



The Need for an Economic Stimulus Package

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A steady drumbeat of bad economic news over the last few months clearly indicates that the economy is facing a recession, that is likely to rank among the worst of the post-war downturns. The economy's current weakness, and the likelihood that it will deteriorate rapidly in the near future, underline the need for crafting a substantial stimulus package as quickly as possible. While the Federal Reserve has been lowering interest rates in hopes of stimulating the economy, the best way to forestall the worst-case scenario is to adopt an aggressive fiscal stimulus package. We propose a fiscal stimulus package equal to 1 percent of GDP. This sum may not be sufficient to fully offset the sources of weakness in the economy, but it will provide an important boost. If the downturn proves to be deeper and more long-lasting than most economists now expect, this amount can be raised at a later date.

The underlying source for the economy's weakness is the collapse of the housing market. The extraordinary run-up of house prices since 1995 had been the main force propelling growth in the current business cycle. At its peak in 2006, the house-price bubble had generated more than \$8 trillion in housing wealth compared to a scenario in which house prices had just followed their long-term trend.¹ The unsustainable increase in house prices pushed residential construction to a record share of GDP, but even more importantly for the economy, homeowners also rapidly spent their newly created housing wealth, fueling consumption and the broader economy, and leading the savings rate to fall to the lowest level since the beginning of the Great Depression.

These effects are now being felt in reverse. The record rate of construction led to enormous overbuilding. The nationwide vacancy rate for ownership units is more than 40 percent higher than the level reached in any prior housing slump.² The inventories of unsold homes are at or near record levels. This has caused construction to plummet, with housing starts now down by more than 40 percent compared with 2005 levels. More importantly, the overbuilding has led to sharp declines in house prices over large areas of the country.

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¹ The impact of the run-up in house prices on the economy is discussed more extensively in Baker (2007).

² Census Bureau, 2007. "Housing Vacancies and Homeownership, Historical Data" Table 7, [<http://www.census.gov/hhes/www/housing/hvs/historic/histtab7.html>].

The November data from the Case-Shiller house-price index showed prices nationwide falling at more than an 11.0 percent annual rate over the prior three months.³ This rate of price decline will destroy more than \$2 trillion of housing wealth over the course of a year.

This rapid pace of decline in house prices will cause the already record high rate of foreclosures to rise further. Foreclosures will spread well beyond the subprime segment of the mortgage market and into the prime segment, leading to much greater distress in the financial industry than it has experienced thus far. This decline in house prices will also sharply curtail consumption as tens of millions of homeowners will no longer have any equity against which to borrow. The Federal Reserve Board's data for the fourth quarter is likely to show that, for the first time in history, the ratio of homeowners' equity to housing value will fall below 50 percent.⁴

The evidence of waning consumption is already apparent in data showing the weakest holiday shopping season since the last recession. In response to drooping demand, several major car manufacturers have already cutback projections for sales and production in 2008. With job growth now slowed to a trickle and wages no longer keeping pace with inflation, consumption is almost sure to be even slacker in the months ahead.

The deterioration in housing is also having an impact on state and local governments, which depend heavily on construction related fees and property taxes. Revenue projections are being revised sharply downward. As a result, state and local governments will be forced to raise taxes and/or cut spending to balance their budgets, further weakening the economy. The Center on Budget and Policy Priorities recently added up the projected shortfalls for 2009 budgets in 13 states at \$23 billion.⁵ This figure will undoubtedly go much higher as more states realize revenue shortfalls and the size of these shortfalls grows.

With languishing residential construction, stagnating consumption, and weakening state and local government spending all acting as a drag on the economy, it is difficult to imagine how the economy can remain healthy. Non-residential construction now appears to be softening after a boom in 2006 and 2007,⁶ and equipment investment is also stagnating. Net exports had provided some boost to the economy in the first three quarters of 2007, but over the last two months, they have turned flat. There is a limit to how rapidly foreign countries will allow U.S. exporters to gain shares of their markets.

The most important consequence of this economic weakness is job loss. The 0.3 percentage point jump in unemployment in December is likely a sign of further trouble in the months ahead. A jump in the unemployment rate of this size almost never occurs outside of a recession. The employment rate (the percentage of the population that is working) shows an even bleaker picture. The share of the population in work has fallen 0.7 percentage points from its peak in December of 2006, corresponding to a falloff in employment of more than 1.5 million people.⁷

Many economists are now predicting a recession in 2008, which is very alarming since economists, contrary to their reputation as the "dismal scientists," actually are typically quite optimistic about the economy and almost never predict recessions. When they do, it must mean that the economy is in poor shape.

3 Standard & Poor's Case-Shiller Home Price Index (20 city composite)

[<http://www2.standardandpoors.com/portal/site/sp/en/us/page.article/0,0,0,0,1145923002722.html>].

4 Federal Reserve Board, Flow of Funds, Table B100, Line 50 [<http://www.federalreserve.gov/releases/z1/current/z1r-5.pdf>].

5 McNichol, E. and I. Lav, 2007. "13 States Face Total Budget Shortfall of at Least \$23 Billion in 2009; 11 Others Expect Budget Problems." Washington, DC; Center on Budget and Policy Priorities [<http://www.cbpp.org/12-18-07sfp.htm>].

6 The December employment report actually showed job loss in the non-residential construction sector.

7 The decline in the employment rate is larger than the increase in the unemployment rate because some of the people who lose jobs give up looking for work and therefore are not counted as being unemployed. While this decision can be voluntary, such a large increase in the number of prime age workers who leave the labor market is almost certainly a reflection of labor market weakness and workers' belief that acceptable work is not available.

TABLE 1
Economic Forecasts for 2001 and 2002, as of December 2000

	2001		2002	
	Projection	Actual	Projection	Actual
Unemployment	4.3%	4.8%	4.5%	5.8%
GDP growth	3.1%	0.8%	3.4%	1.9%
S&P500 (year-end)	1490	1145.0	1639.5	899.0

Source: Federal Reserve Bank of Philadelphia

For example, every six months the Philadelphia branch of the Federal Reserve Board conducts its “Livingston Survey,” of 31 leading economists.⁸ Table 1 shows the results for the survey done in December of 2000, just three months before the beginning of the last recession. The consensus forecast of leading economists --just three months before the onset of the 2001 recession-- was for strong economic growth in both 2001 and 2002.⁹ The Blue Chip Economic Forecasters, a survey of 50 economic forecasters, also showed a consensus for solid growth in 2001, with the lowest projection from the group coming in at 2.8 percent. Actual growth in 2001 was 0.8 percent.¹⁰

The official government forecasters were no more accurate in their predictions. In its January 2001 *Budget and Economic Outlook*, the Congressional Budget Office (CBO) projected 2.4 percent year-over-year growth for 2001.¹¹ At that time, the Office of Management and Budget projected 3.3 percent growth for 2001 (CBO, 2001 Table 2-5). . In short, the overwhelming majority of economists completely failed to anticipate a recession in 2001 even as it was just about to begin.

The extraordinary bias among economists against forecasting recessions (if they were unbiased, we should expect economists’ forecasts to be roughly evenly distributed around actual growth) means that the recent spate of recession predictions among economists is especially ominous. Given their bias, recession predictions by economists are probably best viewed as a lagging indicator, providing evidence that the economy is in fact already in a recession, rather than an assessment of the economy’s future prospects.

In assessing the need for stimulus, it is also important to keep in mind the asymmetric nature of the risks. Right now, the U.S. economy is undoubtedly weak and operating below its capacity. There is little risk that a temporary stimulus equal to 1 percent of GDP (approximately \$140 billion) would overheat the economy. Since the proposed stimulus is temporary, the impact on the long-term budget situation will be modest. Even if the stimulus increases GDP by just the actual amount of increased spending and tax reductions (i.e. the multiplier is 1), the federal government can count on collecting roughly 20 percent of the amount spent in additional tax revenues. This means that the net addition to the debt would be just over \$110 billion, an amount that is frequently less than the error in projecting the annual budget deficit. On the other hand, if the economy falls into a recession, this package could generate close to 2 million jobs. The additional jobs will also provide a much greater sense of security to millions of workers who are not directly employed as a result of the stimulus measure.

8 Federal Reserve Bank of Philadelphia, 2000. “The Livingston Survey,” Philadelphia, PA: Federal Reserve Bank of Philadelphia [<http://www.philadelphiafed.org/files/liv/livdec00.pdf>].

9 The attacks of September 11, 2001, do not explain the forecasters’ failure to foresee the recession. According to the National Bureau of Economic Research, the 2001 recession began in March 2001, six months before the attacks, and the recession ended in November 2001, just two months after the attacks.

10 Blue Chip Economic Indicators, Vol. 25, No. 9, September 10, 2000, Table 2.

11 Congressional Budget Office, 2001. *Budget and Economic Outlook, 2002-2011*, Washington, D.C.: Congressional Budget Office, Summary Table 3 [<http://www.cbo.gov/ftpdocs/27xx/doc2727/entire-report.pdf>].

The nature of the impending recession means that Congress, as much as the Federal Reserve Board, will play a central role in turning the economy around. Ordinarily, the Federal Reserve Board could expect to give the economy a boost with interest rate cuts. However, it may be more reluctant to lower interest rates now than in prior recessions because of concerns about inflation stemming from a falling dollar. More importantly, the main channel through which interest rates stimulate demand has been through the housing sector, as lower mortgage interest rates encouraged people to buy homes and also to borrow against their homes to support consumption. With an unprecedented accumulation of unsold homes and lenders writing off tens of billions in mortgage debt, this channel for generating demand is unlikely to be effective in the current economic environment.

Finally, the bursting of the housing bubble has the potential to lead to a downward spiral, as happened in Japan in the early 1990s. An appropriately devised fiscal stimulus package could be an important force in sustaining the economy, giving Congress the time needed to plan stronger steps.

Directing the Stimulus

The stimulus program outlined here is a healthy, but limited, start towards counteracting the effect of the housing downturn on the economy. The package of measures sums to approximately 1 percent of GDP (\$140 billion): \$85 billion in tax cuts, \$20 billion in tax credits for energy-conserving home and business improvements, \$7 billion to subsidize use of public transportation, \$3 billion to subsidize the purchase of heating oil and gas for low- and moderate-income families, and an additional \$25 billion for temporary revenue sharing for state and local governments.

A Temporary Tax Cut for Every Worker

The core of this package is a one-time \$600 tax cut for every worker. A temporary tax-cut of this size is desirable both because it would be progressive and because it targets working families who are likely to spend the proceeds quickly, giving a speedy lift to the economy. Research on the 2001 tax cut showed that most of that cut was spent shortly after it was received, especially by low- and moderate-income families.¹² Since consumers will spend a temporary tax cut when they receive it, there is no need to make a tax cut permanent, with the resulting permanent loss of revenue. Running deficits during a downturn when the economy needs stimulus is good economics; when the economy recovers, however, it is important to maintain responsible budgets.

We propose that the temporary tax cut be designed as a combination of (1) a one-time rate reduction for those who have more than \$600 in income-tax liability and (2) an Enhanced Earned Income Tax Credit (EITC) for those with less than \$600 in income-tax liability. The tax cut can be implemented by sending taxpayers and recipients of the EITC a \$600 check.

We believe strongly that the tax reduction should focus on general tax revenues and not the payroll tax. First, such a tax cut benefits everyone who works or pays taxes. Second, we are concerned that providing even a one-time payroll-tax cut would reverse a 70-year-old policy that payroll taxes are tied exclusively to financing particular programs, most notably Social Security. Tapping payroll taxes to pay for a short-term stimulus plan would set a dangerous precedent that critics of Social Security could use to undermine the program's long-term solvency. Finally, the administrative expertise already exists to have a rebate based on

¹² See Johnson, D., J. Parker, and N. Souleles, 2006. Household Expenditure and the Income Tax Rebates of 2001. "American Economic Review 96 (December): 1589-1610.

the income tax since it has been done several times in the past, most recently in 2001. The mechanisms would have to be created from scratch to put in place a rebate or reduced payment for Social Security taxes. Setting up this structure could delay the stimulus by several months.

Tax Credits Targeted Toward Housing Sector, Green Building

The second part of our stimulus package is a 30 to 40 percent tax credit to households or businesses for renovation and improvements that will substantially reduce greenhouse gas emissions. This would extend and expand credits that were passed in the 2005 energy bill. The credit would apply to increased insulation, the installation of solar paneling or windmills, or other improvements that reduce the use of fossil fuels. The credit would have the benefit of providing a large incentive to employ workers in construction, precisely the sector that has been most seriously hit by the downturn in the housing market. The credit can be limited to a modest amount (e.g. \$2,500) which would minimize the opportunities for fraud and ensure that the benefits are widely spread among homeowners and small businesses. This program would also be an important start towards reducing the country's greenhouse gas emissions.

This tax-credit program is similar to the program that has been in place under the energy bill passed in 2005. However, the credit would be considerably more generous than the 10 percent credit provided under that legislation. In addition, with housing construction sinking to its lowest levels in more than a decade, contractors are likely to have far more incentive to seek out business with this tax credit than they did at the peak of the housing boom in 2005.

Transit and Home Heating Tax Credits

In the same vein, the package includes \$7 billion in subsidies for mass transit which would take the form of a one-time payment to mass transit systems to be used to reduce fares for riders for one year. Transit riders take approximately 10 billion trips a year on buses, light rail, commuter trains or other forms of mass transit.¹³ If these fares can be cut by an average of 70 cents per ride, this would directly put money in the pockets of mass transit users. For someone who takes mass transit to and from work each day, this would amount to savings of \$350. This would provide a substantial incentive for commuters to try public transportation and at the same time put money directly in transit riders' pockets.

It should be possible to implement such a system of temporary fare cuts in a relatively short period of time. Under this portion of the package, the government would announce that it has \$7 billion, available on a first-come first-serve basis, to mass-transit agencies that submit a specific plan to lower fares over the specified time period. The purpose of the plan is first to lock in a commitment to lower fares, and second to ensure that the agencies have actually made a plan so that they will be able to accommodate the increased usage that would be associated with large fare cuts.

Since agencies would be alerted to the prospect for increased funding as a bill is coming up for debate, they should be able to submit plans soon after any legislation is actually passed (2-4 weeks). The first-come first-served standard ensures that any plans can be approved after minimal review. The point is to make sure that some thought has gone into accommodating increased usage, and that the numbers actually add up. It is not to determine whether a particular agency has come up with the best plan.

The package also includes \$3 billion to subsidize the purchase of heating oil and fuel by low- and moderate-income families. This would more than double the current appropriation for the LIHEAP

13 American Public Transportation Association, 2006. "Historical Ridership Trends," Washington, D.C: American Public Transportation Association [<http://www.apta.com/research/stats/ridership/ridetrnd.cfm>]

program and would limit cutbacks or even increase non-fuel purchases by families struggling with high oil and energy bills. This is a reasonable increase given both the jump in energy prices and the need to get money that can be spent on other consumption items into people's pockets.

Provide Temporary Aid To State and Local Governments

The final part of the program is a \$25 billion temporary revenue sharing package for state and local governments to defray the impact of projected revenue shortfalls due to the collapse of the housing market and the slowing of the economy. This sum can be divided into two portions, one of which would be allocated to state governments based on standard-revenue sharing formulas that do not take into account the extent to which the state's economy has been affected by the downturn. The second portion would be allocated to state governments in a way that is directly related to the economic hardship that the state is currently experiencing. Ideally, the second portion of this package would be larger than the first, both because it would mean that the money is being directed to the areas where it is most needed and also because it would be spent most quickly in areas that are facing the most serious revenue shortfalls.

This sum will not be sufficient to fully offset the lost revenue, but it will be helpful to the economy insofar as it prevents spending cuts or tax increases in the middle of an economic downturn. If the downturn proves to be deeper and more long-lasting than most economists now expect, this amount can be raised or expanded to include Medicaid matching funds at a later date.

Total Spending Package

Table 2 lists the key items included in the stimulus package and the proposed allocation for each one.

TABLE 2
Division of \$140 Billion Stimulus Package

Type of Stimulus	Cost, in dollars
Tax Cut	\$85 Billion
Energy Conservation Tax Credit	\$20 Billion
Public Transportation Subsidy	\$7 Billion
Home Heating Oil Assistance	\$3 Billion
Temporary Revenue Sharing	\$25 Billion
<i>Total</i>	\$140 Billion

Conclusion

The U.S. economy is almost certainly headed into a recession in the very near future, if a recession has not already begun, obviating the need to wait for a trigger before acting to offset the downturn. The main cause of this downturn is the deflation of an \$8 trillion housing bubble. This collapse has already led to an enormous contraction in the housing sector. The loss of housing wealth is likely to lead to an even larger reduction in consumption, which will push the economy into recession.

The seriousness of the situation is not generally appreciated because economists have an enormous bias against predicting recessions. This bias prevented the overwhelming majority of economists from recognizing the 2001 recession until it was well underway. Similarly, Alan Greenspan and other prominent economist continued to tout the economy's strength long after the 1990 recession had begun. Delaying a stimulus package could lead to a much longer and more severe downturn.

The stimulus package outlined here is intended to provide a modest boost to the economy. The targeted sum of \$140 billion may prove insufficient to prevent a recession if house prices continue to fall precipitously, as is presently the case. However, it will help boost the economy and reduce the severity of the downturn while Congress has the opportunity to consider stronger measures.

In a somewhat longer term framework, it would be desirable for Congress to take further steps to shorten the downturn and put the economy firmly on the path to economic and employment growth. The expansion and modernization of unemployment insurance, already under discussion, would enable workers to better meet the challenges of today's economy. The commitment of additional resources to rebuilding the country's infrastructure in ways that meet the environmental and economic demands of the 21st century – by extending broadband Internet access to areas currently without service or building mass transit systems, for example – would meet an important need and could provide an important source of stimulus if the downturn proves to be more long lasting than most economists currently anticipate. This larger agenda cannot be addressed in the context of a stimulus package that can be quickly enacted and put in place. However, it would be reasonable for Congress to begin now to consider a range of programs that both meet the nation's long-term needs and can provide the necessary stimulus to the economy should the downturn prove to be steeper or longer than currently anticipated.