programs that work more generally throughout Medicare and Medicaid. The essence of the President's alternative is to continue this kind of bold experimentation.

Will this approach work? I honestly don't know. What we do know is that there is a great deal of inefficiency in the government health care programs. Convincing research shows huge differences across regions of the country in what Medicare spends on care, with no corresponding differences in outcomes.²⁷ So it ought to be possible to slow cost growth a lot, for example by figuring out what works in low-cost areas and spreading those innovations nationwide.

One of the things that I would like to hear from President Obama is what he would do to ensure that greater efficiency and cost saving become a reality. And it would be helpful for him to spell out a fallback plan of more significant changes he would consider if efficiency gains can't be found.

The bottom line is that on the deficit, as on the issue of jobs, there are huge decisions to make. Deficit reduction is coming one way or another – it has to. The big

question is how it will be done. The two presidential candidates have very different plans. The American people need to decide which they like better.

IV. LONG-RUN GROWTH

So far, I have talked about two big economic issues at stake in this election: jobs and the deficit. But, believe it or not, there is a third issue that may be even bigger than these two: What do we do to raise our long-run growth? The issue of unemployment and jobs is about how we get the economy back to normal. The issue of long-run growth is about how good “normal” is, and how fast it is improving over time.

Issue and Diagnosis

What’s at stake here really is the American dream. In the first 25 years after World War II, economic growth was very rapid. Figure 7 shows a graph of real GDP per person – which is the broadest measure of what we produce. In the early postwar period, it grew at an average rate of about 2½% a year.²⁸ There were ups and downs as we had recessions and booms. But averaged over many years, growth was very strong.

But the process of growth slowed down around 1973. In the last 40 years, real GDP per person has grown by about 1.6% per year – instead of 2.5% as before. That may sound like a small difference, but it matters a lot over long periods of time. The red line in Figure 7 shows what GDP would be today if we had continued growing as rapidly as we did in the early postwar period. You can see that a large gap has opened up over time.

A second change that has taken place is that income inequality has risen. Figure 8 shows the share of income going to the top 1% of the income distribution over time.²⁹

In the early postwar period, it was less than 10%. In 2007, that number was 24% – more than double. This means that economic growth was more widely shared in the early postwar period. Throughout the income distribution, everybody did better. More recently, what growth there has been has benefitted disproportionately the very wealthy.

Now why overall growth has slowed down and inequality has risen are topics that could fill up an entire lecture on their own. There are many explanations. But one that feels particularly appropriate to discuss at a university lecture like this is the slowdown in educational attainment.

Figure 9 shows the average number of years of schooling that an American child coming of age in different years received. What you can see is that the trend was strongly upward for most of the 20th century. Americans were getting more and more years of schooling. Part of the explanation for why economic growth was so high for most of this period was that we were constantly improving the quality of our workforce. We could come up with innovative ideas and put them into production because we had one of the best educated workforces in the world.

It also helps to explain why income inequality didn't rise for most of this time. Average workers were able to share in the resulting economic growth because they kept adding the skills needed to keep up with the new technologies. This is the theme of an excellent book by Claudia Goldin and Lawrence Katz.³⁰

But the growth in educational attainment started to slow down in the 1970s. We were still adding years of schooling – but much more slowly. This likely slowed our ability to generate the new ideas that fuel technological progress. And it meant that many workers don't have the education needed to use advanced technologies like computers, and so don't reap the rewards.

The result of the slowdown in overall growth and the rise of inequality has been a slowdown in the growth of the standard of living for the typical family. Economists like to talk about the median family income – the earnings of a family right smack in the middle of the income distribution.

Figure 10 shows that between 1948 and 1973, the real median family income (real just means controlling for inflation) more than doubled.³¹ So the typical American family saw their standard of living rise dramatically. But living standards for the typical family have effectively stalled in the last few decades. Real median family income grew just 20% between 1973 and 2000. Since 2000, real median income has actually fallen. For virtually the first time in our history, children may face bleaker economic prospects than their parents.

So that's the problem – stagnating incomes for the typical American family.

Possible Solutions

What can we do about it? Economists are less sure of how to generate long-run growth and greater equality. But some things seem likely to help.

One thing that could strengthen long-run growth is better institutions. The economic evidence is quite convincing that democracy, secure property rights, free markets, and other institutions are important to growth.³² So a natural place to look for continued growth in standards of living is in improvements to our institutions.

A second way the government could help growth is by increasing the kinds of investment the private sector tends not to do. For example, studies show that government spending on basic scientific research is both incredibly valuable, and absolutely necessary.³³ A key fact is that no one firm has a strong incentive to invest in

basic science. The returns are too uncertain. And even when there is an important discovery, it is hard for the one firm doing the investing to capture all of the rewards. So the private sector tends to not do very much of this kind of investment.

Public investment in infrastructure has the same characteristics. No one firm is going to build the roads and bridges and airports it needs to get its goods to market. But the returns to the whole economy from this kind of investment are huge. As a result, there is an important role for government in carrying out this type of investment.

Another thing that could improve our long-run growth is to improve our human capital by educating our workforce better. Public investment in education is the ultimate “two-fer.” First, it is good for overall economic growth – it helps create a trained workforce that can boost productivity and spur technological change. And, indeed, the social returns to education are pretty well established.³⁴ Second, if the education dollars are spread evenly – or even better, if they are disproportionately aimed at the disadvantaged – they can be a source of growing equality. By evening the playing field, they allow children from poor families to succeed and prosper.

A final area of policy options that may affect long-run standards of living involves tax policy. I have already discussed that tax cuts can cause a temporary rise in output.³⁵ This is a demand-side effect. When you cut people’s taxes, they spend more and this raises output for a while. But this effect is temporary – it doesn’t affect normal growth.

Some economists, however, believe that other effects of tax changes can be more long-lasting. For example, perhaps lower marginal tax rates will make people work harder, or spur entrepreneurs to invest and grow their businesses. This is the essence of Ronald Reagan’s notion of supply-side economics.

Unfortunately, this view is not backed up by solid empirical research. The most

careful studies have shown that these supply-side effects are modest.³⁶ They are there, statistically significant even. But they are small.

While the long-run growth effects of tax changes are controversial, the income inequality effects are not. Tax policy that increases the share of taxes paid by the wealthy can absolutely reduce the inequality in after-tax income.

The Candidates' Positions on Institutional Reforms

So those are some of the tools that the government has for helping to raise long-run growth and share the gains more evenly. Where do the candidates stand on these issues? Interestingly, there is a fair amount of agreement between the two presidential candidates in the area of institutional reform.

For example, both are big proponents of international trade as a source of growth. At its best, trade functions like technological progress: it allows us to have better choices and better standards of living. This is a view strongly supported by the empirical evidence.³⁷

President Obama has passed a number of free trade agreements – including one with South Korea, which is a major trading partner and a large potential market for American goods. Governor Romney has urged more such agreements, and has been passionate about the need to ensure that our trading partners play by the same rules.³⁸

Likewise, both presidential candidates agree that our current corporate tax system is a mess. We have high stated tax rates on corporate income, but then tons of special tax breaks and loopholes. The result is that most corporations pay an average rate very much in line with what businesses pay in other developed countries.³⁹ But they waste a lot of time and money lobbying for tax breaks and gaming the system.

Although President Obama and Governor Romney don't agree on all of the details of corporate tax reform, they agree on the need to do it.

Another institutional factor where there is more agreement than there might seem involves regulation. Governor Romney talks a lot about how regulation is holding back American business. He stresses the importance of cost-benefit analysis in evaluating the wisdom of new regulations.

One of the key jobs of the Council of Economic Advisers is to participate in the regulatory review process. I can tell you that the Obama administration has worked incredibly hard to regulate well. During my time in Washington, we had plenty of protracted battles that resulted in agencies rewriting rules to be more effective and less costly. The CEA was a fierce advocate not only of cost-benefit analysis, but of *good* cost-benefit analysis. That idea even got written down in an executive order President Obama issued in January 2011: “[E]ach agency is directed to use the best available techniques to quantify anticipated present and future benefits and costs as accurately as possible.”⁴⁰

I have no doubt that Governor Romney would draw the line differently and eliminate or change regulations President Obama supports. But the truth is – the difference in rhetoric far exceeds the difference in practice.

The Candidates' Positions on Other Policies to Raise Long-Run Growth

On the other issues related to long-run growth, however, there is less agreement between the candidates. President Obama believes strongly in public investment. He increased infrastructure spending a lot in the Recovery Act, and has been pushing for another big round for the last two years. The President has also supported increasing

the budgets of the National Science Foundation and the National Institutes of Health to levels not seen since the 1960s – precisely because he sees the role basic science can play in long-run growth.⁴¹ And he is particularly passionate about spending money to further the research and development of clean energy. Such spending is not only good for overall growth, it also helps to solve the long-run problem of limited fossil fuels and the terrible consequences of climate change.

President Obama also wants to increase public support for education. As with infrastructure, he has already increased spending substantially. The Recovery Act included about \$50 billion in extra support for education and job training.⁴² A large chunk of it was tied to school reforms. The President and his Secretary of Education, Arne Duncan, are enthusiastic supporters of the Race to the Top program, which gave out competitive grants to school districts taking concrete steps to improve outcomes.

The President is also trying hard to protect and improve access to higher education. The Pell grant program, which provides money for low-income kids to go to college, was greatly expanded in the Recovery Act – and the President has been fighting ever since to keep it going at the higher level. He has said he wants to continue increased funding for student loans, to keep down borrowing costs and tie repayment to future income.

Finally, on taxes, President Obama wants to raise more money from the wealthy. This will directly decrease inequality in after-tax income.

Where does Governor Romney stand on these issues? Mr. Romney says very good things about infrastructure. He wants to do smart infrastructure investment. And he wants to decide what we build based on cost-benefit analysis, not horse-trading. That is a sentiment President Obama has also expressed.

Governor Romney also has some good ideas for education. For example, I find a lot I can agree with in his proposals about job training.⁴³ He rightly points out that our current job training system is very complicated and doesn't do nearly as good a job as it should. Governor Romney has proposed cutting the number of separate programs and trying to make the system more efficient. He also supports tying job training more closely to industry, so that honest-to-goodness jobs follow the training.

But the sensible ideas Governor Romney has concerning public investment and education run into what seems to me (in the words of Charlotte Brontë) an insuperable impediment. His budget plans leave him with no money to do these good things. Indeed, as we discussed, the arithmetic of his plan suggests simply enormous cuts in exactly this type of discretionary spending.

Now, we don't have hard numbers from Governor Romney. But what he is proposing is very similar to what Representative Ryan proposed in the House Budget plan. The Ryan budget from last March cut spending on education and job training by 31% over the next 10 years.⁴⁴ It cut transportation spending by 25%. If Governor Romney supports reductions like that, I worry that devastating cuts in existing programs will swamp the benefits of the new ideas.

The main way that Governor Romney proposes to increase long-run growth is by cutting marginal tax rates. His economic advisors have been very clear – that is the essential element of his economic plan.⁴⁵ As I have described, the evidence isn't there that it will actually work. So I fear this is fundamentally a hope, not a plan, for long-run growth.

The other key fact about Governor Romney's tax plan is that it will exacerbate income inequality – regardless of whether it works to raise growth. His plan calls for

cutting everyone's tax rate by 20%, and paying for this by cutting deductions and credits.

The problem is, Governor Romney is not willing to cut one of the biggest tax preferences benefitting the wealthy – the low tax rate on capital gains and dividends. Capital gains and dividends are only taxed at 15%, whereas the top rate on ordinary income is 35%. Without touching that low rate, the only way to raise enough revenue pay for the 20% cut in all rates is to cut deductions and credits for middle class families.⁴⁶ So Governor Romney is proposing a significant redistribution of tax burdens from the wealthy to those earning less than \$200,000.

Clearly, on this issue of long-run growth, there are very large differences between the two candidates.

V. CONCLUSION

We have been through a lot of policy detail today. I hope I have convinced you that we face some tremendous economic challenges: a desperate need for more jobs; a large and growing budget deficit; and anemic long-run growth and rising inequality. I firmly believe that good policy could make a huge difference. That is why it is crucial to learn where President Obama and Governor Romney stand on these issues.

Let me end with some history. In my academic life, I am an economic historian, researching economic policies in the past rather than in the present. I think a lot about the Great Depression in particular.

We all know that the 1932 presidential election between Franklin Roosevelt and Herbert Hoover was very important. The country was in the darkest days of the Great Depression. Voters had to decide who they thought could stop the terrible downturn

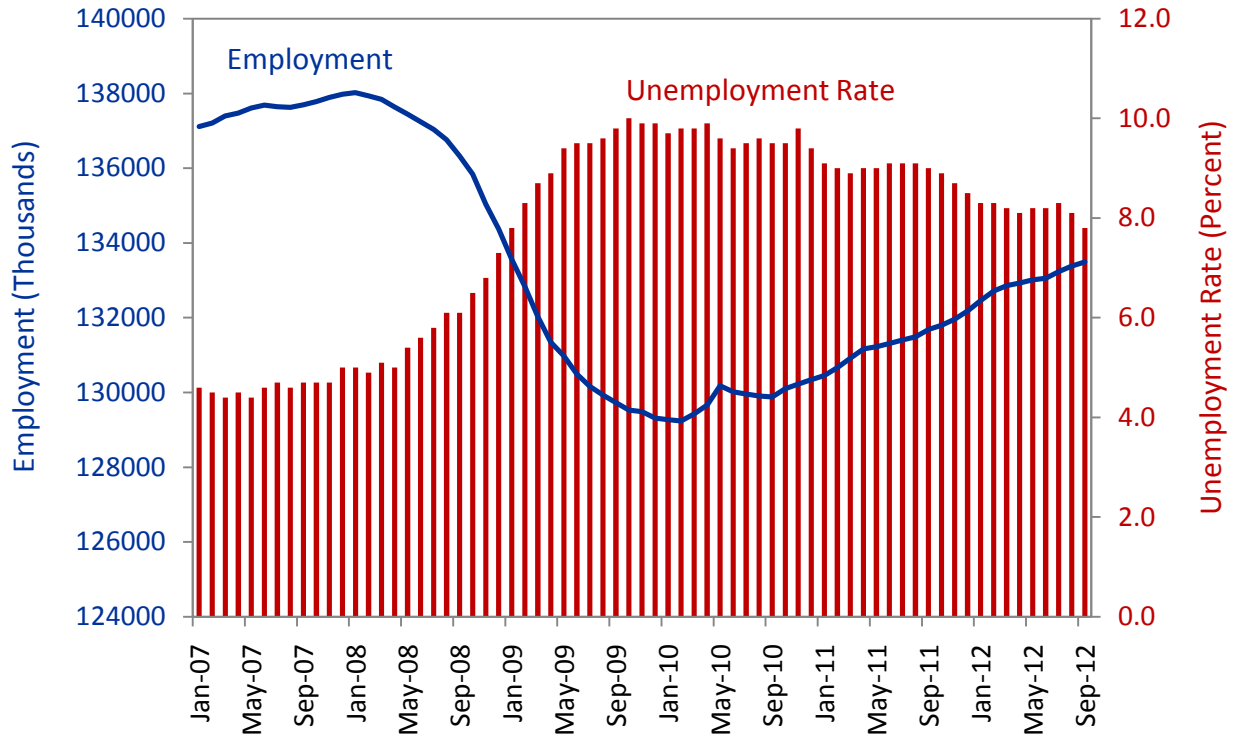
and start the economy growing again.

But I sometimes wonder if the 1936 election wasn't even more consequential. Despite strong growth thanks to Roosevelt's policies, the economy was still quite weak – unemployment in 1936 was a wretched 17%, and there were real questions about whether the U.S. would ever return to the prosperity of the 1920s. The budget deficit in 1936, though puny by modern standards, was at the time the largest on record outside of wartime. And Europe was on the verge of a cataclysm. Is any of this sounding familiar?

I won't pretend that conditions are the same today as they were in 1936. Unemployment today is low by comparison. And Europe's problems, while severe today, are thankfully about mere money, not about military aggression and genocide. But our budget problems are much worse, and feel far more intractable.

The point is: elections can have huge consequences. As in 1936, the decisions we make in 2012 will decide how we handle some fundamental challenges. We need to learn all that we can about where the candidates stand on the issues. And then we need to vote like our future depends on it – because it does.

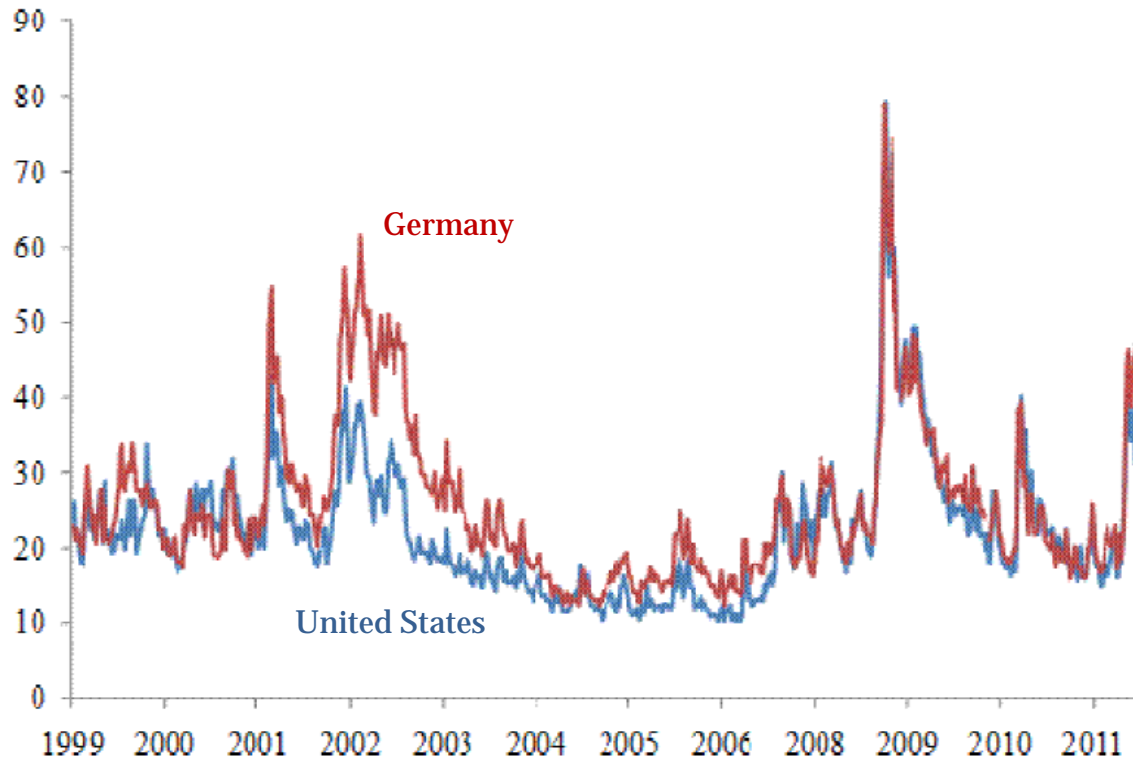
Figure 1
 Employment and Unemployment



Source: Bureau of Labor Statistics.

Figure 2

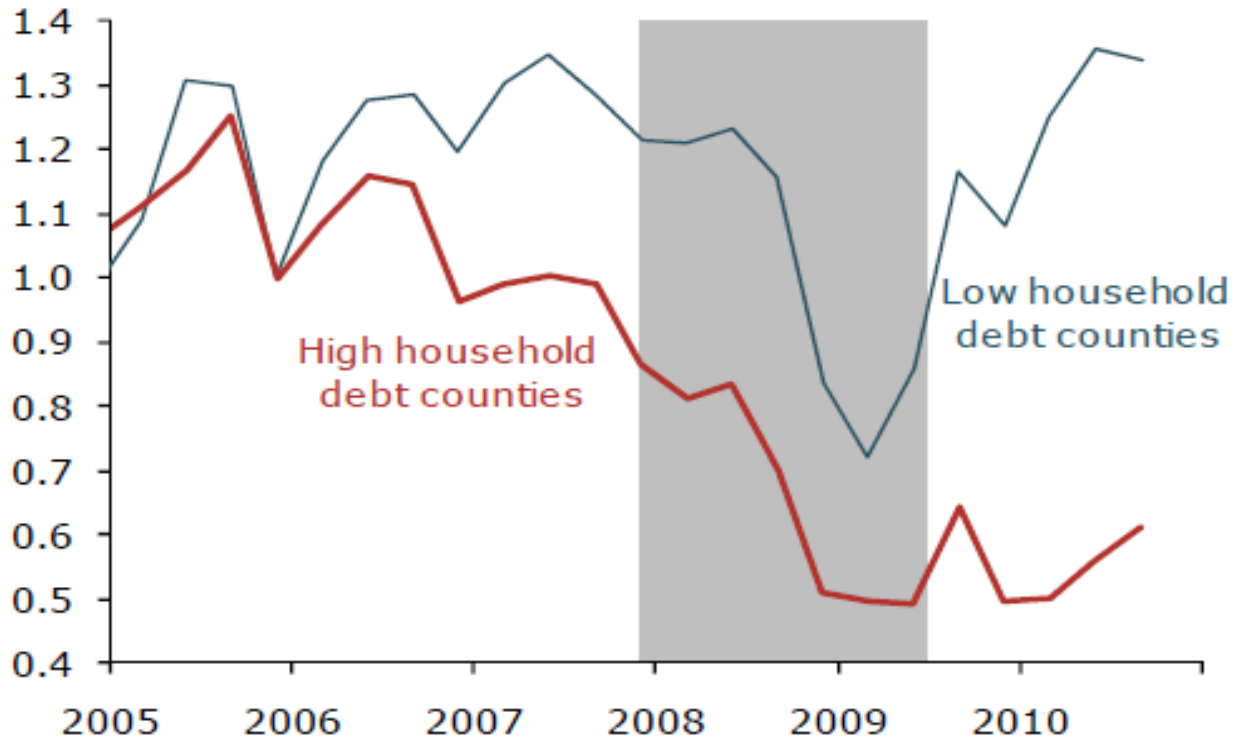
Stock Market Volatility in the U.S. and Germany



Source: Janice Eberly, ““Is Regulatory Uncertainty a Major Impediment to Job Growth?”

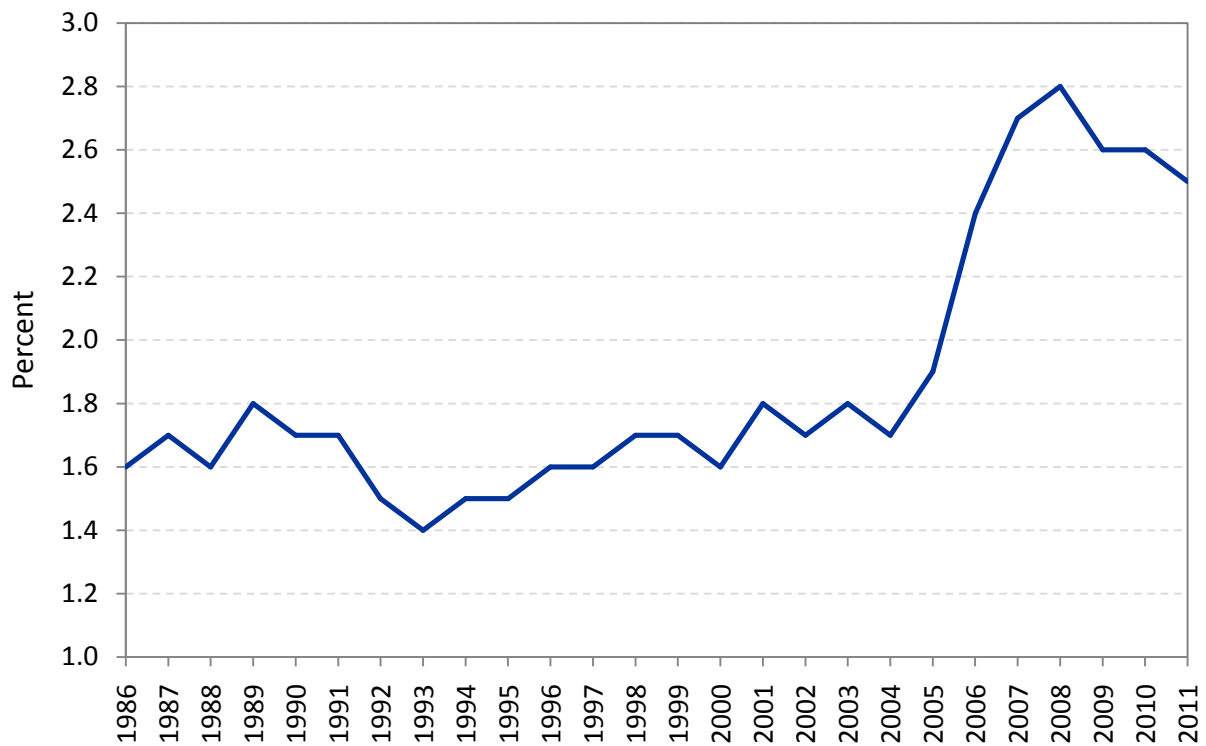
Figure 3

Auto Sales Growth (Indexed to 2005:Q4)



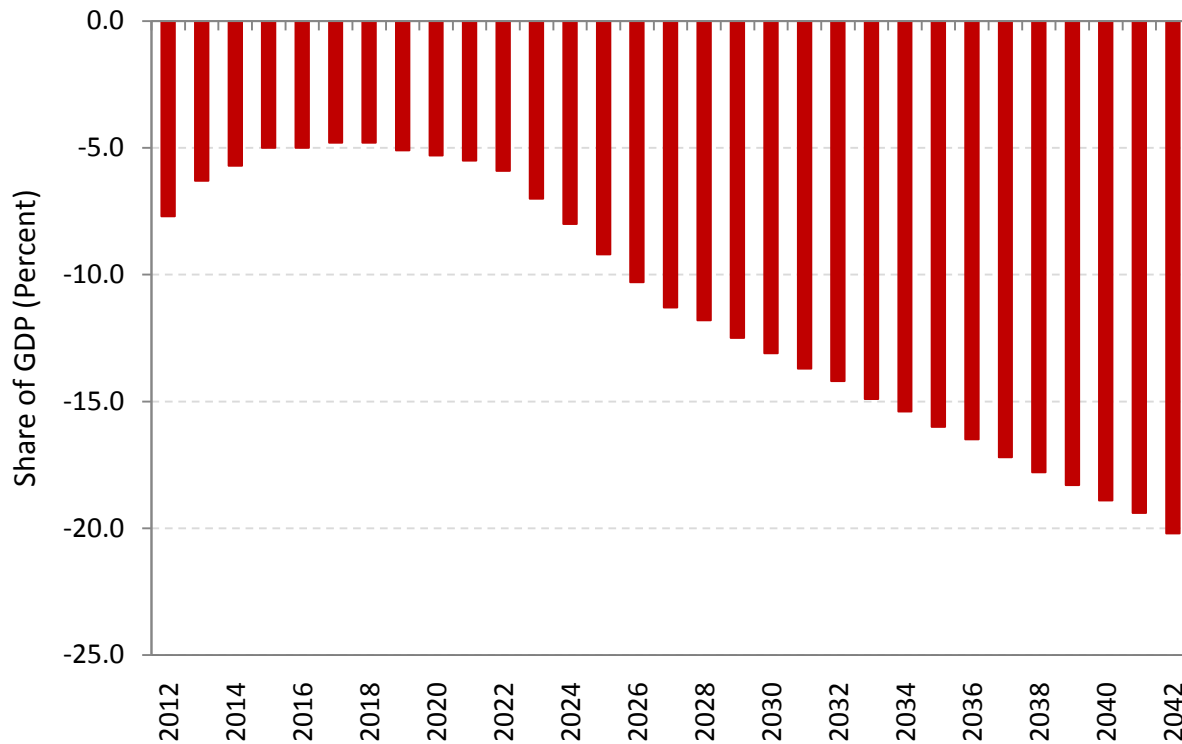
Source: Mian and Sufi, "Household Debt and the Weak U.S. Recovery"

Figure 4
Home Vacancy Rate



Source: Bureau of the Census.

Figure 5
Projected Federal Surplus as a Share of GDP

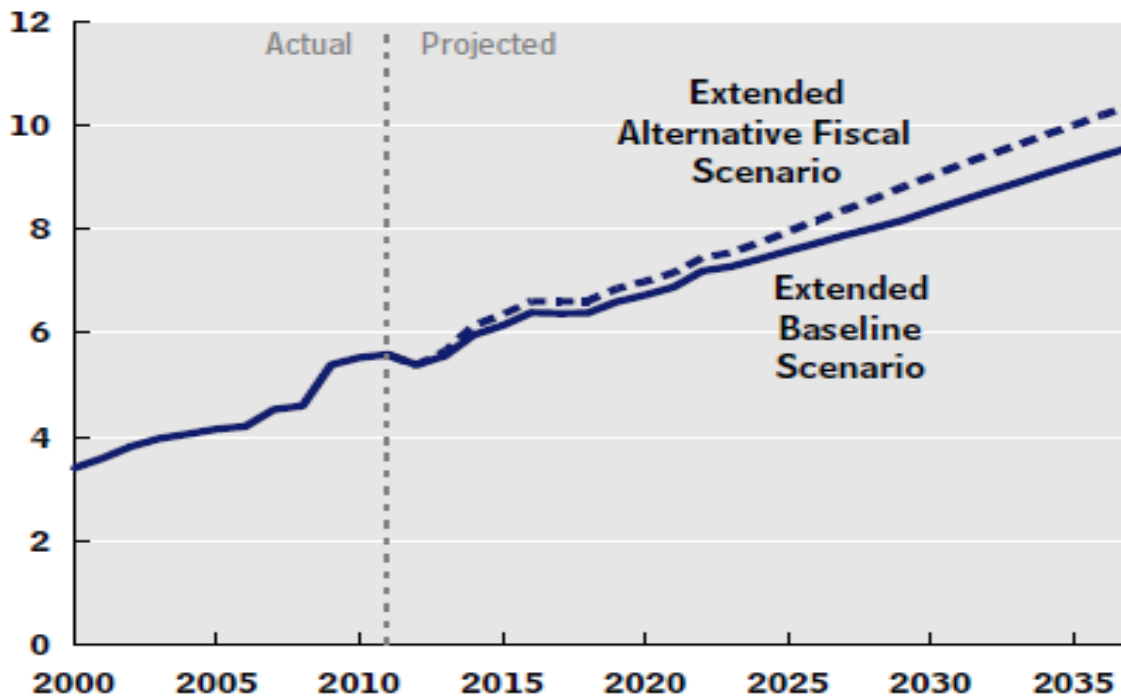


Source: Congressional Budget Office, *The 2012 Long-Term Budget Outlook*.

Figure 6

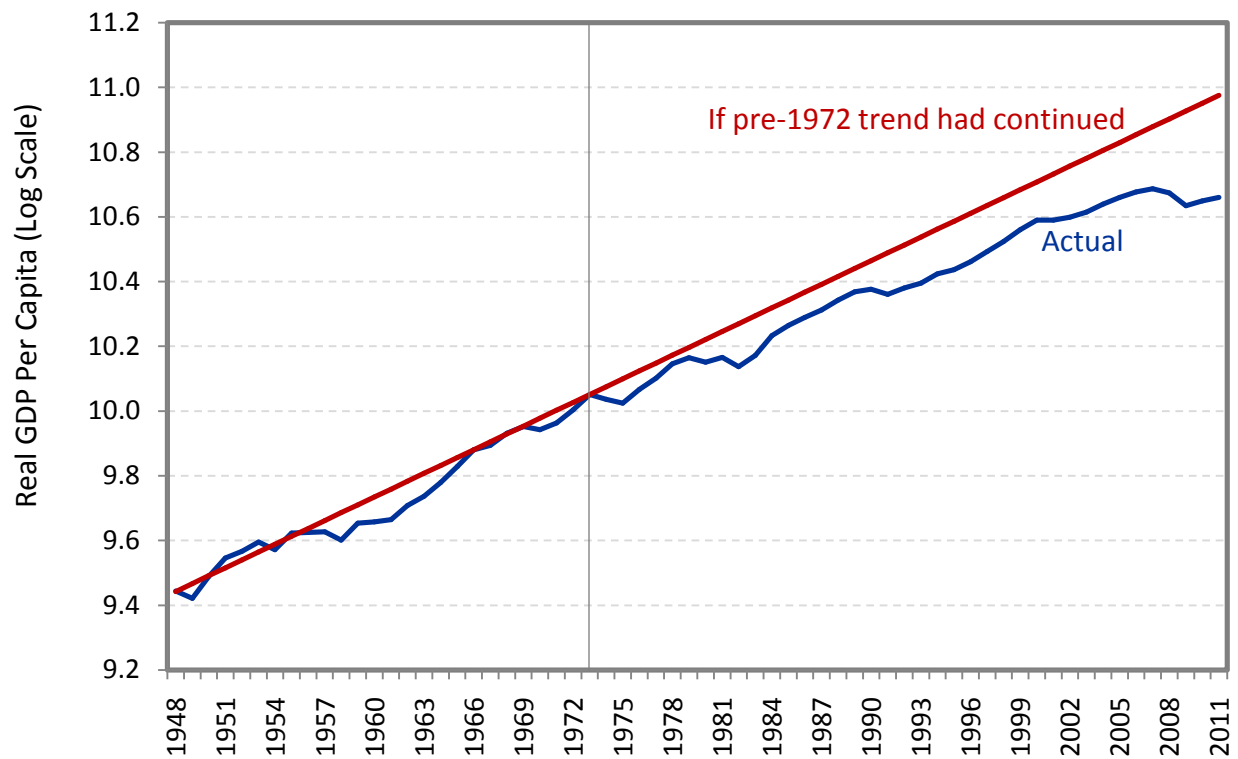
Federal Spending on Major Health Care Programs
under CBO's Long-Term Budget Scenarios

(Percentage of gross domestic product)



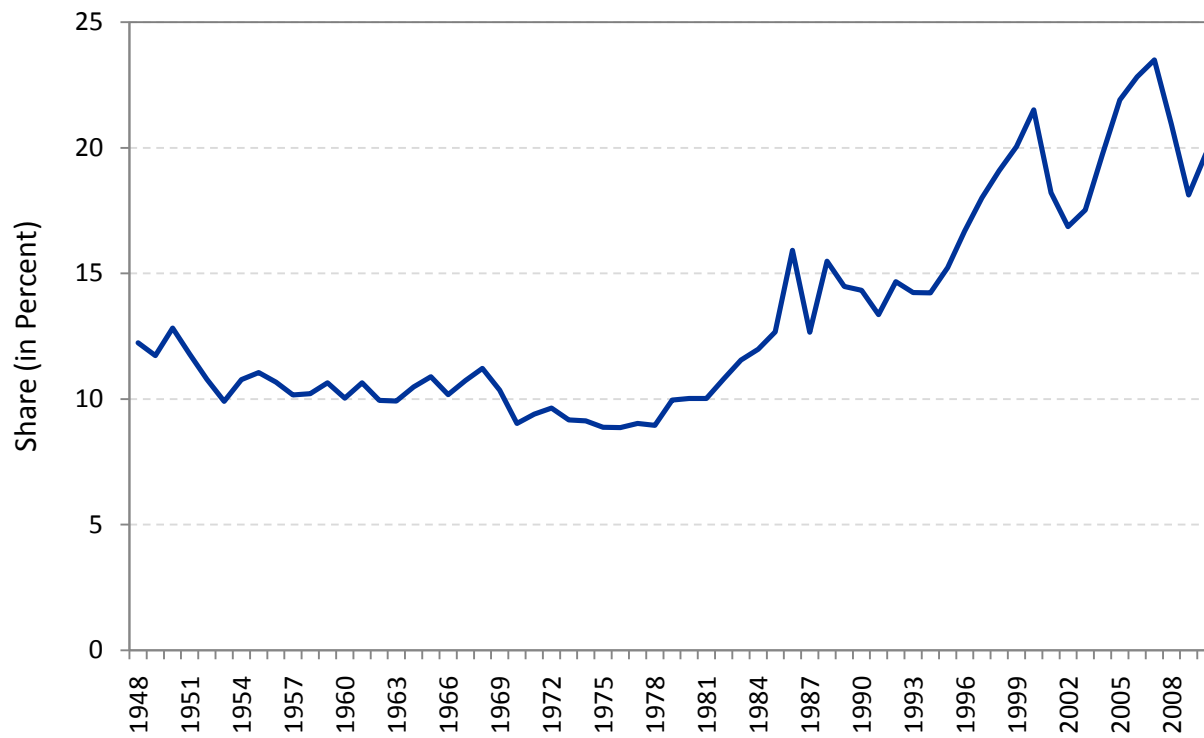
Source: Congressional Budget Office, *The 2012 Long-Term Budget Outlook*.

Figure 7
Real GDP Per Capita



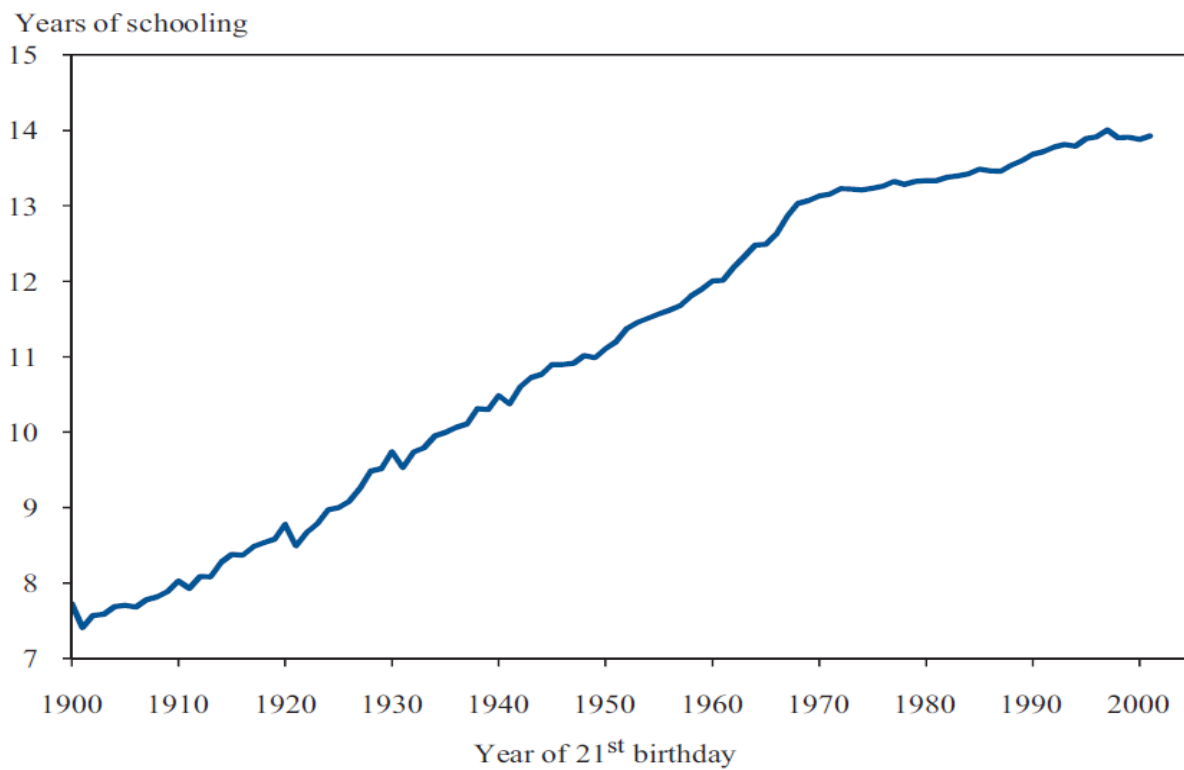
Source: Bureau of Economic Analysis, National Income and Product Accounts.

Figure 8
Share of Income Going to the Top 1%



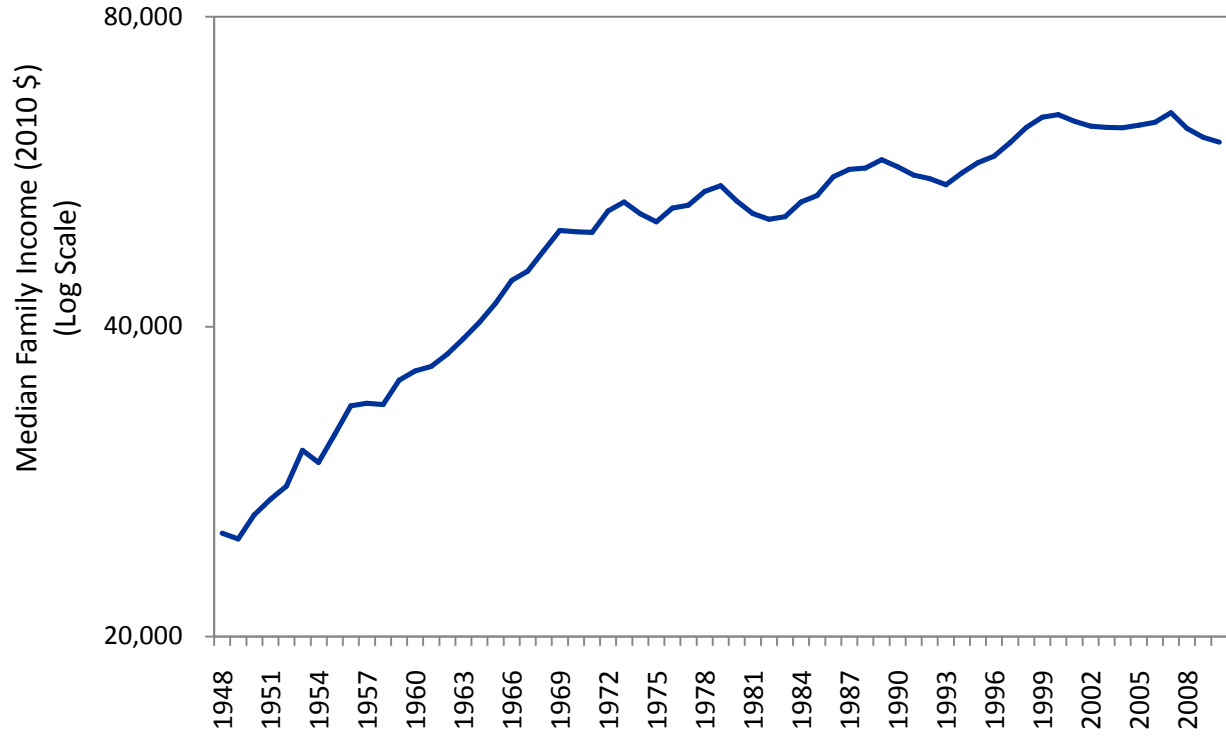
Source: Piketty and Saez, "Income Inequality in the United States, 1913-1998."

Figure 9
Mean Years of Schooling by Birth Cohort



Source: Goldin and Katz, *The Race Between Education and Technology*, as updated in the *Economic Report of the President, 2010*.

Figure 10
Median Family Income



Source: Census Bureau, Current Population Survey, Annual Social and Economic Supplement.

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