**The Economic Crisis – One Year Later**
**Forum for the Future of Higher Education**

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## Outlook for the Economy

**Panelists**

**Gary Burtless, Brookings Institution**

**Karen Dynan, Brookings Institution**

**Alice Rivlin, Brookings Institution**

**Charles Schultze, Brookings Institution**

**Barry Bosworth, Brookings Institution, moderating**

## Introduction

**MS. DYNAN:** In this session here we're going to dig in a little more deeply into the outlook for the economy. What we have here is we have an all-star team of Brookings experts on the economy. As I'm sure you know, the unemployment rate is the highest it's been since the early 1980s. In percent terms, the percentage decline in employment is actually the worst we've seen since the Great Depression. And on top of that most forecasters are projecting a pretty moderate rate of recovery relative to historical experience after a downturn. The average forecast is around 3 percent. So that's just a little bit of background on this issue.

Our speakers today will be myself and, to my left, Alice Rivlin, who is a distinguished member of the Brookings Economic Studies Program. She has done a ton of stuff in the policy world. I actually met Alice when she was vice chair of

the Federal Reserve Board, but she was also the founding director of CBO. She was director of OMB. She's an expert on many things, including fiscal policy. And in fact, she has just been appointed to the President's Bipartisan Commission on Fiscal Responsibility.

And to my right I have Gary Burtless, who is an expert on all things related to labor markets and the economy more generally. And we also have at the end of the table Charlie Schultze, who is an expert on the business cycle, as well as a former chairman of the President's Council of Economic Advisors.

So we're going to start with Alice.

**Alice Rivlin**

**MS. RIVLIN:** Thank you very much, Karen. With all this stuff about distinguished economists and so forth, I think one should remember that economists did not foresee this catastrophe. And so you should take anything we say with a large grain of salt.

A year ago, we were staring into the abyss and people were asking, is this going to be another Great Depression? We now know that it is not, and that's quite reassuring. I think the reasons that it is not — and it wasn't reasonable to think that it would be — are that the policies that were put in place as a result of the Great Depression of the 1930s really helped us in this one. They did not help in the 1930s. They didn't come into place fast enough. Unemployment insurance was mentioned earlier. Didn't have that in the '30s. Didn't have deposit insurance, so there was this huge run on the banks. This time we didn't bank runs. People didn't go rushing to their community bank

to draw their money out because they were afraid it might fail. They knew it was insured.

Social Security. This time we had a floor holding up the incomes of millions of people who are on Social Security. Maybe their pensions — if they had private pensions — went down, but the Social Security check kept coming every month. And that was not true in the 1930s. And the government is bigger. We may bemoan that from some points of view, but the good side is recessions are counteracted by the sheer fact that the income tax falls off rapidly. People don't have to so much tax out of their declining income. So there's a huge counteracting force. And that helped a lot.

So it's not the Great Depression, but it's very bad. We have very high unemployment rates. The GDP has begun to grow again and that's good. A year ago a lot of us were skeptical that the forecasts of returning to positive growth by the end of '09 would actually happen. I was one of the skeptics, but they did. Score one for economic models, I think, on that. And there's hope that growth will strengthen over the coming period. But unemployment is going to come down very slowly. Employment, jobs created, hasn't begun to rise yet. We keep saying every month as the numbers come out, maybe next month we'll have positive growth in payroll employment. Let's hope. The best that can be said at the moment is that the declines have been getting smaller. But that's not great.

The reasons for the expected slowness have been discussed. We had this huge overconsumption, overborrowing. We don't want to go back to that. And so consumption will rise slower. Now, that doesn't mean it won't rise. And savings will be higher. So the prospects of job creation out

of this deep hole are not so great.

Our government didn’t see this financial crisis coming. And it was the financial crisis that caused the depth of the recession. There’s much fault to go around, including the regulators and the forecasters. But once it happened the government functioned, I think, very well. The Federal Reserve rushing in to rescue the banking system. Nobody wanted to do that, but it was necessary. And the government passing the stimulus packages, which have helped. There is no doubt about that.

## Implications for the Federal Budget

But I want to turn to the federal budget implications of all of this because as you look forward on the federal budget — and also on state budgets, but let’s stick with the federal for the moment — as you look forward on the federal budget, the news is not just grim; it’s really scary. And the reason it’s scary predates the recession and the fiscal crisis. If I had been making this speech two or three years ago — and I did make such speeches, as did most of the people on this panel — I would have said we’re in an unsustainable budget situation. We have an aging population and a very rapidly growing cost of medical care per capita. And those two facts together mean that federal spending over the foreseeable future, but especially in the next couple of decades, is going to rise faster than the economy can possibly grow. That’s largely because of the medical programs: Medicare and Medicaid. And it’s largely not because of the aging, although that contributes. It’s because health care spending per person has been going up so fast. And we don’t yet see an end in sight.

So the projections of federal spending, largely driven by health care and to a lesser extent by Social Security, have been scary for a while. We knew this was coming. We knew that people were aging and had been born in large numbers, and we knew that medical care spending was rising. That’s not new news. The basic situation is the same as before the crisis — federal spending will rise faster than the economy is growing and tax revenues at any set of tax rates grow about as fast as the economy grows, and there’s a widening wedge there that has to be financed by borrowing. What has changed in the last couple of years is not that set of facts. Those were there before. It’s the fact that the response to the recession — partly the automatic response and the fall-off of revenue, and partly the policy response in rescuing the banking system and putting in place the stimulus packages — has increased the debt so much. So we start from a higher level of debt.

If we’d been talking about this two or three years ago I would have said it’s a scary situation looking forward and we have to do something to reduce the rate of growth of federal spending and/or to add new revenues. And one of you might have said, yeah, but our debt as a percent of GDP, that’s not so high. It’s 37, 38 percent. Not such a scary thing. Many countries have higher debt than that. Right. But that was then and this is now. And now our debt to GDP ratio is more like 60 percent and rising as you look forward through 80 to 100 percent if nothing is done. So, obviously we’ve got to do something.

What are the choices? This new commission that Karen alluded to is supposed to get on top of this problem, but the choices are very limited. They have to include

slowing the growth of entitlement spending, especially Medicare and Medicaid. I think the new bill actually that just passed will help do that, but not nearly enough. We've got to go way beyond that. We are slowing the growth. But the question is can we slow the growth enough so that the federal health programs are not growing that much faster than the GDP and therefore the revenues to support them? The mandate of this new commission is try to figure out what to do and bring it to the Congress. I'm hopeful that we can produce a partial solution, but don't hold your breath. This is going to be a difficult problem. And it's going to impact all of you in the sense that there isn't going to be a lot left over for anything. Although the problem doesn't come mainly from discretionary spending, the solution will come partly there. It's going to be hard on higher education programs. It's going to be hard on states. And it's not over yet.

**MS. DYNAN:** Thanks, Alice. We're going to turn now to Charlie. And Charlie has a handout, so I hope everyone got it. Great.

**Charles Schultze**

**MR. SCHULTZ:** I'm going to mainly address the economic output in three time periods: right now, in the medium term, and in the longer term. And at the end I've got a small elaboration on what Alice just said.

The economy as measured by national outputs clearly turned the corner. And the prior quarter was a pretty big jump of nearly 6 percent in GDP, and it's currently rising nicely, too. But a large part of that, about two-thirds in the fourth quarter, was due to restocking of inventories, which is not going to last.

## A Slow Recovery

There are a number of reasons to think that the economy over the next two to three years may have to swim upstream against the current, making it less likely that the initial spurt from inventory restocking will set in motion a recovery of the normal vigorous sort.

And there are there reasons for that, at least. First, the $4.5 trillion dollars' worth of losses from soured loans that have already or shortly will be suffered by U.S. and European banks and financial institutions, combined with the rising commercial mortgage defaults and a newfound reluctance of most financial institutions to take on risks, is depressing the availability of credit. Right now the recession has lowered the demand for credit so the pinch isn't felt so strongly. That's a bad way to get out of a pinch, but in any event it isn't. But the lower availability of credit that comes out of this in the next two to three years will significantly pinch the supply of credit needed to finance a robust recovery.

The second reason for a possibly sluggish recovery is the fact that over the last two years the net worth of the American household has fallen some $7.5 trillion, housing prices and stock prices. And it's likely to keep the growth of consumer spending at or below the growth in wage and salary incomes, which themselves, despite the economic recovery, haven't been rising very rapidly.

And then there's a third problem, the abnormally large fall in employment during this recession and recovery. Employment normally falls less than proportionately with GDP. Employers are slow to lay off because it's expensive to fire and then have to rehire workers if you think that sales

aren’t likely to rise very much in the future. To the extent the current abnormal behavior continues, the sluggish growth of household income will tend to reduce the speed of recovery.

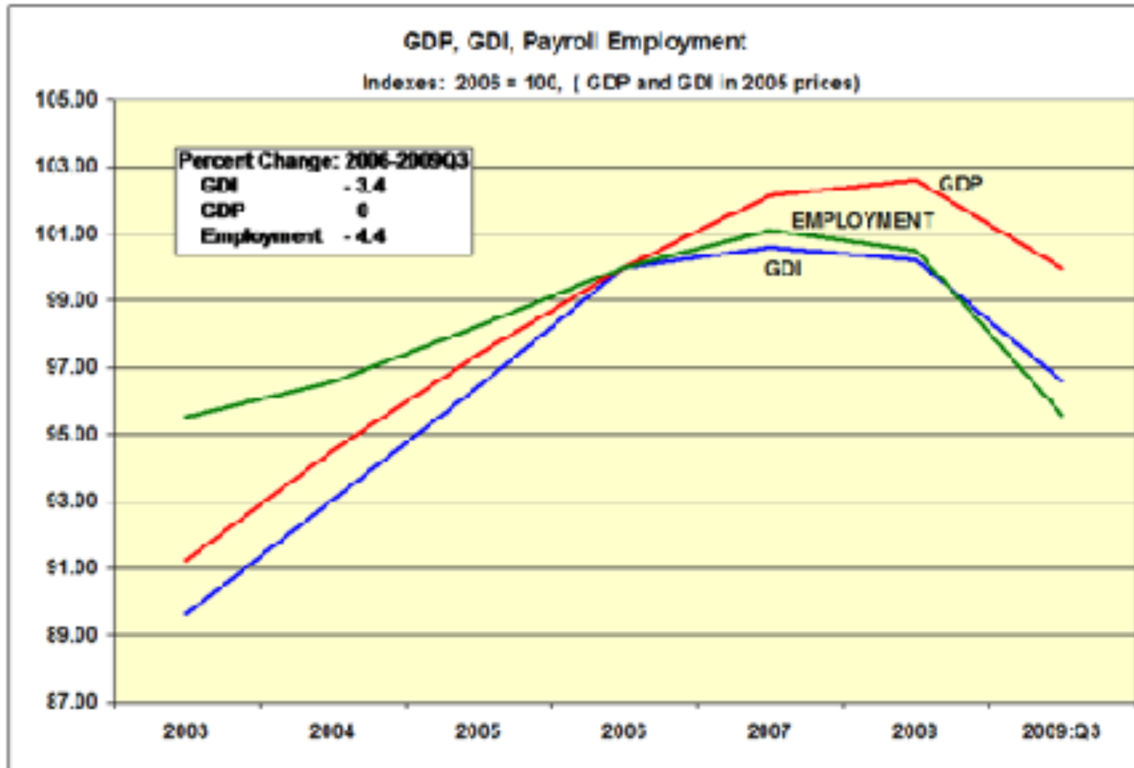
**GDP vs. GDI**

Now, there’s another explanation that could give us a different kind of reason for the apparently weak behavior of employment. The official statistics may have unwittingly been understating the depth of this recession. And now I’m going to have to do a little bit of the economists’ equivalent of inside politics, but stay with me. There are two ways to measure output in the economy.

One, GDP, gross domestic product. You sum up the dollar value of all sales of domestically produced goods and services to consumers, housing, construction, government, et cetera, and adjust for inflation and you get gross domestic product. But for every dollar of production — and you can think about this longer after you leave, you’ll see it’s true — for every dollar of production there’s a dollar of income created: wages, corporate profits, self-employed income, and so forth. And you sum them all up and adjust for inflation and you should get the same number.

But in a $14 trillion economy, statistics collected to measure production income aren’t perfect. And you almost always get some discrepancy between the two. Theoretically, identical numbers. Usually not big, but recently the size of the divergence in measuring the depth and the fall in GNP has been abnormally large.

# GDI vs. GDP




If you look at Chart 1, the red line is the measure of GDP. These are all indexes set so they're at 100 in 2006. The red line is GDP, the product side, which is what you normally get when you read the papers and what the Commerce Department stresses. The blue line is gross domestic income adjusted for inflation. That's the income side. And finally, the green line is employment. To the extent the income side has recently been a better measure, we've had a much larger recession than we thought.

If you look at the little box over on the left, from the year 2006 to the third quarter of last year, which is the latest point I can get the number on gross domestic income, over that period, first GDP rose sharply in 2007 and

then fell to the third quarter of this year. GDI, gross domestic income, rose much less in 2007, the peak of the boom, and then fell more during the recession than GDP. Between the two periods the GDI fell 3.4 percent. The GDP didn't fall at all over that span. It had just lost what had been made up in the boom of 2007.

Employment, as you'll see, has come down more than both of them. However, on the surface at least, it comes closer to following the GDI output than the normal measure. And that's one other reason why you might think that in this recession the GDI is a better measure. And that suggests that we've had, as I say, a much larger fall and have further back to go to get to normal to get employment up.

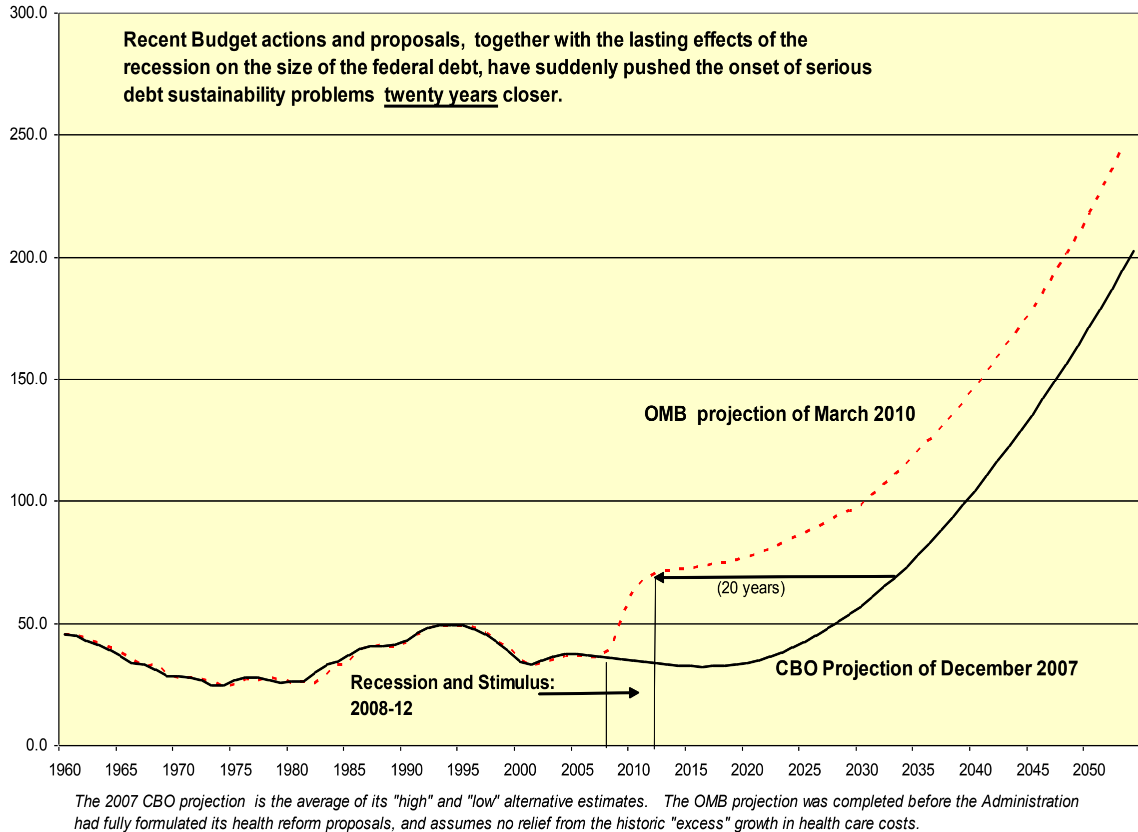
Now, so far I've talked about the features in the economy that could well generate a slower than normal economic recovery over the next two to four years. It's not a cinch, but it's better than an even bet.

## The Federal Budget Deficit

So now I want to turn — because the two will come together — to a different kind of problem associated with the gloomy long-term outlook for the federal budget deficit. I'm just elaborating a little bit on what Alice said.

As Alice pointed out, for years budget experts have been warning about the long-run fiscal threat facing the nation, and about what would happen if major changes in taxes and expenditure policy weren't made and something weren't done about spiraling health care costs. But all along both politicians and the general public felt that while this was a possible threat from economists and budget gurus about a relatively distant future, and even if real, there was plenty

of time to begin thinking about unpleasant steps to deal with it. Well, over the last several years, the future has suddenly become a hell of a lot closer.



*The 2007 CBO projection is the average of its "high" and "low" alternative estimates. The OMB projection was completed before the Administration had fully formulated its health reform proposals, and assumes no relief from the historic "excess" growth in health care costs.*

The bottom, black line on this chart shows the Congressional Budget Office estimate made in December 2008 about the long-run budget deficit problems. This is the debt side of it, the debt that accumulates, the debt-to-GDP ratio. Now, there are a tremendous number of assumptions you've got to make to do these long-term numbers. So what I've done is take an average of what CBO gave us at the time of an optimistic and pessimistic outcome. And that's going up so fast that even a big wedge of possible outcomes around it still makes it a problem.

The top line is the OMB long-term projection published February the 1st of this year. It reflects the permanent effect on debt-to-GDP ratio from the recession and the stimulus and the new administration's various tax and spending proposals. Now I'll just throw this in: When OMB did it, they didn't really have the administration's health care in front of them. So they just assumed health care costs would go up at the excess rate they've been growing in recent years. And that adds greater uncertainty about the precise magnitudes because some aspects of the health reform legislation are aimed at bending that curve down. On the other hand, it's very difficult to predict whether the reforms are going to be successful or not, even the promising ones. They won't go into effect for a while, and even if God were running it I don't think he could bend that curve down much. So that's greater uncertainty.

In any event, the main message of that chart is that in the last two years the formerly distant budgetary threat has moved a full 20 years up. That top line with the little arrow on it shows you how much closer that 2008 CBO projection is now. And now all the legitimate excuses for not doing anything really are just fading very quickly. Financial markets haven't yet reacted with higher long-term interest rates to this radical shortening of the time period before accelerating debt-to-GDP ratios go into effect. But policymakers will continue to ignore the so-called long-run deficit and debt problem at their peril.

And so at a bare minimum, if a prolongation of the employment problem — which may continue for a while slowly edging down, but not by much — if that continues, then further stimulus measures will have to be undertaken. It

would be crucial to legislate simultaneously towards deficit reduction, but schedule it to take effect several years down the road. And, ideally, you would do that even if you didn't have an additional stimulus program.

I've got my own pet way of doing it, but unless somebody wants want to bring it up in the discussion, I'll let it go.

It's politically impossible to do something in a hurry. Well, luckily with Alice as a member of the recently formed committee on dealing with the deficit, I know at a minimum that group is going to be very well informed of the urgency rather than the distance to the problem.

**Karen Dynan**

**MS. DYNAN:** Okay. I'm going to speak next. So we've all been focusing on issues that are near and dear to us. I'm going to dig in a little more deeply on household financial conditions right now. And this actually is my favorite topic. It's an area in which I've done research on longer term trends in income volatility at the household level, and trends in financial opportunities and what they imply. But I'm going to stick to the near term since we're talking about the outlook right now.

**Household Financial Conditions**

So to build on what Charlie was saying, everyone is talking about the prospects for consumer spending right now. It's not surprising. It is the largest, single component of our nation's output. It accounts for more than two-thirds of aggregate demand. It doesn't typically lead us out of recessions — what typically happens is that other parts of the economy spur the growth and then consumer spending

expands as income starts to expand with a broader recovery. And it is certainly the case in this episode that consumer spending is not going to lead us out of the recession and into the recovery. The first reason for that is the extremely weak state of labor markets, which has depressed growth in wages and salaries.

Just to give you an idea of the magnitudes, in 2006, real wages and salaries expanded 6 percent, and then that dropped to 2 percent in 2008. And then last year, in 2009, real wages and salaries actually shrunk more than 3 percent. So that's been part of the issue.

I think the good news is that after-tax income broadly measured, so that's including other components of income, like transfers, and also taking into account taxes — so after-tax income hasn't decelerated by nearly as much thanks to the automatic stabilizers and the fiscal stimulus. So, for example, after-tax income actually increased in 2009. It was a weak growth, an increase of 1-1/4 percent, but it was still growth.

Now, if you look ahead, you know, we are looking for a firming of labor markets. That does mean that wages and salaries should stabilize and they should begin to grow again, even if it's going to be a weak growth rate. But in the near term we can't expect any more significant support from fiscal measures. Charlie and Alice both talked about the long-term prospects for the budget, and I just want to bring up a short-term issue, which is just that current law calls for the expiration of several important tax provisions at the end of this year — the 2001 and 2003 tax cuts, the fix to the alternative minimum tax, and the Making Work Pay tax reduction that was part of last year's fiscal stimulus. Under

current law, those things are all going to be expiring by the end of this year. Congress is not likely to let that happen because the economy is so fragile right now. But that just tells you that if they let those things stay in effect, it really limits the prospects for adding anything on top of that that would support after-tax income.

So, that’s the weak prospect for income. Now, consumption can grow even if income is growing weakly if people choose to spend more and save less out of the income they have. But that’s not likely to happen either. And as Charlie said, the main reason for that is wealth has declined so much. So even though there’s been some recovery in stock prices and there have been some glimmers of improvement with respect to house prices, both stock and house prices are still 25 to 30 percent below their peaks a couple of years ago. And there’s something called the wealth effect, a fairly robust relationship between the saving rate and wealth changes that’s been seen historically. So how big is the wealth effect? The saving rate hit a low of 1 percent prior to the recession. Not surprising — households were seeing these big capital gains and they didn’t feel like they needed to save as much. The savings rate has since been coming up. It’s up to between 4 and 5 percent right now, but given the historical relationship between saving and wealth, we’re likely to see that saving rate increase further, to something like 7 percent based on wealth effects alone if historical patterns hold. So that’s going to tend to damp consumer spending.

And there are also reasons to think that saving might even rise further than what’s implied by wealth effects. We might see an increase in what’s called

precautionary saving. That’s the term economists use to refer to what you probably think of as saving for a rainy day. It turns out that our climate is rainier than we thought it was: a lot of households perceive a more uncertain future than they did previously. So it would be natural to see an increase in this precautionary saving. We don’t have evidence as to how big that increase should be, but there is certainly anecdotal evidence. People talk about how the cohort from the Great Depression was more prudent going forward after the Great Depression than it had been previously. And if you look at surveys, for what they’re worth, you see some evidence of household belt tightening.

**Household Deleveraging**

Now, this all brings me to the question of household deleveraging. Borrowing is the opposite of saving. It’s just de-saving. So you can think of it much like the influence of saving on the outlook. Less borrowing is like more saving, so it’s also dampening consumer spending. We’ve seen household debt shrinking in what’s a fairly unprecedented way in recent years. Mortgage debt has been shrinking for about two years now and other types of household debt — consumer credit, auto loans, et cetera — have been shrinking for about a year now. In terms of what to make of this, a good part of the decline is actually due to defaults. According to my calculations, based on charge-offs, maybe half or three-quarters of the decline that we’ve seen in outstanding debt of households is related to households defaulting. This does count as deleveraging: it gets the debt off households’ balance sheets. But it’s a fairly violent way to do it. I mean it has disruptive effects on one’s credit

score, not to mention your lifestyle if you have to lose your home.

So that is part of the deleveraging. But it's also true that households are borrowing less. Part of that is supply. We know from surveys of financial institutions that bankers have tightened terms and standards a great deal. We know that some households are just cut out of credit markets altogether. So if you qualify for a government-supported conforming loan, that's great. You can get a mortgage loan. If you need a jumbo loan, something that's too large to be financed by Fannie and Freddie, then you're going to find it harder to get a mortgage. And if you want a nonprime mortgage, it's going to be extremely hard to get that loan unless you qualify for an FHA loan. So there is a supply side to the lower borrowing, and there's also a demand side, as Charlie mentioned, when people are buying less they need to finance less.

Looking ahead the big question right now is how much more deleveraging are we going to see because that really bears on how consumer spending is going to be going forward. So starting with the supply side, we do expect the supply of credit to remain tight for a while now. Part of that is it's normal. It's a normal reaction to the higher credit risk out there when job loss is so high, but I think banks themselves have changed their behavior. They understand now that there's more uncertainty than everyone thought there was during the boom years of the last decades.

In fact, there is survey evidence. They've gone out and asked banks, when are you going to return lending conditions back to where they had been historically? And particularly for the riskier households, a lot of banks are

saying, not in the foreseeable future.

And then the other side of that is that part of the deleveraging is going to be by choice. Again, it's like the greater precautionary saving. I think households now realize that too much debt was taken on during the credit boom and that that's not optimal from their point of view. And in fact, it's really hard to quantify because we just don't have the data. What you really want to know at the tails. What about the households that had the most debt? What's happened to them now? I can't quantify it scientifically, but it does look like if you look at either debt payments relative to income, which is one way to think about whether people have too much debt — that is still fairly high. Another way to think about whether people have too much debt is to look at debt levels relative to assets. That's a traditional measure of leverage. And there, even though debt has declined by a whole bunch, asset prices have come down so much that the ratio of debt-to-assets is really high. It's much higher than we were a couple of years ago. So both of those measures tell you there's more deleveraging to come.

So greater saving and less de-saving, are going to slow the recovery. I do want to point out that there is a silver lining, and several people have already alluded to that today. And I think this is relevant to you as university administrators since you probably take a long view in many contexts. So over the long run, more saving, less debt. That's going to leave households in a more solid and sustainable position. And that's going to be good for them. It's going to be good for longer-term economic growth.

So with that let me hand things over to Gary.

**Gary Burtless**

**MR. BURTLESS:** When this group met 13 months or so ago we talked about the stimulus. I'm going to talk about the stimulus in a minute, and I also want to talk about the impact of a very weak job market on your customer base, which is the student population — people between 18 and 30 or so. A year ago or 13 months ago, Congress was very near passing a stimulus bill. The stock market had slumped and declined in value about 50 percent over the previous 14 months, and it was still declining. House prices were also falling, and they had been in decline for the previous two and a half years. About $20 trillion in household net worth had been lost.

Employment was falling 600,000 to 800,000 per month when we met. State and local finances were in the toilet, to use an impolite phrase. And I think few people had a hundred percent confidence that the main private financial institutions of the country were going to survive. There was a lot of doubt about their solvency. A couple of weeks later in this very room, Larry Summers came over to talk to us, and bank solvency was clearly on the Administration's mind.

Okay, it is now 13 months later. The stock market is up about 60 or 70 percent. House prices are slowly rising. Wealth is now only off $10 trillion instead of $20 trillion. Payroll employment is either rising slightly or falling slightly, depending upon which recent month you look at. The unemployment rate is falling. If you ask people in a household survey, "Are you employed? Were you employed last week?" the number of people who report being employed has been rising about 350,000 a month since the beginning of the year.

State and local finances are still in the toilet,

but certainly relative to where they would have been in the absence of the stimulus, they're quite a bit stronger. Most people now think that big financial institutions are going to survive. It's true the unemployment rate is much higher than was predicted by private forecasters a year ago. And I think the slump in employment has been much worse than the Federal Reserve Board or the Council of Economic Advisors or the Congressional Budget Office predicted.

## **Public Opinion of the Stimulus Package**

You would nonetheless have to say the outlook looks a lot sunnier in March 2010 compared with February 2009. But the odd thing here is that the public is broadly under the impression that the Administration's economic policies have failed. Early in the fall, CBS and the *New York Times* did a survey asking people what they thought of the stimulus program. A clear majority thought that it had either hurt — that was the most common single answer — or it had failed to help. Three-quarters felt that way. Early this year, in January, I think, CNN conducted a poll and asked people how they thought the stimulus money had been spent. Three-quarters responded that half or more of the stimulus dollars had been wasted; 45 percent thought that most or nearly all of the stimulus dollars had been wasted.

There are some implications of the public's views. It's going to be much harder for Congress to pass another stimulus package. Members of Congress read these polls, just as I do, and probably much more attentively than you do and most newspaper readers do. They read them. At the end of last summer, when most private economic forecasters already were saying the economy was growing based on current economic

statistics, I was up on Capitol Hill. I spoke with Congressional staffers, and they said, “Oh, this is just terrible. We can never do anything called stimulus again.” Congress can consider what are called “Jobs Bills,” but let’s be clear: It would be very tough for the President to ask, or for the Democratic leadership in either House to ask Congress to pass another “stimulus” package.

An exception would be extra spending for extended unemployment benefits and COBRA [health insurance] subsidies, and possibly some smaller-scale handouts to politically well-connected groups, like the aged. One popular proposal is to give everybody collecting Social Security an extra couple of hundred bucks. Personally, I find that very bizarre. Of all people who have been protected against the effects of the recession, Social Security recipients have been protected the best. You would think if you had a few billion dollars to hand out it would be to people who have actually suffered a great deal in the recession, but that is not always the prevailing logic.

This means there may be some small-scale and possibly pointless programs, like hiring subsidies. I don’t mean that in general they’re pointless. I mean that the particular one that the Senate just passed and the House apparently has approved is not a very well-structured one to achieve the goals of the politicians who sponsored it. But we’ll get that kind of measure because Congressional Members can say they have achieved bipartisan agreement to proceed along these lines. But I don’t think one should expect that we will see an upwelling of Congressional sympathy for the situation of higher education, in particular, or state and local governments, in general.

The recession has not really so far been so bad for state and local employment and, in particular, for employment in the education sector of state and local government. I checked the statistics this morning before coming down here. In higher education there has been no loss of employment. In fact, year over year employment in that sector has increased. It might not be a spectacular rate of increase, but it certainly is far better than what's happened in the rest of the economy, with the exception of the health care sector.

I think, given the way this has been managed, it'll be many months before we know for sure from GDP statistics and from employment and pay statistics whether total pay in the education sector has increased or declined. I suspect what's happened is that state and local governments (and their higher education institutions in particular) have reduced spending on pay by asking people to take furloughs. Unlike the private sector where an employer's loss in ability to pay workers takes the form of firing them permanently and having big reductions in staff, in state and local government and in publicly supported higher education, staff have been forced to take unpaid days off. Based on the experiences of my friends who teach it seems unlikely furloughs have had much influence on how much work they do, but they're certainly getting less pay over the course of the year.

## Higher Education and the Stimulus

Let me briefly remind you what the stimulus did for higher education. The first thing it did, and probably the most important for public institutions, is something that was not done in any previous post-war recession when we had a stimulus program. The 2009 stimulus package gave massive

amounts of aid to state and local governments. So far, this element has been the second largest of the four main components in the package. The biggest component is tax reductions to households. About 45 percent of the total stimulus has consisted of tax cuts to people, making it all the more surprising that Americans would say that most of the money in the stimulus has been wasted. Almost half of it went to them directly as tax reductions. Another dose of stimulus paid for longer unemployment benefits and subsidies so that the unemployed could continue their former employer's health coverage. But let's leave that aside.

But the second biggest component of the stimulus package gave aid at an unparalleled level to state and local governments. We've heard thank you's from almost no governor, with the exception of Gov. Schwarzenegger. He's the only guy who has come to Washington to say "Thank you." We have had some people come to Washington, or tell us from their state capitals, "I don't want to take this stimulus money." That particular governor happened to be the governor of a state with 12 percent unemployment. But again, let's let that slide.

The 2009 stimulus package provided improved generosity in the student aid programs in two forms – first, as direct student aid and more generous loan programs, and second, as a bigger tax subsidy for people who are helping their kids attend college. We also ramped up by a sizeable amount extra R&D spending that is going mainly to higher education, both public and private. The extra funds are channeled mostly through NIH, but to a lesser extent through NSF. The federal stimulus package gave funding to capital projects — laboratories, college buildings and so forth. The

capital spending is going to be spread over a long time. It looks to me as though the student aid improvements are going to continue; I don't think that they're going to be curtailed. But the other elements, in particular the aid to the states, will end shortly. I think it's going to be a tough case for the Administration or the Democratic leadership to argue that this kind of fiscal relief should continue. It should be continued, but recall that no one said, "Thank you."

It is amazing that people think that the money that went to the state and local governments is wasted. The fiscal relief has meant their Motor Vehicle Department is open a couple of more days a month than otherwise it would be. It means that it's easier to get a wedding license. It means the trash may be picked up a little bit more frequently. Perhaps a few more cops are on the payroll. Firemen are on the payroll. The classrooms in schools and in public universities are not facing such a shortfall in funds as they otherwise would. But the public's verdict so far on the stimulus package is that the money has been largely wasted.

**Higher Education Enrollment and Payoff**

So much for your public sources of financing. What about your customer base? Your customer base is your student body. I checked to see what we know about enrollment. Unfortunately, the Census Bureau takes a survey of what people are doing every October, and they haven't told us yet what was happening in October 2009. We're still waiting for the report, so that means the most recent report we have is for October 2008. Unfortunately this was the very beginning of the severe part of the crisis, the point when everybody

recognized this was a disaster for the economy. It's very doubtful that enrollments at that stage reflected how bad the job market subsequently got. Because, in fact, the unemployment rate hadn't risen by very much through the end of summer 2008. Most of the damage was done after September 2008.

Based on past experience my guess would be that for colleges and universities the biggest enrollment impact is on junior colleges. These seem to be very sensitive to the state of the economy and not in the direction that some people might think. As the job market gets worse, demand for enrollment in junior colleges tends to rise. There's much smaller effects like that on four-year colleges. I've never seen any analysis of what happens to graduate education. It may be cyclical, but I haven't seen an examinations of that. It certainly is a good time, if you want to improve your credentials, to enroll in college.

Every once in a while I get a question from someone who says, "Look at how high the unemployment rate is for people who have university educations or graduate degrees." My response is "You're not making the right comparison. The right comparison is not how much higher unemployment rates are for new graduates today compared with the past. The right one is the unemployment rate of college graduates relative to that of people who don't have as much education. And that comparison shows unemployment is a whole lot better for the well-educated than for the less well-educated. Period.

The payoff to going to school, by my reckoning, is just as big as ever. And if you care about being employed, especially steadily employed, the payoff is probably even bigger than it was in 2007. I think there probably are enough

smart people in the United States between the ages of 18 and 35 who recognize that, but I still don't know what today's enrollment numbers look like.

And one issue we talked about a year ago is that if you take a broad look at the last 25 years, it looks as though there is an important split in the American population. There is a split between those who seem to understand what the implications of the returns to education are for their futures, and the people who don't recognize those implications. And the first group contains a disproportionately large share of women. The second group consists disproportionately of men. Men, as far as you can tell from enrollment statistics, look like they don't understand that the payoff to staying in school or going further in school has improved greatly. If there's any group in the industrialized world that has not gotten that message, it seems to be men in the United States. Perhaps you have better explanations for that phenomenon than I do.
The customer base of higher education should be growing, based on what we know at this moment, in spite of the fact that many new graduates are having an abysmal time getting jobs in the labor market. I personally think graduates' outlook will improve because I'm confident that the American job market will improve. The right way to look at the world if you're between 18 and 30 or so is, what's the world going to look like over most of my future life? And most of their future life is not the current recession. Even if the current recession is painful and long, most of their life is the life after that recession is over.

**Discussion**

**MS. DYNAN:** Thanks, Gary. We have some time for some

questions, so if you just want to raise your hands that would be great.

**SPEAKER:** Well, this is for Alice and Charles.

I think what you told us is that compared to the Great Depression we used the tools, the Keynesian tools, in our toolkit and they worked. And I think what you also told us is we've used those tools up and they aren't available to us right now — increasing the deficit, negative interest rates, and so on. And there's this deficit chart, right? So you haven't talked about any other threats. For instance, the exchange rate, the value of the dollar. You've described a kind of sluggish, fragile recovery. If something else happens and you have no tools, what do you expect to do?

And I guess for Charles, any time you see a big increase in the deficit you know what's going to happen, which is you'll inflate it away. That's what governments do. They inflate away. When is the big inflation going to show up that will solve that problem?

**MR. SCHULTZE:** The one good thing is that, to overstate it, the chances in the medium-term foreseeable future of rising deficits giving us inflation is pretty close to zero. The inflation is going to occur because we're overheating the economy.

**SPEAKER:** What if there's a run on the dollar?

**MR. SCHULTZE:** There are two things. A gradual decline in the dollar would be one of the best things that could happen to us right now. Maybe not for other countries, but it would stimulate our exports. If it gets to be a run on the dollar and disorderly and sets off a new kind of financial panic, well then, all bets are off. But I think the realistic worry is that the deficit problem could soon begin

to give us increases in interest rates, not so much because people are fleeing from the dollar. It's not going to be the interest rates going up and up and nobody will lend to us — you know, this is the way the world ends. The world ends, not with a bang but a whimper. And it'll be a problem for the strength of the recovery, but I don't see that in the near-term future.

Now, the charts I showed you are absolutely impossible because we'd never get all the way up there. So somewhere along that line, if we wait, you'll be right. But I don't think that inflation is the big problem. If something can't go on, it won't. My point is that what makes the biggest difference in the world is *how* it won't go on. And the whole thing Alice and I were talking about is to find a way of what they call a soft landing on it. We're not going to get rid of the problem quickly, but we can begin to make an impact. And that's what's important to anybody who is buying 20- or 30-year bonds. It's not so much next year or the year after that, it's what's down the pipe.

**MS. RIVLIN:** I agree with all of that. Let me just put a little gloss on it maybe.

I think you can think about alternative futures and I am reasonably confident, as Charlie seems to be as well, that we will do the politically difficult things that are necessary to reduce the rate of growth of federal spending, which means mostly reduce the rate of growth of health care spending. And that we will also increase revenues, because we're going to have to, with a value added tax or some other new source of revenue. And if we do that over the next few years we have one thing going for us, which is the world apparently believes we will. The confidence in the U.S.

Treasury as the safest security in the world has continued. During the financial crisis caused by our profligacy, our banks, what did the world do? They bought U.S. Treasuries. And the interest rates came down. Rather remarkable.

So we've got a lot going for us. But there is the possibility that our political system simply does not function well enough to do this, and that we go on trying to borrow over a long period at these unsustainable rates. And then what? And then that's the disaster scenario: interest rates spike, the dollar plummets rather than coming down gradually, and we find ourselves in the Greek situation.

The one thing, and I agree with Charlie, that people keep saying — they learned somewhere in school that once you increase the money supply the inflation inevitably follows. But right now we have such slack on our economy and in the world economy. And there are so many other alternative sources of supply and skilled labor that –you can cross the idea of runaway inflation off your list of worries.

**MR. SCHULTZE:** Pat Moynihan had a good phrase for that. He said, that fear is 99th on my list of fears, right after the fear of being eaten alive by piranhas. (Laughter)

**SPEAKER**: Charlie, I'll bite. You said there was a solution.

**MR. SCHULTZE:** It's not a solution. It's one step you could take. I think the value added tax in the longer run may be needed.

But while I'm a great admirer of Obama's, one of the things he did that I think was absolutely stupid is define the middle-class as ending at $250,000. He has proposed, and my guess is he may get his way, to extend the Bush tax cuts for everybody up to income of $200,000 to

$250,000, depending on whether you're single or married. Now, there's no good way of doing this, but one possibility to extend that tax cut the way he wants to is to not boost taxes up for people up to $250,000 for 2 to 3 years, and then move the income limit gradually down to something more reasonable, like $50,000. Because there isn't a ghost of a chance that you can do anything about this budget deficit telling people earning less than $250,000 you're not going to get touched. So this is a way of edging into that and not at the same time doing something to harm the recovery. It's also probably politically impossible, but that's a minor problem.

**MS. DYNAN:** Okay.

**SPEAKER:** Thank you. Just two questions — one, a little more targeted and one, a little more global.

The targeted one is, we keep talking about the Health Care Bill reducing the federal deficit going out. And that certainly is the estimate. But isn't that really the case because of the tax increase provisions in it? So it's not really a step in net-net lowering of federal entitlement spending. It's actually increasing federal entitlement spending, just coupled with a tax increase — a targeted tax increase.

And then the second question, a little more global, don't you really think that the debt problem is really here? I mean, I'm no economist and wouldn't claim to be, but the simple math seems to be that for this year the federal government looks like it will take in about $2.2 trillion from all sources of cash revenue and it'll spend $3.8 trillion. And I think that's relatively close to the real numbers. And I just find that absolutely alarming.

**MR. SCHULTZE:** Let me take the first part of your

question.

First, it is those tax increases you were talking about which mainly are the ones that offset the cost of the health care. The other part of it — which is the part that gets very little attention in the newspaper — deals with really bending that debt curve down. To do that, you're going to have to change the whole structure of the medical care system from fee-for-service — it's like a slogan — to fee-for-value. There are lots of ways that you can get at this or try to get at it, but the problem is we don't really know. For example, they're going to start to set up accountable care organizations and change the Medicare reimbursement. Well, first, you've got to do a lot of studies to nail down what are best practices. And then you start reimbursing people where there is a premium for using best practice in terms of quality and, secondly, for economizing and where you can keep some of the savings. Now, that's just one thing.

Another set of aims that is in that bill — and some seed money to get them going and so on — is to really push the organization of delivery of health care to the point where you get groups of primary care physicians and specialists and hospitals working together where they're not paying a fee for every little thing you do, but for the particular care over a particular diagnostic problem for the length of the problem. And you're not going to be paid by just pushing more tests on people. In other words the current system says it really pays — as much as Medicare will let you get away with it — to increase the amount of services you sell. So that's going to take a long time. It's not certain. You can't really cost it out. If we are reasonably lucky it'll start working, but it's not going to do anything much

for 10 years or 12 years or 15 years in pushing that curve down to take the place of anything else. So you're going to need big measures in the next — if I'm optimistic — in the next 10, 15 years to get that bulge where the bill does work. Now, if the bill doesn't work your problem is even bigger. But that's the hope.

**MS. RIVLIN:** I agree with that and I'm even a little more optimistic than Charlie.

One of the advantages that the United States has is that we have such an inefficient health care system that there's a lot that can be squeezed out over the next few years if we do it right. Isn't the debt crisis here? No. I'm not worried about our borrowing that much this year or next. And those deficits will come down, although not as fast as one would like. It really is the longer term trend that's the problem, not the immediate future.

**SPEAKER:** It's worth mentioning Japan if you think the problem is imminent. Their great crisis occurred almost 20 years ago, at least in their financial system. And they have run large deficits for a long, long time. And their debt-to-GDP ratio is much worse than that of most European countries and the United States, and worse than the United States will be for quite some time in the future.

We can talk about why it hasn't turned out to be a threat. The point, simply, is that the simple link that says you have a spectacularly exploding debt, therefore, you have an immediate and grave problem is not certain — It doesn't lead to the problems that I think are frequently described in newspaper articles. Japan hasn't had those problems.

**MR. SCHULTZE:** Let me quarrel a little bit — not so much quarrel, but let's say moderate. You know, Japan isn't

the world's currency. The debts of Japan are not massively held by foreign governments. So what we can get away with — not the actual debt-to-GDP ratio, but what it's maybe going to be is much more — we're going to be much more sensitive in terms of what happens, I think, mainly to our interest rates and, I think, the way-out possibility of a run on the dollar. So I'm not sure Japan can be compared to us in that respect. I don't really know the numbers on how much of the world's currency is in yen, but I don't think it can compare to the dollar.

**MS. DYNAN:** Okay. We're standing between you and your lunch. I think we have time for one more question. And there's a hand up right there.

**SPEAKER:** The government-university partnership on research has obviously been phenomenal for the last 50 years. I think we're all a little anxious about what to expect, and whether we've got to rethink the source of funding for basic research, whether there is any expectation that university-industry partnerships will grow. I'm interested in any of your thoughts about what we should anticipate in terms of federal and other support for the basic research that we all do.

**SPEAKER:** I don't have any answer to that except, number one, if we're serious about the problem everybody is going to get pinched. It's like the medical care system. In many cases we may end up so that we not only cut out things that aren't any good, we cut out things that are valuable, but of marginal value.

My bias is that it's critical that the federal government maintain its support of basic research. Conversely, if I had to look — and I have to some extent —

about where I'd cut, I would cut a lot of the stuff we do for applied research, demonstration projects in the commercial field. We have a bad record of it. We usually screw it up. So if you want to lobby for something, lobby for not more money to research in a broad sense because you'll get it in kind of pork barrel stuff. Oh, I'm exaggerating. But really do push on the basic and say, okay, just reallocate. **MS. DYNAN:** So just a follow up on that. I don't have an answer, but I will say something, which is we have what's called an all-Brookings initiative here called Growth Through Innovation. The all-Brookings means it's spanning the various research programs here at Brookings, but the motivation behind it is we've been so focused on the near-term issues on just fighting the fires and, you know, it's really important that we attend to creating an economic environment that's laying the foundation for solid and strong, long-term growth in the economy. And the issue that you're raising is definitely on the agenda there. We're just ramping up this all-Brookings priority, but I hope that perhaps if you come back a year from now we'll have more to say on the topic.

Okay. Thank you very much.