

November 2, 2008

Economic Team: Fiscal Stimulus
Discussion Document

Overview

Unless action is taken in the lame duck session, fiscal stimulus likely to be new Administration's first major legislation.

Will be early test of leadership even in lame duck.

In addition to direct policy impact it will be symbolic of competence to execute effectively.

Stimulus will set the stage for broader economic and budget program, of which it is the first chapter.

Major Questions

- How much fiscal stimulus is needed?
- What are the core components of a fiscal stimulus package?
- Should stimulus become a recovery package and include measures to jumpstart a longer term growth agenda?
- Should the package be paid for?
- How should action be divided between the lame duck, pre-inaugural session in 2009 and first 100 days?

Principles

Earlier this year economists and policy officials came together around three principles to guide the debate: fiscal stimulus should be timely, targeted and temporary.

- timely fiscal stimulus package should take effect while the economy needs the boost and not before or after -- it is critical to avoid controversies that would delay enactment
- targeted fiscal stimulus should be aimed at individuals, geographical areas and possibly sectors most in need, where the stimulus will result in immediate economic activity
- temporary fiscal stimulus should disappear after it is quickly spent and not become either a lagging or permanent expenditure – if stimulus is used to jumpstart longer term growth agenda could combine emergency spending during recession with longer term spending paid for as part of overall fiscal plan

Stimulus Already Enacted in 2008

The Economic Stimulus Act in February enacted \$115 billion in refundable tax rebates which together with other provisions totaled roughly 1 percent of GDP:

- tax rebates were distributed quickly
- moderately well targeted to families most in need
- roughly half appears to have been spent
- appears to have softened economic decline – no technical recession yet – but not a lasting effect
- ongoing financial crisis has caused more damage but economy would have been even worse without stimulus

July 2008 Iraq Appropriations extended unemployment insurance for 13 additional weeks for individuals who had exhausted the base 26-week benefit (\$8.2B).

Prior positions

Measures proposed on October 14

- New jobs tax credit -- \$40 billion over two years
- Extend unemployment benefits -- \$10 billion
- Small business lending -- \$6 billion
- Additional assistance for auto industry -- \$4 billion
- Waive penalty on early IRA withdrawals – n/c

Statement in support of TARP

Washington has to show the same sense of urgency in dealing with the crisis facing Main Street and the middle class by passing an emergency economic stimulus plan that would create jobs by rebuilding our crumbling roads; shore up flagging state budgets to prevent drastic cuts in education and health care; and extend expiring unemployment insurance benefits for those who have lost their jobs in this downturn and cannot find new ones.

Earlier positions

- Fast track Making Work Pay Credit \$1000/married couple and \$500/individual tax rebate, offset by taxing oil company windfall profits, to help pay for gas, heating bills or even pay down debt over the next few months (\$65 billion)
- State Growth Fund to prevent cuts in health, education, housing assistance; prevent cuts in essential services like police and fire and provide home heating and weatherization assistance (\$25 billion).
- Jobs and Growth Fund (complements National Infrastructure Bank proposal that will leverage \$6 billion/year into \$35 billion in new investments, and help improve competitiveness and energy efficiency) -
- create new jobs and save over one million jobs now in danger; replenish highway trust fund; prevent cutbacks in road and bridge maintenance; and fund new, fast-track projects to repair schools (\$25 billion)
- Fund to avoid foreclosures (\$10 billion) -- covered in financial crisis discussion

Jumpstarting long term growth agenda

- with deeper economic downturn more long term economic growth initiatives may overlap with stimulus goals -- spending on projects that last two to three years will be needed as stimulus
- accelerating long term agenda (e.g. fast track Making Work Pay rather than enacting a one time rebate) would capture overlaps
- could be opportunity to launch energy conservation and other green energy proposals – some of which are short term
- projects that span 3 to 5 years less effective as short term stimulus, but early year/s emergency funding could be combined with more traditional longer term funding
- short term spending options will be more effective as stimulus but less directed toward long term growth agenda, particularly assistance to individuals and states
- risk of package growing large and losing control -- longer term objectives could expand size of emergency package and might be difficult to control
- risk of driving too much spending to longer term agenda and not providing sufficient short term stimulus
- stimulus may be only chance for quick action on longer term growth and energy/environment agenda

How much stimulus is needed?

Broad expectation that economy will be anemic late 2008 and into 2009

- 2008 third quarter likely to mark beginning of recession and decline is expected to last several quarters with long and slow recovery
- Blue Chip now forecasts .5 percent growth in 2009 and consumer confidence is at a 40 year low
- not clear where economic jumpstart will come from with tight credit markets, tapped out consumers, trading partners following behind economic cycle and heading into recession and a stronger dollar
- unemployment likely to peak at over 8 percent and remain high for most of 2009 and into 2010 – increasing need for stimulus and weakening inflationary wage pressures
- however rising deficit will make passing a large stimulus package more of a challenge and might drive up the cost of credit for private investment which could delay recovery
- inflation concerns not immediate but will increase once a recovery is underway

Arguments for significant stimulus package

- financial rescue did not address working families
- state government face shortfalls of approximately \$100 billion and state budget cuts would have opposite effect of stimulus
- financially led recessions tend to last longer -- unemployment likely to trend up and may exceed 8 percent in 2009 and 2010 -- unemployment peaked two years after the last recession
- fiscal stimulus only real option since monetary tools are exhausted and there is room for monetary policy response if fiscal policy overshoots -- recession risk much greater than fears of inflation and crowding out
- GDP gap leaves room for significant stimulus – economists consulted support 1-2 percent of GDP (\$150-300 billion) with consensus that 2009 stimulus should be around \$150 billion and some differences on duration and size in subsequent years
- Goldman Sachs economic review on 10/24 called for \$300-\$500 billion to offset sharp drop in spending relative to income by US households and businesses – rejecting criticism that deficit is too large as “misguided because it ignores the fiscal cost of letting the downturn continue unchecked and the fiscal benefits of stabilizing the economy”
- at the end of October Martin Feldstein wrote in the Washington Post that there is a need for \$300 billion in stimulus and that spending would be more effective than tax rebates
- safety premium likely to make federal borrowing cheaper in the near term and private borrowing more expensive, increasing need for public sector stimulus
- negative market response to small package could produce pessimistic projections that will flow back into budget forecast as additional drag – preventing further decline will have positive budget impact in terms of both revenue and spending

Arguments for a small stimulus package

- at over \$1 trillion the response to the financial crisis is already large enough -- TARP increased national debt by as much as \$700 billion, with \$150 billion of additional spending/tax relief and a prior stimulus bill of \$150 billion
- focus should shift to fiscal discipline – spending that slips into late recession/early recovery will contribute to inflation and crowd out investments needed for long term growth
- history of prior first year stimulus efforts is daunting: Carter stimulus effort in 1977 ran off course because of inflation fears; Clinton 1993 effort bogged down as economy rebounded, complicating effort to launch broader economic program and focus on fiscal discipline
- multiplier impact lags so 2010 spending will linger into 2011 – when concerns about inflation will be more serious
- risk that large package will take too long to spend
- risk that adding to deficit will spook the bond markets and produce interest rate spike that will reduce private investment

Offsets – Should fiscal stimulus be paid for?

Early congressional consultation critical -- House Blue Dogs objected in September because stimulus was not paid for.

Concerns may diminish as financial crisis continues, but could be challenge to pass large package unless offset or presented in the context of broader budget proposals that tackle long term fiscal discipline.

Options:

- do not pay for stimulus package arguing that immediate stimulus is critical and was neglected when TARP was enacted
- require offsets for impact above certain level or spending projected to take longer than 18 months (easier to enforce a strict dollar limit)
- require budget neutrality over 5 or 10 year time horizon – major challenge will be making offsets credible when the spending comes immediately and savings are in out years or future legislation
- could propose offsets without drawing hard line that would force veto if Congress rejects offsets
- could consider trigger for all or part of spending and/or offsets

Arguments against offsets

- in short term defeats the purpose of stimulating the economy
- fast action needed and specific offsets likely to cause delay, particularly in Senate
- GOP likely to oppose any revenues without overall budget agreement
- unfair to require offsets to help families; financial bailout not paid for

Arguments for offsets

- need to focus on fiscal discipline as the economy recovers and deficits and debt are soaring
- case can be made that long term offsets should be greater than stimulus
- longer term items in particular are not an emergency and should be subject to normal budget process
- stimulus may become Christmas tree if it is the last chance to escape budget discipline – offsets naturally limit size and scope
- Blue Dogs may slow down effort unless stimulus bill is either offset or part of agreed upon broader fiscal approach

Congressional offset options

Passed by either House or Senate

	5/10 year revenue
• Delay worldwide allocation of interest	\$5/19 billion
• Treaty withholding rate fix	\$3/7 billion
• Carried interest	\$18/31 billion
• Codify economic substance doctrine	\$1/3 billion
• Deny domestic production deduction for some oil/gas	\$5/13 billion

Other options discussed

• Reform deferral on active business income through controlled foreign corporations	\$53/115 billion
• Repeal LIFO	\$62/102 billion
• Repeal lower of cost/market accounting	\$5/7 billion
• End subsidies to student loan providers	\$4/20 billion
• Reform sale of excess property	\$2-5 billion (one-time)
• Sale of spectrum available after digital conversion	\$3-9 billion (one time)

Triggers

- Stimulus could be divided into rounds with 2009 actions immediate and subsequent round or rounds triggered if economic indicators show prolonged recession
- Offsets could take effect after economy improves to avoid drag during recession – could apply to all stimulus or only later rounds.

Argument for triggers

- puts in place package large enough to address severe recession and restore confidence
- avoids need for time consuming process if additional stimulus is needed later
- prevents need to spend political capital on multiple rounds of stimulus
- might be more acceptable to Blue Dogs than larger package all at once

Arguments against triggers

- difficult to define triggers that will operate smoothly
- politically difficult to build consensus for actions that may or may not occur
- strong pressure to put items in first round since it is the one certain to take effect

Options for additional stimulus in 2009/2010

Faster/more efficient

- income transfers to people struggling the most and need to spend immediately
- fiscal relief to states – balanced budget requirements forcing state budget cuts that deepen the recession and reduce education and health care services – likely to be spent immediately
- infrastructure spending that is ready to go and can be spent quickly is highly efficient – to avoid risk that this will lead to pork barrel projects, should consider absolute policy of no earmarks

Slower/less efficient

- individual tax rebates easy way to distribute a large amount of money widely and quickly but generally less efficient stimulus
- strategic infrastructure investments that require planning will not move quickly
- business tax incentives – investment tax credits and accelerated depreciation could help restore liquidity for business investment

Options for additional stimulus in 2009/2010

Emergency response may be needed

- auto industry assistance – rising layoffs and risk of bankruptcy creating emergency – will be covered in discussion of responding to financial crisis
- SCHIP (State Child Health Insurance Program) – expires in March as rising unemployment is increasing the number of uninsured children
- homeownership assistance – will be covered in discussion of responding to financial crisis

Stimulus Options: Assistance to Individuals -- Benefits

Arguments for unemployment compensation extension

- 13 week extension short relative to other recessions -- could target extra weeks to high unemployment states (House bill added 7 weeks to all states + 13 additional weeks in high unemployment states for total of 33) (\$6.5 billion)
- additional weeks will target those hardest hit who will spend immediately
- can implement quickly
- high fiscal impact per dollar spent (CBO; Moody's)
- could include provisions to target low income workers proposed by UC Commission and passed this year by the House

Stimulus Options: Assistance to Individuals -- Benefits

Arguments for food stamp increase

- food stamps are distributed electronically and can be adjusted almost immediately
- targeted to those most in need and would be spent quickly– could increase maximum benefit and phase out to avoid sharp cliff (\$3-10 billion)
- jobless adults without children have the least access to assistance since benefits are limited to 3 months over 3 years – could temporarily or permanently change standard to 3 months per year to provide emergency support

Stimulus Options: Assistance to Individuals -- Benefits

Arguments against

- unemployment benefits criticized by Republicans as delaying the need to look for work
- food stamp increases may be criticized as expansion of welfare benefit
- direct spending will generally be criticized as big government

Stimulus Options: Assistance to Individuals – Benefits

Low Income Home Energy Assistance (LIHEAP)

Arguments for Low Income Home Energy Assistance:

- energy bills are immediate crisis and families will spend quickly and avoid reducing other spending
- states have experience disbursing LIHEAP funds quickly – could distribute \$2-3 billion rapidly

Argument against Low Income Home Energy Assistance:

- energy bills will be coming down with declining oil prices
- does not provide consistent benefits across populations in need – varies by state and locality and participation rates

Stimulus Options: Relief to States

Fiscal relief to states

- more than 30 states have budget gaps -- state shortfalls now total over \$100 billion and state spending cuts will add to fiscal drag
- assistance can be targeted to states most in need – House Democrats developed a targeting formula to direct assistance based on a combination of unemployment rates, foreclosure rates and food stamp caseload increases
- House formula directs roughly three quarters of assistance to the half of states with the most need, while providing at least some relief for all states

Stimulus Options: Relief to States

Medicaid match increase

Arguments for increasing Medicaid match

- most direct way to distribute substantial resources to states immediately (House bill included \$15 billion – could do more)
- could be scheduled to last for 12, 15, 18 or 24 months and phased out on a predetermined schedule
- states could avoid cutbacks in health and education spending which would further slow the economy
- no medicaid eligibility reductions in states that benefited from 2003 round
- highly fungible -- states can use to meet most immediate needs

Argument against increasing Medicaid match

- long term fiscal risk that states may push to make higher federal match rate permanent to offset rising health costs, however after 2003 stimulus match reverted back to old level

Stimulus Options: Relief to States

Title XX

Arguments for increasing Title XX

- provides services for those most in need (child care, foster care; services for people with disabilities) – could distribute \$5 billion quickly
- target to low and middle income areas
- funds dispersed quickly and provided employment and critical services when included in 2003 stimulus bill

Arguments against increasing Title XX

- needs being met are not all directly related to the economic downturn
- may be seen as traditional Democratic spending

Stimulus Options: Relief to States

Flexible state block grant

Arguments for flexible state block grants

- gives states discretion to put resources out effectively
- could set criteria to direct generally towards specific objectives
- could use states to pass assistance through to localities
- any money spent quickly likely to be additive and stimulative
- supported by governors

Arguments against flexible state block grants

- more difficult to target specific purposes
- pass through to localities may not work
- Congress may resist spending money that governors get credit for spending

Stimulus Options: Relief to States Community Development Block Grants

Argument for Community Development Block Grant (CDBG)

- popular with mayors because funding goes directly to local governments
- can be used for neighborhood stabilization in areas hard hit by foreclosure

Argument against CDBG

- long planning periods before money can be spent
- not targeted to support those most in need
- does not address state operating deficits

Stimulus Options: Infrastructure

Arguments for infrastructure spending

- huge backlog of unmet needs
- critical foundation for future economic growth
- if spending lags recovery still important for future economic growth
- economic crisis likely to be prolonged and two plus years is timely
- could waive or expedite environmental reviews
- case for substantial resources stronger if paid for over time
- states can backload matches to move more money quickly
- unemployment concentrated in blue collar jobs
- Goldman Sachs paper described as most effective if spent quickly

Stimulus Options: Infrastructure

Arguments against infrastructure spending for stimulus

- infrastructure spending likely to take well over two years to be completed -- past efforts to use highway and bridge repairs as stimulus took years to be completed
- not clear whether plans, materials and personnel are in place to accelerate public works rapidly – past experience suggests not
- efforts to identify specific projects with delays invites subjective standards and ultimately earmarking.
- could undermine overall fiscal plan if it grows into long term effort that is not paid for
- environmental and social impact may be undermined if projects are rushed
- rush to create stimulus could lead to funding low priority projects

Infrastructure Options

- downpayment on national infrastructure bank -- replenish highway trust fund to fund and prevent cutbacks in bridge and road maintenance – (House bill \$12.8 billion).
- fast-track school repair projects -- should be easy to draw on resources and personnel normally engaged in homebuilding (Senate bill \$2 billion; House bill \$3 billion).
- fast track weatherization program
- support to states to compensate for rising material costs
- public housing – repairs and modernization
- flood control through Army corps of engineers which has list of approved projects that can be started more quickly – need to consider whether projects are consistent with other policy goals
- green energy program – install solar energy; efficient lighting and conservation measures in federal, state and local buildings
- block grant to states for specified range of purposes favored by governors

Stimulus Options: Assistance to Individuals – Tax rebates

Arguments in favor

- system in place for fast distribution of rebates
- accelerating Making Work Pay Credit would not be one shot that fades away quickly
- first round appears to have been reasonably effective – roughly half of it was spent quickly
- provides relief broadly
- can be dialed up to provide as much stimulus as is needed
- can better target than first round to low and middle income families more likely to spend quickly -- could lower threshold and make fully refundable to low income taxpayers

Arguments against

- flat rebate families do not give more to families most in need
- benefits to families now saving reduces stimulus effect – recession fears increasing number of families saving
- paying down credit cards is another form of saving which reduces stimulus
- looks like more of the same when the first round did not stop the recession

Stimulus Options: Business Tax Incentives

Credit and liquidity conditions are making it very difficult for businesses to undertake investments and conditions are likely to remain difficult for some time.

Some progressive economists suggesting that it would be helpful at this point to consider tax incentives that would provide liquidity relief to businesses that undertake investments over the near term which could be in the form of investment tax credits or accelerated depreciation.

To target assistance to increase investment activity, business incentives would be incremental and only apply to investments above a threshold. An incremental investment tax credit of 10 percent for investments above 90 percent of last year's level, for example, would amount to a 10 percent discount for incremental investments and would be much less costly since it would not provide additional tax relief for the base level of investment.

Stimulus/Emergency Options: SCHIP (\$5/1 year-15 billion/2.5years) (State Child Health Insurance Program)

- federal fund for child health coverage expires in March 2009
- extension paid for by tobacco tax was vetoed by President Bush
- Hill Democrats until recently wanted to hold SCHIP extension as engine for larger health care debate but growing recognition that action on health reform cannot be completed by March
- growing concern about rising numbers of children without coverage because of recession combined with state fiscal pressures that make it impossible for many states to maintain current coverage without federal support
- vetoed bill could be included in stimulus and extend SCHIP for up to two and a half years without taking away pressure for health reform – might be possible to avoid new policy debate and open controversial issues, e.g. coverage of legal immigrants
- if attempt lame duck effort fails, would cue issue up for quick action in 2009
- need to coordinate with health care strategy

Stimulus/Emergency Options: Homeownership and auto industry assistance

- Will be discussed in context of financial crisis options, but costs need to be added to emergency package in terms of overall size

Summary of Options

Faster spending/more efficient

Unemployment compensation	\$6 -12 billion
Foodstamps	3-10
Low income home energy assistance	2-5
Short term infrastructure projects	20-50
Assistance for states	20-50

Slower spending/less efficient

Fast track Making Work Pay Credit	\$65 billion
Longer term infrastructure projects	tbd
Investment tax incentives	tbd

Emergency responses

Auto industry	tbd
Housing support	tbd
State Child Health Insurance Program	\$5-15 billion

Timing considerations

How should action be divided between the lame duck, pre-inaugural session in 2009 and first 100 days?

- Can lame duck complete action on immediate emergency items such as unemployment extended benefits; foodstamps and/or SCHIP?
- Can Congress work between the convening of the new session and the inaugural to present a more complete stimulus/emergency package to the President immediately after the inaugural?
- If Congress does not act between the election and the inauguration, how quickly can action be taken both to provide stimulus as quickly as possible and to avoid having the first hundred days and beyond dominated by action on stimulus?
- How much of the longer term agenda can be accomplished in stimulus without slowing it down or having it grow out of control?

Major Questions

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