COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET

Fiscally Responsible Stimulus
November 10, 2008

Summary

In light of the current state of the economy, it appears likely that Congress will pass another stimulus package. The Committee for a Responsible Federal Budget (CRFB) urges policymakers to carefully weigh the benefits of additional stimulus with the risks of additional borrowing, and to ensure that economic rather than political motivations drive the process. Borrowing should be used only to finance temporary measures while the economy is still in distress.

The Committee for a Responsible Federal Budget strongly urges Congress and the White House to include as part of any stimulus package a mechanism to begin a process for addressing the nation's fiscal imbalances. Even though deficit-reducing measures should not be implemented until the economy has been stabilized, starting the discussion of how to remedy the government's fiscal imbalances over time will send a reassuring signal to creditors and markets that the U.S. is both a safe place to lend and a sound place to invest.

Background

The United States has entered a period of serious economic difficulty. GDP declined by 0.3 percent in the third quarter of 2008. The October unemployment rate reached 6.5 percent. Over the last year, average home values fell approximately 18 percent, with some experts predicting that housing prices will continue to decrease for the foreseeable future.[1] Consumer confidence, meanwhile, fell to the lowest level this September since records began more than forty years ago.[2] The International Monetary Fund is projecting output in advanced economies to contract in 2009.[3] These and numerous other economic indicators suggest that the financial crisis of the past months may be steering the country—and indeed, perhaps the world—towards recession.

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[1] S&P/Case-Shiller Home Price Indices, http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/indices_csmahp/0,0,0,0,0,0,0,0,0,1,1,0,0,0,0,0.html

[2] The Conference Board, http://www.conference-board.org/economics/ConsumerConfidence.cfm

[3] International Monetary Fund, "IMF Urges Stimulus as Global Growth Marked Down Sharply," available at: http://www.imf.org/external/pubs/ft/survey/so/2008/NEW110608A.htm

Since the economy began to sour in late 2007 a number of measures have been taken to moderate the downturn. On the monetary front, the Federal Reserve has dropped the Federal Funds rate a number of times – from 5.25 percent last September to a five-year low of 1 percent today. As part of this series of drops, the Fed twice took the unusual step of dropping the rate by 75 basis points (0.75 percent) this year, rather than the normal 25 or 50 basis points. And in October, it took another unusual step by coordinating its 50 basis point cut with five other central banks around the world.

Congress and President Bush passed a fiscal stimulus package in February of 2008. The central feature of this bill was $115 billion in tax rebate checks, distributed to most families making under $150,000 (or individuals making under $75,000). This stimulus bill spent another $50 billion on some payments to veterans and seniors, and "bonus depreciation" tax breaks for businesses that purchase equipment.

In July, Congress followed the stimulus bill with an extension of unemployment benefits, which were signed into law as part of a war spending supplemental. A number of measures have also been taken to address problems in the economy directly. In late July, President Bush signed a housing bill that allocated $15 billion for tax credits for some first-time home buyers, provided another $4 billion in grants to communities with high foreclosure rates, and allowed the Federal Housing Administration to offer loan-guarantees for some homeowners facing foreclosure who wanted to restructure their loans.

Despite these measures, dramatic events on Wall Street put large swaths of the financial sector in danger of failure, prompting the government to respond with a $700 billion rescue package in October of 2008 which aimed to help stabilize the banking sector and infuse capital directly into financial institutions.

With the subsequent turmoil on Wall Street and in the credit markets, and because of spillover effects to the real economy, there is now a growing chorus of calls for further stimulus measures. These voices included the Chairman of the Federal Reserve, Ben Bernanke, leaders of both major parties, and President-Elect Obama. (See table next page)

Table 1: Major Stimulus Proposals

Proposal	Major Elements	Cost
House Democrats Proposal: Short Term[4]	• Investment in infrastructure • Aid to state and local governments • Extension of unemployment insurance • Increase in food stamps • Help to low-income families for energy costs	$60 billion to $100 billion
House Democrats Proposal: Long Term[5]	• Unspecified permanent tax cuts	Uncertain
House Republicans Proposal [6]	• Expansion of offshore drilling • Permanent tax breaks to businesses for capital investment • Permanent reduction of tax on corporate profits • Reduced capital gains taxes for two years • Permanent doubling of child tax credit	Uncertain
Obama Campaign Proposal [7]	• Tax rebates • Aid to state governments • Investment in infrastructure • Tax credits to employers for job creation • Extension of unemployment benefits • Loan guarantees to automakers	$190 billion

There is significant dispute about the extent to which efforts during past recessions to provide economic stimulus have been helpful.[8] In most cases, the measures took effect after the low-point in the recession, and persisted beyond when they were needed. Monetary stimulus and automatic stabilizers have had a better record, but they face constraints which limit their capacity for effectiveness.[9] Economist Martin Feldstein estimated that only ten to twenty percent of every stimulus dollar was spent from the last stimulus package, calling it a "flop."[10] Another analysis concluded that the stimulus provided a moderate boost to consumer expenditures of 2.4 percent in the second quarter, and 4.1 percent in the third.[11]

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[4] AP, http://ap.google.com/article/ALeqM5h-gENT7GyBLgKEZWNC-abt69PwtQD94908R81
[5] Wall Street Journal, http://online.wsj.com/article/SB122600310456906045.html?mod=googlenews_wsj
[6] Freedom Project, http://www.freedomproject.org/Blog/Read.aspx?Guid=34cebc84-6934-4490-bb42-323d66b765d9
[7] US Budget Watch, http://www.usbudgetwatch.org/files/crfb/USBWstimulus_guide.pdf
[8] Christina D. Romer and David H. Romer 1994, *NBER Macroeconomics Annual*, Vol. 9 (1994) pp 13-57
[9] Elmendorf and Jason Furman, "If, When, How: A Primer on Fiscal Stimulus," http://www.brookings.edu/~/media/Files/rc/papers/2008/0110_fiscal_stimulus_elmendorf_furman/0110_fiscal_stimulus_elmendorf_furman.pdf
[10] Martin Feldstein, "The Tax Rebate Was a Flop. Obama's Stimulus Plan Won't Work Either," http://www.nber.org/feldstein/wsj080708.pdf
[11] Christian Broda and Jonathan A. Parker; "The Impact of the Tax Rebates on 2008 Consumer Spending," http://insight.kellogg.northwestern.edu/index.php/Kellogg/article/the_impact_of_the_2008_tax_rebates_on_consumer_spending

Table 2: Strengths and Weaknesses of Selected Stimulus Proposals

Fiscal Stimulus Approach	Strengths	Weaknesses
Aid to State and Local Governments	By offering aid to states, which generally have to balance their budgets, the federal government can help them avoid implementing tax increases or spending cuts that could exacerbate a recession.	Because the federal government cannot control state or local action, there is considerable uncertainty about how well the money will be targeted and how fast it will move through the economy.
Expansion of Food Stamps	Food stamp increases are easily administered, quickly spent, and well targeted toward those most likely to consume due to asset/credit constraints.	An expansion of food stamps would likely be too small to have considerable impact by itself.
Extension of Unemployment Benefits	Unemployment insurance is well targeted since it provides money to unemployed individuals who are likely to spend additional funds.	Extending unemployment benefits can reduce work incentives (people will take longer to find a job), which could prolong an economic downturn.
Infrastructure Investment	If the government pursues increased funding of already extant projects, this can provide some short-term stimulus, in addition to encouraging long-term growth.	Infrastructure projects generally spend out quite slowly and are therefore often ineffective at providing considerable short-term stimulus to the economy.
Corporate Tax Reductions	Corporate tax reductions, including bonus depreciation and investment tax credits, can encourage businesses to speed up investments and reduce the need for layoffs.	There is a lag time between when the tax rate is changed and when corporations make decisions about new investments, which makes this slow-acting relative to other types of stimulus.
Increase in Child Tax Credit	A larger child tax credit increases take-home pay, which encourages people to spend.	If it is not refundable, this will no reach non-tax payers, who would be most likely to use the money for new consumption.
Capital Gains Tax Cut	Lower tax rates would encourage further business investment.	This cut would have little stimulating effect in the short term, and gains would largely go to wealthier earners who are more likely to save any benefits received.
Flat Tax Rebate	Rebates have the advantage of being simple and politically appealing. To the extent they are refundable, they also tend to be well-targeted to those who would spend.	Sending out rebates can be a lengthy process, and evidence suggests individuals will save, rather than spend, much of their rebates.
Payroll Tax Holiday	A payroll tax cut is moderately well targeted and studies show that households spend a larger portion of a perceived increase in take home pay than of a rebate.	A payroll tax holiday leaves out recently unemployed taxpayers, as well as retired individuals.

Source: Congressional Budget Office, *Options for Responding to Short-Term Weakness*, available at: http://www.cbo.gov/ftpdocs/89xx/doc8916/01-15-Econ_Stimulus.pdf; Elmendorf and Jason Furman, "If, When, How: A Primer on Fiscal Stimulus," *The Hamilton Project*, Washington, DC: The Brookings Institution, January 2008, available at: http://www.brookings.edu/~/media/Files/rc/papers/2008/0110_fiscal_stimulus_elmendorf_furman/0110_fiscal_stimulus_elmendorf_furman.pdf

Recommendations

The Committee for a Responsible Federal Budget recognizes that there is a strong enough risk of a prolonged recession that a fiscal stimulus package may well make sense. Given the many risks associated with a significant downturn, it makes sense to err on the side of caution in determining whether more stimulus is appropriate. Assuming Congress proceeds with plans to offer some type of stimulus package, CRFB offers three recommendations.

1) The package should be designed to accomplish economic, not political, objectives. There is already a good deal of momentum behind the idea that there should be another stimulus package and the size of this package seems to be growing by the week. It is critical that this not become a political package filled with Members' favorite items or unrelated spending and tax initiatives, dress up as stimulus.

Congress has a poor recent track record on this point: the September $700 billion dollar package included tens of billions of dollars in unrelated giveaways like tax breaks for sales of wooden arrowheads and a credit for turning chicken waste into jet fuel. The package also included more substantive measures like the $80 billion patch on the Alternative Minimum Tax, which never received the full and open debate it deserved because it was rushed through as part of an emergency spending measure.

If Congress passes a second stimulus proposal, CRFB urges it to pass a "clean" bill that is free of unrelated provisions and political bargaining chips.

2) Borrowing should only be used for temporary measures. Pay-as-you-go (PAYGO) rules need not apply to temporary fiscal stimulus—in fact, any short-term or immediate offsets would defeat the purpose of fiscal stimulus, which relies on deficit spending to help boost aggregate demand and GDP.

However, if the federal government borrows too much, it risks creating serious long-term damage to the nation's economy. While deficits can stimulate growth and encourage consumption in the short-run, they stifle long-run growth by crowding out investment. Interest payments also crowd out other areas of the budget, and present a particularly worrisome situation if they are growing faster than the economy. If the new debt associated with the stimulus becomes permanent, we will pay interest on that borrowing *indefinitely* in return for temporary employment and consumption gains. The long-term fiscal picture is already quite bleak; and it would be a mistake to make the situation worse by prolonging stimulus policies and borrowing past the window of need.

Accordingly, CRFB strongly urges Congress to make all parts of any stimulus package *temporary.* The stimulus should not include outlays or tax cuts that extend beyond the period in which they are expected to mitigate the effects of an economic downturn. Permanent policies developed to encourage economic growth, such as fundamental tax reform or investment spending on areas such as energy, infrastructure and research, should be evaluated on their own merits and paid for rather then deficit-financed. Part of the stimulus agreement should be that Congress will find corresponding offsets for any tax or spending policies that are passed as part of a stimulus package, but have costs beyond the period when the economy is in recession.

3) The creation of a mechanism to address fiscal imbalances should be included with any stimulus package. We strongly recommend that any stimulus package include a mechanism to help start the process of addressing the nation's long-term budget imbalances. As the economy struggles to gain its footing, it is not the time to implement the types of policies—raising taxes and cutting spending—that will be necessary to re-balance the country's short- and long-term budget. But a stimulus package should put in place the mechanism to begin crafting a longer-term budget plan. This could take the form of a Members Working Group, or a Task Force to present recommendations that could be implemented once the economy has stabilized. Such an action would send an important signal to markets and our creditors that the current economic crisis is not being viewed as an excuse to borrow endlessly without a credible plan to pay down the debt in the future.

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If the government had run surpluses during past years of economic growth, the country would be in a much better position to accommodate the high levels of borrowing we are now undertaking. Entering the economic downturn in an already vulnerable fiscal state means that all the new borrowing poses far greater threats to the economic health of the country. The current tension between the need to borrow and the risks of doing so serves as an unfortunate reminder of the downside of the shortsighted policies we have adopted in recent years. The country must now enter into a delicate two-part strategy of both stabilizing the economy in the short-run and addressing the tremendous fiscal imbalances we face.