

Principles for the relief and recovery phase of rebuilding the U.S. economy

Use debt, go big, and stay big, and be very slow when turning off fiscal support

Report • By [Josh Bivens](#) • November 24, 2020

The economic shock of the COVID-19 pandemic demands an overwhelming policy response. The pandemic has both caused horrendous economic harm and exposed the rot in our economy’s ability to provide security for all. The policy response must first stop the economic bleeding caused by the pandemic, and then second, build a more resilient economy that repairs the rot.

By “stop the bleeding” we mean using fiscal policy to end the crisis of joblessness and restore the labor market to a reasonable degree of health. Failing to invest enough to sustain a healthy labor market would fatally compromise both the political and the economic ability to structurally reform the economy’s key institutions to create fairer outcomes. We have seen this failure before, with fiscal recovery efforts following the Great Recession of 2008–2009 that were insufficient and too short-lived. As a result of this austerity, it took a full decade for the labor market to return to even its pre–Great Recession health (which was too modest a benchmark to begin).¹ It seems clear that a key reason why the Obama administration was unable to get ambitious reform efforts finished after its first year in office was the continued intense labor market distress.

This memo explains why policymakers need to pass roughly \$3 trillion in debt-financed fiscal support now, with the first \$2 trillion hitting the economy between now and mid-2022. This amount of upfront stimulus, combined with investments that ensure a very slow phaseout of this fiscal support, are needed to ensure a return to a high-pressure, low-unemployment labor market by mid-2022. Specifically, the memo calls on policymakers to take the following actions:

- **Finance fiscal support with debt.** The point of federal spending now is to boost aggregate demand growth (spending by households, businesses, and governments), so financing this support with taxes would make it less effective.²
- **Aim for a high-pressure labor market by picking an ambitious unemployment rate target that constitutes labor market health.** Pre-COVID, the unemployment rate hit 3.5% with no evidence that it was too low and likely to lead to a surge of inflation. We suggest targeting an overall unemployment rate of 3%.³

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Running the economy at this low level of unemployment for a sustained period creates a high-pressure labor market, one with enough competition for workers to drive faster and more equal wage growth and reduce race-based disparities in wages and unemployment.

- **Refuse to accept the self-defeating notion that the COVID-19 shock will leave (or has already left) permanent and unfixable economic scars.** Policymakers should run the economy hot and see how much we can heal the damage that the COVID-19 shock inflicted on measures like potential output.⁴
- **Avoid the premature and precipitous withdrawal of fiscal support by ramping up public investments in public goods that are appropriate to debt-finance even during times of full economic health.** For the sake of future crises, we should also start building automatic triggers in things like unemployment insurance and aid to state and local governments. But, for the coming years, *discretionary* fiscal support should be continued. Specifically, to avoid tumbling down a fiscal cliff into an economic contraction in 2023, policymakers should ramp up public investments in such public goods as clean energy, energy efficiency, and early child care and education, and sustain these investments—and their debt-financing—at least through 2024.
- **Finally, note that this \$3 trillion in needed fiscal support is for hitting economic targets.** Money is still clearly needed for virus containment and will be needed for rapid vaccine deployment in coming months. Public health measures are the most important part of the response to the pandemic, so whatever money can usefully help on this front should be added on top of this *economic* package of relief and recovery.

Below we elaborate on this proposal for \$2 trillion in debt-financed fiscal support between now and the middle of 2022, followed by support on the order of \$400 billion annually until the end of 2024.

Do not fear debt: Relief and recovery measures should be unambiguously debt-financed

The point of fiscal support is to increase spending by households, businesses, and governments to spur employers to hire. Tax increases put a drag on this spending. While the U.S. needs major progressive reform to taxes, as policymakers plan how to stop the economic bleeding caused by COVID-19, they should be thinking of how to maximize the plan's stimulative effects, and this means financing with debt. Progressive tax reform, when it occurs, should target economic “bads” like emissions of greenhouse gases and the staggering number of socially unproductive financial transactions that funnel money to Wall Street. This reform should also aim to put a brake on rising inequality and reduce incentives for CEOs and other high earners to rig the rules of the economic game to transfer more money their way.⁵

But there is no need to think about revenue as policymakers plan on how to stop the economic bleeding caused by COVID-19. All relief measures should be debt-financed. Even the “back-end” relief measures that help to avoid a sharp fiscal cliff as the front-end stimulus winds down should be debt-financed. Because any such back-end measures could in theory come on line with the labor market largely healed, optimally they should be measures that make sense to finance with debt even during times of full employment. Two such measures that meet this requirement are investments to mitigate the emission of greenhouse gases and investments to shore up our woefully underfunded early child care and education system (Gould and Blair 2020).

The logic of using debt even in normal times to finance these investments is clear: The vast majority of their benefits will accrue to future generations. But for the effects of climate change or present-day malinvestment in education, these future generations will almost surely be richer than present generations. Given this, borrowing from future generations to finance these types of investments makes perfect sense. Some hold the misconception that debt incurred always constitutes a burden on future generations. It does not. The heirs of a society and economy also receive any assets financed by debt, which in this case would be a cleaner, more energy-efficient economy and a better-educated workforce.

Go big and stay big: Do not repeat mistakes of past crises

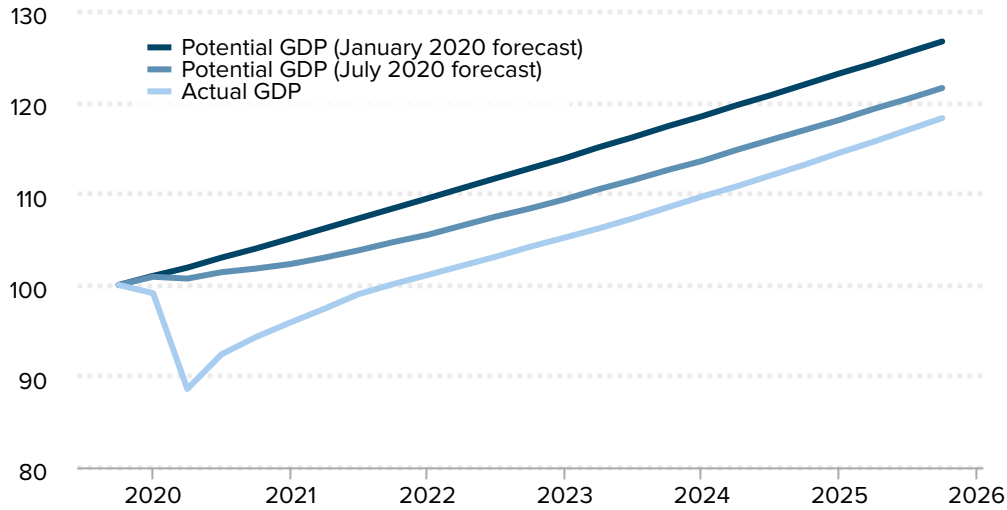
Recovery from the Great Recession of 2008–2009 was agonizingly slow, largely because the admirable initial round of fiscal recovery efforts was too small and ended too quickly. Policymakers did not acknowledge what has become increasingly clear: Long-run trends (such as rising inequality) are making it harder and harder for the U.S. economy to generate sufficient spending by households, businesses, and governments (aggregate demand) to absorb the economy’s resources (including potential workers).⁶ This “secular stagnation” means that fiscal support cannot be a one-shot “jump start” that can be pulled back quickly as private-sector demand generation roars to life. Instead, fiscal support must be large enough and last long enough that the boost provided ebbs only *after* the Federal Reserve begins raising interest rates. In short, there must be an attempt to overshoot the target to ensure that private-sector demand generation really is running fast enough when the last bit of fiscal support fades out.⁷

When setting the target we should avoid fulfilling the bleakest prognosis by setting it too low. Economists and policymakers often express concern that severe recessions can permanently “scar” the economy’s underlying productive capacity (sometimes called *potential output*), leading to slower growth for a long time—even after the short-run demand shortfall is rectified.⁸ We should not assume this, and in particular we should not assume it when addressing a shock that is still less than year old. Given the very promising signs of a vaccine on the horizon, there is every reason to think that economic normalization will be possible in 2021, as long as recovery is not held back by a shortfall of demand. This means that policymakers’ goal today absolutely should be to *return*

Figure A

It is far too soon to assume COVID-19 shock has permanently scarred U.S. growth

Forecasts for actual GDP and potential GDP (in January and July 2020), 2019–2025



Source: Data from Congressional Budget Office (2020a, 2020b).

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economic growth to the trajectory it was on before the shock. This goal will inform the assessment of how much fiscal support is needed.

For insight on the level of fiscal support needed when the economy is depressed and interest rates are stuck at near-zero like today, policymakers often look to measures of the “output gap”—the difference between what GDP is projected to be in coming months and years under current conditions (actual GDP) and projections of what it would be were the economy running at maximum sustainable output (potential GDP).

Figure A shows forecasts made by the Congressional Budget Office (CBO) for actual gross domestic product (GDP), a forecast for potential GDP made in January 2020 (pre-COVID-19) and a forecast for potential GDP made in July 2020.

CBO has projected a large decline in potential output growth for coming years, as shown by the distance between the top and middle lines in the figure. To the degree that this is driven by estimates of the effect of the COVID-19 economic shock, this degradation of the economy’s potential should not be taken as a given.⁹ Specifically, focus on the difference between the forecast of actual GDP by the middle of 2022 and the two forecasts of potential GDP. If one believed the July 2020 forecast of potential GDP (with the effect of COVID-19 baked in), then one would think the “output gap”—the difference between potential GDP and actual GDP averaged across every quarter between now (November) and the middle of 2022 (July)—is 4.1%. If one instead compares the forecast of actual GDP with the January 2020 forecast of potential GDP, the gap averaged across quarters in the

same period is 7.7%.

For our goal of estimating the size of the stimulus needed to close the real output gap, we land between the two CBO estimates. Specifically, we estimate an output gap based on comparing the forecast of actual GDP with a forecast of potential GDP that is derived from projected unemployment rates. For these unemployment projections, we adjust CBO forecasts based on two factors: Unemployment has already fallen in the second half of 2020 more rapidly than CBO projected, yet reductions in labor force participation and the misclassification of unemployed workers as employed during the pandemic has led to official estimates of unemployment understating the true degree of labor market slack. Based on this adjusted unemployment projection, and applying historical relationships between unemployment and output gaps, we find that between now and the middle of 2022, there is an average output gap of 5.0%.

‘Going big’ means aiming for 3% unemployment

Additionally, CBO estimates of output gaps are based on assumptions that the unemployment rate should be roughly 4.5%. This actually represents some real progress. Before the Great Recession hit, CBO estimated this “natural rate of unemployment” to be 5.0%. But the unemployment rate reached 3.5% right before the COVID-19 shock, and yet there was no sign of economic “overheating”: Both interest rates and inflation were far below historical averages, and inflation continued to register below the Federal Reserve’s 2% target. Given the lack of recent overheating, and given especially that there are real benefits to running the economy “hot” after periods of steep recessions, policymakers should not aim to merely close the output gap, they should aim for a very low unemployment rate in the ensuing recovery. Specifically, it seems like 3.0% unemployment is a reasonable target.¹⁰ It is possible that 3.0% is too ambitious, and that economic overheating will set in before we hit that rate, and the Federal Reserve governors might feel compelled to raise interest rates. But it is far more likely that the economy can sit at 3.0% unemployment—or even below—for quite some time before inflation rises fast enough and for long enough to compel the Fed to step in.

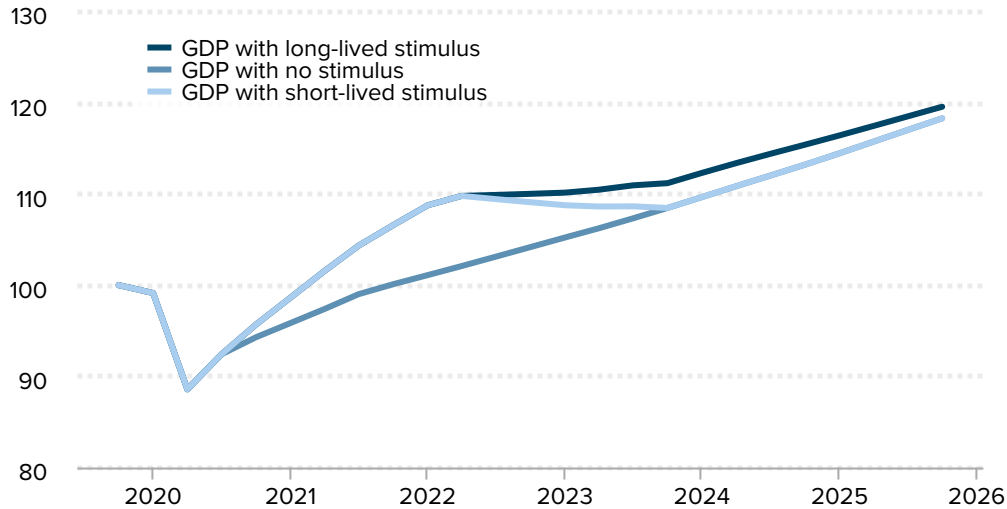
Most crucially, however, a scenario involving fiscal support that is strong enough to prompt a monetary policy offset *is a sign of success, not failure*. The entire point of fiscal support is to push the economy to a point where private-sector sources of demand growth are strong enough to keep the economy pinned at a healthily low unemployment rate even as extraordinary fiscal support is withdrawn. Providing enough fiscal support to overshoot the goal of closing CBO’s estimated output gap and instead hitting an unemployment rate of 3.0% would require an extra 1% of GDP in fiscal support. Applied to our adjusted output gap of 5% identified above, this means fiscal support in the next couple of years should be closer to 6% of GDP, or even a bit above given that social distancing measures might reduce the multiplier effects of stimulus in the very near-term.

Don’t withdraw too quickly: Ending

Figure B

Fiscal support needs to be big and long-lasting

Forecasts of actual GDP with no stimulus, short-lived stimulus, and long-lived stimulus, 2019–2025



Note: The forecast of actual GDP with no stimulus is from CBO. Construction of stimulus effects is described in Appendix A.

Source: Author's analysis of data from CBO 2020b.

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fiscal support should be done very gradually

In the era of chronic demand shortfalls, fiscal policy measures to fight recessions should not be seen as jump-starting a car—providing a one-time burst that can be immediately removed. Private sources of demand generation in recent decades have been quite weak. This means that if large fiscal support is removed quickly, the fiscal contraction can overwhelm private sources of growth and tip the economy back into recession.

Figure B compares CBO's forecast of actual GDP with two possible scenarios of fiscal support. Under the "short-lived stimulus" scenario, ambitious support is provided between now and the middle of 2022 but is removed quickly thereafter. Under the "long-lived stimulus" scenario, the same level of ambitious initial support is provided, but it is supplemented by a more gradual drawdown between mid-2022 and the end of 2024. Under the short-lived fiscal support scenario, the economy enters a period of substantial *contraction* in early 2023 as the rapid fiscal contraction overwhelms trend sources of private demand growth. Under the long-lived fiscal support scenario, the back-end support allows the economy to return to trend growth without ever entering an outright contraction.

Putting it all together: How much and what should be in relief and recovery measures?

Closing an output gap of roughly 5% (a more realistic estimate than CBO's for the reasons outlined above) and then overshooting to push the unemployment rate to 3% requires fiscal support equivalent to roughly 6%–7% of GDP. Given the unique nature of the COVID-19 economic shock, the most pressing part of this aid should be to provide relief to those made jobless by the pandemic. A clear model is the enhanced unemployment insurance (UI) provisions that were part of the Coronavirus Aid, Relief, and Economic Security (CARES) Act passed in the spring. These provisions significantly increased the generosity of UI payments and also expanded the universe of people eligible to receive UI. These are incredibly well-targeted measures, and would also serve to provide a powerful economic stimulus when we are able to relax virus-induced social distancing measures (Bivens 2020c). For the purposes of this memo, we assume that UI benefits are increased by \$600 per week between now and the middle of 2022, eligibility expansions are maintained over this period, and available weeks of benefits are extended. Given the projected path of unemployment, these extended benefits will cost on average \$250 billion at an annualized rate between now and the middle 2021.

Another obvious pressing need for relief and recovery measures is federal aid to state and local governments. State and local governments have revenue sources that have been damaged enormously by the COVID-19 shock. They also provide the front-line public response in many areas related to health and education—and both health and education services have been put under enormous strain by the virus and the need to respond safely. For this memo, we assume that \$500 billion at an annualized rate is provided to state and local governments between now and the middle of 2022.

Besides enhanced UI benefits, a range of other targeted safety net measures would provide crucial relief to families and a needed spur to recovery once social distancing measures relax. We assume \$100 billion at an annualized rate is provided in enhancements to the Supplemental Nutrition Assistance Program (food stamps), low-income rental assistance programs, and other targeted safety net measures in coming years.

Finally, we provide for public investments in early child care and education and in mitigating greenhouse gas emissions that ramp up immediately and reach peak levels of \$400 billion annually by the fourth quarter of 2021. Crucially, these investments do not begin ramping down in 2022. Instead, they remain—and remain debt-financed—at least through the end of 2024. While these public investments will take time to ramp up to full potential, a key virtue is that they provide a very gradual ramping down of fiscal support over time, hence avoiding any sharp contraction. These investments are what kept the “long-lived-stimulus” line in Figure B from ever becoming outright negative.

Relief and recovery measures are just stage one of what is needed from here

A very substantial near-term, debt-financed package of relief and recovery is needed just to allow U.S. families to survive the coming years and to push the labor market back to genuine health by mid-2022, while avoiding a fiscal cliff that would cause contraction soon thereafter. It is important to note that these estimates only include what it would take for a return to health of the *economy*. Obviously the most important issue in the coming months will concern virus containment and the rapid deployment of vaccines. These public health measures will likely be expensive to do well, and this money should absolutely be spent (and debt-financed). Any cost for these public health measures should go on top of what is estimated for economic relief and recovery in this report.

Labor market normalization should *not* constitute the limits of economic policymakers' ambition. The COVID-19 shock did not just cause enormous economic harm, it also exposed huge weaknesses in the economy's ability to guarantee economic security—both now and when faced with future shocks. These weaknesses were bred by decades of intentional underinvestment and this underinvestment will need addressing in myriad transformative ways.¹¹

But unless we address the immediate crisis of the labor market, both the political and economic support for these longer-run measures to rectify past underinvestment will be crushed. Failure to engineer a rapid recovery from the Great Recession was politically poisonous to the prospects of progressive policy change more generally, as voters lost any confidence in the federal government's capacity to effectively tackle big issues. On the economic side, there are numerous reasons why long-run investments to change the structure of the U.S. economy will have their greatest effects when the labor market is closer to healthy. Reforming social insurance systems, for example, is likely best done when the existing systems are not inundated by desperate claimants. Building up a stable, professionalized workforce for care work will become easier when the labor market is not so damaged that millions of potential workers will take nearly any job available. Granting workers greatly enhanced rights to join a union will likely lead to much better outcomes if it is not done in a context in which a large pool of unemployed workers gives employers a huge power advantage when bargaining. In short, stopping the economic bleeding first and fully is not a substitute or a distraction from the longer-run effort to create a fairer U.S. economy generally. It is instead a crucial first step.

As here and in earlier reports, the cautionary tale for future efforts is the failure to generate sufficient fiscal support for recovery from the Great Recession. Too many people blame the slow recovery from the Great Recession on largely irrelevant things like its association with a financial crisis. This is excuse-making that lets policymakers off the hook. The fact is that the too-slow recovery was driven by a fiscal policy response that was too weak. We should not make the same mistake following the COVID-19 recession.

Appendix A: Methods

This appendix explains how the effects of fiscal stimulus in Figure B were constructed. For the spend-out of unemployment insurance, we took the effect of enhanced UI benefits from May through July of 2020 on personal income, as measured by the Bureau of Economic Analysis (BEA) and divided by a measure of the unemployment rate in those months that accounted for misclassification within the Current Population Survey (CPS) and the falloff in labor force participation between January and those months. This gives a measure of additional UI payments per percentage point of unemployment. We then took a modified measure of CBO's forecast for unemployment (CBO 2020b) and applied this measure to that forecast to obtain the extra UI spending that would result.¹²

For the measure of federal aid to state and local governments, we first use estimates of the likely state and local budget shortfalls caused by the COVID-19 shock between now and the middle of 2022.

For the measure of safety net programs, we use the roughly \$100 billion included for these programs in the HEROES Act (Health and Economic Recovery Omnibus Emergency Solutions Act) passed by the House of Representatives in June.

The modified CBO unemployment forecast accounts for the fact that CBO's last projection was made in July 2020, and unemployment as reported by the Bureau of Labor Statistics (BLS) has recovered more rapidly than CBO forecast it would. Concretely, CBO forecasts unemployment averaging 13.3% in the third quarter of 2020, but it instead averaged 8.8%. However, accounting for the pandemic-induced rise in labor force nonparticipation and the rising misclassification in surveys would boost this 8.8% unemployment rate to roughly 12.2%.¹³ From there, we allowed the unemployment rate to decline in percent terms at the same pace forecast currently by CBO.

We use this path of estimated unemployment rates that take account of pandemic-induced nonparticipation to back out an implicit output gap. Historically, each percentage point of unemployment over the CBO nonaccelerating inflation rate of unemployment (NAIRU) is associated with an increase in the output gap of 1.4 percentage points. This derived output gap is the one we identify in the paper as averaging over 5% between now (i.e., the third quarter of 2020—the latest date for which we have decent data) and the middle of 2022.

We assume that the full effect of UI benefits, aid to state and local governments, other safety net spending, and public investments hit the economy over six quarters. Although this is slightly more spread out over time than some other estimates of fiscal stimulus, a slower phase-in seems particularly appropriate in the current moment, as social distancing measures are almost sure to reduce any economic effect of relief and recovery spending for a couple of quarters at least (though these efforts will still be improving human welfare, if not GDP in full measure).

For multipliers we assume 1.5 for each provision. This is a small underestimate relative to some past research, but, again, these effects might be attenuated in the short run due to social distancing measures, so this seems like a safe estimate.

For our public investment measures, we assume they take a year of phasing in to reach the full \$400 billion annualized spending. The difference between the “short-lived stimulus” and “long-lived stimulus” is simply that this fiscal support stays on line through the end of 2024.

Appendix B: Can automatic stabilizers substitute for the gradual phaseout of stimulus?

Some might wonder if putting triggers on key policies like UI and federal aid to state and local governments might substitute for passing fiscal support today that has a longer phaseout (as called for in this memo). It would absolutely be a good thing if new and improved “automatic stabilizers” that wind down only as key benchmarks of labor market health are reached were passed into law (see for example, Gould 2020). But even on top of much better triggers for making some of these policies automatic in the future, we also need to ensure long-lasting discretionary fiscal support in the coming years.

Automatic stabilizers, by definition, begin providing less fiscal support as the economy improves. In this way, unless the triggers for winding down are extremely powerful and long-lasting, automatic stabilizers are unlikely to provide enough fiscal support on their own to overshoot current estimates of the natural rate of unemployment and help push the economy all the way to 3% unemployment. Given the unique nature of the COVID-19 shock, a uniquely large and long-lasting fiscal support is needed to ensure that a fully healthy labor market is quickly regained.

If we pass powerful and well-calibrated triggers for programs like UI and for federal aid to state and local governments in coming years (and, again, we certainly should do that), the discretionary fiscal stimulus that will be needed in coming recessions will be far smaller. Most of the work in combatting the earliest phases of future recessions will be done by automatic programs.

Endnotes

1. See Bivens 2016 for documentation of the historically austere fiscal policy support given to recovery from the Great Recession.
2. See Bivens 2020a on the relationship between aggregate demand and debt-financed stimulus.
3. See Bivens 2020b on the lack of inflationary pressures stemming from a sub-4% unemployment rate in the pre-COVID-19 economy.
4. See Bivens 2019 and Girardi, Meloni, and Stirati 2018 on the potential long-run macroeconomic benefits of rapid and sustained aggregate demand growth.
5. See Piketty, Saez, and Stantcheva 2014 for evidence of the correlation between low top marginal

tax rates and aggressive bargaining by high earners to increase their compensation.

6. See Summers 2014 for the first elucidation of this “secular stagnation” thesis. See Bivens 2017 for how it is likely driven in large part by rising inequality.
7. This logic is slightly different from, but largely related to, the arguments laid out in Krugman 2015.
8. See Ball 2014 for the logic and evidence that prolonged periods of demand shortfalls cause reductions in estimated potential output, as well as for some evidence that this “hysteresis” can be potentially reversed with a period of rapid demand growth.
9. Following the Great Recession, CBO began systematically downgrading its estimates of potential GDP growth as well. Even though this downgrading took place over a much longer time frame than the January-to-July period in which the latest potential output revisions took place, it likely was still quite misleading. Much of the decline in potential output was likely driven by an aggregate demand shortage, and could have been substantially healed with a period of rapid aggregate demand growth (again, see Bivens 2019 and Girardi, Meloni, and Stirati 2018).
10. It is worth noting that an overall unemployment rate of 3% implies a Black unemployment rate of roughly 5%. While this would be a historically low Black unemployment rate, there likely would still remain a gap between white and Black unemployment. Macroeconomic policy alone is unlikely to completely erase the Black/white unemployment ratio, but macroeconomic policy can certainly make the gap *much* less pronounced.
11. For the overarching policy agenda indicating what is necessary to provide for a more efficient and far fairer U.S. economy, see EPI’s policy agenda, <https://www.epi.org/policy/>.
12. These unemployment adjustments follow the methodology used by Shierholz (2020).
13. For more on misclassification and other issues with the unemployment rate, see Shierholz 2020.

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