

Back to a Better Normal: Unemployment and Growth in the Wake of the Great Recession

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My life as a policymaker began the Monday before Thanksgiving in 2008 when President-Elect Obama announced his economic team. By the following Monday, we were all in Washington formulating the recovery policies. I vividly remember the Friday of that first week in December: the employment report for November was released showing that we had lost more than half a million jobs. It was clear that what might have been an ordinary recession a few months earlier was taking on ominous proportions. As I was briefing the President-Elect by phone, I found myself saying, “I am so sorry, the numbers are horrible.” The President-Elect replied, “It’s not your fault—yet.”

In the next few months, we saw even more terrible numbers. The American economy lost almost 3 million jobs between November 2008 and March 2009. Real GDP fell at an annual rate of 6.4 percent in the first quarter of 2009, and countries around the globe began to report staggering declines.

The policy response was swift and bold. The Federal Reserve had taken dramatic actions when the crisis began, and continued to find creative ways to unfreeze credit markets. The TARP legislation, though deeply unpopular, provided crucial ammunition for dealing with the panic. Less than a month after the inauguration, President Obama signed the American

Recovery and Reinvestment Act of 2009—the largest countercyclical fiscal stimulus in American history. And over the spring, the stress test and other measures taken by the Federal Reserve and the Treasury helped to stabilize and begin to heal our financial markets.

By the second quarter of 2009, GDP had nearly stopped declining. It actually grew in the third quarter, and surged in the fourth as inventory liquidation finally slowed to a trickle. Real GDP appears to be continuing to grow solidly. Job losses gradually slowed over 2009, and in the first quarter of 2010 we averaged job gains of 54,000 per month. By almost every indicator, the U.S. economy is finally on the road to recovery.

It is against this backdrop that many are beginning to talk about what the world will be like when we come through this ordeal. Indeed, the discussion of “the new normal” has become the new norm. This is, of course, something the President and his advisers discuss frequently. I thought I would take time this morning to give my perspective on unemployment and economic growth as we come out of the Great Recession.

Very Far from Normal

My first and most fundamental point is that when it comes to the economy we are very far from normal. The unemployment rate is currently 9.7 percent. I find it distressing that some observers talk about unemployment remaining high for an extended period with resignation, rather than with a sense of urgency to find ways to address the problem. Behind this fatalism, there seems to be a view that perhaps the high unemployment reflects structural changes or other factors not easily amenable to correction. High unemployment in this view is simply “the new normal.” I disagree.

Deficient Aggregate Demand Is Key. The high unemployment that the United States is

experiencing reflects a severe shortfall of aggregate demand. Despite three quarters of growth, real GDP is approximately 6 percent below its trend path.¹ Unemployment is high fundamentally because the economy is producing dramatically below its capacity. That is, far from being “the new normal,” it is “the old cyclical.”

In this regard, I am reminded of a frustration I have felt many times when people write books and organize conferences about the unemployment problem in the Great Depression—as if the high unemployment were somehow separate or distinct from the rest of the Depression. Then, as now, the economy had been through a wrenching crisis that had caused demand and production to plummet. Unemployment was a consequence of the collapse of demand, not a separate, coincident problem.

Now, to be fair, the unemployment rate has risen somewhat more during this recession than conventional estimates of the relationship between GDP and unemployment would lead one to expect. In this year’s *Economic Report of the President*, we presented estimates that suggest that the unemployment rate in the fourth quarter of 2009 was perhaps 1.7 percentage points higher than the behavior of GDP would lead one to expect.² Some of that unexpected rise goes away when one takes a more sophisticated view of GDP behavior. The Bureau of Economic Analysis estimates GDP in two ways—one by adding up everything that is produced in the economy and the other by adding up all of the income received. These two measures should be identical. But in this recession, the income-side estimates have fallen substantially more than the product-side ones. Therefore some, but not all, of the anomalous rise in unemployment may be due to the fact that the true decline in GDP may have been deeper than the conventional estimates suggest.³

Many have suggested that the fact that long-term unemployment is at record levels is a

sign that the high unemployment rate is the result of structural factors. There are now 6½ million workers who have been unemployed for more than 26 weeks, and these workers represent a record 44 percent of the unemployed. Long-term unemployment is cause for serious concern. Long spells of unemployment cause much greater hardship than short spells, and they can be associated with deterioration of skills and long-term falls in earnings.⁴

But, this rise in long-term unemployment is readily explained by the prolonged collapse of aggregate demand. When hiring rates are very depressed, workers who lose their jobs are unlikely to find work quickly, and thus face a substantial chance of becoming long-term unemployed. This effect is compounded by the fact that exit rates from unemployment, both in normal times and in recessions, are typically lower the longer a worker has been unemployed.⁵ This makes it even more likely that those who do not find work quickly will have long spells of unemployment. Thus, the rise in long-term unemployment is the almost-inevitable consequence of the severe recession. We do not need to appeal to any underlying structural changes to understand it, and there is every reason to expect that long-term unemployment will come back down when aggregate demand recovers.

Structural Factors Are Not Central. Other observers point to troubling trends, such as the decline in traditional manufacturing jobs and falling rates of employment among less educated middle-aged men, as signs of the inevitability of permanently high unemployment. These developments have led to terrible distress in some communities and devastation for the workers affected. But, these trends were in full sway in the 1990s and mid-2000s, when the unemployment rate fell to very low levels. They are trends that we absolutely need to work to change, but they are not indications that the United States is doomed to permanently higher unemployment.

Another concern is that certain sectors, notably construction and finance, are likely to remain substantially smaller than they were during the boom even after the economy returns to normal. As a result, some observers have suggested that the workers who lost their jobs in these sectors may have trouble finding work after the economy recovers—and thus that reallocations across sectors might mean higher unemployment in the long run. In fact, however, we have seen only slight declines in the rate at which workers who have lost their jobs in declining sectors exit unemployment relative to workers who lost jobs in other sectors.⁶ The dominant pattern is that workers from all sectors have seen their exit rates fall, exactly as one would expect when job creation is low.

In short, in my view the overwhelming weight of the evidence is that the current very high—and very disturbing—levels of overall and long-term unemployment are not a separate, structural problem, but largely a cyclical one. It reflects the fact that we are still feeling the effects of the collapse of demand caused by the crisis. Indeed, at one point I had tentatively titled my talk “It’s Aggregate Demand, Stupid”; but my chief of staff suggested that I find something a tad more dignified.

The reason that I have been emphasizing that the high unemployment we are experiencing is cyclical rather than structural is not to somehow minimize or downplay it. In fact, just the opposite. It is to shake people out of the complacency that says, “That’s just the way life is.” It may be the way life is right now—but it doesn’t have to be. We have the tools and the knowledge to counteract a shortfall in aggregate demand. We should be continuing to use them aggressively.

Why Do We Have a Lingering Aggregate Demand Shortfall?

This discussion naturally raises the question of why we face such a severe and lingering aggregate demand shortfall. At the most fundamental level, the answer is the exceptional severity of the recent crisis. Among the effects of the crisis were a dramatic fall in wealth, severe disruptions of credit, devastation of state and local government budgets, much greater caution on the part of consumers and firms, and falls in output around the world. All of these developments reduced spending greatly.

The policy response has greatly mitigated those consequences and, in doing so, has moved us beyond the immediate crisis. Indeed, a recent report by the Council of Economic Advisers estimated that the Recovery Act alone has played a key role in generating the positive GDP and employment growth we have experienced.⁷ But although the challenges have been reduced, they have not been eliminated. Let me highlight four key headwinds that the American economy is facing as it tries to recover.

First, credit availability remains tight. One important indicator of credit conditions is the Federal Reserve's Senior Loan Officer Opinion Survey. This survey shows that although banks have largely stopped tightening their lending standards, they have not yet begun to loosen them. In addition, many small businesses report difficulty in obtaining credit. This is a development that makes it harder for businesses to hire and invest.

Second, state and local governments face continuing budget shortfalls. For example, a recent report estimates that even given the support from the Recovery Act funds, the states face a collective budgetary shortfall of \$128 billion in fiscal 2010, and similar amounts in the next two years.⁸ And, because almost all states have balanced budget requirements, they have to respond to the shortfalls with a combination of spending cuts and tax increases. As a result, to some

extent we are seeing a replay of what happened during the recovery from the Great Depression, when a significant part of the fiscal stimulus by the Federal government was offset by fiscal contraction at the state and local level.⁹

Third, no one expects consumers, after the searing events of the past few years, to go back to their free-spending ways. Nor, as I will discuss in a bit, should we want them to. But, this means that consumption is unlikely to be the main engine of a strong recovery.

Finally, foreign demand for our goods remains subdued. Recovery has not taken hold as firmly in Europe as in the United States, limiting European demand for American goods. And, low consumption growth and persistent trade surpluses in some countries have contributed to unbalanced trade, again restraining our exports. Exports have grown 18 percent from the depth of the crisis, but they are still 13 percent below the pre-crisis peak.

The other fundamental source of the lingering shortfall of aggregate demand comes from the limits of monetary policy. The recession we have just been through is different in character from almost every other postwar recession. The usual postwar recession has a fairly simple narrative. The groundwork is laid when for some reason policy is overly expansionary and so generates inflation. The recession occurs when the Federal Reserve realizes that things have gone awry. It raises interest rates, slows the economy, and so brings inflation down—at the cost of a recession.¹⁰

That type of recession is easy to end: once the Federal Reserve is satisfied with the behavior of inflation, it can slash interest rates and provide the economy with a large jolt of stimulus. The result is that the recoveries from severe recessions caused by tight monetary policy have been very strong. For example, in the year following the trough of the 1981-82 recession, real GDP grew almost 8 percent and the unemployment rate fell 2.3 percentage points.

The recent recession was obviously not caused by tight monetary policy. Interest rates were not especially high when it began, and so the Federal Reserve had only limited room to cut them. It has brought short-term rates down to virtually zero, but it cannot push them below that. The result is that we have not had the strong monetary stimulus that we would normally have in these economic circumstances. One study found that given the Federal Reserve's usual responses to inflation and unemployment, economic conditions would lead it to cut its target for the federal funds rate by an additional 5 percentage points if it were able to do so.¹¹ That is, despite the very low level of interest rates and all the attention to the growth of the Federal Reserve's balance sheet, current monetary policy is in fact unusually *tight* given the condition of the economy.

The combined result of the policies that we have taken, the inherent resiliency of the American economy, and the headwinds that we face, is that we are growing again, but not booming. GDP is rising at a solid pace, but not as quickly as after other severe recessions and not as quickly as it needs to. As a result, the unemployment rate remains painfully high and is not predicted to reach normal levels for an extended period.

What More Can We Do?

Given this situation, the obvious question is: What more can we do? Here, it is important to emphasize that the crucial source of demand has to be the private sector. Especially at a time of large long-run fiscal challenges, there are limits on the role the government can play. Fortunately, the private sector is starting to show some life. Last Wednesday's retail sales numbers suggest that consumer spending, while not exuberant, is stronger than anticipated and indicates a move toward replenishing some of the household goods that have not been purchased

over the past two years. Likewise, durable goods orders have been steadily rising, showing a willingness on the part of many firms to invest even though capacity utilization remains very low. Our focus as policymakers should be on how we can help the private sector recover faster.

In light of these considerations, the President and his economic team see a key role for targeted actions. There are fiscally responsible measures we can take that can make an important difference between so-so recovery and strong recovery; between stubbornly high unemployment that falls only very slowly and unemployment that is on a steady downward trend.

We have already taken some additional steps. For example, Congress recently passed the HIRE Act, which provides tax incentives for businesses to hire unemployed workers and retain them over time. The Act also has provisions to spur infrastructure spending.

Beyond these measures, there are new actions aimed at stimulating aggregate demand that would be very valuable. One targeted measure that is likely to be very effective is additional fiscal relief to the states. At this point, almost all of the adjustment in states' budgets is coming from changes in spending and taxes, not changes in their rainy-day funds.¹² As a result, relief is likely to alter states' spending and tax decisions quickly. By preventing tax increases and spending cuts, this relief raises income and employment relative to what it otherwise would be.¹³ The President has therefore called for additional funds to support state and local governments. This measure has been endorsed by policymakers of both parties.

The President is particularly worried about potential layoffs of teachers. Recent reports suggest that between 100,000 and 300,000 teachers could lose their jobs because of state and local budget difficulties.¹⁴ These layoffs would harm the teachers, their local economies, and most importantly the millions of students they teach. For this reason, the Administration is anxious to work with Congress to craft additional Federal support for teachers.

A closely related type of targeted stimulus is extensions of support to those who have been most directly affected by the recession. An obvious—and important—example here is extensions of emergency unemployment insurance benefits. While there is some evidence from better economic times that unemployment insurance extensions can lead to reduced job search, this not a concern at a time when there is a shortage of jobs, not of willing workers. Additional benefits will greatly mitigate some of the worst direct harms of the recession. And, the difficult financial positions of families suffering from extended periods of unemployment mean that most of any such support will be spent quickly, and so have a rapid impact on the economy.

A third targeted measure that has the potential to be very effective is the provision of capital to small banks to promote small business lending. The President has proposed the creation of a \$30 billion small business lending fund to provide capital to small and community banks, which play a critical role in small business lending. These government investments would include incentives to increase this lending, thus further magnifying their impact. And, because the government will be getting capital stakes that will lead to future repayments, these investments will involve little long-run cost to taxpayers. This program would complement the many other steps the Administration has taken to support creditworthy small businesses seeking to expand and create jobs, such as a proposal to eliminate capital gains taxes for investments in small businesses.

A fourth targeted action is our steady effort to open markets to U.S. goods and move the global economy toward more balanced growth. These measures not only promote economic recovery, they move the world economy toward a more stable and fairer outcome.

Finally, the President supports creation of the Homestar program to jumpstart home energy efficiency retrofits. Modeled on the successful Cash for Clunkers rebate, the Homestar

program would let homeowners receive rebates at home improvement stores for efficiency-improving home remodel supplies and from servicers for installation costs. By making energy retrofits temporarily less expensive, the program aims to bring forward such projects from well in the future. This stimulates demand for production and for construction labor at a time when the economy desperately needs it, and should save consumers money over time. And, of course, it provides much needed energy conservation.

These targeted policy actions are what the economy needs to ensure a more rapid return to full employment. By speeding up and strengthening the recovery, policy could help lessen the pain and devastation that prolonged high unemployment would bring to millions of American families.

Furthermore, more rapid recovery is the most important thing that we could do to prevent the currently high rate of cyclical unemployment from becoming structural. The academic literature suggests that there may be a link between prolonged recessions and higher normal unemployment. In a well known paper, Olivier Blanchard and Lawrence Summers found that in Europe in the 1970s, one-time unemployment shocks seemed to have almost permanent effects on the unemployment rate.¹⁵ In more recent work, Laurence Ball found that in advanced countries in the 1980s, extended recessions driven by changes in aggregate demand were associated with substantial increases in economies' normal rates of unemployment, while similar recessions that were reversed by aggressive stimulus were not.¹⁶ Thus, it is possible that by encouraging more rapid recovery, we can help ensure that unemployment does not remain permanently higher.

A Better Normal

So far, all of my discussion has focused on returning the economy to a more normal rate of unemployment quickly. I feel strongly that such a return to full employment is both possible and a policy imperative. High unemployment is a disaster for the economy, and more importantly, a tragedy for those affected. We need to do all we can to combat it.

But the obvious question is, can we do better than just get back to where we were before the recession? And here, I am thinking about economic performance more generally, rather than just the unemployment rate. Could good economic policies lead to economic growth that is stronger and more durable than before?

The answer to this question is yes. There are a number of policy actions that can help ensure that we not only return to normal, but return to a better normal.

Dealing with the Budget Deficit. The first is to put in place a plan to deal with the long-run budget deficit. As will surely be discussed in the next session, we face an unsustainable long-run fiscal situation. The deficit is large today, primarily because of the recession. It is expected to decline as the economy recovers. But over the long haul, in the absence of corrective action it will grow tremendously, largely due to the effect of rising health care costs. Now, I won't take you through the history of how we got on this terrible path—Chapter 5 of the *Economic Report of the President* does a good job of that—other than to say that the budget problem was years in the making. It is not, as some have suggested, due to actions taken this past year. The Recovery Act, which was absolutely necessary to turning the economy around, is the source of at most a tiny part of our long-run fiscal challenge.¹⁷

But, regardless of its source, the deficit must be addressed. Once the economy has returned to normal, high budget deficits would raise interest rates and discourage investment.

And attempting to embark on a path of exploding deficits would, sooner or later, lead to catastrophe.

The sensible way to address the deficit is with a long-run plan. It would be penny-wise but pound-foolish to try to deal with our long-run problem by tightening fiscal policy immediately or foregoing additional emergency spending to reduce unemployment. Immediate fiscal contraction would inevitably nip the nascent economic recovery in the bud—just as fiscal and monetary contraction in 1936 and 1937 led to a second severe recession before the recovery from the Great Depression was complete. And nothing would be more damaging to our fiscal future than a protracted recession and permanently higher unemployment. But, a credible, comprehensive plan for deficit reduction would create a favorable climate for investment and ensure that the economy remains strong.

Thus, we should be taking concrete steps now to ensure that as we recover from the recession, we get our fiscal house in order. And we are. The health reform legislation includes the key cost control mechanisms that experts say will slow the growth rate of health care costs over time. We will need to be vigilant in the implementation of the reforms to make sure that those mechanisms work. The President has also made some difficult choices that will slow the growth of other types of spending. And he has appointed a bipartisan fiscal commission to forge a consensus on the range of other measures that are needed.

Rebalancing Demand. A related way that we can build a better normal involves policies that can help rebalance the composition of the economy's output. The boom of the mid-2000s was fueled by the accumulation of private and public debt. Personal saving and business investment (excluding information technology) were low, and budget deficits, housing construction, and trade deficits were high. This type of boom, in addition to being unstable,

contributes too little to growth in our standards of living. Low investment in equipment and factories slows the growth of productivity and wages. And large trade deficits mean that America is borrowing from the rest of the world, and so foreigners have more net claims on what we produce in the future.

With appropriate policies, the normal we return to will be a higher-saving, higher-investment economy than that of recent decades. Consumer caution, sounder lending practices, and pro-saving policies are likely to lead to higher personal saving. Responsible fiscal policy will tame the budget deficit, further contributing to national saving. This will help to promote low real interest rates, high investment, and low trade deficits. New investment opportunities in areas such as clean energy, health information technology, and biotechnology, encouraged by appropriate policies to correct market failures or jumpstart key innovations, will further raise investment. A normal that involves robust business investment and exports is better for our economic health than a normal built on borrowing, consumption spending, and unsustainable construction.

Financial Regulatory Reform. A third policy choice that can also help to ensure that we don't return to the bubble and bust pattern of the past is sound financial regulatory reform. The crisis showed that the nation's financial regulatory structure, much of which had not been fundamentally changed since the 1930s, had failed to keep up with the evolution of financial markets. The current system provided too little protection for the economy from actions that could threaten financial stability and too little protection for ordinary Americans in their dealings with sophisticated and powerful financial institutions and other providers of credit. Strengthening our financial system is thus a key element of the rebalancing needed to assure stable, robust growth.

What is needed is a new set of rules of the road for our financial system, greater accountability for Wall Street, and increased protections for consumers. Those rules include a comprehensive regulatory framework where capital and liquidity requirements control excessive risk-taking and where regulators consider risks to the system as a whole and not just to individual institutions. They involve putting complicated financial products such as derivatives onto exchanges and into clearinghouses so that risks are known and values are clear. They include a mechanism for winding down failing financial institutions in a way that protects both the rest of the financial system and taxpayers. And, they create a dedicated agency that has consumer financial protection as its only mandate.

Such a revamped financial regulatory system will maintain what is best about the American financial system—its ability to efficiently channel trillions of dollars of funds from savers to productive uses. But it will help curb destructive bubbles and help ensure that ordinary Americans will never again have to endure years of devastating recession caused by a financial crisis.

Investing in Education and Innovation. Finally, there are a range of policy actions that can affect the key sources of productivity growth. Investing in education prepares our workers for the jobs of the future. An educated workforce can seize new opportunities when they arise, adapt to changing technologies, and discover better ways of producing things. All of this increases standards of living and makes our workers less likely to suffer persistent dislocation as the economy evolves.

Investing in basic science—something that the private sector tends not to do enough of—is a way for the government to help spur innovation. Funding laboratories, research facilities, and graduate fellowships is a wise public investment that makes it easier for entrepreneurs to

develop new production methods and whole new products. These new technologies and products not only improve our lives, they generate the jobs that will employ our children. By doing so, they make the economy stronger and more prosperous than before.

A Final Thought

During my tenure in Washington, I have gotten typecast as the optimist on the economic team. The headline of a recent profile in my hometown paper was “Obama’s Sunny Economic Forecaster.” But the truth is, I have a very realistic sense of the tremendous challenges we face. Indeed, I set out this morning to deliver the stern message that even though things are better, they are not nearly good enough. We are painfully far from normal. But I can’t help ending on an optimistic note. I have a deep belief in the potential of the American economy and the promise of good economic policy. The extraordinary actions that we have taken have already meant the difference between freefall and the beginnings of economic recovery. My plea today is for continued action—both to accelerate the return to normal for the millions of American families who are still suffering and to make the normal that we return to better than it was before.

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ENDNOTES

¹ This calculation uses the estimates of potential GDP from the Congressional Budget Office, <http://www.cbo.gov/ftpdocs/108xx/doc10871/PotentialGDP.xls>.

² Council of Economic Advisers (2010a, p. 74).

³ Moreover, the conventional estimates of the relationship between unemployment and GDP are most appropriate for situations where GDP falls for only a short time period. They may understate the rise in unemployment that should be expected from long-lasting output declines, like those in 2008 and 2009.

⁴ See Arulampalam, Gregg, and Gregory (2001) and Gregory and Jukes (2001).

⁵ Elsby, Hobijn, and • ahin (2010).

⁶ Elsby, Hobijn, and • ahin (2010). One limitation of this paper (which reflects a limitation of much of the data that are available) is that the measures of exit from unemployment include not only workers who find jobs, but those who exit the labor force. There is no evidence, however, that departures from the labor force are driving the authors' results.

⁷ Council of Economic Advisers (2010b).

⁸ Center on Budget and Policy Priorities (2010)

⁹ See the classic paper by E. Cary Brown (1956).

¹⁰ Romer and Romer (1989).

¹¹ Rudebusch (2009).

¹² National Governors Association and National Association of State Budget Officers (2009).

¹³ See Council of Economic Advisers (2009).

¹⁴ Duncan (2010).

¹⁵ Blanchard and Summers (1986).

¹⁶ Ball (1999).

¹⁷ Council of Economic Advisers (2010a).