S. HRG. 110–948

STRENGTHENING AMERICA'S ECONOMY: STIMULUS THAT MAKES SENSE

HEARINGS

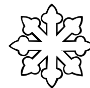
BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

JANUARY 22 AND 24, 2008



Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

53–865—PDF WASHINGTON : 2008

For sale by the Superintendent of Documents, U.S. Government Printing Office
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CONTENTS

JANUARY 22, 2008

OPENING STATEMENTS

	Page
Baucus, Hon. Max, a U.S. Senator from Montana, chairman, Committee on Finance	1
Grassley, Hon. Chuck, a U.S. Senator from Iowa	2

ADMINISTRATION WITNESS

Orszag, Dr. Peter, Director, Congressional Budget Office, Washington, DC 5

JANUARY 24, 2008

OPENING STATEMENT

Baucus, Hon. Max, a U.S. Senator from Montana, chairman, Committee on Finance 35

WITNESSES

Feldstein, Dr. Martin, Baker professor of economics, Harvard University, Cambridge, MA; and president and CEO, National Bureau of Economic Research (NBER), Cambridge, MA 36
Furman, Dr. Jason, director, the Hamilton Project, Washington, DC 39

ALPHABETICAL LISTING AND APPENDIX MATERIAL

Baucus, Hon. Max:
- Opening statements 1, 35

Bunning, Hon. Jim:
- Prepared statement 65

Feldstein, Dr. Martin:
- Testimony 36
- Prepared statement 66

Furman, Dr. Jason:
- Testimony 39
- Prepared statement 70

Grassley, Hon. Chuck:
- Opening statement 2
- Prepared statement with attachment 83

Orszag, Dr. Peter:
- Testimony 5
- Prepared statement 86

Salazar, Hon. Ken:
- Prepared statements 114, 116

COMMUNICATIONS

American Hospital Association 119
Association of Fundraising Professionals (AFP) 122
Independent Sector 126
National Committee to Preserve Social Security and Medicare 130
United Jewish Communities 132

STRENGTHENING AMERICA'S ECONOMY: STIMULUS THAT MAKES SENSE

TUESDAY, JANUARY 22, 2008

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:01 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Conrad, Bingaman, Lincoln, Wyden, Stabenow, Salazar, Grassley, Hatch, Snowe, Bunning, and Roberts.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The hearing will come to order.

First, I want to wish everybody a Happy New Year.

Vaclev Havel once defined hope to mean "the certainty that something makes sense." We meet today to evaluate what economic policy can give Americans hope. We meet to discuss what economic stimulus makes sense.

As we meet today, the economy is weak, the housing sector is in a slump, a larger credit crunch looms on the horizon, and stock markets are falling. Retail sales dropped in December. In the latest report, the unemployment rate jumped from 4.7 to 5 percent. Some States are already in a recession, and consumer expectations for a better economy are at a 16-year low.

Today we will consider the arguments for why the economy needs fiscal stimulus, and, assuming that it does, we will consider what kinds of stimulus make the most sense. To help us understand these questions and to get the answers, we have Peter Orszag, who is Director of the Congressional Budget Office, before us today. We are very honored to have you here, Peter, and thank you for coming.

CBO just issued a report on fiscal stimulus, and that report states "there is a strong possibility of at least a few quarters of very slow growth" in calendar year 2008. The Federal Reserve Board appears to believe that the economy is weak enough to need monetary stimulus.

With its three-quarter-point reduction today, the Fed has already lowered its target for interest rates by a total of one and three-quarters percentage points over the last couple of months. Last week, the chairman of the Federal Reserve Board said the Fed would "stand ready to take substantive additional action as needed

to support growth and to provide adequate insurance against downside risks."

But will monetary stimulus be enough? There are reasons to believe that it might not. There are reasons why Congress might do well to provide fiscal stimulus, *i.e.,* cutting Federal taxes or raising Federal spending.

For one thing, a lot of houses on the market right now might prevent lower interest rates from having their usual punch. For another, skittish lenders who have suffered losses as a result of the subprime mortgage crisis may remain reluctant to make loans, no matter how low interest rates go.

Fiscal policy, if enacted quickly, can work faster than monetary policy. We need to consider that the economy may be weak enough that we may need fiscal stimulus to augment monetary stimulus. Economists differ on the odds of a recession, but either way fiscal stimulus could be valuable to improve otherwise weak economic growth, even if we are not technically in a recession.

If fiscal stimulus is needed, what kind of fiscal stimulus should we enact? The consensus is growing that it must be three things: timely, targeted, and temporary. Stimulus occurs when households and businesses spend any additional income that they receive rather than save it. To get households and businesses to spend more money, the government can do two things: cut taxes or increase spending.

Fiscal stimulus must be timely. That means that, once enacted, the stimulus must take effect quickly. It needs to be out of the door quickly so that the intended recipient can spend it quickly. Spending in 2011 will not avert a recession in 2008.

Fiscal stimulus should be well-targeted. Stimulus should be targeted to those who most need the help. Stimulus should be targeted to those who will spend the money quickest. Lower and middle-income households are the ones most likely to need additional income during a recession. Because the financial resources of these households are more limited, they are also the ones who would be likely to spend the money quickly.

And fiscal stimulus must be temporary. If fiscal stimulus extends beyond the end of the recession, it could overheat an expanding economy, causing inflation. Moreover, permanent fiscal stimulus would increase Federal budget deficits.

So let us think through what sort of economic stimulus makes sense. Let us see what stimulus can be timely, targeted, and temporary, and let us imagine what sort of economic stimulus can help to give Americans renewed hope.

Now I would like to turn to my colleague, Senator Grassley.

Senator GRASSLEY. Happy New Year, Senator Baucus.

The CHAIRMAN. And to you, Senator. Thank you.

OPENING STATEMENT OF HON. CHUCK GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. There are two opposing points of view on the economy. Some people say that consumption is the key to economic growth. When people go shopping, business is good. When people stay home, business is bad. Now, according to this view, we need to spend more. Other people would say investment is the key.

When people invest, business is good. When people do not invest, business is bad. According to this view, then we need to save more.

Some economists try to reconcile these opposing views by suggesting that the correct view depends on the circumstances. When workers are fully employed and factories are fully utilized, they say we need to save more and increase supply. But when workers are unemployed and factories are idle, they say we need to spend more and increase demand. While this explanation is appealing, it does not withstand careful scrutiny.

As a family farmer, I would like to consider a barnyard example. I am talking about the proverbial chicken and egg. In the first example, we have five chickens that each lay five eggs a week. But people want more eggs. The solution is to save some eggs, let them hatch, and then you have more chickens to lay more eggs. In the second example, you have five chickens that lay five eggs a week, but people want fewer eggs. The solution cannot possibly be to buy more eggs, because that is a problem. There is a surplus of unwanted eggs.

Now, when economists talk about stimulating consumer demand, they give the impression that we can grow our economy by getting people to go shopping and it does not matter what they buy. But such talk obscures the fact that, at any given point in time, our economy is comprised of a specific set of goods, a specific set of services, each with its own unique factors of supply and demand.

When market conditions change, either because of fickle consumers, maybe foreign competition, maybe rising oil prices, or a stock market bubble or housing bubble, and maybe a lot of other things, the goods and services that existed before the change are no longer suitable to meet the market conditions that exist after the change.

For example, if consumers decide they want more milk and fewer eggs, no amount of consumer demand is going to magically turn our eggs into milk. Farmers are going to have to raise fewer chickens and get more cows, and that of course takes time.

When workers are unemployed and factories are idled because of changing market conditions, those workers and those resources must often be reemployed or redeployed in a new occupation or industry. Economist Joseph Sumter refers to this process as, in his words, “creative destruction.”

This process, as we know, is ongoing. Millions of jobs are created and destroyed each year. Most of the time we end up with more jobs than we started with at the beginning of the year; regardless of how many were created or destroyed, more are created. But whenever our economy falters and millions of Americans are out of work, it is only natural to want to help.

As the President said during the last economic downturn which occurred earlier in his first term, “Everyone who wants a job ought to be able to get a job.” Thankfully, we have had several years of robust economic growth since. The question is, how do we get the desirable level of economic growth? How do we put in place policies to ensure the economy provides enough jobs for workers? How do we respond to the near-term economic problem without doing long-term damage?

The last question is really a critical question for today's hearing. Chairman Bernanke has said there should be fiscal stimulus, and we found out this morning that he is trying in that direction. Leading economic thinkers on the Democratic side, such as former Secretary of Treasury Summers, have agreed, as has Dr. Martin Feldstein, a leading economic thinker on our side of the aisle. So, turning to another farm analogy, the fiscal stimulus horse has left the barn, and I would prefer that horse to be a thoroughbred rather than a swayback.

So with the die cast that we need some kind of fiscal stimulus again, how do we best respond to the immediate situation and not damage the economic growth over the long term? We are told that in order to stimulate the economy, all the government has to do is put money into the hands of consumers and they will spend it, and in the process spend us back to prosperity.

The problem with this approach is that, the only way the government can put money in somebody's hands is by taking it from somebody else's pockets. That power is exercised either in the form of higher taxes or more borrowing. Over the long term, this can be a zero sum game in which one person's loss is another person's gain.

Some economists tried to obscure this fact by introducing a concept known as the "marginal propensity to consume." That is a fancy way of saying some people spend more of their money than others spend. According to this concept, low-income people are more likely to spend the extra dollar than high-income people; thus, taking money from the rich and giving it to the poor will stimulate consumer demand and boost the overall economy.

They will point, then, to the multiplier effect. This concept is flawed because it ignores the role of saving. Money that is saved does not disappear. It flows back into the economy in the form of investment. Investment is just another form of spending, specifically spending on capital goods like factories and equipment. Thus, money spent on capital goods adds to the overall economy, just not like money on consumer goods.

Designing an effective policy requires a clear understanding of why the economy is slowing and unemployment is rising. The idle workers and resources that exist today are the result of changing market conditions, primarily rising oil prices and falling home prices. Government efforts to stimulate consumer demand can neither force people to buy things they no longer want, nor transform unwanted items into things that they do want.

I do not think that we will find many folks who feel that, currently over the long term, Americans are saving too much. Realigning our economy in a manner consistent with the changing market conditions will take time. Efforts to stimulate more consumption will only come at the expense of investments needed to bring about necessary realignment. Everyone agrees, investment is the key to higher productivity and a rising standard of living. We should not let our desire for a quick fix divert our attention from this fact.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator, very much.

I would like to now introduce our witness, Dr. Peter Orszag, Director of the Congressional Budget Office. Thank you, Dr. Orszag,

for being here today. As you know, customarily witnesses get 5 minutes for oral presentation, and we will put your printed remarks in the record.

Why don't you proceed?

STATEMENT OF DR. PETER ORSZAG, DIRECTOR, CONGRESSIONAL BUDGET OFFICE, WASHINGTON, DC

Dr. ORSZAG. Thank you very much, Mr. Chairman, Mr. Grassley, members of the committee.

The risk of recession is significantly elevated relative to normal economic conditions. This morning the Federal Reserve took aggressive action to address what it called appreciable downside risk to growth. Especially in light of this most recent Federal Reserve action, many professional forecasters suggest continued, albeit sluggish, economic growth in 2008 rather than an outright recession. In any case, several quarters of unusually weak growth are likely. This type of situation is relatively rare.

I did not grow up on a farm, so I am not sure whether it makes me a chicken or an egg, but I would note that the type of policies appropriate to address this type of unusual situation are not necessarily appropriate to more normal economic conditions.

In particular, when the economy is weak the key constraint on short-term economic growth is demand for the goods and services that firms could produce with existing resources. In most circumstances, by contrast, and certainly over the long term, the key constraint on economic growth is the rate at which that capacity to produce is expanded through forces like increases in capital and labor, and improvements in productivity.

One of the constraints on short-term growth is aggregate demand, as appears to be the case today. Both monetary and fiscal policies can help by boosting spending. On the fiscal policy side, the automatic stabilizers built into the budget will help to attenuate any economy downturn by providing a cushion to after-tax income.

The question is whether additional fiscal action would be a useful complement to the monetary policy actions already taken and the automatic stabilizers built into the budget. One way to think about that is that fiscal stimulus can help provide insurance against the risk and severity of a possible recession. Our estimates suggest that stimulus of somewhere between a half and 1 percent of GDP would reduce the elevated risk of recession to more normal levels, as long as the stimulus were well-designed.

The stimulus need not be targeted at what caused economic weakness in the first place. Instead, the key is that it bolsters aggregate demand and thereby helps to jump-start a positive cycle of increased demand, leading to increased production, until the constraint once again becomes how much we can produce rather than how much we are willing to spend.

So what would work? A well-designed fiscal stimulus would have several central principles.

First, it would be delivered relatively rapidly so that it took effect in a matter of months, not years, when the economy was expected to be weak.

Second, it would be temporary. As CBO highlighted in our long-term budget outlook released last month, the Nation faces a severe

long-term fiscal gap. Stimulus that exacerbates that long-term budget imbalance could impose greater economic costs than benefits.

Finally, it would be cost-effective in the sense of boosting aggregate demand as much as possible at a given budgetary cost.

With those principles in mind, we can briefly examine some of the leading proposals under discussion on both the tax and spending sides of the budget.

First, on the tax side, with regard to individual tax changes, the key is to get money quickly to people who will spend most of it, if the objective is short-term economic stimulus. On that note, the experience with the 2001 tax rebates was more auspicious than studies of earlier rebates would have suggested. Roughly one-third of the rebates were spent within 3 months, and roughly two-thirds of the rebate amounts were spent within 6 months.

To boost cost-effectiveness further, policymakers would need to focus on lower-income households and those with difficulty borrowing. The studies of the 2001 tax rebate suggested that lower incomes and credit-constrained recipients increased their spending substantially more than the typical recipient did.

Those low-income and credit-constrained households most likely expend money quickly; however, they typically do not owe income tax liability. According to the Joint Committee on Taxation, of the 154 million tax units in the United States, about 66 million do not owe income tax liability, and about half of those, or about 30 million, have wage income and file an income tax return.

Regardless of whether such households are included, a knee-jerk administrative issue with rebates involves when the checks could go out, given that the IRS is busy with tax filing season. It will be a major challenge to issue checks before May or June, at the very earliest.

The Joint Committee on Taxation explores this and other crucial administrative questions in a document prepared for today's hearing.[1]

On the business side, economic theory suggests that temporary investment incentives can lead firms to shift investments into the short run, which is helpful as stimulus. The experience with the bonus depreciation provisions enacted in 2002 and 2003, however, was somewhat disappointing. So this approach holds promise, but the most recent results suggest some caution in our expectations about their effectiveness.

Finally, on the spending side, we can divide spending into three categories. First, activities like infrastructure do deliver effective short-term stimulus for any dollar that is actually out the door, but the problem is that the projects typically involve such long lags that, in aggregate, they are not effective stimulus because of the low spend-out rates in the short run.

A second category of spending involves relief to State and local governments, and there the effectiveness depends on how well it is targeted to States in distress, and what the States then do. To the extent that the relief precludes or obviates the need for States to

[1] *See,* "Overview of Past Tax Legislation Providing Fiscal Stimulus and Issues in Designing and Delivering a Cash Rebate to Individuals," Joint Committee on Taxation staff report, January 21, 2008 (JCX–4–08), *http://www.jct.gov/publications.html?func=startdown&id=1337.*

raise taxes or cut spending, it, too, can be effective short-term stimulus.

A final category involves transfer payments, like unemployment insurance and food stamps. These payments should be evaluated much like individual tax rebates, and they rank relatively high on cost effectiveness from a short-term stimulus perspective because they tend to get money quickly to people who will spend most of it. They may also be attractive administratively because it is possible to get the money out the door perhaps even faster than for tax rebates.

On the other hand, some of these proposals underscore the tension between what is best in the short term and what is best in the long term. During periods of economic strength, for example, expanding unemployment insurance benefits or durations has been shown to increase unemployment levels somewhat. Such expansions may thus be effective stimulus in the short run but, if they were perpetuated over the long term, raise economic efficiency concerns that warrant attention.

Thank you very much, Mr. Chairman.

[The prepared statement of Dr. Orszag appears in the appendix.]

The CHAIRMAN. Thank you, Dr. Orszag.

My first question is, have your views changed one way or another in view of today's stock market drop?

Dr. ORSZAG. I think it is important to keep our eyes on the real economy and not respond too dramatically to short-term movements in financial markets. In terms of the risk to the real economy, again, what I would say is, the risk of recession is significantly elevated compared to normal economic conditions. Monetary policy is acting aggressively to try to counter that. There are, however, lags typically involved in the impact of monetary policy changes on the real economy.

The CHAIRMAN. So even though the Fed is lowering, or trying to lower, interest rates by three-quarters of a percent in addition to the last month, or the last several months, still, do you think fiscal stimulus is necessary?

Dr. ORSZAG. The traditional lag involved in the transmission of Federal Reserve policy changes onto the real economy has a peak after, say, a year or so, so between a year and a year and a half. That would deliver most of the impact out in 2009. It may be the case that in current conditions the primary effect of the Federal Reserve's action is to calm financial market turmoil, and so the effects may be felt more quickly than normal. That having been the case, there is likely to be some time lag between the maximum impact of the Federal Reserve's actions, during which time, if you delivered fiscal stimulus quickly, you could have an appreciable effect on short-term economic conditions.

The CHAIRMAN. Going back to the earlier point, you feel that it is more appropriate that Congress focus on economic fundamentals and trying to decide whether or not to enact a stimulus rather than, in your words, sort of temporary or short-term changes in the stock market.

Dr. ORSZAG. I think it probably would not be a wise course of action for policymakers to try to target fiscal stimulus to short-term movements in the stock market, no.

The CHAIRMAN. The President has not given a proposal yet but, in the press, has hinted at something of the nature of eliminating the 10-percent bracket, which in effect is a rebate of $800 for individual taxpayers and $1,600 for families. That would be for income tax payers. It is my understanding that that would affect, what, maybe two-thirds, or even a lower percentage than that, of Americans?

That is, are there many Americans who pay payroll taxes but do not pay income taxes? Any Americans who file tax returns, even though they do not have significant income tax liability—for example, senior citizens, sometimes other people whose employers withhold even though they, the employees, just do not have any tax liability?

So my question is, do you have data which shows how much more stimulus there would be to the economy if the rebate were given to all tax filers? That would include not just those who pay income taxes, but those who also pay payroll taxes and the other Americans that I mentioned.

Dr. ORSZAG. The most recent evidence we have is from the 2001 tax rebate. Again, that, similarly, did not go to individuals who did not owe income tax liability.

The CHAIRMAN. Correct.

Dr. ORSZAG. However, if you look among those recipients, the further down the income distribution you go, the bigger the impact was from the rebate on spending. So if you extrapolate that a bit out to even lower-income households, you can get appreciable effects. The effect for lower-income recipients of the 2001 rebate was substantially more than for the typical household.

The CHAIRMAN. The President's proposal—again, he has not given one, but it is implied that there will be no limits on the income that an American would pay. That is, it would apply to all taxpayers, whether they make a million bucks or $100,000. For those taxpayers at the very upper end, say $500,000 and above, what effect does an $800 or $1,600 rebate have on their propensity to spend versus someone whose income is much lower? Can you quantify that at all?

Dr. ORSZAG. It is difficult to quantify, but I would again say, the higher up the income distribution you go, the more likely it is that you do not face borrowing constraints and that you are less likely to spend any additional increments of money.

I would note one thing, which is that some of those upper-income taxpayers would not benefit on the type of proposal under discussion unless there were corresponding changes made to the Alternative Minimum Tax, because, if you are on the AMT, changing the regular income tax does not affect you.

The CHAIRMAN. Right.

This may not be a fair question because you have not had time to analyze it, but what would the effect be if, instead of the $800/$1,600, it was $400/$800, but an additional, say, $400 bonus given to families for each child? My initial analysis of that is 2-fold. One, you would get a significant number of dollars to families who are more likely to spend.

Second, it does not cost as much as, say, $800/$1,600 only to persons who pay income taxes, which leaves some dollars available for

other purposes, maybe UI, Unemployment Insurance, extension or food stamps, without raising the total aggregate amount of, say, $145 billion.

Dr. ORSZAG. And under your proposal, or under that proposal, would benefits be available to households with children who do not owe income tax liability?

The CHAIRMAN. Yes.

Dr. ORSZAG. That would likely have a higher cost effectiveness in terms of the budgetary effect. That would, as you know, be the responsibility of the Joint Committee on Taxation, and I will not hazard a guess in this setting.

The CHAIRMAN. Right. But my question is more on the stimulative effect.

Dr. ORSZAG. Yes.

The CHAIRMAN. Would that have an equal stimulative effect or greater stimulative effect than, say, the $800/$1,600?

Dr. ORSZAG. For any given pot of money, the more you target lower-income and credit-constrained households, the bigger the bang you get for your buck. The facts from the 2001 rebates, within the pool of recipients, were very substantial. For example, in the first quarter, the lowest third of the income population that received the rebate spent something like 67 percentage points more than the typical household. The effects were pretty large.

The CHAIRMAN. Thank you.

Senator Grassley?

Senator GRASSLEY. Thank you, Mr. Chairman.

I appreciate your testimony very much. We are gathered here because we may not know the exact answers, but we know that everybody is nervous and that the sooner we do something the better, if it needs to be done.

Question number one deals with this. CBO's economic and budget outlook is scheduled for release tomorrow, so obviously I do not expect you to reveal any of its contents this morning. However, the consensus among economists appears to be that it is still too early to tell whether we will have a recession this year.

On page 1 of your current testimony it says "A stimulus package could provide insurance against a recession or reduce its severity." However, on page 5 your testimony says that "poorly timed policies may do harm by aggravating inflation and increasing the debt." Given the level of uncertainty, how do we know we need a stimulus and how do we know that it will not do more harm than good?

Dr. ORSZAG. First, on the risk of recession, and without commenting on the outlook that we are going to be putting out tomorrow, various market participants have suggested that the risk of recession is elevated. If you look at the blue chip economic indicators, for example, that suggests probabilities of perhaps even a little north of 40 percent.

A thinly-traded contract that pays off if the economy does enter recession has an even higher probability than that, and that contract's price jumped substantially over the past several months, suggesting at least one indication of a perceived increased risk of recession.

In terms of timing, I said months, not years. I think the sooner in 2008 any stimulus were delivered the more likely it is that it

would have greater benefits than costs. But the further out into 2008, and certainly into 2009 you go, the more risk you are running that you will deliver additional demand stimulus when the economy is already back on its feet, and all you succeed in doing is adding to inflationary pressures.

That brings back the point about some of the administrative challenges. On rebates, for example, if the earliest that the checks can go out is, say, May or June and a significant impact comes, especially after two quarters, a lot of the impact will be felt in the latter half of 2008, not in the first half of 2008.

Senator GRASSLEY. On page 5 of your testimony it says that a spending increase or tax cut of a dollar, if it is well-timed and directs the money to people who will spend it quickly, adds about a dollar to GDP in the short term in times of economic weakness. So this raises a number of questions.

First, where does the dollar increase in GDP come from, since we are talking about fiscal policy, not monetary policy? The Fed is not going to create it out of thin air. Since we are talking about stimulus, as your testimony says on page 8, we cannot assume it is paid for with tax increases or spending cuts. Thus, it would appear that the government would have to borrow the dollar from the credit markets. How does the government borrow a dollar then without reducing investment or net exports by that dollar?

Dr. ORSZAG. I think that is a very important question. During normal economic conditions, when the government borrows an additional dollar there is a substantial degree of crowding out of private investment. During periods of economic weakness, however, the situation can be significantly different.

Let us consider two possible sources of that borrowing. The Federal Government could either borrow from abroad, in which case I think it may be easier to see that the domestic offset is not as salient, or it borrows from individuals or other domestic lenders.

In that case, the domestic lenders who are shifting, say, a dollar in cash into government bonds do not necessarily restrict their ability to spend; they are shifting their assets from one kind of asset to another. So in periods of economic weakness, the fact that the government is borrowing more does not necessarily have the same crowding out effects as it does in normal economic conditions.

Another perspective on the same point is that, during these unusual—and I need to emphasize how unusual these kinds of periods are—periods of economic weakness, the constraint is really that firms and households do not want to borrow that much, so there is room for the government to borrow more and thereby promote an overall level of economic activity, and put us back on a growth path, where those normal economic laws apply.

So again, I would just say that during these unusual periods the tension is that, what may work best is not what typically works best. The normal concerns about government borrowing crowding out private investment and other economic activity are much less salient during these unusual periods of economic weakness.

Senator GRASSLEY. I will continue on the second round. Thank you.

The CHAIRMAN. Senator Bingaman?

Senator BINGAMAN. Thank you very much for the testimony. Just to reemphasize the points you are making about tax rebates, as I understand it, your calculation and the calculation of the Joint Committee on Taxation is that it is not practical to complete distributing cash rebates until the peak filing season is completed, which in past years has been in the very end of May. So we are not going to do any cash rebates until the very end of May, at the earliest.

So you are talking about mid- to late summer at the earliest for people to actually receive funds through a tax rebate. Is that correct?

Dr. ORSZAG. That is right. That is when the process starts. It would also take, perhaps, 8 to 10 weeks to distribute the checks, as occurred last time.

Senator BINGAMAN. So, if we look at the spending options, those could happen much more quickly, at least if you did something like you are suggesting with unemployment benefits, which we have done in the past, or increased food stamp payments. How quickly do you expect that money would actually be expended in those cases?

Dr. ORSZAG. That is obviously dependent on the details, but based on our preliminary analyses, those could be implemented, in the sense of cash actually being received by a beneficiary, perhaps in a matter of 2 months or so after enactment.

Senator BINGAMAN. Well, one other suggestion that several of us have made is that the government significantly increase the payments per household for LIHEAP, the Low-Income Home Energy Assistance Program. My understanding is, there are about 6 million households receiving LIHEAP benefits now. I have also been advised that those are funds that could be distributed quickly. Do you have any thoughts on that?

Dr. ORSZAG. It really depends on the magnitude. I have seen some proposals for LIHEAP funding, numbers that almost seem like they are off by a decimal point. If you are talking about putting, perhaps, one or two or a couple billion dollars more into LIHEAP, it is possible that that could spend out rapidly.

But anything beyond that likely would not—and we also need to remember that we are at a point in the LIHEAP season where you may not get the money out as quickly as possible because you are later in the season, at least for the heating part of the program, than would be optimal. So there may be some possibility. It is not ideal from the stimulus perspective because it is difficult to put significant amounts of money to that in a timely and cost-effective manner, although obviously anything that you do would help the households affected.

Senator BINGAMAN. Let me ask about another aspect of this issue that you deal with in your report. That is what the funds are spent on once they are received. I mean, as I see it here there are sort of three questions: how quickly can you get the money to people, how quickly will they spend it, and then what will they spend it on?

You say in here, the degree of stimulus that a policy can provide to the economy will depend on how much of the resultant spending goes to purchase domestically produced goods, and then go on to

talk about how it is possible for the stimulus essentially to be exported if the funds that are provided are spent on imports rather than on domestically produced goods. Could you elaborate on that idea and tell us how we deal with that?

Dr. ORSZAG. Well, I do not know that there would be any specific policies that "deal" with it. But to the extent that any additional spending came exclusively through higher imports, the stimulus to production is eliminated because the additional production occurs abroad rather than domestically.

You should expect that, to some degree, this will occur. In fact, one of the consequences of an effective stimulus will likely be some slight expansion in the current account deficit relative to what it otherwise would be, precisely because we boost our spending here relative to income temporarily. In a sense, that is one of the objectives.

Senator BINGAMAN. But I gather, or at least I would assume, that expenditures that are in the nature of increased unemployment benefits, increased food stamp benefits, those kinds of things would be more likely to be expected to be spent on domestically produced products than perhaps a tax rebate.

Dr. ORSZAG. I think it is difficult to reach that kind of judgment, but I would say that it is unlikely that this consideration, which we know is going to be a paramount one—in other words, most of the funds that will be spent will be spent on domestically produced goods, almost regardless of who receives the funds, on average.

Senator BINGAMAN. All right.

My time is up, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman.

Thank you, Dr. Orszag, for a very useful presentation. I just came from home and discussed these issues with people, and I have found that, with this kind of economic situation, people, in effect, were saying that handing them $800 was something like putting a Band-Aid on arterial bleeding. I would like to explore with you a little bit of a different way to approach it.

My sense is, working people save income that is temporary and then working people spend income that is permanent, so what I have been interested in is a policy that will raise incomes permanently. So as I looked around at the options and read the good work you all did, I came, first, to infrastructure and transportation, because that is a huge economic multiplier and the need is so great, with bridges falling down, Katrina, and all of these problems.

Senator Thune and I have introduced a bipartisan proposal to let $50 billion worth of Build America bonds, and I wondered about the applicability of that to this situation. So I went to your very good report, and you all seem to feel that transportation funding, infrastructure, takes a while to get out. It takes a while to kick in. That seems to be the conclusion of your people.

So we did some research at that point, having looked at your report, and we found that some areas of infrastructure spending could be utilized very quickly, such as road resurfacing. There is an enormous need for those kinds of projects. So what would be

wrong with the idea of doing something like that very quickly—very quickly, especially since you have just given the chairman the information about the third quarter for the tax rebates—and start with that?

Dr. ORSZAG. Well, it is funny. Actually, in our internal discussions, road resurfacing was also held up as perhaps the one example of infrastructure spending that actually would spend out relatively rapidly. I think the challenge is, in a broad-based infrastructure package, targeting those things that would spend out quickly because, in general, these projects do spend out very slowly, and that substantially attenuates their stimulative impact in the short term.

Senator WYDEN. Because it seems to me you are spot-on in terms of the longer term, so what Senator Thune and I are interested in will take a bit longer to kick in. But I noticed you also did an analysis forecast on the 36-percent cut in highway funding next year because of a short-term drop in highway trust fund income.

So the combination of that crunch that we already have, rebates taking longer to get out based on your current analysis, if the Congress can—and there is an association of these officials—find projects that would kick in quickly, say in the next 3 months, would that not be something worth looking at?

Dr. ORSZAG. Again, I think the challenge is "that kick in within the next 3 months." Limiting an infrastructure package to that kind of thing, and also deciding quickly on exactly what those things are, is the challenge. So, if it were possible to do that and get money out the door fast, yes. As I said, any dollar that is actually spent is relatively effective. The question is limiting the package to those things. I think that is complicated.

Senator WYDEN. I thank you for your analysis. I am going to follow up with you. If you could ask the CBO staff to see if there are additional areas besides road resurfacing, which I think your folks have already seen has some potential. I have had some independent analysts look at that. We did an assessment of this and found that each billion dollars of transportation funding creates an estimated 47,500 jobs. Of course, the multiplier is everywhere. It is all over these local communities, and it is something that can kick in quickly.

So, if we could follow that up with you further, Dr. Orszag, I would appreciate it, and I appreciate the good work that you have done.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Conrad?

Senator CONRAD. Thank you, Mr. Chairman. Thanks to the chairman for holding this hearing, and thanks to you, Dr. Orszag, for your appearance here.

Chairman Spratt, chairman of the Budget Committee, and I had asked you for this analysis of the various stimulus options. Where would we get the biggest bang for the buck? Just for a moment, I would like to direct your attention to the question of how much we do in relationship to the size of the economy. We have about a $14 trillion Gross Domestic Product. As I understand it, the President's package would be somewhere in the range of $140 billion. That is roughly 1 percent of GDP.

As I read your report, it indicates that you get about a 1 for 1 return in terms of increase to GDP for what you put into stimulus. Is that a correct reading of the analysis?

Dr. ORSZAG. If it were well-designed. It is very possible to design packages where you get a lot less than that.

Senator CONRAD. So it is critically important. So let us just put this in context. If we put in $140 billion, roughly 1 percent of GDP, you could get on the order of a three-quarters of 1 percent to 1 percent boost in GDP if it were well-designed?

Dr. ORSZAG. That is correct.

Senator CONRAD. So that is pretty modest in terms of a slowdown, going from 3 to 4 percent growth down to potentially negative growth. But nonetheless, it softens the blow. That is the concept.

Dr. ORSZAG. That is correct.

Senator CONRAD. If I could just go to the graph. When we look at what has happened, this is what has happened to housing starts, a very dramatic reduction there. That is contributing to economic weakness. We have workers being laid off who are in the construction trades.

Go to the next one. We have Chairman Bernanke telling us, with respect to temporary stimulus, any program should be explicitly temporary, both to avoid unwanted stimulus beyond the near-term horizon and, importantly, to preclude an increase in the Federal Government's structural budget deficit. Do you agree with that assessment?

Dr. ORSZAG. Yes. As I emphasized, and as we reported to you in December, the Nation faces a very severe long-term budget imbalance, and significantly exacerbating that would be a serious mistake.

Senator CONRAD. All right.

Let us go to the next one. This is also from Chairman Bernanke's testimony before the House Budget Committee. There is good evidence that cash that goes to low- and moderate-income people is more likely to be spent in the near term. Getting money to people quickly is good. Getting money to low- and moderate-income people is good in the sense of getting bang for the buck. Your assessment tracks with what the chairman of the Federal Reserve is saying there as well.

Dr. ORSZAG. Both theory and evidence suggests that conclusion, yes.

Senator CONRAD. So when we are talking about, if we put $140 billion of stimulus, roughly 1 percent of GDP on the table here, it has to get out quickly and it has to go into the hands of people who will actually spend it if there is to be a stimulative effect. Is that correct?

Dr. ORSZAG. Yes, sir.

Senator CONRAD. Let me ask one other question. That is, what would be things we should avoid here? What would be things that could actually be counterproductive? I take it one would be to put measures in place that would not have a near-term effect. Things that would have a longer-term effect, that could actually come as the economy is in recovery and create an inflationary effect. Is that correct?

Dr. ORSZAG. That is the risk of mistimed fiscal stimulus.

Senator CONRAD. What, in terms of timing, would your assessment be? When should we try to get money in the hands of people? What would be the range of time that we should design a fiscal stimulus package for?

Dr. ORSZAG. The sooner the better, and the more that can be delivered during the first half of 2008, the better. The more that is delivered into 2009 and thereafter, the greater the risk is that you are exacerbating fiscal outcomes and exacerbating inflationary pressures without addressing the short-term economic weakness.

Senator CONRAD. And which of the options that you analyzed most closely fit those requirements?

Dr. ORSZAG. Well, in a table that was included in the report to you and Mr. Spratt, we rank various proposals according to their bang for their buck and their timing, so one can go down the list and try to combine large bangs for the buck with short time elapsed to delivery to how things rank.

Senator CONRAD. And what would your conclusion be as the single best thing we could do?

Dr. ORSZAG. I do not think I should name a single best thing.

Senator CONRAD. What would be the top options, as you analyze them?

Dr. ORSZAG. The things that we ranked as having a large bang for the buck had to do with getting cash to households that would spend the money quickly, including things like a rebate geared towards such households and including things like expanded unemployment insurance benefits and food stamps.

Senator CONRAD. Thank you.

The CHAIRMAN. Thank you, Senator.

Senator Salazar?

Senator SALAZAR. Thank you very much, Chairman Baucus and Ranking Member Grassley. Thank you for putting the spotlight on this issue which is so important to the people of America.

I, like the rest of us, back home, think there is a debate going on, frankly, among economists as to whether or not we are in a recession and how bad these times are economically for us, but I would imagine that for most Americans, including the 5 million people whom I serve in Colorado, their view is that things are bad.

They believe that they are paying higher energy costs than we ever have before, whether it is for heating their homes or whether it is for the gasoline they are putting in their cars. They believe that their major assets, the value of their homes, are declining. They see their neighbors who are having their homes foreclosed upon. They see the rising costs of education, and so on and so forth.

So we debate, from an expert's point of view, as to whether or not we are in a recession already. My question to you, Dr. Orszag, is whether or not we already are in one. This is just the debate going on among the experts. How bad are the economic times that we are facing as a country as of today?

I would imagine that when you look at what the Federal Reserve did this morning by doing its cut of three-quarters of a percentage point, which seemed to surprise the world that it would go with that kind of a cut, that the signals are out there that we have some great danger on the immediate horizon.

Dr. ORSZAG. I think it is clear that many households are experiencing significant economic distress, and financial markets have also been subject to a significant amount of turmoil recently. That is often a distinct question from, as you know, whether the macro economy is in recession. There, there is a lot more ambiguity.

Senator SALAZAR. I very much agree with what Chairman Baucus is doing here, and other leaders, in terms of trying to stimulate the economy in the short term. As I went through your policy recommendations, Peter, from the Congressional Budget Office, I was going through these policy recommendations that you had provided.

It seems that, if you look at the major recommendations, what we really ought to be trying to do is to match up from your charts those that would fit in the category of cost effectiveness, which would be wanting to make sure that cost effectiveness is large, with a category then that says uncertainty about the effects minimal with respect to that policy choice.

So when you look at the direct transfer payments to households on extending or expanding unemployment benefits and increasing food stamp benefits, for example, you have cost effectiveness, large, and the uncertainty about the effect, small. So would those be good policy choices relative to some of the others in terms of your rating of these policy choices, given the history of what the Congress has done before?

Dr. ORSZAG. Senator, let me just immediately say CBO does not make recommendations. We try to help you analyze options. In analyzing those options, those proposals rank relatively highly from the perspective of short-term cost effectiveness. Money that you get out the door in those programs is going to be spent very rapidly by the recipient families. In terms of how quickly we get money out the door and in terms of confidence in that cost effectiveness—in other words, we are relatively certain that families receiving those funds will spend them quickly.

Senator SALAZAR. All right. So, if we have expanding unemployment benefits as one and increasing food stamp benefits as another, what else would you rate in terms of that category of effectiveness in terms of these policy choices that you have here? What comes after that?

Dr. ORSZAG. Again, tax rebates that are directed, especially directed towards households that are lower-income and credit-constrained, will also have a large cost effectiveness that is a relatively high bang for the buck.

As I noted before, there is more concern about the timing delay involved in getting checks out the door there. There is somewhat more uncertainty about the exact impact of that kind of approach because the results from the 2001 rebate were somewhat different than the results from earlier studies of past rebates.

Senator SALAZAR. When you talk about providing general aid to State and local governments, you say cost effectiveness, medium, uncertainty about effects, large. Does that mean that based on past experience that we do not know what that would do in terms of jump-starting the economy?

Dr. ORSZAG. The effects are really going to depend on what States do, and in particular on the extent that giving an extra dollar to a State obviates the need for a State to cut spending by a

dollar or raise taxes by a dollar. You can get an effective stimulative effect from foregoing those harmful steps.

But the response of the States will likely depend on their own fiscal condition, and right now there is a significant variation across the States in those that are experiencing fiscal distress and those that are not, thereby raising the question of, can you target any fiscal relief to the States and local governments, which are also experiencing difficulty, to those that are experiencing distress?

The Government Accountability Office, a year or two ago, came out with a study evaluating different ways of trying to accomplish that kind of objective, and I would refer you to that study for some specifics about different ways of allocating a given pot of State and local fiscal relief to the State and local governments experiencing the most difficulty, which would raise the bang for the buck that you get.

Senator SALAZAR. Thank you, Dr. Orszag.

The CHAIRMAN. Thank you, Senator.

Senator Stabenow?

Senator STABENOW. Thank you, Mr. Chairman. It is great to be back with everyone. This is a very, very important topic. I said, as someone who comes from the State with the highest unemployment rate in the country, when Senator Salazar speaks about recession, people in Michigan, at 7.6-percent unemployment as of December, would say yes, certainly in Michigan. When we have looked at what we can do and we look at the headlines, even reading this morning with the Fed cut of 75 basis points, the big question is, what will consumers do?

Over the Christmas holiday, consumer spending was down. Basically, the bottom line is: how well are middle-class people doing? Do people have jobs? Do they have confidence? Do they have the ability to spend in the economy?

Unfortunately, too many of our tax policies, our focuses, have not been on making sure those middle-class families really do have money in their pockets. So, when we look at this chart, it makes sense to me that we should be focused on, as you indicated, Doctor, those things that would most quickly get money directly into people's pockets.

You indicated, and we have talked a lot about unemployment compensation, that you think, on the unemployment side as well as food stamps, that we could have, within 2 months after enactment, something in that range. It sounds like that is one of the quickest turn-arounds that we could make in terms of getting money directly to people. Is that what you are suggesting at this point?

Dr. ORSZAG. That is my understanding at this point. Given where we are in the tax filing season, those types of approaches likely would get money out the door somewhat faster than a tax rebate.

Senator STABENOW. And that makes sense. I mean, if you are unemployed and do not have a job and have not been able to find a job, certainly you are going to spend whatever money comes in the door to be able to pay your costs. So, that makes sense to me. Food stamps. You are going to go in the grocery store and buy what you need for your kids, so that makes sense to me as well.

On the rebate side, it is concerning to me. I certainly like the idea of putting $800 or $1,600 into consumers' pockets. I think the chairman has a really good idea of focusing that on the more children you have, being able to somehow target that to larger families whom I assume are in greater need.

But if we cannot see that happen until June or July, something like that, is the payroll tax, when you are looking at a withholding holiday, the quicker way? It certainly would address more taxpayers, those who pay not only income tax, but withholding. Is that a quicker way in your mind to be able to deal with what would be a rebate?

Dr. ORSZAG. That type of approach—which, by the way, I should note probably would have somewhat larger bang for the buck, even for the same households—evidence suggests that you are more likely to save a little bit more of a lump sum amount than of extra income each week or each month. But it is not a simple undertaking to change withholding, and that involves lags and complexities for payroll administrators and other things also.

We could work with the Joint Committee on Taxation to get you an answer on what would be faster, but you should not expect that approach to have a very short time lag either. And again, I want to emphasize the lags involved here: the evidence from 2001 suggests that the rebates were effective, but they had their largest impact in the 6-month range. So, if the checks go out the door in June and July, you are most affecting Christmas spending in 2008, not spending in February or March.

Senator STABENOW. As opposed to directly affecting people who are unemployed, without a job right now, who are trying to put food on the table for their children, it appears that that is the quickest way to be able to stimulate the economy.

We have not talked about Medicaid, FMAP, and the fact that more people who are unemployed or under-employed, the more States will have people needing to get their health care from Medicaid. Have you looked at what the stimulus effect is of targeting support rather than an across-the-board health issue? You have indicated you have concerns about it in terms of State and local governments. If we were to target that to States for the additional health care spending for those who are unemployed/under-employed, what is your analysis in terms of the stimulus effect of that?

Dr. ORSZAG. Coming back to that GAO report I mentioned earlier, the GAO examined tying changes in the FMAP, or the fixed share of Medicaid spending paid for by the Federal Government, to changes in State-level unemployment rates, for example. One could also imagine actually tying changes in FMAP to changes in State-level food stamp beneficiary rolls.

But that kind of approach does better target the States that are experiencing difficulty, albeit not perfectly. There are States that are experiencing disproportionate declines in revenue because of recent events that have not experienced as large unemployment rate increases as other States. It is not perfectly correlated, but it is better-targeted than just an across-the-board increase.

Senator STABENOW. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thanks, Senator.

Senator Bunning?

Senator BUNNING. Thank you, Mr. Chairman, for holding this hearing.

Thank you, Dr. Orszag, for being here. I assume you are familiar with the fallacy of the broken window. Economist Frédéric Bastiat pointed out that when someone's window is broken, the money spent to repair the window is seen. But what is not seen is how the money would have been spent if the window had not been broken. Please explain what is seen and what is not seen when the government spends a dollar on economic stimulus.

Dr. ORSZAG. During normal economic conditions, when the government spends an extra dollar, one needs to be very concerned about the displaced economic activity that the government is sort of crowding out. So, fixing that window precludes some other activity. During these unusual periods of economic weakness, though, that logic does not necessarily apply. It is possible, by stoking or jump-starting aggregate demand, to lead to an overall increase in income rather than just staying within a fixed amount of total income.

Senator BUNNING. Then it is CBO's opinion that we are at that point?

Dr. ORSZAG. I think it is the view of Chairman Bernanke and many economists that the risk of being at that point is substantially elevated relative to normal conditions.

Senator BUNNING. Well, please do not bring Chairman Bernanke into this, because he has been wrong so many times I do not want him quoted by anybody on this panel. They are going to do it anyway.

The CHAIRMAN. I was going to say, Senator, the Senators are going to say what they want to say.

Senator BUNNING. Well, I want to say what I want to say, too.

The CHAIRMAN. You should. You should.

Senator BUNNING. And I will.

The CHAIRMAN. I know you will.

Senator BUNNING. The problem I am having with that is that Chairman Bernanke and his predecessor put the U.S. economy in this situation by their monetary policy, and now they are getting into the business, the Federal Reserve, of advising the Congress on fiscal policy, which is none of their darned business. So, I get a little upset sometimes when our Federal Reserve gets into our job. It is our job to try to stimulate the economy if we think it is in dire straits.

If you get 50 economists in this room and ask them where we are as far as recession or non-recession, you will get 25 saying that we have a chance to be in a recession and you will have 25 who will say that we have a chance of not being in a recession. So, Chairman Bernanke happens to be one of the 25 who says that we possibly could be.

Dr. ORSZAG. And we can leave him out of it.

Senator BUNNING. Thank you.

Dr. ORSZAG. I would say that, if you got 50 economists in the room at this point—I do not know if I want to say 50, but—almost

all of them would say that the prospect of economic weakness—at least sluggish growth for several quarters—was very likely.

Senator BUNNING. There is no doubt in my mind about that. That is absolutely true, so we have no disagreement there.

Dr. Orszag, in your testimony you cited studies that showed very well that the President's 2001 tax cuts helped to moderate the economic downturn that followed the collapse of the Internet stock bubble in 2000, but you attributed the economic boost almost entirely to the rebate checks delivered in 2001 and you discounted the effect of the tax rate reductions.

When taxpayers experience an increase in lifetime wealth, after a significant tax cut, for example, are they not more likely to spend with confidence whatever money they have?

Dr. ORSZAG. Two comments. First, economic theory does suggest that a permanent tax reduction can have an important effect on spending because it can affect lifetime after-tax income. However, the Nation does face a severe long-term fiscal imbalance, and in that situation, widening the long-term fiscal imbalance has unclear effects on perceived after-tax lifetime income.

Senator BUNNING. The last question I am going to ask you, because it is very important, if we do a stimulus package—and I think we should—it should be temporary. Is that accurate or not?

Dr. ORSZAG. I believe that that would be beneficial, yes.

Senator BUNNING. Thank you very much.

The CHAIRMAN. Thank you, Senator.

Senator Hatch?

Senator HATCH. Well, thank you, Mr. Chairman. I appreciate this hearing, and I certainly appreciate you, Dr. Orszag.

Now, your testimony indicates that there would be a significant lag time, perhaps until late June or July, maybe as early as May, before we could get tax rebate checks into the hands of taxpayers, if this is the way Congress decides to resolve this situation by delivering the so-called stimulus.

Do you think that this would be too late to stave off what might be in the eyes of some an entrance into the recession?

Dr. ORSZAG. It would be desirable if it could happen faster. It is remarkable that the world's leading economic power cannot get checks out the door faster than that, but it is a reflection of the fact that the IRS's IT infrastructure is still in a state that is under pressure and consumed again with the normal tax filing season that is currently under way.

Senator HATCH. Well, what do you think would be the stimulative effect of a proposal that gave electing employers a 100-percent credit against their payroll tax deposits for extra payments they give to their employees, say up to $500 each, with the Social Security Trust Fund being made whole by a transfer from the General Fund, which is what we have been doing around here? While I can see potential promise with such an idea, would it not be a faster way to potentially get cash into the hands of millions of workers in a very short period of time?

Dr. ORSZAG. I was a little unclear about the employee versus the employer part of that.

Senator HATCH. Well, you give the employers a 100-percent credit against their payroll tax deposits for extra payments that they give to their employees.

Dr. ORSZAG. Right. Oh, for the extra payment.

Senator HATCH. Yes.

Dr. ORSZAG. Again, the key thing is translating——

Senator HATCH. Let us say it is $500.

Dr. ORSZAG. Yes. If you just provide a payroll tax holiday for employers, it probably would not have that big of an impact in terms of short-term stimulus. That is somewhat similar to many of the corporate tax proposals in terms of increasing cash flow for corporations that are not getting a very big kick. If it were translated into higher take-home pay for workers, and that part is key, it could have a more substantial impact, and that is basically the kind of withholding holiday option that we analyzed.

There is still some delay in administering that kind of proposal, and we would have to, in collaboration with the Joint Committee on Taxation, get back to you on exactly how quickly that kind of proposal could be implemented.

Senator HATCH. It would certainly be less time than the rebate check system.

Dr. ORSZAG. It may be. It may be.

Senator HATCH. I do not see any reason why it needs to be a long time.

My understanding is, certain sections of this Nation are seeing the effect of a slow-down more than others. Is this unusual or do economic slow-downs often affect certain regions, while leaving others relatively unscathed? You heard the Senator from Michigan citing her State. Is there any way to target stimulus to those places where it may be most needed?

Dr. ORSZAG. Well, a couple of things. First, for example, on State fiscal relief, we have already had a discussion about how that could be done. Expanding unemployment benefits and food stamp benefits does tend to target the areas that are hardest hit, because that is where you tend to get the biggest increase in beneficiaries. Beyond that, nothing is coming to mind. I would say, though, that it is a feature of many past economic downturns and economic booms that we have a variation in economic performance across different parts of the United States. That is not abnormal.

Senator HATCH. Yes. Unemployment is about 5 percent. Would it be beneficial if we decided to reduce corporate taxes dramatically? It has certainly helped nations like Ireland, and it certainly has stimulated employment and all kinds of investment and opportunities. Would it not be better for us to maybe consider something like that, even though it is more of a long-term stimulus?

Dr. ORSZAG. Well, yes. I think that is the key issue. There are important long-term issues involving the continued viability of our corporate income tax. We have experienced a very rapid increase between 2003 and 2006 or 2007 in corporate income tax receipts, but that follows a secular decline in the share of corporate income tax receipts relative to GDP.

There are important issues there, but those really have to do with long-term economic performance. From the perspective of

short-term economic weakness, those proposals usually do not rank as highly as other options, as we lay out in our analysis.

Senator HATCH. Thanks, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Snowe?

Senator SNOWE. Thank you, Mr. Chairman. Thank you, as well, for holding this first hearing in the second session on a most urgent issue facing the Nation's economy with respect to the erosion that we are all experiencing across this country.

In fact, I was talking to one of my constituents in Maine who told me that she holds three jobs, one to pay for the mortgage, one to pay for the oil, and the third to pay for gasoline to get to her other two jobs. I mean, I think that illustrates the drastic impact that this eroding economy has had on average Americans in this country.

Dr. Orszag, thank you very much for being here to help us shape the conversation and focus on the size and the composition of the stimulus package. One of the overriding issues, of course, is to whom we give this tax rebate. Obviously, the greatest dynamic, the greatest influence is on those who are in the low-income categories, low- to middle-income.

I noticed that in the Hamilton Project report and your assessment of the past as well, and CBO, that the temporary tax rebates, assuming 50 percent is spent, that has the greatest impact in the second quarter in 2008.

How do we craft that tax rebate? I think that is the essence of this debate. You have 22 million Americans who do not have income tax liability. They pay payroll tax but not income tax. You have another more than 20 million Americans, seniors who live on Social Security and so on, who do not pay any income tax. So, that is more than 40 million Americans who might not benefit, or will not benefit, from the tax rebate. This is going to be the essence and the underpinning of any effective stimulus that needs to happen.

Dr. ORSZAG. The Joint Committee on Taxation, in the documents that they prepared for today's hearing, goes through some of the ways of designing or the administrative issues surrounding a refundable rebate or refundable tax credit.

An important issue involved there is, if you create a refundable tax credit for those who do not owe income tax liability, if you base it on 2007 returns, you could create a significant incentive for new, additional filers. That is, there are currently almost 30 million tax units that do not file a return.

One way of mitigating that incentive is to limit the refundable tax credit to wage earners, most of whom already do file tax returns. If you were not to do that, you probably would have to rely on 2006 returns, and that involves a different set of complexities involving people who move, and outdated addresses, and inability to use electronic funds transfer, and a whole series of other questions, all of which is to suggest that—the Joint Committee on Taxation actually lays out quite nicely many of the administrative issues. It is possible to do. You need to be careful about creating an incentive for very significant increases in filing. If you limited it to wage earners, some of the tensions would be attenuated.

Senator SNOWE. Senator Lincoln and I have introduced legislation once again on the refundable Child Tax Credit, for example, because now it is indexed to inflation, eroding the base of the $10,000 income in which it is triggered. That is obviously a model that could be used that was passed in 2001 originally as well. So, that could obviously be more targeted to those categories and could be useful in designing this package, could it not?

Dr. ORSZAG. That is one model. Sure.

Senator SNOWE. Well, obviously the income level becomes key here in terms of who benefits from the tax rebate, and the sooner the better, I would gather. So, I mean, you could design an income limit, could you not, in a tax rebate?

Dr. ORSZAG. You mean, an upper limit?

Senator SNOWE. Yes. Yes.

Dr. ORSZAG. One could do that.

Senator SNOWE. Yes.

Dr. ORSZAG. You could do that.

Senator SNOWE. All right.

First, from what has been indicated, there will be another reset of more than $600 billion in adjustable rate mortgages, perhaps as early as this spring. What would be the impact again in terms of the size of this package? Second, is it important for us to pass a stimulus package so that we could also blunt the impact before that is implemented?

Dr. ORSZAG. One of the things leading many analysts—and I will just leave it at that—to conclude that we are faced with a period of economic weakness has to do with the burden imposed on homeowners from resets. The aggregate impact, though, is not as large as you would think in terms of impact on spending. But, nonetheless, it is one of the forces, along with financial market turmoil, high oil prices, and other things that raises concerns.

Senator SNOWE. So it could be critical to pass this package in advance of any expected resets of mortgages to help blunt it even further in addition to the rate cuts that occurred today.

Dr. ORSZAG. Again, the resets and other housing market problems are one of the forces leading to this elevated risk of recession.

Senator SNOWE. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator, very much.

Senator Lincoln?

Senator LINCOLN. Thank you, Mr. Chairman. We especially thank you and our ranking member, Senator Grassley, for bringing us together and beginning this discussion.

Dr. Orszag, we really appreciate your counsel in coming up with the appropriate solution in what we have to do. So in my home State of Arkansas, the impact of the economic slow-down is very evident. Just as Senator Stabenow mentioned the unemployment rate rising in Michigan, it is in Arkansas as well, well above the national average. So, we are anxious. People are very nervous at this juncture. They are worried about how they are going to pay their gasoline, as Senator Snowe mentioned.

Having been home for several weeks now, listening to folks talk about not only issues of getting to work and is their job going to be there, all the talk is of the recession. They are worried about

interest rates, mortgages going through the roof. They do have tremendous concerns about what we are going to do and how swift our action will be. So, I think your counsel in terms of moving in a timely way is critical, and also focusing what we are going to do. Focus being on the largest component of our GDP, the consumers, I think is critical.

Kind of building on what Senator Snowe mentioned, making sure that we are getting those resources to people who are going to put them back into the economy. There is no doubt that when you have people who are working one job, two jobs, three jobs, with children, particularly, that they are going to be the critical element, I think, in revitalizing some of the economy.

I guess one of my questions would be, one of the issues of doing it in a timely way and getting those resources into a place that they will be spent and put back into the economy means that we need a model, we need a delivery tool that is going to work.

We talked about a lot of those, whether it is the EITC, whether it is the Child Tax Credit, whether it is refundability in the tax code, whether it is payroll taxes, or what have you. From what I have gathered that you have answered here, it is really using some of those tools. Is there any one that you think, in terms of a delivery model, is the best in place, the most timely, and the most efficient in targeting those resources in a place that are going to make the biggest effect quickly?

Dr. ORSZAG. Again, to the extent that you can piggy-back off of existing delivery mechanisms, as you put it, you are more likely to get money out the door faster. As I mentioned previously, it is likely that some of the transfer payment options—unemployment insurance benefits and food stamps changes—could take effect and deliver cash to people faster, or cash for benefits to people faster, than other options. Changes in State fiscal relief could have an immediate impact to the extent they cause Governors to change their policies immediately. Then, as you work down the list, tax rebates start to become feasible in the kind of May/June range.

Senator LINCOLN. Well, I certainly agree with Senator Snowe. I hope that as we look, that we will be looking at tax filers and really focusing on families, working families with children in the low-income/middle-income category, who I think are going to be the best vehicle for us as a Nation to rejuvenate our economy, because I think they are going to use it and put it to good use as quickly as possible.

You also mentioned, just kind of as a follow-up from your report, the idea of a triggered stimulus. Have you talked about that yet today?

Dr. ORSZAG. I have not talked about it today yet, no.

Senator LINCOLN. Maybe you will. Is that something we should be considering? What is the direction you are going in there?

Dr. ORSZAG. I think it depends on what you do. The longer you wait and the longer the lead time until things take effect, the more beneficial a trigger might be. If something were to take effect tomorrow, almost all of the triggers that people have in mind would be triggered, so the trigger becomes kind of superfluous or unnecessary. But the further out in time you go, and again the more pos-

sible it is that the economy will be back on its feet, the more salient a trigger might be. That raises an important point.

I mentioned the automatic stabilizers that are already built into the budget. One could, not in an immediate situation but on a longer-term basis, consider changes that strengthen those automatic stabilizers, and a triggered stimulus package that sort of is in place ahead of time is like that. It bolsters the automatic response to an economic downturn. But you could do that in lots of different ways.

Senator LINCOLN. Well, I was certainly keen on Senator Wyden's issue of infrastructure investment. Could that be some type of a triggered solution in terms of—I do not know. There has always been talk of an operating budget and dealing with an operating budget in our Nation for infrastructure investment. I think the chairman and the ranking member are planning some further hearings on infrastructure investment down the road in the coming months.

Dr. ORSZAG. Again, I would say, most of the discussion about infrastructure really has to do with long-term economic issues and long-term economic performance. In general, infrastructure spending does not rank that well as short-term economic stimulus because the money does not spend out that quickly. Senator Wyden pointed out there are some subcategories and some specific projects where that may not be the case.

Senator LINCOLN. Right.

Dr. ORSZAG. The challenge is sort of narrowing the short-term activity to those activities.

Senator LINCOLN. Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator.

Senator Roberts, you are next.

Senator ROBERTS. Well, thank you, Mr. Chairman. I hope you had a nice break. I guess you did.

I want to thank you for giving us all these options. I must admit, I am reminded of the intelligence reports that we get in the Intelligence Committee, and the analytic product that has four larges, three mediums, and five smalls. Although I will say, on the intelligence side, mostly it is moderate and low, very few highs. It just seems to me that we have to move in an expeditious fashion.

I just came back from my hometown of Dodge City, KS, spending a couple of days in talking to the Chamber there, talking to, oh, all the education folks and all of the service folks and everybody.

There is an obvious need to provide short-term economic growth. My concern is that we not do anything that would be counterproductive to long-term tax relief, which I still think is an advisable goal. So I hope that, whatever we do, one does not work at odds against the other.

I think this question has been asked before, but what types of tax relief would be most beneficial to encourage businesses to make investments and create jobs? Because that is really what I heard as we had our legislative breakfast, which we have once every month. That was replicated all throughout the State, and will be again as of this January when we have a big meeting statewide.

So how can we encourage businesses to make investments and to create jobs as part of an economic stimulus package, which I

think, both short-term and long-term, would be helpful more especially from the small business standpoint?

Dr. ORSZAG. Well, let me first say that many businesses make decisions not just based purely on tax considerations, but on their expected cash flow and expected prospects.

Senator ROBERTS. Exactly.

Dr. ORSZAG. So boosting overall economic activity could have the most important effect on business investments. But if you focus specifically on tax incentives for new investment, economic theory suggests that temporary investment incentives like the bonus depreciation that was adopted, or like an investment tax credit, can shift investments that firms were planning to make in 2 or 3 years into the near term, and thereby boost the economy in the short term. As I mentioned previously, the experience with the 2002 and 2003 bonus depreciation was somewhat disappointing. We did not get as much kick from that as had been expected or hoped for.

There are ways of designing investment incentives for businesses that make them more effective. For example, providing incentives only for investment above some threshold, based on historical investment levels, for example, would better target new investment, but it may also create administrative complexity.

So I think in the area of business investment incentives, we have good theory. We have ways of trying to kind of super-charge the incentives by focusing on incremental investment. But the most recent experience should suggest some caution in relying just on kind of a tax incentive as opposed to prospects for stronger economic activity in substantially boosting investment levels.

Senator ROBERTS. I note here in one of your suggestions on cost effectiveness—that is in the large category, the lag short, the uncertainty small—temporarily increasing food stamp benefits, as one who allegedly helped save the food stamp program back about 10 years ago, maybe 11 or 12, simply gave that to the States. The States wanted the money, but they did not want to operate a food stamp program. So, there was considerable reform at that time. This latest farm bill, there is a House version, a Senate version. We hope to go to conference and work it out.

There is a considerable increase. You have down here temporarily increasing food stamp benefits. I can tell you, as a long-term observer of that program and many other programs, there is not such a thing as temporary. Once you do it, you do it. I am not saying that is either bad or good. It is just something that I wanted to point out. That would, of course, have an immediate effect.

The other thing I wanted to ask you, and this has been touched on, I think Senator Salazar touched on it, at any rate, was in regards to the assistance that we would provide to the States, about $10 billion, as I recall, back in 2003.

Has there ever been some kind of an accountability as to how the States used these programs and whether or not it was effective? I am assuming most of them went to Medicaid, although they do have options. They are somewhat limited, but they are also pretty flexible. Has there ever been any kind of a look-back to see just how effective that was?

Dr. ORSZAG. There has been some. The Kaiser Family Foundation and others have examined the impact of the Medicaid compo-

nent of the State fiscal relief that was provided in 2003. In general, the evidence does suggest that when you provide money to States, there is the so-called flypaper effect, that where you put the money, say in Medicaid, it tends to stick there.

Senator ROBERTS. Exactly.

Dr. ORSZAG. Even though money is fungible. It does not stick there perfectly, but it sticks there to a significant degree.

The CHAIRMAN. Thank you, Senator, very much.

Senator ROBERTS. I appreciate that. Thank you.

The CHAIRMAN. Dr. Orszag, we have not discussed business stimulus options very much yet. That is roughly one-third of what I think the President has in mind. I am looking at your report here. In Table 1, the varying corporate rate, tax cuts, investments, new investment, and also standing and operating loss carry-back, I am surprised that you think that those have either small or medium effects.

You mentioned in the comments that sometimes businesses, with respect to the corporate tax rate, make their capital decisions significantly in advance of when they might get the cut. Also, the period of the stimulus might be a bit short and harder for businesses to actually make the capital expenditures.

But could you just kind of comment briefly on the stimulative effects of those various business stimulus options?

Dr. ORSZAG. And before I do, you were surprised because you thought they should be bigger or smaller?

The CHAIRMAN. I thought they would be a little bigger.

Dr. ORSZAG. All right. Let me try to explain. The way that you can affect business investment decision is through the after-tax cost of making an investment, and possibly also through cash flow effects. Especially for smaller firms and those that have difficulty borrowing, having more cash available can have some effect on investment decisions.

With regard to that first category, which tends to be the one that scholars have examined more carefully, a corporate tax cut reduction today, if it is permanent, has some effect on incentives for new investments, but its biggest impact is on the pay-off for the investments that have already been made.

The CHAIRMAN. What about the accelerated depreciation?

Dr. ORSZAG. Again, there, the theory is stronger that if you temporarily provide bonus depreciation or an investment tax credit, you can accelerate investment into the qualifying period. However, the experience from 2002 and 2003 was disappointing. Some studies have suggested that we did not even get the predicted impact on the type of investment; that is, you would expect a larger effect on longer-lived assets, those in the, say, 20-year category. There is at least some ambiguity about whether even that investment mix effect occurred, let alone whether there was a significant aggregate impact.

The CHAIRMAN. Senator Grassley is not here.

Senator Wyden, you are next.

Senator WYDEN. Thank you.

The CHAIRMAN. Thank you. Thank you very much.

Senator WYDEN. Thank you, Mr. Chairman.

I want to come back to this question of infrastructure and the short term versus the long term. It seems as if the stimulus debate really comes down to whether you ought to focus on immediate help, and of course that is critical because there is this world of hurt in the country, or, as I would like us to look at it, immediate help plus some long-term benefit.

Now, we are going to work with you on these studies from the transportation officials indicating that they think that they could hire workers within weeks, and shortly after that individuals could be getting paychecks.

But I think I want to ask this from an economic standpoint. If Dr. Orszag has one dollar for stimulus, just one dollar, should the search not initially be for the double benefit that I am talking about here, the immediate help plus the prospect that that can lead to longer-term, sustainable benefits such as employment in infrastructure? I am talking just from an economic standpoint. We are going to have to work with you on trying to find these categories, like road resurfacing, that I think can be done quickly.

But just from an economic standpoint, if Dr. Orszag has one dollar for stimulus, should the search not be for what I think is the two-shot benefit?

Dr. ORSZAG. I would think that any long-term benefit should be just an auxiliary kind of complement or benefit and the focus should really be on what works best during this unusual period of weakness. There are options that work really well in the short term that do not work well in the long term, and I am not sure that we should rule them off the table if the immediate concern is boosting the economy in the short run.

Senator WYDEN. I share that view. If the choice is between getting the immediate benefit, as we all know exists when you help people, for example, with unemployment compensation, or frittering away money in terms of these longer-term projects that people are not going to see, then I think that is a no-brainer, you ought to go with the immediate help.

But what I want to do is to find a way we can get the two-for, we can get the immediate help to people so that folks who are suffering see that there is some effort on the part of the Congress to put a tourniquet on this. I have compared the $800 as sort of like a Band-Aid on arterial bleeding. People want the immediate help.

But I also think, when you look at the crisis in infrastructure, which you all have correctly pointed out is going to get worse because of the short-term decline in funds, here is a chance, if we get good counsel from folks like you, to get both the short-term help and the long-term help. I just look forward to working with you on that.

Dr. ORSZAG. I would just say, you have given me an opportunity to use a really big word, lexicographic. I think the best way of proceeding at this point is to rank short-term stimulus by their bang for the buck, and then there are other considerations that U.S. policymakers can take into account once that has been accomplished.

Senator WYDEN. Fair enough.

Thank you, Mr. Chairman.

Senator Grassley is here now.

Senator GRASSLEY. For a little while.

My next question deals with savings versus expenditures. Everyone agrees investment is the key to higher productivity and a rise of standard of living. However, some economists say that during a recession we have idle resources and non-use capacity, so the money that people save will not be invested. Presumably they think that it just sits around gathering dust. I do not think there is evidence to back that up. This argument is used to support the claim that additional consumer spending will provide a boost to the economy, whereas additional savings will not.

However, in America we have a very diverse and dynamic economy. There are always opportunities for new investment. While some sectors are shrinking, others are expanding. Financial markets are designed to direct savings to those areas that need it. In addition, many consumers finance major purchases—and I would use autos and appliances as a couple of examples—through consumer loans, savings that are not invested or available to consumers.

So, my question to you, are you aware of any evidence—any evidence—to support the view that, during a recession, a dollar of savings does not boost business investment or consumer credit by a dollar?

Dr. ORSZAG. I guess the way I would put it is, it is true it is an identity—it is a mathematical accounting identity—that the total amount that we save will equal the total amount that we invest, plus our transactions with the rest of the world. But it is also true that, during these unusual periods of economic weakness, that one can move the overall level of savings and investment to a higher level, and the way to do that tends not to be to increase savings rates.

There is an unfortunate tension between these unusual periods of economic weakness when higher consumption rates and lower savings rates can be beneficial in leading to a higher overall level of income, which is exactly the opposite of what is beneficial in the long term, where higher savings leads to higher rates of investment and higher rates of economic growth.

That tension, I would note, is very awkward. The policies that are appropriate to accomplish one objective are typically the opposite of the policies appropriate to another. That is, unfortunately, the situation in which we sometimes find ourselves.

Senator GRASSLEY. Yes.

On another point, you commented in your statement that extending the AMT patch for individuals would have a near-term effect on demand. Is it your recommendation that a stimulus package should either extend an AMT patch, or even possibly repeal it altogether? With more emphasis upon the patch than the repeal.

Dr. ORSZAG. Yes. The way I would see it, it is failure to enact an additional patch for the 2008 tax year that would likely have a significant effect, albeit probably more in 2009 than in 2008, where taxpayers who may have been expecting another patch all of a sudden realize that it has not happened, and you would likely have a noticeable impact on behavior in 2009 if a patch that was expected was not actually enacted.

Senator GRASSLEY. All right.

Your written statement indicated that the corporate AMT could effectively undo investment stimulus. How would you recommend that the corporate AMT be modified to make other business incentives more effective?

Dr. ORSZAG. Well, there are important questions about the short term and the long term. Over the long term, again, on the structure of the corporate income tax, I would just come back to saying there are important issues that need to be addressed that we and the Joint Committee on Taxation can help the Congress evaluate in terms of the structure of both the regular corporate income tax and the corporate AMT.

In the short term, there are targeted fixes that can be made to the AMT to try to boost the carry-through or the effectiveness of changes made in the regular corporate income tax, just like there could often be changes on the individual AMT made to extend the impact, if you chose to. I am not saying one should, but if you chose to, you could extend an individual rebate to those taxpayers on the individual AMT.

Senator GRASSLEY. You mentioned that the 2002 and 2003 bonus depreciation provisions had a modest impact on business activity. However, do you not think that the partial expensing, coupled with other business tax reliefs, such as extending the net operating loss carry-back period, would result in a more substantial impact overall on investment and the economy? Then I will follow with this question. Moreover, are we not dealing with apples and oranges here, since there is such a huge overhang in investment back in 2002 and 2003?

Dr. ORSZAG. First, let me answer that question. Yes, economic conditions are different, and it may be the case that the response to additional tax incentives on the corporate side will be stronger than it was at that time. We also do point out that it is correct that the combination of, for example, a net operating loss carry-back provision, with things like bonus depreciation, could be stronger than the two pieces individually.

Senator GRASSLEY. Senator Salazar?

Senator SALAZAR. Thank you, Senator Grassley.

Dr. Orszag, my own sense, just from the people that I represent, is that our economy is more in the ditch than Washington realizes. When you are in the ditch, if you are a farmer, you have to figure out what kind of power you need to get out of the ditch. I think that is what we are trying to figure out here, how we get out of the ditch. My question has to do with respect to the housing market and what is happening there. I think, if you look at the pain index in tough economic times, you see it is from people who lose their homes. You see that pain in foreclosure.

In my State today, 1 out of 326 homes is in foreclosure. We are 6th in the Nation in terms of the housing foreclosure rate. You see the pain also with respect to families whose housing prices have spiraled downward significantly in the last year, and you see it with the construction industry and workers in the housing and construction industry. There is a lot of pain going on in housing.

My question for you is, given this major sector of our economy, to what extent should the economic stimulus package that we are

working on here in the Congress, and we will be working on with the President, address the issue of the housing crisis in America?

Dr. ORSZAG. I would go back to the point that, to be effective, fiscal stimulus need not target the source of economic weakness. So the housing markets clearly are one of the major forces leading to this period of economic weakness, but that does not then mean that effective fiscal stimulus has to target that sector. Instead, what one wants to do is boost aggregate demand as effectively as possible for a given budgetary cost.

In our report, we do go through some measures that would affect the housing markets. In general—not exclusively, but in general—those proposals usually do not rise to the sort of macroeconomic level by themselves. They may have important effects on a dynamic that could ensue involving increased foreclosures leading to reduced economic activity, leading to increased foreclosures. But their direct impact tends not to be sort of big enough on a macro scale to rank close to other types of proposals that we are discussing, despite the fact that they would be beneficial to the households involved.

Senator SALAZAR. So your view, Dr. Orszag, is then that we ought to deal with the housing crisis that we have in the country separate from the stimulus package that we are dealing with here?

Dr. ORSZAG. That is obviously up to you, but you should probably be evaluating those housing proposals, primarily in terms of the trade-offs involved in the housing market and future credit transactions, and probably not primarily in terms of fiscal stimulus.

Senator SALAZAR. In terms of the policy options that you evaluated in the report that you have provided to this committee, what would the impact of any of those policies be ultimately in terms of the housing pain that we are seeing across the country?

Dr. ORSZAG. It depends on which ones you adopted. I should also note, one of the unfortunate things about getting into a mess like this is that there is pain that is involved, and working that pain out is part of the unfortunate and difficult adjustment processes, as difficult as that is for me to say.

So there are some policies and proposals that would try to sort of take away all the pain, and that can create longer-term problems. There have been other examples where trying to step in after the fact and alleviate all of the difficulties that arose from an imbalance that occurred just prolonged difficulties in general.

So, I guess I would come back and say there are options that we evaluate that would clearly provide benefits for homeowners. There are other options that one should be cautious about because of their impact on both future credit market transactions and the risk that they merely prolong an adjustment that has to occur.

Senator SALAZAR. One more quick question. That is, the debt. Whatever proposal is adopted here—the President's proposal is $145 billion. In terms of it adding on to our already huge deficit spending and debt that we have been in for the last 6 years, what impact would the additional debt cause, long-term, on the economy?

Dr. ORSZAG. Well, that depends on whether it was offset in the back years. There is nothing in terms of short-term economic stim-

ulus that would preclude you from offsetting the cost in years 5, 6, 7, 8, 9, 10 if you wanted to.

If you didn't do that, then obviously you would be adding some amount to the long-term fiscal imbalance that we are facing, although in the scale of that large fiscal imbalance, the types of magnitudes that are being discussed are relatively modest, again, as long as it is kept to that and kept temporary.

Senator SALAZAR. Thank you very much.

Senator GRASSLEY. Senator Lincoln?

Senator LINCOLN. Thank you, Mr. Chairman.

I would like to follow up, because that was one of my questions, the long-term impact in terms of the deficits we create. You are saying that what is being talked about is not offset, and could be offset in the out-years. But if it is not, or even if we did offset it in the out-years, what we spend in the most recent years is modest. But when you put that on top of the incredible debt that we have incurred, particularly with the war and other things in these past 6 years, does that not magnify what we would be doing in terms of that debt?

Dr. ORSZAG. I guess the way I would put it is, some increase in the Federal Government's budget deficit during unusual periods of economic weakness is beneficial because it adds demand to an economy that needs it. And as long as it is limited to that period, the impact on the Nation's long-term fiscal imbalance is likely to be modest because that fiscal imbalance arises over a very long period of time in which deficits are growing and growing and growing. If the intervention is limited to 1 year, it is not that large a share of the overall long-term imbalance.

Senator LINCOLN. Then do I understand you to mean that the current deficits that we have now are not large enough that, when we add $150 billion to that, unpaid for, that it is just not going to make that big of a difference? Is that what you are saying?

Dr. ORSZAG. We are in an unusual situation where the short-term deficit—the deficit last year was 1.2 percent of GDP—is relatively modest, but we are on a path where the long-term fiscal imbalance is daunting.

Senator LINCOLN. Right.

Dr. ORSZAG. And in that context, anything we do that significantly exacerbates those long-term fiscal pressures is a bad idea. But if there is an intervention that is limited to the very short term that does not have a market effect on that long-term fiscal imbalance, those considerations are much attenuated.

If fiscal stimulus were limited to this year or to next year, or some short period of time and limited in size relative to the massive deficits that we are projecting over the long term, it does not change the picture all that much.

Senator LINCOLN. So it does not have that much impact on interest rates or other things?

Dr. ORSZAG. The key to our fiscal future is that we face a massive increase in especially health care spending and the imbalance between projected spending and projected revenue, and $150 billion this year may slightly exacerbate that long-term imbalance, but does not have a very large effect.

Senator LINCOLN. The last thing I just wanted to touch on was, one of the things that has resonated here today is the timeliness of what we do and how critical that is. Enacting the right policy is important, but obviously at the right time. We do not move at breakneck speeds up here. That is certainly not new, I do not guess. I wonder about the timing and how we fit into that timing. Could we be doing something too soon? Could we be doing something too late? How critical is that? I mean, how much of a role does that play?

Dr. ORSZAG. I think at this point it would be difficult for you to do anything too soon. It is possible for you to do something too late. Indeed, the history of attempts at fiscal stimulus in the past have highlighted examples in which the lags involved in the constitutional and other decision-making process have been so extended, that additional fuel was added to an economy that was already, by that time, growing rapidly. That is something that one would want to avoid.

Senator LINCOLN. Well, that is a nature we have to change up here, I suppose. But I just look at my own State, and when I was home, the fear in people's faces. We have had 13 mill closures in the last year. If we just enacted some of our trade policies, an agreement that we have, the way that we approach things could have such an impact on our economy in terms of keeping jobs going, keeping mills open, and a whole host of other things. It would make a big difference, I would think, in how we operate, both in a timely fashion and actually doing, implementing, and requiring what it is that we agree to. Does that have any impact? I guess it is certainly long-term.

Dr. ORSZAG. Again, it probably is not a good idea for me to comment on the speed of your decision-making, but I will just say that the sooner fiscal stimulus is delivered, the more likely it is to have larger benefits than costs in the current environment.

Senator LINCOLN. Thank you so much, Dr. Orszag. We appreciate it.

Senator GRASSLEY. I have no further questions. For Senator Baucus, me, and the rest of the committee, we appreciate very much your helping us get started on one of the most important things we have to work on this year, a stimulus package. Thank you very much.

The hearing is adjourned.

[Whereupon, at 11:49 a.m., the hearing was concluded.]

STRENGTHENING AMERICA'S ECONOMY: STIMULUS THAT MAKES SENSE

THURSDAY, JANUARY 24, 2008

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:05 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Wyden, Schumer, Stabenow, Salazar, Hatch, Snowe, Kyl, Smith, Bunning, and Crapo.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The hearing will come to order.

Willa Cather once wrote, "Religion and art spring from the same root and are close kin. Economics and art," she wrote, "are strangers."

Today, despite Cather's admonition, we will seek common ground between economics and art. We will continue our examination of economic stimulus, and we will consider whether we can find any artful solutions for the American economy.

Tuesday, we discussed the criteria for what makes sense for fiscal stimulus. The consensus is developing that stimulus needs to be timely, targeted, and temporary. Today, we discuss specific proposals with two prominent economists.

There are reports that a deal on a stimulus package may be close on the House side. The Senate will want to speak as well. We may well want to change the House package to ensure that Congress does its utmost for the American people. I have spoken with Senator Grassley, and we have agreed that we will hold a mark-up in the Finance Committee on economic stimulus next week.

For example, tax rebate checks for middle-income and lower-income Americans could provide an immediate stimulus for the economy. Middle- and lower-income Americans could spend those rebates quickly. That would provide income to businesses across America, and those businesses could then spend that money. Last week, CBO said that tax rebate checks could be very cost-effective.

Another example would be expanding Unemployment Insurance benefits. In recent recessions, Congress has extended the number of weeks that unemployed workers could receive benefits. We could do that again. We could provide a further extension for recipients in high unemployment States, and we could also temporarily in-

crease the dollar amount of benefits to help unemployed workers pay their bills.

Unfortunately, under current law, fewer than 4 in 10 unemployed workers receive Unemployment Insurance benefits. To address this problem, we could extend eligibility. For example, we could extend benefits to part-time workers. I understand there may not be anything on unemployment insurance in the House deal. I believe that is a mistake, and I hope that we can improve on that when we consider the tax bill here in the Senate.

Another example would be tax incentives for businesses. Businesses are employers. Keeping Americans employed is an important way to fight economic decline. We could allow companies experiencing losses in the current economic downturn to deduct those losses against income from prior tax returns and get an immediate tax refund. The refund could inject cash that could allow a company to survive, retain workers, and maybe even expand.

Another option would be to temporarily allow businesses to deduct from their taxable income more of the money they spend on investment. This would encourage businesses to spend now on buildings, equipment, and other fiscal capital. Others are suggesting stimulus proposals related to the housing sector. Still others advocate fiscal relief to State governments that are struggling to comply with balanced-budget requirements.

So let us see whether there is any art in economic stimulus, let us press to find that common ground between the two disciplines and between the two parties, and let us try to find those artful solutions for the American economy.

Senator Grassley, unfortunately, cannot be here this morning. I spoke with him earlier today. He is ill. But he certainly will participate fully and aggressively when he returns, maybe even later today, in getting ready for the mark-up.

Senator BUNNING. Can I suggest we do the mark-up now?

The CHAIRMAN. We could have a mark-up now, yes. [Laughter.] We would want Senator Grassley to participate, I think. Right?

So, thank you very much, Dr. Feldstein and Dr. Furman, for attending here. The first witness is Dr. Martin Feldstein, who is the Baker professor of economics at Harvard, and the president and CEO of the National Bureau of Economic Research. He was formerly chairman of the Council of Economic Advisors in the Reagan administration.

The next witness is Dr. Jason Furman, the director of the Hamilton Project of The Brookings Institution, formerly an economist with the National Economic Council in the Clinton administration.

Thank you both for coming. As you know, we are allotting witnesses 5 minutes for their oral remarks, and then their prepared statements are automatically included.

So, Dr. Feldstein, why don't you begin?

STATEMENT OF DR. MARTIN FELDSTEIN, BAKER PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY, CAMBRIDGE, MA; AND PRESIDENT AND CEO, NATIONAL BUREAU OF ECONOMIC RESEARCH (NBER), CAMBRIDGE, MA

Dr. FELDSTEIN. Thank you very much. Thank you for your invitation to appear before this committee.

Because of the limited time and because I am eager to hear your questions, let me just hit the highlights of the first part of my written testimony and then turn to some of the more specific points.

First, I think it is generally agreed that the economy is weak and that it could get substantially weaker. But I think it is worth stressing that a recession is not inevitable. Indeed, most private forecasters are still not calling for a recession, but rather for a slow-down, thanks to the fact that services like health and education play a large part in our economy, that the Fed has cut aggressively, and, perhaps most importantly, that the dollar is down significantly and that has given a very big boost to our Nation's exports.

But I think the risk of a serious downturn remains, and therefore what the Federal Reserve did earlier this week was a very good thing. I think the 75 basis-point reduction in interest rates was helpful. I think they should do a further 50 basis-point reduction when they meet next week.

But I think they have to be careful about going below 3 percent because of the continuing inflation pressures that we see, and because, in fact, the actual inflation is now up significantly, as I point out in the written testimony.

But having said all of that, I think monetary policy is potentially of limited effectiveness this time because of the problems that we see in the credit markets. Simply cutting interest rates will not overcome the lack of confidence that causes financial firms to be very reluctant to lend and makes it difficult to get prices for financial assets. I think that is the real case for a fiscal stimulus.

When I testified to the House Budget Committee on December 5, I suggested that Congress should move very quickly to put in place legislation to have a fiscal stimulus, but that that stimulus should only be triggered if we see an actual downturn in economic activity. I suggested, as an automatic trigger, 3 months of declining employment. So, pass it quickly, but have it take effect only if we see 3 months of declining employment.

I thought that such a delayed triggered fiscal stimulus would provide confidence because individuals would know that, if the economy turned down, that fiscal package would be there. Then, of course, if there is an actual decline, we would have that stimulus taking effect without the long legislative lags that normally slow down achieving a fiscal stimulus.

Well, we have not seen that decline in employment, and we may never see that decline in employment. Yet, as I outline in the written testimony, there have been a number of further deteriorations in various economic indicators, the most obvious of which was the increase in the unemployment rate, but also declines in disposable personal income and a more rapid decline in housing construction.

Nevertheless, I still favor a triggered fiscal package, one that the Congress would pass now that would only take effect if we see clear evidence of a sustained economic downturn, or perhaps a 2-part fiscal package in which a smaller part takes effect as quickly as possible, and a second part is written into legislation to be triggered if we actually see the downturn in employment in the economy. But if triggering is not in the cards, then I would say it would be better

to have an immediate fiscal package than to wait and see whether in fact the economy is turning down.

With respect to the specifics of it, I think that the things that we have been hearing in the last 48 hours from the congressional and White House negotiators make a good deal of sense. A flat tax rebate to all who——

The CHAIRMAN. Dr. Feldstein, even though your 5 minutes are up, you are starting to get into substance here, so why don't you continue for another 5?

Dr. FELDSTEIN. Sorry.

The CHAIRMAN. No. Continue for another 5. Go ahead.

Dr. FELDSTEIN. Thank you very much.

The CHAIRMAN. Yes. Yes.

Dr. FELDSTEIN. I think that the things we have heard in the last couple of days make a good deal of sense. What I favor is a flat tax rebate to all who pay taxes, plus an increased cash transfer to low-income groups who are not taxpayers, done by increasing Federal Government payments for food stamps, for TANF, and/or for Supplemental Security Income, where the choice among those would depend on what you hear about the speed with which those things could be done.

I think too much is made of the fact that lower-income households may eventually spend a higher portion of their tax rebates as a case for slanting the tax rebates toward those who are not currently taxpayers. Those with higher incomes may actually respond more rapidly, using credit cards or available savings, to spend their tax rebates even before they receive the cash.

It is clearly important to have a significant-enough-sized tax rebate to catch people's attention. I think what is being discussed, numbers like $500 and $1,000, makes a good deal of sense. That means adding up to a total package of $100 to $150 billion in one-time stimulus.

Let me conclude with a few other specific points. First, I think that an investment incentive of the sort that we saw in 2003, and that I gather the negotiators are talking about again now, would be a good thing. Even before the actual tax payments are made, businesses would respond to the change in legislation. So, we do not have any IRS administrative lag in that process. I think what we saw in 2003 showed that that could work.

What about unemployment benefits? It is clear that raising unemployment benefits or extending the duration would help some individuals who might otherwise face financial hardship, but I think it would also create undesirable incentives for individuals to delay returning to work. Moreover, it is not a program targeted at the poor. I think it is better to use food stamps, SSI payments, or TANF as a way of increasing transfers.

I also think that transfers to State and local governments or Federal spending on infrastructure would be a slow and complex process. It really does not belong in a proposal aimed at what we hope is a relatively short-term downturn.

Finally, and I think this is widely agreed, the pay-go rules ought to be waived in this context, not only because you would not want to do it on a concurrent basis for stimulative reasons, but also because trying to agree on what should be done to raise revenue to

offset this tax cut would probably prevent enacting any stimulus package at all.

So let me stop there. I look forward to your questions, and those from other members of the committee.

The CHAIRMAN. Thank you, Dr. Feldstein, very much. That was very interesting.

[The prepared statement of Dr. Feldstein appears in the appendix.]

The CHAIRMAN. Dr. Furman, why don't you take 10 minutes?

STATEMENT OF DR. JASON FURMAN, DIRECTOR, THE HAMILTON PROJECT, WASHINGTON, DC

Dr. FURMAN. Well, given that I agree with about 90 percent of what Dr. Feldstein said, I will not need the full 10 minutes.

So, Mr. Chairman and other members of the committee, thank you for inviting me to testify today. I am very glad to hear that your committee is going to be playing a major role in designing the fiscal stimulus legislation.

Tuesday's cut in the Federal funds rate will have a major effect on output and jobs, but given the historical performance of monetary policy we will probably not see the full impact on the aggregate economy until 2009. So, well-designed fiscal stimulus has an important supporting role to play. A diverse set of economists agree that any stimulus package should be timely, temporary, and targeted.

The economic logic that motivates this tripartheid test is simple. First, the rapidly evolving downturn provides a motivation for timely fiscal stimulus which, if well designed, could raise economic output and create jobs by the middle of 2008, adding to growth before monetary policy is fully effective.

Second, any tax or spending changes should be temporary. Based on current forecasts, the economy will not need a boost in 2009. If Congress and the President give it one, then the Fed is likely to offset the fiscal stimulus by not cutting interest rates as much as it otherwise would have. Plus, permanent policy shifts would unnecessarily swell our long-term budget deficit.

Third, to achieve maximum bang for the buck, as well as to help those who are most hurt, stimulus should be targeted. Research demonstrates that these goals are complementary. The households most in need of money are the families most likely to spend it.

In my view, the three measures that best meet the timely, temporary, and targeted tests are: (1) a temporary increase in food stamps, a step that could be administered quickly through electronic debit cards and would go to families likely to spend much, or all, of the money; (2) a temporary extension, and possibly expansion, of Unemployment Insurance benefits, reflecting the fact that the long-term unemployment rate is already nearly double what it was going into the last recession and the unemployed will spend a very large fraction of these benefits; (3) the largest step I urge is a temporary, one-time refundable rebate aimed at working households. I will discuss this in greater detail in a moment, but I would like to outline my opinion on three other stimulus options under consideration.

State fiscal relief is worth serious consideration if it is directed at State operating budgets, which, unlike capital budgets, generally face balanced budget rules. Temporarily increasing the FMAP for States that agree to maintenance of effort rules for Medicaid and SCHIP would be one way to accomplish this.

Temporary investment tax incentives could induce businesses to undertake investment they would not otherwise have done. In fact, in 2001 and 2002, I was somewhat optimistic that bonus depreciation would make an important contribution to our economy.

What I have seen in the data, and what three academic studies have found, however, is that the effect of the 2002 and 2003 bonus depreciation was small at best, and much of the tax benefit was a windfall for companies that would have undertaken the investment decisions anyway. As a result, today I am considerably less optimistic about business tax incentives than I once was.

Increased infrastructure investments, in theory, could have a significant positive effect on the economy. In practice, the majority of the ways in which we increase infrastructure might contribute to long-term productivity but do not contribute to short-term stimulus. There may be some ways to design infrastructure to get around that problem, but it would be difficult.

Finally, I would like to go into a little bit more detail about the tax rebates. The canonical consideration in designing tax policies are efficiency, equity, and simplicity. Because rebates would be a function of decisions made in 2007 that can no longer be unmade, the classic efficiency concern with distorted incentives does not apply.

Instead, the key efficiency consideration is how much of any rebate households would spend, and, thus, how much it would stimulate aggregate demand and overall economic performance. These considerations motivate my three recommendations.

First, ensure that rebates go to lower-income households. There is broad agreement and numerous academic studies, including one published most recently in December, 2006 in the premier economic journal, *The American Economic Review,* that find that, from a macroeconomic perspective, a tax rebate would be more efficient if it includes the lower-income households who are most likely to spend the money.

As Chairman Bernanke testified, if you are somebody who lives paycheck to paycheck, you are probably more likely to spend that extra dollar. A study by *moodyseconomy.com* estimates that a refundable credit which goes to low-income households will have 24 percent more bang for the buck than a non-refundable credit. Equity also suggests that lower-income households should receive rebates. A refundable credit would benefit the more than 25 million wage-earning households that pay payroll, but not income, taxes.

Second, the rebates should be phased out for higher-income households. As Chairman Bernanke put it, if you are somebody who has lots of financial assets and you receive an extra dollar, you may not change your spending much. Phasing out a rebate for higher-income households would increase the overall cost effectiveness of a stimulus package.

Third, and this is something you have discussed, Mr. Chairman, and been a leader on, the rebates should be adjusted for family

size. Such adjustments could make the rebates correspond more closely to family needs, thus increasing the likelihood that rebates will be needed and spent.

One $104-billion option consistent with these recommendations would be to provide a maximum rebate of $550 for a single filer, $1,100 for a married couple, and $275 for each additional dependent. In total, a family of four would get $1,650. The rebate would be partially refundable for low-wage workers, and phased out for higher-income households. In my written testimony I discuss this and two other options in more detail.

In closing, I would like to thank this committee for paying attention to the economic lessons of past slow-downs and wish you good luck in turning the agreement that stimulus should be timely, temporary, and targeted into a specific plan.

I look forward to your questions.

The CHAIRMAN. Thank you, Dr. Furman.

[The prepared statement of Dr. Furman appears in the appendix.]

The CHAIRMAN. I thank both of you.

Senator Grassley has a prepared statement for this hearing. Without objection, it will be included in the record.

[The prepared statement of Senator Grassley appears in the appendix.]

The CHAIRMAN. Essentially as I understand what the agreement may be in the House, it will be rebates to taxpayers, that is, based on taxable income. There is no provision, as I understand it—the announcement has not been made—that amounts to lower-income Americans would be half that. They would be, in a certain sense, refundable. But let us say $600 per individual/$1,200 for a couple for taxable income for people who have tax liability, and then half that, that is $300/$600 for individuals who do not have income tax liability.

So my question is, is there any economic difference between one's propensity to spend between the first category and the second category? I will ask you first, Dr. Feldstein. From an economic perspective, does it make sense for lower-income people to get half? By lower-income, I mean the cut-off might be $5,000 or something of taxable income.

Dr. FELDSTEIN. How is that proposed to be done, through transfer payments?

The CHAIRMAN. No, no.

Dr. FELDSTEIN. Or in an explicit refundable——

The CHAIRMAN. Explicit, refundable. It is a rebate check. That is correct. No transfer payments.

Dr. FELDSTEIN. Yes. The economic evidence on differences in spending is really quite weak. I think what you heard in my colleague's testimony is that the case that is put forward for doing a refundable, rather than giving it just to those who pay taxes, amounts to a difference that I would say is within the measurement error that economists bring to that.

The CHAIRMAN. That is negligible.

Dr. FELDSTEIN. It is negligible. The difference between what he calls an efficiency measure of 1 or 1.25, I think, is not something that economic analysis is good enough to carry.

Moreover, there is a question of the speed with which the money can be spent. We hear that getting the checks out will take a matter of months, surprisingly. Individuals with somewhat higher income, with credit cards, with some cash in the bank, may say, well, our family is going to get another $1,000, what should we spend it on, or what should we spend most of it on? They may start that spending before the check actually arrives, since they know that that is money that is coming.

So, in fact, even if the cumulative, the eventual impact is higher for the lowest-income groups, for those with a little bit of cushion, they may find themselves contributing more rapidly when we need it.

The CHAIRMAN. Dr. Furman, your view?

Dr. FURMAN. I would say two things. First of all, there is absolutely no evidence that low-income households would spend less of that money, so I think a certain amount of fairness would suggest that everyone, at the very least, would get the same amount of money.

The economic evidence, though, I think is a little bit stronger—in fact, a lot stronger—than the way I think Dr. Feldstein characterized it. Certainly the Congressional Budget Office, in their assessment, said making the rebate refundable would further boost the cost-effectiveness of the stimulus. Chairman Bernanke testified to this effect to the House Budget Committee last week.

Finally, what economists do to figure out whether something is truly a difference is, they assess in a statistical model whether the difference is so small that it is statistically indistinguishable within the margin of error or whether this is a statistically significant difference.

The study of the rebate experience in 2002 that was published in the premier economics journal did perform precisely this statistical test and found that it was outside the margin of error, the difference between low and high——

The CHAIRMAN. I appreciate that. My time is close to expiring, but when I get back in the second round I am going to ask both of you about the desirability of cash transfer payments, the degree to which that should be part of this, and what the compensation of those cash transfer payments should be. But I have only 18 seconds left, so we will not get into that right now.

Senator Kyl?

Senator KYL. Thank you very much.

Dr. Feldstein, just, first of all, two things from your testimony I just want to make sure I understand. With regard to the statements to State and local governments which some have proposed, I do not think that is a part of the House proposal, but it could be something that is proposed over here.

You state in your testimony, “Transfers to State and local governments would be a slow and complex process. So too would Federal spending on infrastructure. These would weaken the effectiveness of any size stimulus package.” So I gather what you are implying there is, that would not be a good idea to include in the stimulus package. Is that correct?

Dr. FELDSTEIN. That is correct.

Senator KYL. And, second, you said, “Its purpose,” the stimulus package, “is to increase household and business spending in order to raise total GDP. It should not be taken as an occasion to build infrastructure, to reduce poverty, or to strengthen economic incentives.” I mean, all of those may be worthwhile policy provisions, I am sure you would agree. “It should not be taken as occasion to redistribute the burden of taxes.” That leads me to favor a flat tax rebate to all who pay taxes, plus an increased cash transfer to the low-income groups who are not taxpayers. Is that correct?

Dr. FELDSTEIN. That is correct.

Senator KYL. So if there were a proposal, as I understand it, to cap the income at, say, $75,000 of adjusted gross income for receiving the rebate, that would be inconsistent with the proposal as you would like to see it evolve?

Dr. FELDSTEIN. Yes, that is correct.

Senator KYL. Now, is part of the reason for that—and I will address this question, Dr. Furman, to you as well. There are a lot of different ways to ask the question, but let me just frame it as I understand fiscal policy. Fiscal policy does not work because the government gives people money to spend, it is because there is money available for investment.

Therefore, it really does not make much difference, does it, whether one buys something, spends money, and then indirectly that money can go into investment into more capital goods, employment, or the like, or an individual “saves” money, and of course when one saves money it is being invested by someone, so either directly or indirectly the money, likewise, is made available for the same capital investment and the like. Is there any real difference between the two, except that direct investment might be a little more quick than consumer spending?

Dr. FELDSTEIN. I would say, in the current context, in an economy where there is extra slack in the economy, where there is unemployment, we really do want to increase consumer spending. This is not an indirect way——

Senator KYL. For what purpose?

Dr. FELDSTEIN. To increase the demand for goods and services.

Senator KYL. For what purpose?

Dr. FELDSTEIN. And thereby create jobs, to move the economy to a higher level of economic activity.

Senator KYL. Right.

Dr. FELDSTEIN. To get us out of a recession, if we are sliding into one.

Senator KYL. And it takes money to create jobs.

Dr. FELDSTEIN. It creates demand for goods and services, to create production and employment. So, in the long run there is no question, we need more investment, we need better incentives. But what we are focusing on, what I think the legislation should focus on, is creating spending. The best way to do that is to give people back some of their tax dollars so they can spend them.

Senator KYL. All right.

Before I call on you, Dr. Furman, Mr. Chairman, I wish we had a witness—I mean, I have been reading a lot and watching a lot on TV. With all due respect, I do not think this panel is balanced,

in that it does not represent a significant point of view that would argue with the proposition that this is simply a demand problem.

I turn on the finance channels on TV, and the things I read talk about the need for capital investment, more liquidity, and the like, and suggest that it is not just a matter of demand, but it is very much a matter also of liquidity, and in this case investment would be as useful, if not more useful directly than consumer spending. So, I posit that as a concern.

The CHAIRMAN. I appreciate that, Senator.

Senator KYL. Not that both of these witnesses are not eminent——

The CHAIRMAN. Senator? Senator, I might say, Dr. Feldstein was chairman of the Economic Advisors in the Reagan administration.

Senator KYL. I understood that.

The CHAIRMAN. And Dr. Furman——

Senator KYL. There are a lot of Republicans with whom I disagree.

The CHAIRMAN. Right. So we are trying to get——

Senator KYL. What I am saying is that there is——

The CHAIRMAN. We are trying to get a balanced panel here.

Senator KYL. I understand.

The CHAIRMAN. I think it is pretty balanced.

Senator KYL. Give me an extra 10 seconds here, Mr. Chairman.

The CHAIRMAN. Absolutely.

Senator KYL. A significant point of view with respect to fiscal and monetary policy is not represented here, is my point.

Dr. Furman, I have just a little bit of time left. Please comment on that.

Dr. FURMAN. Sure. I would say there are a lot of areas of economics that are very controversial. That stimulating aggregate demand can raise economic growth during a downturn is something I think 98 percent of economists would agree on.

Senator KYL. So we are all Keynesians now, is that it?

Dr. FURMAN. They might disagree on the details of what exactly is the most cost-effective element to include in that, but I do think 98 percent of economists, when the economy is turning down, believe in the Keynesian remedy because you essentially—one way to picture it is, you have empty factories, workers not working, people not buying things. If you can get people to buy things, the factories will start working, it will employ the people, and all of that will become like a virtuous cycle.

The CHAIRMAN. Thank you, Senator.

Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman.

Thank you both for excellent testimony. I come to this by way of saying that working people save their income that is temporary and they spend their income that is permanent. So what I have been interested in is approaches that raise people's incomes permanently. So on this infrastructure issue, Senator Thune and I, on a bipartisan basis, introduced a comprehensive proposal to let Build America bonds.

But as we looked at this whole issue of stimulus, it became very clear that you needed to drill down into only those areas that you could spend out quickly. I was very pleased that Dr. Orszag yester-

day, the CBO Director, said that especially road resurfacing was something that could be spent very quickly.

So my question to you is, and I want to unpack this infrastructure debate in a different way. Senator Reid, to his credit, yesterday said he wanted to pass this legislation February 15. By my calculation, we could get transportation projects out, a number of them, faster than you could get out the rebate checks, because we were told that the rebate checks were not going to get out, perhaps, until June. So you look, for example, and these transportation officials, they did not exactly fall off the turnip truck. They sent me the projects from Montana and Iowa. I guess that is not exactly by accident.

The CHAIRMAN. That is very wise of you, Senator.

Senator WYDEN. I thought they were very wise. They said that there were projects that were on the shelf that could begin within 90 days—so they would be faster than the rebate checks—that would include areas like resurfacing and some of these other areas that were related to what Dr. Orszag was talking about yesterday.

Give me your assessment about whether that particularly, Dr. Furman, Dr. Feldstein, might at least open the door here to the possibility that some areas of infrastructure, given what Dr. Orszag has talked about, might be eligible for the kind of criteria that we all agree ought to be looked at for stimulus.

Dr. Furman?

Dr. FURMAN. I do think, as I testified, that you should apply a very high degree of skepticism to infrastructure proposals. Proposals that do not spend out until, for example, 2009 are not going to help the economy when it is needed, might destabilize it when it is not needed, and will be offset by the Federal Reserve.

My understanding is, there are some infrastructure projects that can be identified—and I have learned never to argue or disagree with Dr. Orszag when he says anything. So if road surfacing is one of those, then it would certainly help the economy if you could do it more quickly, but you would want to be very, very careful and very, very sure that it actually would be done quickly.

Senator WYDEN. Dr. Feldstein, I want to let you add and then I want to ask a question about health care. I think you are right. I mean, this is something that has to be done with considerable focus on speed. I know you have made comments on infrastructure. Does something like this, in terms of the timetable where rebates would actually take longer, cause you to say that perhaps this ought to be thought through more?

Dr. FELDSTEIN. First, with respect to the rebates, I think we might find that people are spending those rebates before the checks arrive.

Senator WYDEN. Fair enough.

Dr. FELDSTEIN. I do not know enough about the budget processes of State and local governments to know how representative those 3-month lags would be.

Senator WYDEN. Fair enough.

Dr. FELDSTEIN. So I think there is a real risk that we would start down what looks like a helpful road, and then folks would say, but what about mass transit, et cetera?

Senator WYDEN. Fair enough.

Dr. FELDSTEIN. So I worry about that.

Senator WYDEN. Let me get one other question in for you, Dr. Furman. A number of us now, Democrats and Republicans—in fact, four on this committee—have come together to advance a universal coverage health bill. It is very clear that medical costs are gobbling up everything in sight, and this is taking a huge toll, both in terms of the short term and the long term.

Give us your assessment of how health care ought to be approached, both from the standpoint of the short term, the stimulus, and in the long term. I am very grateful to my colleagues, Senator Stabenow, Senator Crapo who is here, Senator Grassley. We want to approach this in a bipartisan way. We want to make it different than 1993 and 1994. So, your thoughts on health care.

Dr. FURMAN. In zero seconds.

The CHAIRMAN. Minus 7 seconds.

Dr. FURMAN. Minus 7 seconds. In the context of the stimulus bill, the only health provision I could see making sense there would be temporarily increasing Medicaid payments to States, so that they do not cut back their eligibility, which would be unfortunate. In terms of longer term, I think this is an opportunity, right after the stimulus debate, to look at how we can help better protect people from risk, so in an economic downturn, you lose your health insurance when you lose your job.

So, making health insurance portable, making it so you do not lose your health insurance when you lose a job, these types of things would better help protect people from risk and circumstances like this and would have an ancillary benefit of potentially even being counter-cyclical and helping stabilize the economy.

The CHAIRMAN. Thank you, Senator, very much. Thank you.

Senator Bunning?

Senator BUNNING. Thank you very much, Mr. Chairman. Thank you both for coming and testifying.

Senator Grassley began these hearings with a comment that the package we are discussing should be a racehorse and not a swayback horse. I agree wholeheartedly, but I would add that I would want it to be a winning horse. While I will not say that a racehorse raised in Washington and trained on the White House lawn could ever not win a race, I certainly would prefer a racehorse raised and bred in Kentucky.

In all seriousness, Drs. Furman and Feldstein, you have talked a great deal about the need to act quickly and the 3 “Ts” principles. But what about the “R” of representative government? The need for nearly immediate actions seem to conflict with our need to fully evaluate tax policies developed behind closed doors, with perhaps a bit more concern for politics than the long-term health of our economy.

I would suggest to you that markets around the world understand better than we do the risks associated with a policy of writing checks equal to 1 percent of our GDP whenever recession threatens.

As you know, they reacted by destroying hundreds of billions of dollars in paper wealth. If we really want to win the global economic horse race, would it not make more sense to invest this $150 billion on permanent tax changes that lay the foundation for future

economic growth? To win in the long run, should we not focus more on raising the horse instead of recklessly injecting it with stimuluses, with the knowledge that it could injure the horse?

Dr. FELDSTEIN. I very much favor the long-term incentives that you are talking about. I favor keeping the tax changes that were enacted and that are scheduled to phase out. But I think that we face a potential short-term downturn for which that is not the answer.

Senator BUNNING. Is politics the answer then?

Dr. FELDSTEIN. I would not call it politics. I would say that there is a surprising amount of bipartisan agreement among professional economists that what can reduce the risk of a significant downturn, that can reduce the magnitude of the downturn if the economy starts to slide, is the kind of clean bill fiscal stimulus package that the administration and members of the House seem to be talking about.

Senator BUNNING. Dr. Furman?

Dr. FURMAN. I think tax reform is in our country's long-term economic interest, and I would love to see the committee continue its work on it. But it is a very complicated question, and it is not the most efficacious way to increase economic growth in the year 2008 when it is most immediately needed. So, I think the stimulus route is devoted to a simple task to temporarily increase growth in 2008, but over the long term the more important tasks are the types of long-term reforms to our tax code, health care, infrastructure, and other areas of our economy.

Senator BUNNING. Instead of a cash rebate, what is your opinion of using the $150 billion to make changes to tax policy that have the potential to worsen the business cycle, such as extending the carry-back for net operating loss to keep firms out of bankruptcy, or repealing the 1986 tax on unemployment payments to increase their purchasing power?

Dr. FELDSTEIN. I think providing some of that, if the number is $150 billion, for business would be a good thing. I think it would be better to do it in terms of strengthening incentives for businesses to invest, both small businesses and large businesses, as the bonus depreciation legislation did earlier in the decade. I would not oppose changing the loss carry-back rules.

I think taxing unemployment benefits is important, was a real improvement in incentives, because we previously had an anomalous situation. Before taxation, unemployment benefits replaced, at the margin, 50 percent of lost wages. If you do not subject benefits to tax, then the level of benefits relative to net of tax wages becomes very high, to a point where the incentive to go back to work is essentially so small that individuals would have a very strong temptation to extend their period of unemployment. I think we saw the favorable effects of that when benefits were taxed. So, I favor the taxation of unemployment benefits.

The CHAIRMAN. Thank you, Doctor, very much. I appreciate that. Senator Schumer?

Senator SCHUMER. Thank you. I want to thank you, Mr. Chairman and Ranking Member Grassley, for scheduling these hearings so early in the session on an issue that is so important.

As the press is reporting this morning, it appears progress is being made on a bipartisan stimulus package. While I may not agree with every element of the package, the agreement is a very positive development, for it is most important to move a package quickly with, as its centerpiece, a tax cut for average families. The reported agreement in the House meets that test.

But I want to outline some outstanding issues I believe should be critical components of effective stimulus legislation. First, I believe that any effective stimulus spending should be a combination of tax cuts and spending. As Dr. Furman notes in his testimony, spending programs like extended unemployment benefits are among the most effective stimulus ideas, while business tax cuts are the least effective in terms of the speed of getting money into the economy, which is our number-one criteria. Of course, the political reality is that there will probably be a need for business tax relief as part of the final package.

I am not opposed to including it if it helps the package get done quickly, but I think there has to be balance. In my view, at least, and I think in the view of many of my colleagues, the centerpiece should be stimulus checks. I believe it should make up about two-thirds of the total, with the remaining one-third divided between spending programs and business tax cuts.

The spending programs and temporary tax cuts should be as bookends of the package, so I was disappointed to hear this morning that the purported agreement does not recognize the effectiveness of spending programs like unemployment extensions and jump-starting our economy and puts almost half of the package, at least in the news reports, on business tax cuts.

I would strongly encourage the administration to heed the advice of the experts. For every dollar spent on UI, Unemployment Insurance, the economy benefits $1.73, even more than the $1.17 of the tax stimulus tax cut.

Second, the housing crisis has been the bull's-eye of this potential recession. The President's hands-off approach to the housing crisis clearly has not worked. Each foreclosure has costly ripple effects through neighborhoods. Analysts predict 2 million more foreclosures over the next 2 years.

I think you get the best bang for the buck in stimulus when you deal directly with the worst problems. I think there are two proposals that ought to be in there. One is money for nonprofit foreclosure prevention counselors. The administration's Secretary Paulson has told me the administration agrees with this. I am going to work hard to see that that is added as we move along in the Senate.

Second, the conforming loan limits should be raised. That would provide, temporarily, a much-needed shot in the arm in the struggling mortgage market. I think that—we have been getting reports—may be in the House package, and again could reach broad bipartisan agreement.

The American people know in their guts that the housing and mortgage crisis has gotten into this mess and we are going to have to deal with that problem to both give some confidence in the markets and deal with the core of the problem.

The final difference I would have, or not difference, but in addition, after we get this package done, I agree with you, Dr. Furman, we have to start getting to work on a longer-term package that includes some of the broader reforms and spending needs that everyone knows are necessary: reform of the unemployment system, modernization of trade adjustment assistance, extension of tax incentives for alternative fuels, spending on infrastructure, and State fiscal relief, and a broader housing package. So I hope, after passing this immediately needed short-term package, we get to work on a longer-term package that looks at the structural problems in the economy.

I would like, just my one question to both of you, first to Dr. Furman, then to Dr. Feldstein. What do you think of the two points of, (A) including some things that will alleviate the foreclosure crisis in this package; and (B) you have talked a little about it, Dr. Furman, so maybe Dr. Feldstein, a longer-term structural package?

Dr. FURMAN. I think those two ideas you have would be very sound ideas to deal with the housing situation, and ones that could be usefully included in the stimulus bill.

Dr. FELDSTEIN. I think on the housing, the idea of providing funds for foreclosure prevention counseling may make sense. I really have not thought about it before, but I do not see any reason why that would be a bad thing. How it would be done administratively, you have thought about more than I.

About increasing the conforming loan limits: the current limit of $417,000 does not buy you a lot of housing in New York or California. But remember, nationally the average home purchase is around $230,000. So, we are talking about putting taxpayer money at risk for a relatively small part, a relatively concentrated geographic part. I would rather not see an expansion of Freddie and Fannie. I think they have lots of problems.

As far as the longer term, I am very glad that you emphasized splitting between what needs to be done in this legislation and coming back to more fundamental issues on the spending side, the transfer side, and on the tax side. There is certainly a lot of work to be done on those.

The CHAIRMAN. Thank you, Senator.

Next, is Senator Stabenow. I might say, though, before you proceed, Senator, that it is my hope that we can move as you suggested, Senator Schumer, with trade adjustment assistance fairly quickly, because that will help, too. Also, I very much agree that we should be, right now, working on that second package that will come along a little bit later. I do not think there is much disagreement that, in addition to the immediate stimulus now, that we need something a little more long-term. Thanks.

Senator Stabenow?

Senator STABENOW. Thank you, Mr. Chairman. Thank you for this hearing.

This is actually, I think, a very hopeful hearing in that we are hearing a consensus forming that I think is very important for us in terms of guiding us. We are hearing that we should focus on demand. I think that we are hearing that from people who come from very different perspectives, which I think is very interesting. I would agree with that. We have seen over the last 7 years, really,

a focus on the supply side as we talk about supply and demand all of the time. We have seen that focus for the last 7 years on tax policy and other policies.

What has happened, in fact, is we have seen more and more people, middle-income people, low-income people, stretched farther and farther, losing income, losing jobs. Unfortunately, not all of the investment we have tried to stimulate is in American jobs. It has gone, in a global economy, around the world. So now we find ourselves in a situation where Americans here need us to be focused on their needs, and therefore helping our economy. So, I appreciate the consensus.

I also appreciate, after having the CBO, Congressional Budget Office, come before us and talk about food stamps and unemployment compensation, that certainly both of our witnesses today agree on food stamps. There is a disagreement on Unemployment Insurance, but on food stamps I am hearing an agreement that it is an immediate stimulus. Someone gets additional help for food and they are going to go immediately to the grocery store and buy food for their family. So, I think that is an important part of the testimony today.

Mr. Chairman, I want to thank you for raising Unemployment Insurance. Coming from the State right now with the highest unemployment in the country, 7.6 percent, I appreciate the fact that we are looking at what was done in 2002 in terms of this stimulus package, and including that.

When you mentioned that 4 out of 10 people who are currently unemployed are receiving Unemployment Insurance, that means 6 people are not. They are looking for jobs, as are the 4. I can testify, from a very different perspective, that the small amount of people receiving Unemployment Insurance is not stopping them from looking for a good-paying job that will allow them to keep their house and to be able to support their family. So I am hopeful we will take the recommendations of CBO and include Unemployment Insurance and food stamps as a part of the stimulus.

I did want to speak to something else, though, that we have not directly talked about. We are talking about business incentives as well, and I know those will be part of the package. When we look at bonus depreciation or other kinds of business relief, it unfortunately translates into less revenue for States right at a time when they are cash-strapped, with more people going onto Medicaid because of losing their insurance, and so on.

So I am hopeful that we will do what we did in 2003, what the Congress did, what the White House supported, which is to include some State fiscal relief of some kind. I would personally focus that on Medicaid and insurance to at least allow an offset so we do not put States in a worse situation by the business tax relief that is being contemplated.

So we have not specifically talked about that, but, Dr. Furman, I wondered if you might speak to the impact of the 2003 fiscal relief provisions on State behavior and access to health insurance coverage for low-income families, the same people we are talking about helping be able to stay in their home, be able to look for a job, be able to get food stamps, and so on.

Dr. FURMAN. Right. By the time that passed in 2003, States had already cut a substantial number of people from the Medicaid and SCHIP rolls in response to their mounting deficits. I do not remember the exact number, but it was quite substantial. This time around we have seen a number of States have already floated proposals to lower the income eligibility limits for those programs, but we have not seen a substantial movement in that direction.

So, this time around, if you were able to act earlier, you could actually prevent States from reducing the number of people who are eligible for those programs before it actually happened as opposed to the experience in 2003, when I think it prevented a bad situation from getting worse.

Senator STABENOW. Thank you very much.

Mr. Chairman, I hope we can have that on the table for discussion as we look at a balanced package. I see my time is up. Thank you.

The CHAIRMAN. Thank you. Thank you, Senator, very much.

Senator Smith, you are next.

Senator SMITH. Thank you, Mr. Chairman.

Dr. Feldstein, Dr. Furman, thank you for being here. We appreciate your insights and your expertise and the time you are taking to be with us.

Obviously the economy, for a number of years, has been running along very well, but we have slowed to a jog and we may be walking soon, and hopefully we do not stop. As you look at this package that we are developing, I suppose the reason for my support is, fundamentally, as one who registers on this side of the aisle, I think this is an implicit, if not an explicit, admission that Washington takes too much, and money left at home is better spent by people. The economy works more efficiently when that is the case.

I guess the question I would have for both of you, and, Dr. Feldstein, you mentioned there is broad bipartisan agreement among economists about the value of this injection of cash into the economy, it is 1 percent. Is that enough?

Dr. FELDSTEIN. We do not know. Remember, while there is a lot of concern—and I share it—about the possibility of an economic downturn, and perhaps a serious or deep one, it has not happened yet. We are not sure that it is going to happen. We have a significant easing of monetary policy working to offset that. So, we do not know how much of a fiscal stimulus we need, and that is one of the reasons why I have talked about triggering it, or splitting it and triggering the second phase of it. With good luck, the combination of things that I have referred to will mean that we do not have that downturn and that 1 percent will be enough to do the job.

Senator SMITH. Do you have a thought about 1 percent, Dr. Furman?

Dr. FURMAN. It would hit in the middle of the year, so it would raise the annualized growth rate, what is typically reported, by perhaps something on the order of 3 percentage points in the third quarter. So, that would take a quarter that might have been negative 1 percent annualized growth and turn it to 2 percent annualized growth.

I agree, we do not know the precise number for a package, but given the limited bad data we have seen so far, the uncertainty

about the future and the large amount of Federal Reserve easing that is already in the system, I think it would be premature to go higher than $145 billion.

Senator SMITH. Dr. Furman, you talked about FMAP. In the last recession that we had in the late part of the Clinton administration, early part of the Bush administration, the States were crying for FMAP. And we were in a recession. Senator Rockefeller and I, in particular, were the authors of that and heled to broker that. We are not in a recession yet. Is it too soon to pull the trigger on FMAP?

Dr. FURMAN. As I said last time, I think it helped prevent a bad situation from getting worse.

Senator SMITH. Then. But how about now?

Dr. FURMAN. Correct. I think now you have an opportunity to——

Senator SMITH. To get ahead of it?

Dr. FURMAN. To get ahead of the curve, yes.

Senator SMITH. And so you think we will go into a recession?

Dr. FURMAN. We will go into a growth slow-down.

Senator SMITH. Slow-down.

Dr. FURMAN. And we have already seen State budget deficits start to emerge, and States are already starting to make their budgetary decisions under their balanced budget rules, and Medicaid cuts are——

Senator SMITH. Is that because a lot of States have really added to baseline budgets with tremendous amounts of new spending in the last 6 years?

Dr. FURMAN. I am not an expert on what has gone on with State budgets, but my understanding is, there have also been tax cuts over that period of time.

Senator SMITH. Another thing we did last time, we were about cutting taxes, leaving more money in the American economy than we were bringing in to the Beltway. I was the author of repatriation. As you gentlemen know, many of the companies that have developed in the 1980s and 1990s now have foreign subsidiaries. In 2003, we did a repatriation so that they could bring those dollars back at a 5.5-percent rate.

That produced, I think, conservatively, an infusion of cash into those companies, into those employees, into research and development, the capital equipment investment of $350 billion. It also was not a cost to the Federal Treasury. In fact, it probably accounted for perhaps up to $2 billion of tax revenue to the Treasury.

Is that something that it is time to consider again, or would we be better served to just simply lower the corporate tax rate, as Europe has now done? We are only exceeded in corporate tax rates by the nation of Japan.

Dr. FELDSTEIN. Well, I favor lowering corporate tax rates in a permanent way. I think that is not for this piece of legislation, which focuses on the short run.

Senator SMITH. Of course.

Dr. FELDSTEIN. But the proposal to have one-time relief to bring funds back from the rest of the world, as you did a few years ago, does fit within the notion of a one-time change. As you say, this is not an additional cost in terms of increased fiscal deficits. In-

deed, it is worth saying also that the bonus depreciation, while it costs Treasury money in the short run, any dollar of depreciation that is taken now cannot be taken later.

So over the course of the life of that equipment, the investor gets the same amount, same total amount, of depreciation and therefore has the same total cost. It is delayed. That has a present value. But in terms of the actual budget amounts, there is no net cost to that bonus depreciation. That is also true at the State level.

The CHAIRMAN. Thank you, Senator, very much.

Dr. FELDSTEIN. But they lose in the short run.

The CHAIRMAN. Thank you.

Senator SMITH. May I ask one other, please?

The CHAIRMAN. We are really stretching things here, Senator.

Senator SMITH. I just have a question I am dying to ask you, Dr. Feldstein. I was a great admirer of Milton Friedman. I thought his contribution to economics was, frankly, remarkable. You worked with him in the Reagan administration, perhaps unofficially. Would he have supported this idea of a stimulus package?

Dr. FELDSTEIN. The last thing I want to do is to try to speak for Milton Friedman. [Laughter.]

The CHAIRMAN. Senator Hatch?

Senator HATCH. Well, thank you, Mr. Chairman. We appreciate both of you. Dr. Feldstein, it is great to have one of the world's greatest econometricians here trying to help us, and we have appreciated how Dr. Furman has helped during the Clinton administration.

Dr. Feldstein, I find your conditional stimulus tax cut with a trigger concept pretty interesting. As far as I know, this idea has never been passed through Congress, although there have been some discussions on tax cut triggers in connection with meeting deficits.

Now, do you see any down side risk to such a plan if we were to do it? You mentioned that such a mechanism would serve as another automatic stabilizer to our economy. Given this, shall we consider putting such a plan in place on a permanent basis, both to lend confidence and to speed up economic relief whenever it is needed?

Dr. FELDSTEIN. I do not see a downside risk. I do not see a disadvantage to it. It seems to me it would increase confidence and it would eliminate the long legislative lags that so often have made it difficult to get a fiscal stimulus package in time.

Senator HATCH. Which we are dealing with here.

Dr. FELDSTEIN. Exactly.

Senator HATCH. Everybody has been testifying.

Dr. Furman, what do you think of that idea, Dr. Feldstein's idea for a conditional stimulus package triggered by a 3-month decline in payroll employment as the triggering event?

Dr. FURMAN. Yes. My colleague, Doug Elmendorf, and I studied this and wrote about it in a recent paper, which we can make available to you. I think it is a good idea. I think if you look back at the history of business cycles, it would have delivered very well-timed stimulus in most of our previous experiences.

I think right now the situation in the economy is unusual and deteriorating rapidly enough that I would at least make the first

tranche of this stimulus unconditional and as fast as you could do it as possible, maybe teeing up a second tranche of stimulus that you would pass today and would only go into effect if something like Dr. Feldstein's triggers were reached.

Senator HATCH. That is interesting.

Dr. Feldstein, you mentioned in your testimony that the size of the stimulus package should be large enough to cause a change in spending behavior and that $50 is too small, but $500 should not be ignored, or would not be ignored.

Now, I have heard other economists say that generally only permanent changes in income will change consumers' behavior, and that one-time tax rebates, by their nature, will mostly be saved and not spent. Will a tax rebate be effective in stimulating the economy?

Dr. FELDSTEIN. There is a lot of economic theory that says a one-time rebate does not get spent and there is a lot of empirical evidence that says that is wrong, that a one-time rebate does get spent. It may not get spent as much as a permanent increase in income. If I know I am going to get another $100 a month in income for many years, I will probably end up spending $90 out of that, or maybe even more.

But a one-time $500 rebate, the statistical evidence suggests probably half, or slightly more than half of that will get spent and get spent pretty quickly. So I think that the worry that only permanent changes add to demand is more a theoretical than an actual worry.

Senator HATCH. You mentioned that bonus depreciation has been helpful in the past in stimulating the economy. If you were writing a stimulus bill now, how strong a bonus depreciation incentive would you put in that bill? Would you make it applicable to both large and small businesses?

Dr. FELDSTEIN. I would certainly do something for small businesses. I am not sure that I would do it in the form of bonus depreciation as opposed to just raising the cap on the amount that they can completely write off immediately. But what was in the legislation in, was it 2002 or 2003, I think 50 percent could be written off in the first year and then the rest depreciated in the normal schedule. I thought that captured the interest of businesses and it did lead to a speeding up of investment.

It is very important that there has to be a time table on it, so you say investment that is done in the next 12 months will get bonus depreciation, after that you do not qualify for it. So, a lot of firms will say, "Well, you know, we have these projects that we were thinking of doing, let us get them done fast, put that extra spending in." That puts demand of a different sort into the economy than the demand that comes from households who get extra cash.

Senator HATCH. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator.

Senator Snowe, you are next.

Senator SNOWE. Thank you, Mr. Chairman.

I want to thank both you, Dr. Feldstein and Dr. Furman, for being here today and giving us your thoughts and the benefit of your longstanding and outstanding experience.

Dr. Feldstein, on the business side, as the ranking member of the Small Business Committee, I have been a strong advocate of including the small business expensing, as well as the net operating carry-back. Dr. Orszag, the other day, the Director of CBO, indicated that they could have a good effect integrated because, it would be expensing focusing on those businesses that have some income to make investment, and the net operating carry-back on those that do not that can reach back further. Would you agree with that in terms of the short term and having an impact in that respect?

Dr. FELDSTEIN. I would agree with it, but I would put more emphasis on the forward-looking part, on the bonus depreciation rather than on the carry-back.

Senator SNOWE. You think the carry-back would have less effect in that respect?

Dr. FELDSTEIN. Yes, because a lot of it presumably would go to businesses that are basically healthy, that have experienced a loss, but that fortunately are not about to become bankrupt, not about to go out of business. So for them, it is just putting some more money in the bank, improving their balance sheet. It does not change their incentives. While the bonus depreciation says, get your act together, figure out how you can do some of that investment spending that you are otherwise putting off, because it will be cheaper for you to do it now.

Senator SNOWE. Well, I think the emphasis on small businesses is critical because they create two-thirds of all jobs in America and they represent 99 percent of employer firms. So it is, I think, essential to have that focus.

Dr. FELDSTEIN. And I think for them, simplicity is important.

Senator SNOWE. Yes.

Dr. FELDSTEIN. Complicated rules that they have to go and ask their accountant to explain, that is not very helpful. Something that says, you can now get a much larger one-time complete write-off, they can understand and move quickly to take advantage of.

Senator SNOWE. Absolutely.

Dr. Furman, in the report that you co-authored, you talked about the net effect of the past rebates—I do not know if it was the 2003—in terms of the impact they had on growth in our economy and the GDP. And using it hypothetically, the 1 percent of the GDP, which is about $140 billion, would have an increase in several consecutive quarters with a 1-percent increase in GDP. Is that right?

Dr. FURMAN. That would be a 1-percent increase in the level.

Senator SNOWE. In the level.

Dr. FURMAN. It would actually show up as an even higher increase in the annualized growth rate in the first quarter that it hit.

Senator SNOWE. So making the assumption—we obviously have not heard all the details of the package that might have been agreed to between the President and the leadership—if you are using $70 billion of that $140 billion for tax rebates, do you think

it could still have that impact? Or how much of an impact would it have on growth?

Dr. FURMAN. Well, $70 billion would have half the impact that $140 billion would have.

Senator SNOWE. Half. Yes.

Dr. FURMAN. Then the question is whether the business tax incentives have an impact. I think, in theory, they could. I think in practice, when you look at, for example, surveys of people, the business decision-makers in 2002 and 2003 said it did not actually affect their decisions about investment.

Dr. FELDSTEIN. Businesses always say that. They say, I do things for sound business reasons and I am not drawn by mere taxes to do things.

Senator SNOWE. Right.

Dr. FURMAN. Right.

Dr. FELDSTEIN. I think confidence is very important. Economists do not have a variable for confidence to put into the models. Changes in the rules that cause people to think the government is taking it seriously, the Fed is taking it seriously, I think, can bring about an increase in confidence which leads to more spending by households and more spending by businesses, and we should not forget that.

Senator SNOWE. All right. I think that is right, and especially the combination between the interest rate cuts, as well as a stimulus package. The question on affecting growth and tax rebates, I was a strong believer in the refundability. Senator Lincoln and I have been advancing in the Child Tax Credit, to extend that, because it is now indexed to inflation and it has undermined the income threshold. The fact is, if we had passed it last year, that money would have been in the hands of the low income, ironically. Unfortunately, it did not happen.

But in this case, if it was more directed to low-income, the balance of that rebate, in your opinion does it make a difference or not in terms of affecting the economy and behavior?

Dr. FURMAN. I think it would have a better effect on the economy for any given dollar you spend on rebates if you direct it to low-income households, and there is a substantial amount of economic evidence agreed to by a broad spectrum, but not every single economist would say that.

Dr. FELDSTEIN. Remember the numbers in your written testimony, in Dr. Furman's written testimony, are that instead of getting a $1 increase in GDP by having this broader distribution, the best estimate might be $1.25. So, it is not a big difference. Despite the statistical precision that the published article that he referred to talks about, I think the uncertainty about it is really very substantial.

So I think a cleaner bill that says if you pay taxes you get your money back, but there are also poor people whom we can reach with food stamps, or with TANF, or with SSI, is a better way to go. Extending unemployment benefits—the number of people who are at 26 weeks or higher is about 1 percent of the labor force. The number of people who get food stamps is in the tens of millions. So you are really talking about being able to reach a much broader group, and indeed the long-term unemployed are not necessarily

poor. Not that they are well-off, but that is not a way of targeting the money at those who are poorest.

Senator SNOWE. Well, I will tell you, in speaking to that point, a woman in Maine told me recently that she had three jobs: one to pay for the mortgage, one to pay for the oil, and the third to pay for gasoline to get to the other two jobs. I think that underscores the dramatic and dire situations that so many people are facing today.

Thank you.

The CHAIRMAN. Thank you, Senator, very much.

I would like to go back to an earlier question that I said I was going to ask, namely about cash transfer payments and the degree to which you think that should be part of this package.

An earlier question is, what is the high and low in the total amount you think should be in this package? The President starts at $145 billion. Some suggest maybe a little more, given the greater expectation of maybe a deeper problem in the market, in the economy, maybe it should be slightly higher. But what is the low and the high? Just very, very quickly, because I have lots of questions.

Dr. Feldstein?

Dr. FELDSTEIN. We do not know how deep the hole is going to be and we do not know how much $100 billion would do to fill a given-sized hole.

The CHAIRMAN. Your best guess.

Dr. FELDSTEIN. We do not know what the fiscal multiplier is.

The CHAIRMAN. Your best guess.

Dr. FELDSTEIN. I am happy with a round number on the $100 to $150 billion order.

The CHAIRMAN. All right.

Dr. Furman?

Dr. FURMAN. I am happy with the $145 billion, and I would be worried about going higher because, if the situation is less bad than we think, Congress is not going to ever undo that fiscal stimulus in the way that the Fed would actually undo their monetary stimulus.

The CHAIRMAN. All right.

Now, what portion should be cash transfer payments? What percent, roughly?

Dr. FURMAN. I think I would say about $100 billion of that total.

The CHAIRMAN. One hundred out of the total of $145 billion?

Dr. FURMAN. Yes.

The CHAIRMAN. In cash? I am talking about cash.

Dr. FURMAN. This is tax rebates.

The CHAIRMAN. No, I am not talking about rebates.

Dr. Furman. Oh.

The CHAIRMAN. Other than rebates.

Dr. FURMAN. Oh. You mean food stamps and things, like unemployment?

The CHAIRMAN. Food stamps, SSI, and all of that.

Dr. FURMAN. Oh, maybe about $20 billion.

The CHAIRMAN. Twenty out of roughly $145 billion?

Dr. FURMAN. One hundred and forty-five. Yes.

The CHAIRMAN. All right.

Dr. Feldstein?

Dr. FELDSTEIN. That is a distributional call. It is a political call. I do not think, as an economist, that is going to make a significant difference in terms of the stimulus of this. So, I think it is a decision of how that works out on a per-person basis for the groups that you are going to be able to reach through transfer payments that you are not reaching through the tax rebates.

The CHAIRMAN. All right.

But you did say that there should be some transfer payments.

Dr. FELDSTEIN. Yes, I think there should be.

The CHAIRMAN. From an economic perspective.

Dr. FELDSTEIN. From an economic perspective—I think more from a fairness perspective, perhaps, than from a straight macroeconomic stimulus perspective. I do not think that there is that much of a difference between what you will get if you put $140 billion into across-the-board tax rebates and what if you put, to take Dr. Berman's number, $120 billion into tax rebates and $20 billion into food stamps and increases in SSI. But I would still favor that broader distribution.

The CHAIRMAN. All right.

Dr. Furman, Dr. Feldstein throws a little cold water on UI. I will give you a chance to comment on that.

Dr. FURMAN. I am happy to do that. I think he is right that you always need to strike a balance between protecting people from the hardships in life and making sure you are not taking away an incentive for them to get back up on their feet and find another job.

The optimal place to strike that balance depends on the situation in the economy. If the economy is performing really well, then 26 weeks might be the right place to strike that balance. If the economy is performing less well, you want to change the place that you strike that balance. Right now, the best indicator of how the economy is doing for this question is the long-term unemployment rate, and that is nearly twice as high as what it was going into the last recession.

Historically, as you know, in virtually every recession, Unemployment Insurance has been extended. It was something the President himself proposed on a more limited basis in the wake of 9/11, and on a larger basis in September of 2002.

Finally, I think a very important consideration in thinking about it is to understand what would happen if you did not do it. The Disability Insurance program is becoming the de facto long-term Unemployment Insurance program. When people get on Disability Insurance they tend to stay on Disability Insurance. If you do not extend Unemployment Insurance, you will end up with larger Disability Insurance rolls and a long-term impact on the economy in terms of incentives to work that could potentially be far worse than anything one might worry about.

The CHAIRMAN. Well, getting on Disability Insurance takes a long time, too, these days.

Dr. FURMAN. It takes a long time.

The CHAIRMAN. Is there any area where the two of you agree on Unemployment Insurance? If you were to get together and say, all right, let us compromise on something that makes some sense, what might that be?

Dr. FELDSTEIN. I do not think it would be on extending the duration, even though I know that has been the traditional policy, because there is a lot of evidence now that, as people get close to the 26th week, suddenly the job finding goes up pretty dramatically. People settle for the less-than-perfect job than what they were holding out for.

The CHAIRMAN. What about the amount, increasing the amount?

Dr. FELDSTEIN. The question is, could you increase the amount without increasing—I think you could increase the amount in a way that would be helpful, but I would worry that it not be done so that it increases the ratio of UI benefits to past wages. So, I would take up the ceiling.

The CHAIRMAN. All right. My time has virtually expired.

Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman. This has been an excellent hearing, and I thank you for it.

Both of you have made a number of interesting comments today with respect to the psychology of consumers and confidence. I was struck by your comment, Dr. Feldstein, and I think I largely share it, that, if a rebate program is passed, people might actually start spending before the check arrived. You can debate that, but I think you are on solid ground there.

I want to relate this to the health care issues. My sense, particularly if you look at what people on these talk shows are saying, they say that Congress cannot run a two-car parade, let alone do anything significant like fix health care.

We have now a bipartisan group of Senators, 12, 6 Republicans, 6 Democrats, who have in effect said the Democrats have been right on the coverage issue, you have to cover people because otherwise the uninsured people shift their bills to the insured people, and Republicans have been right about markets, the tax code, and private sector choices, things that Republicans have felt strongly about.

My question to you is, when the country and the markets see that Congress is getting serious about major issues like health care, which we all know is going to gobble up everything in sight, is there a sense that the markets are going to start reacting favorably to something like that?

I have been talking to people in the financial community and they think, because health care is so important, that, if the markets really see that for the first time in decades there is unprecedented effort to be bipartisan, that is going to start rippling through the financial community. I would be interested in both of your thoughts on it. Dr. Furman, do you want to start? Dr. Feldstein? Either one.

Dr. FURMAN. It is actually interesting. One of the things that your proposal does is change the tax treatment for health insurance along the lines of what Dr. Feldstein's research, I think, 35 years ago, was talking about and proposing. I think there are a number of health reforms that could improve the functioning of the economy, making it more dynamic, people more able to shift between jobs, have the type of security they need to take risks.

I think a certain amount of that is inhibited by what we have today, either failures in the market or active failures in govern-

ment policy, like the way we structure the tax treatment for health insurance today, which gets in the way of some of that happening. So, I think it is a very fruitful avenue for——

Senator WYDEN. Dr. Feldstein, the markets. Dr. Furman is right, we have really cribbed on some of your thinking from decades ago. I mean, you started arguing that the system that was created in the 1940s by accident, because we had wage and price controls, really has not kept up with the times either for the employer or for the employee. What our group is trying to do is see if we can modernize that relationship, have a more portable product, more choices for workers, and get some relief to the employers. We thank you for your previous scholarship. Dr. Furman sort of set me up a little bit in terms of his comments.

Do you not think, though, by way of psychology, that the markets are going to start reacting and reacting positively when they see a serious bipartisan effort on this?

Dr. FELDSTEIN. It sounds like I would like a lot of the substance of your proposal, but frankly I do not know the details.

Senator WYDEN. Apart from that.

Dr. FELDSTEIN. I would love to know more.

Senator WYDEN. Yes. Yes.

Dr. FELDSTEIN. There are a lot of good reasons to do it. The market's reaction, if you get a favorable reaction from the markets, that would be a bonus. I do not know how seriously the markets will respond to it, but it cannot be bad news for the markets.

Senator WYDEN. I am going to be consulting with both of you, and the chairman has been very gracious in terms of his time. I am very pleased you are going to be holding these hearings as well. Senator Baucus and Senator Grassley will be leading us on it.

I think that, clearly, the country is waiting for leadership on the big issues, on health care, on the question of energy policy. Fortunately, Senator Baucus and Senator Grassley work in a bipartisan way on it. What I have been picking up relates to the psychology that you talked about, Dr. Feldstein, that people want to have some certainty and predictability that there are going to be some positive developments. When they think that is coming, they go out and make a bunch of investment decisions that are positive for marketplace economics. So, you all have been a very good panel.

Mr. Chairman, there was some back-and-forth, I guess, about whether you had chosen two good witnesses. But I want to commend you for your selection, because I think it was a very good panel.

The CHAIRMAN. Well, thank you, Senator. I would agree. I was about to say how much I appreciate, and I know the country appreciates, your service, in addition to just very, very highly competent, intelligent, independent objective analysis of our Nation's economy and the ideas you have as to what should be done about it. I thank you very, very much for your testimony here today.

Senator Snowe?

Senator SNOWE. Thank you.

Just very quickly, Dr. Feldstein, some of us who have been around long enough to remember the old counter-cyclical program that provided assistance to State and local governments back in 1981, 1982, and 1983, and you were chairman of the Economic Ad-

visors for President Reagan then. Did that have any impact? Because that had a trigger mechanism of a different kind. I am intrigued by what you are proposing, to have it in place so it——

Dr. FELDSTEIN. I would have to go back and look at the evidence on that.

Senator SNOWE. Yes.

Dr. FELDSTEIN. It is, as you say, 25 years ago, and I honestly cannot remember.

Senator SNOWE. It was providing, I think, $1 billion each of those 3 years. I think there were two consecutive quarters of negative growth. So I do not know if it was late or not to help State and local governments to stabilize their own fiscal situation because of their balanced budget requirements and providing more liquidity.

I would be interested in that because I think it is interesting about, what could we put in place that is limited and targeted, but again has the effect of moving quickly without hesitation if it is structured appropriately?

Finally, on the timing, what is the outside in terms of enacting this and having an impact on the economy? What would you consider the outside time limit here when we are talking about getting this completed by the President's Day recess in February? I know Chairman Bernanke indicated that, to have the maximum aggregate impact on the aggregate spending within the next 12 months. Do you think that that is the right time frame?

Dr. FELDSTEIN. Certainly the sooner the better.

Senator SNOWE. Yes.

Dr. FELDSTEIN. We do not even know that the economy is going to slide into recession. If it does, we do not know how deep and how long. But the sooner you have a fiscal stimulus enacted, changing psychology as well as changing cash flow, the sooner it can start to work to either prevent or dampen an economic downturn.

Senator SNOWE. Dr. Furman?

Dr. FURMAN. I think the sooner, the better. I think the motivation for this year is that the Federal Reserve has a lot of monetary easing that will take its time to work its way through the economy, but by 2009 there will be substantial stimulus from what the Federal Reserve has already done. The concern we have is more towards the middle of this year. I also agree that we have talked a lot about confidence, and seeing something happen that was effective and quick would, I think, inspire confidence in financial markets for the business community and consumers more broadly.

Senator SNOWE. All right.

Dr. FELDSTEIN. We agree on so much that I hate to spoil that by disagreeing on a technical issue. But I think we cannot be sure about how effective the monetary policy is going to be, and that is why I came to the conclusion 6, 7 weeks ago and testified then that we ought to move in a fiscal direction. Because the credit markets are so clogged because of these confidence factors, it is just not clear that lower interest rates by the Fed are going to have the same kind of traction that they have in the past.

Moreover, the way in which easing monetary policy has often worked is by stimulating housing. It is not clear we are going to do a lot of stimulating of housing in the next 6 or 12 months. So

I think finding other ways of putting aggregate demand into the economy through the fiscal route becomes more important.

Senator SNOWE. Speaking of policy——

Dr. FURMAN. I think that is probably a more academic disagreement that does not lend itself to different views on the policy questions this committee is dealing with.

Senator SNOWE. On the policy.

Finally, speaking of housing, there is going to be another major reset of adjustable rate mortgages of approximately $680 billion, perhaps in early spring if not sooner. What impact do you think that would have, or do you think it has already been calculated into the equation in terms of the economic situation?

Dr. FELDSTEIN. It is going to be a negative.

Senator SNOWE. It is going to be a big jolt.

Dr. FELDSTEIN. For the people who can afford to pay those higher interest rates, that is going to be cash out of their pockets. For the people who cannot afford it, that is going to increase the number of defaults. And again, this situation is unusual because house prices nationally are declining, and so the temptation to take the keys back to the bank and say, keep your mortgage, keep the house, I am going to go buy myself another one at a lower price, will be very great. Or I am going to go rent an apartment until this housing market becomes more affordable.

Senator SNOWE. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Thank you, Senator, very much.

The Dow Jones, I think, is up about 38 at this moment. It was up 300 yesterday, even though it was supposed to be Black Tuesday, with the Fed's announcement prior to the opening market yesterday. That clearly had a salutary effect.

So the basic question is the degree to which we should proceed here, somewhat independent of the market. That is, how deep are the potential economic problems, or how important is it to have a fiscal stimulus here is somewhat independent of the gyrations of the market. That is my question.

Dr. FELDSTEIN. I would say yes. I mean, until the market sold off the other day, the big puzzle was, why is the market so strong when there is growing evidence of weakness in the economy? So you cannot let the stock market make your macroeconomic policy.

The CHAIRMAN. Thank you.

Dr. FURMAN. I agree. The Federal Reserve, to some degree, needs to factor that in. That is because they can move very quickly, and then un-move very quickly, for example, what they did with long-term capital in 1998. Your fiscal policy is much less frequent, and as a result should be entirely focused—and theirs should still be mostly focused—on the real underlying economy statistics like jobs, the unemployment rate, GDP, consumer spending, all of which were quite negative in December but have not been negative for a very long period of time.

The CHAIRMAN. While I have you here, I would just like your thoughts on a related subject. It is my understanding that in 1991, the bank deposits in the U.S. were about $10 trillion. Today, it is about $10 trillion. The difference is, the structured financial products' value is about $20 trillion, where there are no capital require-

ments, no margin requirements, et cetera. The total amount of credit default swaps is in the trillions.

I am just curious about your thoughts on whether we should be nervous about all of that, or looking at that, or what do we do about all of that? Is that a factor, and so forth, or not?

Dr. FELDSTEIN. You should be nervous about it. Somebody should be holding hearings about it, whether it is this committee or others. Some of it has been generated by the kind of regulatory framework that was put in place that encouraged banks to put things off-balance sheet because the capital requirements associated with it were low, the so-called SIVs.

There was a lot of talk about how the banks were well-capitalized. That ignored the fact that there was this potential need to take these off-balance sheet items onto the balance sheet. So I think that we have created some serious problems, and somebody ought to be asking. It is not that all this happened outside the normally regulated sector of the financial institutions. These are the major money center banks that were creators and holders of SIVs. So, I think it is a serious problem, and I think it is something that needs some further thought.

The CHAIRMAN. I appreciate it.

Dr. Furman?

Dr. FURMAN. I think no one understands the full extent of it, and anything that could help move us closer to that would be particularly helpful. It is still my hope that the losses in the financial system are lower than what we saw, for example, in the 1980s and in some previous banking crises that we have experienced. But one of the problems we have is, no one knows what the magnitude of those losses is.

The CHAIRMAN. All right. This has been a very constructive, fruitful hearing. Thank you very, very much, both of you.

Dr. FELDSTEIN. Thank you very much.

Dr. FURMAN. Thank you.

The CHAIRMAN. I again repeat, this committee will be holding a markup on our own stimulus package bill next week. Thank you very much.

[Whereupon, at 11:41 a.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

STATEMENT FOR SENATOR BUNNING
SENATE COMMITTEE ON FINANCE
"Strengthening America's Economy:
Stimulus That Makes Sense"
January 22, 2008

Thank you, Mr. Chairman.

According to recent studies, the 2001 tax cuts had a strong counter-cyclical impact during the post-2000 economic downturn. Taxpayers spent about two thirds of the 2001 cuts, and the spending helped to moderate the downturn that followed the internet stock bubble of the prior year.

Today, the sub-prime mortgage situation is expected to have a similar adverse impact. The most recent consensus forecast shows that most economists expect slower growth in 2008, and some economists say we are already in a recession. Consequently, the President and Federal Reserve Chairman Bernanke are recommending a fiscal stimulus of about 1 percent of gross domestic product, roughly $150 billion.

The history of Congress's efforts to control the business cycle is littered with failure. Therefore, we should undertake the task with ample humility. Our first objective should be to do no harm.

To be effective, the timing of any stimulus is critical. We should take seriously Chairman Bernanke's warning that a poorly timed stimulus "could be actively destabilizing" if it comes at the wrong time. Late or ineffective stimulus may be worse than doing nothing at all.

According to the IRS, it will take until late June 2008 before the first rebate check can be mailed, even if Congress were to act in the near future. What is more, there is considerable uncertainty about the effectiveness of the proposed strategy.

Unlike the stimulus proposed by Chairman Bernanke, the 2001 rebate checks were part of the President's tax reduction package. Due to lower taxes, consumers felt justified to view the rebate checks as part of a permanent increase in wealth, and the record shows that they reacted by spending with confidence.

This time, there is no promise of a permanent tax change. On the contrary, some of my colleagues are vowing to end the era of low taxes by allowing the 2001 and 2003 tax cuts to expire, resulting in one of the largest tax increases in history. The goal is not to give taxpayers back some of their hard earned money, as it was in 2001. Instead, the checks are a temporary loan that will be repaid in the form of higher taxes in 2011. In this environment, it seems far less likely consumers will be motivated to go out and spend.

And, if they do spend, there is some doubt about whose economy will be stimulated. To the extent that the rebate checks go to buy imported goods, the counter-cyclical effect on our domestic economy will be diminished.

For all of these reasons, and more, we should carefully consider all the facts, before making a decision that could harm the economy in the long run if it leads to higher taxes.

Thank you.

Testimony of

Martin Feldstein

Professor of Economics
Harvard University

to the
Senate Finance Committee
January 24, 2007

Dirksen Senate Office Building
10:00 a.m.

Thank you, Mr. Chairman. I am pleased to appear before this committee to discuss the important issue of a fiscal stimulus – whether it is needed and, if so, what form it should take.

(1) The U. S. economy is now very weak and could get substantially weaker.

There is likely to be little or no increase in real GDP in the current quarter. Virtually every economic indicator – including credit conditions, housing, and employment – has deteriorated during the past month.

I believe that the probability of a recession in 2008 now exceeds 50 percent. If it occurs, it could be deeper and longer than the recessions of the recent past.

(2) A recession is, however, not inevitable.

There are several reasons to believe that a recesssion in 2008 can be avoided.

First, although housing construction is in free fall, the large role played by services like health care makes the economy less cyclically volatile than it was in the past.

Second, since the Federal Reserve only began reducing rates in August, the full impact of easier money has not yet been felt.

Third, the lower dollar has made US products more competitive in the global economy, raising exports by 25 percent in the past two years. Additional dollar declines in 2008 can add further stimulus.

Further easing by the Fed and a fiscal package passed by the Congress would reduce the risk of recession and dampen any downturn that does occur.

Most private forecasters are still projecting that the economy will slow but not actually decline in 2008.

(3) But the risks of a serious downturn that feeds on itself are large enough to warrant strong countercyclical monetary policy.

The Federal Reserve should reduce the fed funds rate by at least 50 basis points at its meeting next week and should continue cutting that rate toward three percent in 2008 unless there is a clear sign of an economic improvement or of significantly deteriorating inflation.

> The CPI is up more than 4 percent over the last 12 months and has been rising at a 5.6 percent rate over the past three months. Even without food and energy, the core CPI is up 2.4 percent over the past 12 months and at a 2.7 percent rate for the past three months.

Because of current credit market conditions, there is a risk that interest rate cuts will not be as effective in stimulating the economy as they were in the past.. That is why a fiscal stimulus deserves attention.

But even with the credit market problems, lower interest rates can still help by lowering monthly payments on adjustable rate mortgages, decreasing the cost of borrowed funds, and making the dollar more competitive.

(4) The lower interest rate should be supplemented by enacting a temporary tax cut and a temporary increase in transfer payments. While it would be best if this package is triggered to take effect only if there are further signs of economic downturn, an immediate fiscal stimulus would be better than doing nothing

When I testified to the House Budget Committee on December 5th, I suggested that Congress enact a major tax cut that would be triggered to take effect if the economy deteriorates substantially. I proposed a three month decline in payroll employment as the triggering event.

Enacting such a conditional stimulus would have two desirable effects. First, it would immediately boost the confidence of households and businesses since they would know that a significant slowdown would be met immediately by a substantial fiscal stimulus. Second, if there is a decline of employment (and therefore of output and incomes), a fiscal stimulus would begin without the usual delays of the legislative process. In effect, such a pre-enacted conditional fiscal stimulus would be an automatic stabilizer in the same way that the payout of unemployment benefits is now.

Although the sustained decline in employment that I favor as a trigger for the fiscal stimulus has not occurred and may never occur, economic conditions have generally deteriorated since early December:

- the unemployment rate is up and private employment has declined;
- real average weekly earnings are down,
- disposable personal income has fallen
- house prices and household wealth have fallen
- retail sales have declined
- housing starts are down 38% from December 2006 and 14 % in just the last month.
- industrial production has slowed and capacity utilization is down
- the Institute of Supply Management survey shows manufacturing declining with contracting new orders, production and employment
- the leading indicators are down for the 3rd straight month

On balance, I still favor a "conditional" triggered package of tax cuts and transfer payments – that is, enacting the plan as soon as possible but triggering it to occur only when there is clearer evidence of a sustained economic downturn. Another possibility would be to start a portion of the stimulus package now with a further amount subject to an automatic trigger.

But I recognize that Congress may be reluctant to enact such a novel package and that triggering is not currently a part of the proposals of either the Administration or the Congressional Republicans and Democrats.

If the choice is between an immediate fiscal package or no fiscal stimulus, I believe that the continued deterioration has been enough to make an immediate fiscal stimulus better than doing nothing at this time.

(5) The fiscal package should be designed to stimulate economic activity and not to achieve other policy goals.

Its purpose is to increase household and business spending in order to raise total GDP. It should not be taken as an occasion to rebuild infrastructure, to reduce poverty, or to strengthen economic incentives. It should not be taken as an occasion to redistribute the burden of taxes.

That leads me to favor a flat tax rebate to all who paid taxes plus an increased cash transfer to low income groups who are not taxpayers. This could be done by increasing federal government payments for food stamps, TANF (Temporary Assistance of Needy Families) and Supplemental Security Income. The key is to use those transfer payments that can be achieved quickly.

While lower income households may eventually spend a higher portion of their tax rebates, those with higher incomes may respond to the legislation more rapidly, using credit cards or available savings to spend their tax rebates even before they receive the cash.

The total size of the package should be large enough so that the amounts received by each household cause a change in spending behavior. A $50 rebate is easily ignored while a $500 rebate is not.

This suggests a total package of $100 billion to $150 billion as a one-time stimulus. The net budget cost of the package would actually be less because these tax cuts and transfers would raise GDP and the higher GDP would produce additional personal and corporate tax revenue. As a rough guide, the net budget cost would be about 25 percent lower than the initial size of the package.

(6) Some other dos and don'ts of designing the stimulus package

Some form of investment incentive should be part of the current legislation because firms respond quickly to such legislation, placing orders even before the tax breaks take effect. In addition, investment incentives stimulate different types of spending than increased cash to households. The "bonus depreciation" provisions that Congress enacted earlier in this decade were helpful in stimulating the economy, just as various investment tax credits have been in the past.

While raising unemployment benefits or extending the duration of benefits beyond 26 weeks would help some individuals who might otherwise face financial hardship, it would also create undesirable incentives for individuals to delay returning to work. That would lower earnings and total spending. I think food stamps and SSI payments and TANF are therefore a preferred form of increased transfer.

Transfers to state and local governments would be a slow and complex process. So too would federal spending on infrastructure. These would weaken the effectiveness of any size stimulus package.

The rule requiring that the cost of tax cuts and increased outlays be offset by increases in other taxes or cuts in federal spending should be waived in this context. It would clearly make no sense to do so concurrently since that would undermine the stimulative effect. Trying to reach legislative agreement on the content of a delayed offset would almost certainly prevent enacting any stimulus package.

Thank you for your attention. I look forward to your questions.

Options for Fiscal Stimulus

Jason Furman[1]
Senior Fellow and Director of The Hamilton Project
The Brookings Institution

Testimony Before the U.S. Senate Committee on Finance
January 24, 2008

Mr. Chairman and other members of the Committee, thank you for inviting me to testify at this hearing on a stimulus plan that makes sense. A spate of bad news, including a jump in the unemployment rate, a decline in consumer spending and a continued plunge in housing starts, leave little doubt that the economy is weakening. Well-designed fiscal stimulus, in the form of increased government spending or tax reductions, has the potential to help cushion the economic blow.

The key to well-designed stimulus is to ensure that it is *timely*, *temporary* and *targeted* – the "three T" principles enunciated by economists as diverse as Harvard Professors Lawrence Summers and Martin Feldstein, Federal Reserve Chairman Ben Bernanke and Congressional Budget Office Director Peter Orszag. Three of the options that best meet this test are (1) a refundable tax rebate that is adjusted for family size and phased out for high-income households; (2) a temporary extension and possibly expansion in unemployment insurance benefits; and (3) a temporary increase in food stamps. Policymakers should also consider state fiscal relief implemented as a temporary increase in the federal share of Medicaid costs.

My testimony today has three parts. First it discusses the underlying economic logic that motivates the three principles of fiscal stimulus. Second, it applies these principles to analyze a range of stimulus options. Finally, it includes a more detailed discussion of the design of an individual rebate.

The Economic Logic Underlying Fiscal Stimulus

How best to increase the economy's productive capacity and thus long-run growth is the most important long-term task for policymakers. But it is also complicated and subject to debate. What is not in real dispute is what to do about an economic slowdown when the economy is not fully utilizing its current capacity. Economists broadly agree that, in principle, both monetary and fiscal policy can increase consumption, investment, government spending, or net exports—thus boosting aggregate demand, which translates into higher GDP and more job growth. To the degree economists sometimes disagree in practice, their differences largely stem from

[1] The views expressed in this testimony are those of the author alone and do not necessarily represent those of the staff, officers, or trustees of The Brookings Institution or the members of the Advisory Council of The Hamilton Project. Parts of this testimony draw on Douglas Elmendorf and Jason Furman, "If, When and How. A Primer on Fiscal Stimulus," Hamilton Project Strategy Paper, January 2008. That paper is attached.

uncertainty about economic prospects and the likelihood that the political system will deliver fiscal stimulus in an effective manner.

The Federal Reserve is capable of acting quickly and dramatically to stabilize the economy, as evidenced by Tuesday's 75 basis point cut in the federal funds rate. But the Fed faces one major limitation: it takes about a year for its interest rate moves to have a major effect on economic output and jobs. While the recent round of interest rate cuts will have some effect on the economy this year, we probably will not see the full impact on the aggregate economy until 2009. Furthermore, although there is little reason to believe that monetary policy has lost its ability to stimulate the economy, turmoil in financial markets has increased the uncertainty about the precise effects. These two considerations provide a motivation for policymakers to use fiscal stimulus as part of a diversified approach to boosting aggregate demand.

Table 1 shows estimates by Douglas Elmendorf and David Reifschneider using the Federal Reserve Board's large-scale econometric model of the U.S. economy to simulate the effects of alternative economic policies, taking into account the full range of responses by both private actors and Federal Reserve policymakers. These estimates confirm the importance of using the "three Ts" to guide fiscal stimulus.

Table 1
Elmendorf-Reifschneider (2002) Estimates of the Effect of Alternative Macroeconomic Policies[1]

	Increase in the Level of Real GDP		
	2008-Q2	2008-Q3	2009-Q1
Permanent income tax cut (1% of GDP)[2]	.2	.3	.5
One-time rebate (1% of GDP assuming 20% spent)	.3	.0	.0
One-time rebate (1% of GDP assuming 50% spent)	1.0	1.2	-.2
One percentage point reduction in the federal funds rate	.0	.1	.4

1 These figures apply the dynamic responses reported in the paper to a hypothetical fiscal stimulus implemented in the second quarter of this year.
2 Tax and spending changes cannot literally be permanent without offsetting changes on the other side of the government ledger, or government debt would spiral upward as a share of output. Therefore, the analysis assumed that changes would be sustained for ten years before budget balance was gradually restored. A permanent ten percent investment tax credit was not calibrated to cost exactly one percent of GDP, but its budget implications turned out to be very similar to that of the other policies shown here.
Source: Elmendorf, Douglas W. and David Reifschneider. 2002. "Short Run Effects of Fiscal Policy with Forward-Looking Financial Markets." *National Tax Journal*, 55(3). September.

- The rapidly evolving downturn provides a motivation for *timely* fiscal stimulus which, if well designed, could raise economic output and create jobs by the middle of 2008—filling in some of the "gap" by acting to add to growth before monetary policy is fully effective.

- Fiscal stimulus should also be *temporary*. Based on current forecasts, the economy does not need a boost in 2009. If Congress and the President give it one, then the Federal Reserve is likely to offset the fiscal stimulus by not cutting interest rates as much as it

otherwise would have. In addition, helping with our short-term weakness should not unnecessarily increase our long-term budget deficit.

- Finally, any steps that policymakers take should be *targeted* in two senses: helping those who most need to be protected from the downturn and achieving the maximum bang-for-the-buck in added output for a given budgetary cost. Fortunately, these are complementary, as the households most in need of money are also the families most likely to spend it.

An Overview and Analysis of the Options

The previous section demonstrated the importance of fiscal stimulus being timely, targeted, and temporary. In this section, I use these principles to evaluate some specific stimulus options. Some options that have been discussed would generate effective stimulus, others would be less effective, and some would be ineffective or even counterproductive. This discussion focuses on the approaches to fiscal stimulus that have received the greatest attention. A summary of estimates of the effectiveness of these stimulus options by CBO and Moody's Economy.com, under the leadership of Mark Zandi, are presented in Table 2.

Table 2. The Impact of Various Stimulus Options				
	CBO		Moody's Economy.com	
	Cost-Effectiveness	Time From Enactment to Impact	Cost-Effectiveness[1]	Time From Enactment to Impact[2]
Tax Cuts				
Non-refundable lump-sum rebate	Large[3]	Medium	1.02	Medium
Refundable lump-sum rebate			1.26	Medium
Payroll tax holiday	Large	Medium	1.29	Medium
Temporary across-the-board cut	Small	Short	1.03	N.A.
Accelerated depreciation	Medium	Medium	0.27	Medium/Long
Extend AMT patch permanently	Medium	Long	0.48	Long
Bush tax cuts permanent	Small	Long	0.29	Long
Dividend/capital gains permanent	N.A.	N.A.	0.37	Long
Cut corporate tax rate	Small	Long	0.30	N.A.
Extend operating loss/carryback	Small	Medium	N.A.	N.A.
Spending Increases				
Extending UI Benefits	Large	Short	1.64	Short
Temporary food stamps increase	Large	Short	1.73	Short
Aid to state governments	Medium	Medium	1.36	Short/Medium
Increased infrastructure spending	Small	Long	1.59	Long

1 One year dollar change in real GDP for a given dollar reduction in federal tax revenue or increase in spending. The estimate is for the year the spending/tax takes place, which is not necessarily the year it is enacted.
2 Author's assessments based on the discussion by Moody's Economy.com.
3 CBO's table does not distinguish between refundable and non-refundable rebates but its text states, "Making the rebate refundable would further boost the cost effectiveness of the stimulus."
Source: CBO, *Options for Responding to Short-Term Economic Weakness*, January 2008 and Moody's Economy.com "Assessing the Macro Economic Impact of Fiscal Stimulus 2008," January 2008.

More effective options

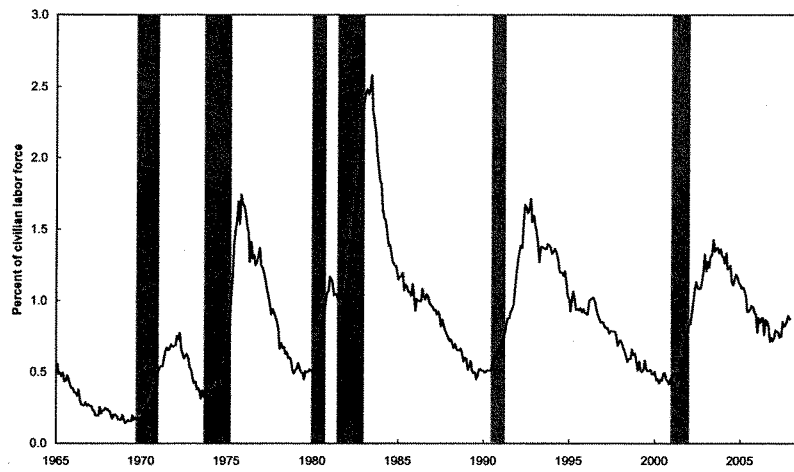
Policymakers designing fiscal stimulus should consider the following policies:

Increase food stamps temporarily. One option is to increase food stamps on a temporary basis; for example, anyone receiving food stamps might automatically receive 20 percent more stamps for six months. This change could be administered easily and quickly by raising the value of electronic benefit cards issued to food stamp beneficiaries. The change would also be well-targeted at families that are very vulnerable to an economic slowdown and that would spend essentially all of the extra income—likely an even higher fraction than any tax policy that is being contemplated.

Extend and possibly expand unemployment insurance benefits temporarily. Unemployment insurance benefits are generally limited to 26 weeks. This limitation is based on a judgment about how to balance the greater protection afforded by additional weeks of unemployment insurance against the greater distortion to people's incentives for finding new jobs. During

economic slowdowns, when new jobs are harder to find, the optimal balance shifts toward longer periods of eligibility. In the past policymakers have recognized this by extending unemployment insurance benefits during recessions. Such action could be even more important this year because, as shown in Figure 1, the long-term unemployment rate was nearly twice as high in the last quarter of 2007 as it was immediately before the 2001 recession.[2]

Figure 1. Long-Term Unemployment Rate



Notes: Percent of civilian labor force unemployed for 27 weeks or longer. Shaded regions show recessions as defined by the NBER.
Source: BLS (2007)

Temporary, refundable tax credits. The previous two policy options would not involve enough money to represent adequate stimulus on their own. A larger-scale option that could satisfy the three criteria of effective stimulus is a temporary, refundable tax credit. The next section of this testimony discusses some consideration in designing these credits, most importantly that they be refundable so that they benefit the more than 25 million wage-earning households that do not have income tax liability and thus would not benefit from a non-refundable credit. To ensure that the tax credits do not worsen the long-run budget outlook, they should be temporary. The economic evidence, most notably from the 2001 rebate, suggests that households would spend the majority of their rebates—with larger spending increases for low-income households. As a result, a refundable credit that goes to low-income households is estimated to have 24 percent more bang-for-the-buck than a non-refundable credit that leaves out these households, according to Moody's Economy.com.

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[2] Note also that the trough of the long-term unemployment rate in this cycle was well above the troughs in previous cycles.

State fiscal relief, especially a temporary increase in the Federal Medical Assistance Percentages (FMAP). In a recession state budget deficits rise, forcing them to cut back on spending and raise taxes – undoing some of the stimulus federal policymakers are trying to achieve. One way to prevent this is to provide fiscal relief to states, particularly for their operating budgets which, unlike their capital budgets, generally operate under rules requiring balanced budgets. One effective way to accomplish this would be temporarily increasing the FMAP for states that agree to maintenance of effort rules for Medicaid and SCHIP. Such an increase would have some macroeconomic stimulus effect but would also help prevent some of the worst impacts of the downturn by helping to protect families from losing their health insurance.

Less effective options

The following policies are likely to be less effective in spurring economic activity than the policies just discussed, either because the available evidence indicates they do not provide well-timed stimulus or because there is considerable economic and administrative uncertainty about how they might work:

Create temporary investment tax incentives. Temporary tax incentives for business investment, like the bonus depreciation provision enacted in 2003, can stimulate the economy by raising outlays for business equipment and structures. In particular, such incentives can induce businesses to undertake investment immediately that they would otherwise pursue in some future year. But research on this topic has found that the magnitude of this effect is small at best. Moreover, any effect appears to work more slowly in stimulating the economy than household consumption-oriented measures—a distinct disadvantage when a principal rationale for adding fiscal stimulus to monetary stimulus is its potential for more immediate impact. Finally, temporary investment tax incentives provide no direct help for families coping with a temporary economic downturn.

Increase infrastructure investment. Although additional physical and technological infrastructure investments might provide an important boost to long-term growth, they are difficult to design in a manner that would generate significant short-term stimulus. In the past, infrastructure projects that were initiated as the economy started to weaken did not involve substantial amounts of spending until after the economy had recovered. However, this approach might be more useful if policies could be designed to prevent cutoffs in ongoing infrastructure spending (such as road repair) that would exacerbate an economic downturn.

Ineffective or counterproductive options

Reduce tax rates. Reducing tax rates would generate less than half as much economic stimulus as flat, refundable tax credits of the same size. Such a tax reduction would give disproportionate benefits to high-income households, which are the households least likely to be hurt by an economic downturn. And the permanence of the tax reduction would likely raise long-term interest rates and crowd out some of the modest direct stimulus.

Make the 2001 and 2003 tax cuts permanent. The tax reductions enacted in 2001 and 2003 expire at the end of 2010. Making those tax cuts permanent would violate all three principles of

effective fiscal stimulus discussed earlier, and it might even hurt the economy in the short run. First, a reduction in income taxes starting in 2011 would provide little or no boost to consumer spending in 2008.[3] Second, the 2001 and 2003 tax reductions offered the largest dollar benefits to the highest-income families, so extending them would provide low bang-for-the-buck in terms of economic stimulus even in 2011. Third, this sort of permanent tax change would increase the long-run budget deficit, likely reducing long-run economic growth. In addition, if making the tax cuts permanent were perceived by forward-looking financial markets as raising the long-run deficit, interest rates would rise today, crowding out investment and reducing GDP in the short run as well.[4]

Designing an Effective Individual Tax Rebate

Policymakers have to consider a number of different questions in designing an effective tax rebate that is timely, administrable, fair, and economically effective in stimulating the economy. A number of these issues are discussed in considerable detail by the Joint Committee on Taxation's (JCT) "Overview Of Past Tax Legislation Providing Fiscal Stimulus And Issues In Designing And Delivering A Cash Rebate To Individuals" issued on January 21, 2008. As JCT explains, a rebate could be computed by the Internal Revenue Service (IRS) based on a formula derived from information on 2007 tax returns and mailed out by the Financial Management Service (FMS) over a five-to-six week period starting in May or June. Although from a macroeconomic perspective it would be preferable that the checks be mailed out sooner, even fiscal stimulus delivered over the summer would likely be helpful in either reducing the depth of a recession or economic slowdown or in speeding a recovery. In addition, it is possible that households would increase their spending in anticipation of refunds, possibly aided by refund anticipation loans through the major tax services.

My testimony provides some further analysis of some of the most important issues, drawing on new estimates from the Tax Policy Center's microsimulation model. After framing the question, I provide a distributional analysis of three potential options: eliminating the 10 percent bracket; providing a fully refundable tax credit; and providing a partially refundable tax credit that phases out for households with higher incomes.

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[3] Consumers who determine their spending based on their expected lifetime income would raise current spending if future taxes were reduced. However, the magnitude of the increase would not be very large if these consumers think there is some chance of a supposedly permanent change being rescinded later, or if they currently think there is some chance of the tax cuts being extended and have already factored that possibility into their consumption plans. Moreover, some consumers are not so forward-looking in their spending decisions, and others may be forward-looking enough to understand that taxes will eventually be raised or outlays reduced in order to satisfy the government's long-run budget constraint. Consumers in these groups would not raise their spending at all today if the tax cuts were extended.

[4] Making the tax cuts permanent could have other short-run economic effects. For example, a rational, forward-looking worker might reduce his or her labor effort today in response to lower tax rates in the future. Extending current provisions for small-business expensing would reduce the pressure on small businesses to make investments before those provisions expire, which could reduce current investment and slow the economy. But extending lower tax rates for S corporations would have the opposite effect, removing an incentive for shifting investment into future periods when deductions would have been more valuable. A complete analysis of these factors lies beyond the scope of this paper; in any event, their total economic effect is unlikely to be large in the short run.

Three key issues in designing an individual rebate

The canonical considerations in designing tax policies are efficiency, equity and simplicity. In the case of the stimulus package, the efficiency consideration is very different from what would be considered in normal tax policy. Typically efficiency is about minimizing the distortions that taxes pose for work, savings, and other behavior. In the current context, however, rebates would be a function of work and savings decisions made in 2007—they would not pose any distortions for this behavior.[5] Instead the key efficiency question here is how much of the rebate households would spend, and thus how much would it stimulate aggregate demand and overall economic performance. These three considerations can be used to evaluate three questions.

First, should the rebates go to lower-income households? From a macroeconomic perspective, a tax rebate would be more effective if it includes the lower-income households who are most likely to spend the money. This is broadly agreed by the economics profession. For example, Federal Reserve Chairman Ben Bernanke testified that "If you're somebody who lives paycheck to paycheck, you're more likely to spend that extra dollar." Fairness also suggests that lower-income households should receive tax rebates. Finally, such rebates could be designed in such a way that they would pose little additional complication for IRS administration.

Second, should the rebates go to higher-income households? The same macroeconomic considerations that apply to lower-income households apply here, but in reverse. As Bernanke put it, "If you're somebody who has lots of financial assets and you receive an extra dollar, you may not change your spending much." Phasing out a rebate for higher-income households would increase the overall cost effectiveness of a stimulus package. It would enable policymakers to either have a larger rebate for low- and middle-income households or reduce the budgetary cost of the rebate.

Third, should the rebates be adjusted for family size? Some proposals would give a fixed amount based on household status, for example $800 for a single household and $1,600 for a married couple filing jointly. Other proposals would include a family size adjustment that provides additional funds for households with additional children. Although either approach would be effective macroeconomic policy, the latter approach has the potential advantage of corresponding more closely to family needs, which are a function of family size.

Table 3 provides a series of illustrative options that show the budgetary cost of alternative approaches to refundability for low-income households and phase-outs for high-income households. The base option is an $800 tax credit for singles and $1,600 for married couples filing jointly.

[5] An exception, which could be important in some circumstances, would be if rebates lead households to change their filing behavior in order to maximize their rebates.

Table 3. Illustrative Options for Refundability and Phaseouts Tax Rebate of $800 for individuals, $1,200 for heads of household, and $1,600 for joint returns				
	Revenue Cost (billions of dollars)	Number Benefiting (millions)	Tax Filers with Zero Benefit (millions)	Earners with Zero Benefit (millions)
Limited by income tax	$99	88	38	35
Fully refundable to all filers	$161	127	0	2
Limited to income tax plus 15 percent of earnings	$147	122	5	2
Limited to 15 percent of earnings	$137	114	13	2
Memo: Changes to the above from				
Phased out for AGI greater than $75K/$110K	-$19	-11	-11	-10
Phased out for AGI greater than $100K/$200K	-$7	-5	-5	-4

Source: Tax Policy Center microsimulation model

Some of the key points from this table:

- A tax credit of $800 for singles and $1,600 for married couples (which is similar to a policy that eliminated the 10 percent tax bracket) would benefit 88 million tax units but leave 35 million wage-earning tax units with no benefit.[6]

- Making this tax credit fully refundable to all filers would benefit all filers, 127 million in total (although 2 million wage-earning tax units would still be left out for administrative reasons, largely because they did not file taxes). The added benefit for these households, however, would raise the total price tag by $62 billion. Alternatively, the credit amount could be scaled down to about $375/$750 to keep the price tag the same while benefiting more households.

- Alternatively, policymakers could limit rebates to income taxes plus 15 percent of earnings, including both wages and self-employment income. This would deliver benefits to most of the tax filers and wage earners left out of a nonrefundable credit. But because the refundability is more limited, the added cost would fall to $48 billion. An even more restrictive refundability would limit benefits to 15 percent of earnings; this would bring the cost down but at the expense of leaving out tax filers with capital income.

- Finally, phasing out the rebate in the same manner as the child tax credit (starting at $75,000 for singles and $110,000 for married couples earners would lose 5 percent of benefits) would reduce the cost by $19 billion while eliminating benefits for 11 million higher-income households. Adopting the higher phaseout rates of $100,000 for singles and $200,000 for married couples would raise the cost by $7 billion and eliminate benefits for 5 million higher-income households.

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[6] Note not all tax filers have wages. And not all wage earners are tax filers. But the bulk of these groups of 38 million filers and 35 million earners consist of the same households.

Three illustrative options for rebates

The following presents a summary of three illustrative options for one-time rebates that would total approximately $100 billion in 2008. A complete set of distributional tables for these options are provided in the Appendix. The options are:

- **Eliminate the 10 percent tax bracket ($101 billion).** This option would provide a rebate equal to the difference between a household's regular income taxes and their taxes assuming that the 10 percent tax bracket was zero. This would provide a rebate of $800 for singles and $1,600 for married couples, providing they had sufficient tax liability. In sum, 30 million households with earnings have no tax liability and thus no benefit from this proposal.

- **Provide a fully refundable rebate with no phase-out ($105 billion).** This option would provide a rebate of $450 for singles, $900 for married couples, and $225 for each additional dependent. As a result, a family of four would get $1,350. This amount would be fully refundable for all tax filers and would not be phased out. As a result, all tax filers would get the full benefit and same total amount. Larger families would get larger rebates.[7]

- **Provide a partially refundable rebate phased out for higher-income households ($104 billion).** This option would provide a maximum rebate of $550 for singles, $1,100 for married couples, and $275 for each additional dependent. As a result, a family of four would get a maximum rebate of $1,650. The rebate would be limited to the amount a family paid in income taxes plus 15 percent of earnings, effectively limiting the rebate to income plus payroll taxes. In addition, the rebate would be phased out like the child tax credit; that is, starting at $75,000 for singles and $110,000 for married couples. As a result of these limitations, 17 million tax filers and 13 million earning households would get no benefit—of which 11 million are high-income households for whom the rebate would be phased out.

Conclusion

Ultimately the biggest economic challenges this country faces are how to promote strong and inclusive long-run growth. Doing this will require a range of responses from health reform to a new energy policy to curbing the long-run deficit. As important as these problems are, they are also complicated. In the short-run, however, the most immediate challenge is helping the economy to fully utilize its current potential. Fortunately, this is a much easier task and hopefully policymakers can move from agreement in principle to working out detailed provisions that are consistent with these principles: timely, temporary and targeted.

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[7] Note that this option could pose a challenge for tax administration because it would encourage more households to file additional tax returns. If such additional returns were not desirable, policymakers could limit the rebates to households who filed for tax year 2006.

Reduce 10-Percent Individual Income Tax Rate to 0 Percent
Distribution of Federal Tax Change by Cash Income Level, 2007 Income Levels [1]
Summary Table

Cash Income Level (thousands of 2006 dollars) [2]	Percent of Tax Units [3]		Percent Change in After-Tax Income [4]	Share of Total Federal Tax Change	Average Federal Tax Change ($)	Average Federal Tax Rate [5]	
	With Tax Cut	With Tax Increase				Change (% Points)	Under the Proposal
Less than 10	1.6	0.0	0.0	0.0	0	0.0	4.0
10-20	27.0	0.0	0.8	3.1	-122	-0.8	3.5
20-30	59.6	0.0	1.8	8.3	-408	-1.6	7.9
30-40	77.6	0.0	2.2	10.1	-658	-1.9	12.0
40-50	88.4	0.0	2.3	10.5	-866	-1.9	14.6
50-75	95.5	0.0	2.2	24.3	-1,141	-1.8	16.7
75-100	97.7	0.0	1.9	17.7	-1,345	-1.5	18.5
100-200	94.7	0.0	1.3	22.7	-1,359	-1.0	21.4
200-500	44.8	0.0	0.3	2.5	-550	-0.2	25.1
500-1,000	38.9	0.0	0.1	0.4	-528	-0.1	27.1
More than 1,000	64.0	0.0	0.0	0.4	-941	0.0	31.9
All	62.5	0.0	1.3	100.0	-668	-1.0	20.2

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-2).
Number of AMT Taxpayers (millions). Baseline: 3.7 Proposal: 5.3
(1) Calendar year. Baseline is 2008 current law assuming extension and indexation for inflation of the 2007 AMT patch. Proposal provides a tax rebate equivalent to a reduction in the bottom tax rate from 10 percent to 0 percent, based on income reported on 2007 tax returns.
(2) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm
(3) Includes both filing and non-filing units but excludes those that are dependents of other tax units.
(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.
(5) Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of average cash income.

Reduce 10-Percent Individual Income Tax Rate to 0 Percent
Distribution of Federal Tax Change by Cash Income Percentile, 2007 Income Levels [1]
Summary Table

Cash Income Percentile [2,3]	Percent of Tax Units [4]		Percent Change in After-Tax Income [5]	Share of Total Federal Tax Change	Average Federal Tax Change ($)	Average Federal Tax Rate [6]	
	With Tax Cut	With Tax Increase				Change (% Points)	Under the Proposal
Lowest Quintile	8.4	0.0	0.2	0.5	-16	-0.2	3.2
Second Quintile	43.6	0.0	1.4	8.1	-271	-1.3	5.8
Middle Quintile	79.1	0.0	2.2	20.6	-688	-1.9	12.4
Fourth Quintile	95.6	0.0	2.2	34.5	-1,155	-1.8	16.9
Top Quintile	86.2	0.0	0.8	36.3	-1,213	-0.6	24.5
All	62.5	0.0	1.3	100.0	-668	-1.0	20.2
Addendum							
80-90	97.2	0.0	1.7	20.6	-1,377	-1.3	19.5
90-95	94.6	0.0	1.2	10.2	-1,363	-0.9	21.9
95-99	59.4	0.0	0.4	4.7	-778	-0.3	24.4
Top 1 Percent	40.7	0.0	0.1	0.8	-561	0.0	30.2
Top 0.1 Percent	64.3	0.0	0.0	0.1	-952	0.0	32.7

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-2).
Number of AMT Taxpayers (millions). Baseline: 3.7 Proposal: 5.3
(1) Calendar year. Baseline is 2008 current law assuming extension and indexation for inflation of the 2007 AMT patch. Proposal provides a tax rebate equivalent to a reduction in the bottom tax rate from 10 percent to 0 percent, based on income reported on 2007 tax returns.
(2) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm
(3) The cash income percentile breaks used in this table are (in 2006 dollars): 20% $13,944, 40% $26,887, 60% $47,151, 80% $83,902, 90% $123,792, 95% $174,283, 99% $425,614, 99.5% $663,650, and 99.9% 1,935,007.
(4) Includes both filing and non-filing units but excludes those that are dependents of other tax units.
(5) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.
(6) Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of average cash income.

Fully Refundable Tax Rebate of $450 ($900 For Couples) Plus $225 Per Dependent
Distribution of Federal Tax Change by Cash Income Level, 2007 Income Levels [1]
Summary Table

Cash Income Level (thousands of 2006 dollars) [2]	Percent of Tax Units [3]		Percent Change in After-Tax Income [4]	Share of Total Federal Tax Change	Average Federal Tax Change ($)	Average Federal Tax Rate [5]	
	With Tax Cut	With Tax Increase				Change (% Points)	Under the Proposal
Less than 10	58.9	0.0	5.5	6.2	-298	-5.2	-1.2
10-20	68.4	0.0	2.7	11.2	-392	-2.6	1.7
20-30	84.9	0.0	2.3	11.6	-514	-2.0	7.4
30-40	91.4	0.0	1.9	9.8	-578	-1.6	12.2
40-50	96.3	0.0	1.7	8.5	-629	-1.4	15.1
50-75	99.3	0.0	1.4	17.5	-737	-1.2	17.4
75-100	99.9	0.0	1.2	12.4	-846	-1.0	19.0
100-200	100.0	0.0	0.9	16.8	-907	-0.7	21.8
200-500	100.0	0.0	0.4	4.6	-918	-0.3	25.0
500-1,000	100.0	0.0	0.2	0.8	-912	-0.1	27.0
More than 1,000	100.0	0.0	0.0	0.4	-903	0.0	31.9
All	86.1	0.0	1.2	100.0	-603	-0.9	20.3

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-2).
Number of AMT Taxpayers (millions). Baseline: 3.7 Proposal: 3.7
(1) Calendar year. Baseline is 2008 current law assuming extension and indexation for inflation of the 2007 AMT patch. Proposal provides a fully refundable tax rebate available to all individual income tax filers of $450 ($900 for married couples filing a joint return) plus $225 per dependent.
(2) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm
(3) Includes both filing and non-filing units but excludes those that are dependents of other tax units.
(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.
(5) Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of average cash income.

Fully Refundable Tax Rebate of $450 ($900 For Couples) Plus $225 Per Dependent
Distribution of Federal Tax Change by Cash Income Percentile, 2007 Income Levels [1]
Summary Table

Cash Income Percentile [2,3]	Percent of Tax Units [4]		Percent Change in After-Tax Income [5]	Share of Total Federal Tax Change	Average Federal Tax Change ($)	Average Federal Tax Rate [6]	
	With Tax Cut	With Tax Increase				Change (% Points)	Under the Proposal
Lowest Quintile	60.3	0.0	4.1	10.3	-317	-3.9	-0.6
Second Quintile	78.0	0.0	2.4	15.3	-462	-2.3	4.9
Middle Quintile	92.1	0.0	1.8	19.4	-584	-1.6	12.7
Fourth Quintile	99.4	0.0	1.4	24.8	-747	-1.2	17.5
Top Quintile	100.0	0.0	0.6	29.8	-897	-0.4	24.7
All	86.1	0.0	1.2	100.0	-603	-0.9	20.3
Addendum							
80-90	99.9	0.0	1.1	14.5	-876	-0.9	20.0
90-95	100.0	0.0	0.8	7.6	-913	-0.6	22.2
95-99	100.0	0.0	0.5	6.1	-926	-0.4	24.3
Top 1 Percent	100.0	0.0	0.1	1.5	-909	-0.1	30.1
Top 0.1 Percent	100.0	0.0	0.0	0.2	-904	0.0	32.7

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-2).
Number of AMT Taxpayers (millions). Baseline: 3.7 Proposal: 3.7
(1) Calendar year. Baseline is 2008 current law assuming extension and indexation for inflation of the 2007 AMT patch. Proposal provides a fully refundable tax rebate available to all individual income tax filers of up to $450 ($900 for married couples filing a joint return) plus $225 per dependent.
(2) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm
(3) The cash income percentile breaks used in this table are (in 2006 dollars): 20% $13,944, 40% $26,887, 60% $47,151, 80% $83,902, 90% $123,792, 95% $174,283, 99% $425,614, 99.5% $663,650, and 99.9% 1,925,007.
(4) Includes both filing and non-filing units but excludes those that are dependents of other tax units.
(5) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.
(6) Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of average cash income.

Tax Rebate of up to $550 ($1,100 For Couples) Plus $275 Per Dependent
Phased Out for Upper Income Taxpayers
Distribution of Federal Tax Change by Cash Income Level, 2007 Income Levels [1]
Summary Table

Cash Income Level (thousands of 2006 dollars) [2]	Percent of Tax Units [3]		Percent Change in After-Tax Income [4]	Share of Total Federal Tax Change	Average Federal Tax Change ($)	Average Federal Tax Rate [5]	
	With Tax Cut	With Tax Increase				Change (% Points)	Under the Proposal
Less than 10	51.2	0.0	5.3	5.3	-287	-5.0	-1.0
10-20	61.6	0.0	3.2	12.1	-472	-3.1	1.1
20-30	80.5	0.0	2.8	13.1	-649	-2.6	6.9
30-40	88.1	0.0	2.5	11.5	-755	-2.1	11.7
40-50	93.5	0.0	2.2	10.0	-826	-1.8	14.6
50-75	98.0	0.0	1.9	21.1	-993	-1.6	16.9
75-100	95.8	0.0	1.6	14.4	-1,100	-1.3	18.8
100-200	63.8	0.0	0.7	11.8	-708	-0.5	21.9
200-500	6.0	0.0	0.0	0.3	-56	0.0	25.3
500-1,000	6.3	0.0	0.0	0.1	-62	0.0	27.1
More than 1,000	2.1	0.0	0.0	0.0	-23	0.0	31.9
All	74.4	0.0	1.3	100.0	-670	-1.0	20.1

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-2).
Number of AMT Taxpayers (millions). Baseline: 3.7 Proposal: 3.7
(1) Calendar year. Baseline is 2008 current law assuming extension and indexation for inflation of the 2007 AMT patch. Proposal provides a tax rebate of up to $550 ($1,100 for married couples filing a joint return) plus $275 per dependent. The rebate would be limited by the sum of individual income tax liability (if positive) and 15 percent of earnings (defined as wages plus self-employment income, if positive). The rebate would be phased out at a rate of 5 percent of AGI in excess of the thresholds for the child tax credit phaseout ($75,000 for singles, $110,000 for couples).
(2) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm
(3) Includes both filing and non-filing units but excludes those that are dependents of other tax units.
(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.
(5) Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of average cash income.

Tax Rebate of up to $550 ($1,100 For Couples) Plus $275 Per Dependent
Phased Out for Upper Income Taxpayers
Distribution of Federal Tax Change by Cash Income Percentile, 2007 Income Levels [1]
Summary Table

Cash Income Percentile [2,3]	Percent of Tax Units [4]		Percent Change in After-Tax Income [5]	Share of Total Federal Tax Change	Average Federal Tax Change ($)	Average Federal Tax Rate [6]	
	With Tax Cut	With Tax Increase				Change (% Points)	Under the Proposal
Lowest Quintile	52.4	0.0	4.2	9.7	-331	-4.1	-0.7
Second Quintile	72.8	0.0	3.0	17.1	-573	-2.8	4.4
Middle Quintile	88.9	0.0	2.4	22.7	-762	-2.1	12.2
Fourth Quintile	97.9	0.0	1.9	30.0	-1,004	-1.6	17.1
Top Quintile	60.5	0.0	0.5	20.4	-682	-0.3	24.8
All	74.4	0.0	1.3	100.0	-670	-1.0	20.1
Addendum							
80-90	88.3	0.0	1.3	16.2	-1,087	-1.1	19.8
90-95	59.1	0.0	0.4	3.7	-496	-0.3	22.4
95-99	6.7	0.0	0.0	0.4	-59	0.0	24.7
Top 1 Percent	4.8	0.0	0.0	0.1	-48	0.0	30.2
Top 0.1 Percent	1.2	0.0	0.0	0.0	-12	0.0	32.8

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-2).
Number of AMT Taxpayers (millions). Baseline: 3.7 Proposal: 3.7
(1) Calendar year. Baseline is 2008 current law assuming extension and indexation for inflation of the 2007 AMT patch. Proposal provides a tax rebate of up to $550 ($1,100 for married couples filing a joint return) plus $275 per dependent. The rebate would be limited by the sum of individual income tax liability (if positive) and 15 percent of earnings (defined as wages plus self-employment income, if positive). The rebate would be phased out at a rate of 5 percent of AGI in excess of the thresholds for the child tax credit phaseout ($75,000 for singles, $110,000 for couples).
(2) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm
(3) The cash income percentile breaks used in this table are (in 2006 dollars): 20% $13,944, 40% $26,887, 60% $47,151, 80% $83,902, 90% $123,792, 95% $174,283, 99% $425,614, 99.5% $663,650, and 99.9% 1,925,007.
(4) Includes both filing and non-filing units but excludes those that are dependents of other tax units.
(5) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.
(6) Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of average cash income.

Statement of Senator Chuck Grassley
Finance Committee Hearing on Economic Stimulus
January 24, 2008

We start this year in an environment of declining house prices and home building, rising foreclosures, financial turmoil, rising unemployment and rising oil prices. This turmoil has caused concern that the country may be heading for a recession or, at best, sluggish growth.

Economists do not all share the view that a recession is inevitable. However, what does seem to be consistent is that the road ahead will be rocky. The general view is that the slowing economy is making life harder for average Americans and a targeted, timely and temporary response is needed.

The continued erosion in the housing market and rising oil prices are having an impact in my home state as well. Iowans' average consumer debt rose 4.1 percent from June to September. Also, for the first nine months of the year, Iowans paid $3.3 billion for gasoline – nearly double the $1.7 billion they paid in the first three quarters in 2000. Some states are harder hit than others, but nobody is immune.

The President recently sent a strong message that Congress must act and act quickly to design a fiscal stimulus plan aimed at boosting the economy. He said that such a plan would provide a "shot in the arm" to keep the economy healthy.

The President outlined roughly a $145 billion fiscal stimulus plan involving temporary tax relief for consumers and companies. He also indicated that the size of such a plan may exceed that amount. While the size of the stimulus is important, substance is equally important.

The President said, and I agree, there is a broad consensus that we can design a stimulus package that can be approved with bipartisan support. In that spirit, a generalist approach should be followed so that the maximum number of taxpayers can benefit.

We must also remember that Congress' failure to permanently deal with the Alternative Minimum Tax means that we need to deal with it again this year. Millions of Americans now at risk of falling into the clutches of the AMT this year are relying on us to act quickly and responsibly. For most of these families, that "stealth" tax increase of roughly $2,000 per family far exceeds any temporary tax relief plan we're looking at. As we start this legislative year, we should be aware that this tax increase hangs over many households.

Finally, we should not be short sighted. I'll emphasize a point I made on Tuesday. And that is that we should not simply target low-income and credit constrained people because of their propensity to spend. Saving plays an important role in a stable economy. Money that is saved doesn't simply evaporate. It flows back into the economy in the form of investment. Investment is another form of spending, specifically, spending on capital goods. Thus, money spent on capital goods adds to the overall economy just like money spent on consumer goods.

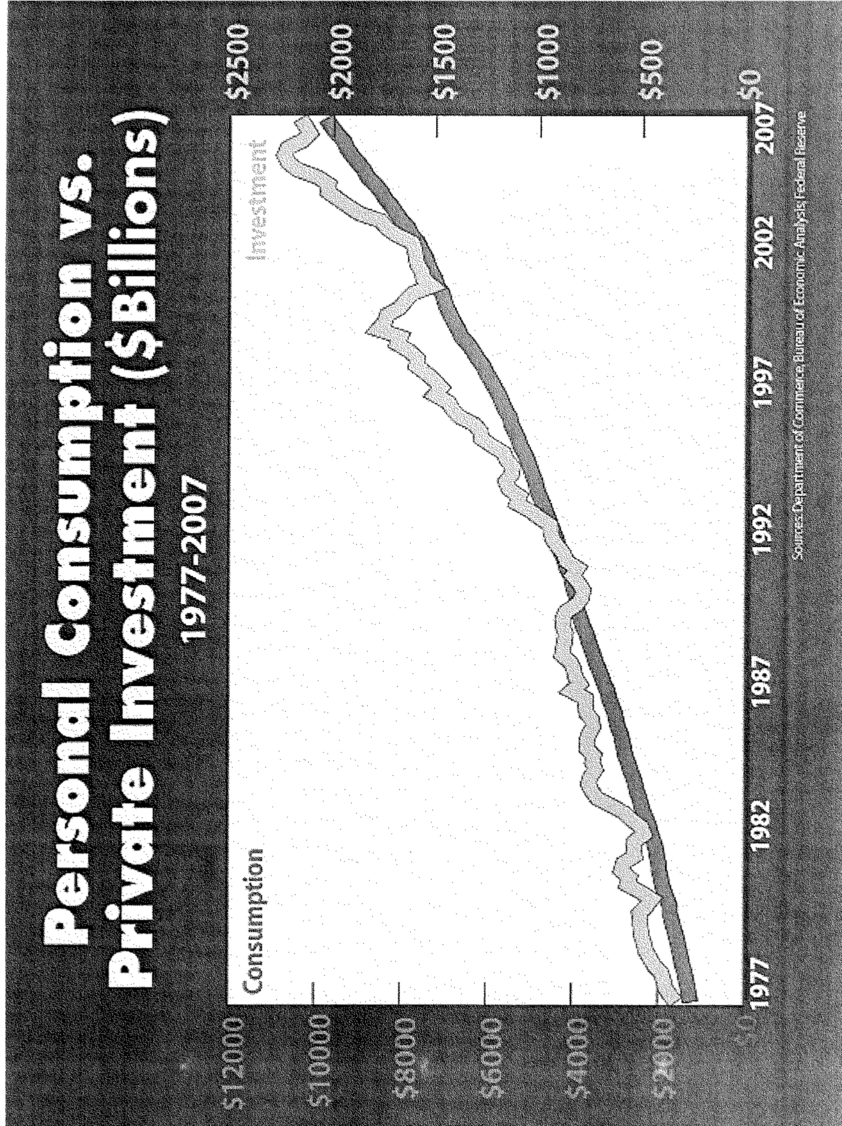
I have a chart here. It will put into perspective the relative patterns of consumption and investment. At our last hearing, the testimony would make you conclude that

investment is fine where it is and there is a material risk of a major decline in consumption. For this reason, some folks came away from that hearing believing the optimal stimulus would be heavily tilted towards consumption incentives and away from investment incentives.

Take a look at this chart. It shows the trend lines on personal consumption on one line. That line flows as steady as river over the prairie. But it flows in a steady upward pattern. Private investment is on the other line. And let's remember that all of us, Democrats and Republicans, have an interest in a healthy growth in private investment. The reason, of course, is that when employers employ more investment, they also generally employ more workers. So, unlike the sentiment of the last hearing, private investment is something we all need to pay close attention to.

Let's take a look at that private investment line. That line is much more volatile. It's more like a mountain stream that zigs and zags. This line is jagged and generally tracks periods of economic growth and decline. So, let's not leave employers and private investment on the sideline. It is an important part of the economic picture. It's where the jobs come from.

We appreciate Dr. Feldstein and Mr. Furman coming here today. I look forward to exploring possible opportunities to address this problem.


Personal Consumption vs.
Private Investment ($Billions)
1977-2007
Consumption
Investment
$12000
$10000
$8000
$6000
$4000
$2000
$0
$2500
$2000
$1500
$1000
$500
$0
1977
1982
1987
1992
1997
2002
2007
Sources: Department of Commerce Bureau of Economic Analysis; Federal Reserve

CBO TESTIMONY

Statement of
Peter R. Orszag
Director

Options for Responding to Short-Term Economic Weakness

before the
Committee on Finance
United States Senate

January 22, 2008

This document is embargoed until it is delivered at 10:00 a.m. (EST) on Tuesday, January 22, 2008. The contents may not be published, transmitted, or otherwise communicated by any print, broadcast, or electronic media before that time.

CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

Options for Responding to Short-Term Economic Weakness

Mr. Chairman, Ranking Member Grassley, and Members of the Committee, thank you for inviting me to testify on the effectiveness of various policies as short-term economic stimulus. My statement today reprises the Congressional Budget Office's (CBO's) recent paper on the topic, which was prepared at the request of the Chairmen of the House and Senate Budget Committees.[1]

Strong indications suggest that economic growth is slowing and will remain sluggish for much of 2008. Most professional forecasters are continuing to project very slow growth, as opposed to an outright recession, this year.[2] The risk of recession is elevated, however, and some respected economists believe that the probability of a recession has now risen to 50 percent or greater.

Discretionary fiscal policy stimulus (that is, legislative action aimed at providing stimulus) may not be necessary to avoid an outright recession, if most current forecasts are correct. Nonetheless, policymakers may choose to proceed with a stimulus package to bolster a weak economy and as insurance against the elevated risk of a recession. Some economists advocating a stimulus also believe that a recession, if it occurs, could prove to be unexpectedly deep; a fiscal stimulus would help reduce the severity of a recession, should one occur.

Effective stimulus does not necessarily require addressing the source of economic weakness directly; instead, it requires strengthening aggregate demand. Although much of the current economic weakness can be traced to the housing and mortgage markets, other factors, such as the high price of oil, have played an important role. If policymakers choose to address problems in the housing and mortgage markets, possible actions should therefore be evaluated primarily with regard to their effectiveness in correcting identifiable failures in those markets—and not necessarily with regard to their value in counteracting economic weakness. Policy actions affecting the housing and financial markets may, however, help the economy by reducing the risks of a self-reinforcing spiral (of less lending, lower house prices, more foreclosures, even less lending, and so on) that could further impair economic activity and potentially turn a mild recession into a long and deep recession.

This testimony first reviews the economic situation, including how the monetary and regulatory authorities have already responded. The next section assesses different fiscal approaches to giving a temporary boost to aggregate demand in the economy. A final section examines policy options geared specifically toward the housing and mortgage markets.

CBO finds the following:

- There is a strong possibility of at least a few quarters of very slow growth. Although the economy may avoid a recession in 2008, the risk of a recession has risen.
- The Federal Reserve has powerful tools to keep the economy growing, but there is no guarantee that it will be able to keep the economy from entering a recession.

1. Congressional Budget Office, *Options for Responding to Short-Term Economic Weakness* (January 2008).
2. The National Bureau of Economic Research (NBER) is by convention responsible for dating the peaks and troughs of the business cycle. According to its Business Cycle Dating Committee, "A recession is a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real [inflation-adjusted] GDP [gross domestic product], real income, employment, industrial production, and wholesale-retail sales." See www.nber.org/cycles/jan08bcdc_memo.html.

- The system of automatic stabilizers built into the federal budget will act to stimulate the economy in a period of economic sluggishness, helping to mitigate any economic downturn.
- If additional fiscal stimulus is deemed necessary, it would be desirable to make sure that the actions take effect when stimulus is most likely needed and are designed to increase economic activity as much as possible for a given budgetary cost. Such well-designed stimulus can help bolster an economy suffering from weak aggregate demand and thereby help reduce the risk and severity of a recession.
- The most effective types of fiscal stimulus (delivered either through tax cuts or increased spending on transfer payments) are those that direct money to people who are most likely to quickly spend the bulk of any additional funds provided to them.
- A variety of options are available for helping people who have been adversely affected by turmoil in the mortgage market. In evaluating the options, it is important to strike a balance between helping financially distressed families meet their basic needs, being fair to other families, and not rewarding imprudent behavior that might create additional costs in the future. In addition, further declines in housing prices are probably necessary to correct imbalances in the economy, and policies that attempt to prevent market prices from correcting could make the situation worse.

The Uncertain Outlook for the Economy

The combination of continued weakness in housing activity and prices, the ongoing problems in the mortgage and broader financial markets, and the persistently high price of energy have raised the risks of slow growth and perhaps even an outright recession in the coming year. The consensus forecast (an average of recent forecasts of about 50 private-sector economists) for real (inflation-adjusted) growth in 2008 has fallen from 2.9 percent in the forecast made in July 2007 to only 2.2 percent in the forecast made this month.[3] However, that recent forecast did not incorporate employment data released in early January 2008 that indicate a weaker outlook for the economy. The civilian unemployment rate of 5.0 percent for December was reported on January 4, after the forecasts were made, and was weaker than expected. Since December 2006, the three-month moving average of the civilian unemployment rate has risen 0.4 percentage points. Such an increase in the unemployment rate over a year has often coincided with the onset of past recessions (see Figure 1). In addition, a number of respected economists believe there is a strong probability that the economy will contract for at least part of this year.[4] Some of these economists fear that any such recession will prove to be prolonged and deep. In general, forecasts based on macroeconometric models tend to project slow growth instead of recession, whereas the economists suggesting a higher probability of recession tend to believe that the models are not accurately capturing key parts of current economic dynamics.

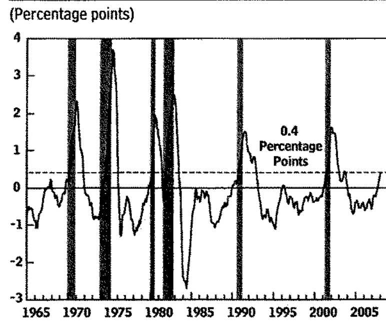
Economists' uncertainty about the outlook for the economy is a major challenge in evaluating the need for, and potential benefits of, discretionary fiscal policy stimulus. Economists' estimates of the magnitude of the spillovers from the problems in the housing and financial markets to other sectors of the economy vary widely. The economy could tip into recession if growing defaults on home mortgage loans and the subsequent financial losses for lenders lead to a severe economywide curtailment of lending, but many economists believe that these effects will be contained. Similarly, how far and fast housing prices will fall, how long energy prices will remain high, and the extent to which consumers will curtail spending because of reductions in their housing wealth or because of high energy costs are uncertain. The economy has been quite resilient to macroeconomic shocks over the past two decades, and the underlying flexibility of the economy, combined with the current strength of foreign demand for U.S.-produced goods and services, may keep the economy from going into recession this year.[5]

3. Aspen Publishers, Inc., *Blue Chip Economic Indicators*, January 10, 2008.
4. Economists Richard Berner (Morgan Stanley), Martin Feldstein (Harvard University), William Gross (PIMCO), Robert Shiller (Yale University), and Lawrence Summers (Harvard University) have all stated that the probability of a recession this year is greater than 50 percent.
5. Statement of Peter R. Orszag, Director, Congressional Budget Office, *The Current Economic Situation*, before the House Committee on the Budget (December 5, 2007).

Figure 1.

Changes in the Unemployment Rate

(Percentage points)



Sources: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics.

Note: Changes are from the previous year in the three-month moving average of the civilian unemployment rate. Data are plotted through December 2007. The shaded vertical bars indicate periods of recession.

Automatic Fiscal Stabilizers

Automatic fiscal stabilizers also reduce the risk of recession. As the economy slows, slower growth of income, payrolls, profits, and production causes tax receipts to fall relative to spending—and causes outlays on programs such as unemployment compensation and Food Stamps to rise. That combination temporarily boosts demand for goods and services, thereby helping to offset some of the weakness in demand. CBO estimates that, since 1968, automatic stabilizers have added between 1 percent and 2.5 percent of gross domestic product (GDP) to the deficit during recessions, which translates to about $140 billion to $350 billion in today's economy, and thereby helped mitigate past economic downturns. The automatic stabilizers already built into current law will partially offset any further weakening of the economy.

Actions by the Federal Reserve

In addition to the budget's automatic stabilizers, policy actions by the Federal Reserve in 2007 are helping to maintain liquidity in financial markets and keep the economy growing. On August 9, the Federal Reserve injected $24 billion in temporary reserves into the U.S. banking system, a larger-than-usual amount, by accepting greater-than-normal amounts of mortgage-backed securities as collateral. That and subsequent injections temporarily lowered the federal funds rate below the 5.25 percent target the Federal Reserve set on August 7. (The federal funds rate is the rate at which banks make overnight loans to one another. It is one of the Federal Reserve's main instruments for managing the economy.) On August 17, the Federal Reserve narrowed the spread of the discount rate (the rate at which depositories can borrow from the Federal Reserve) over the target federal funds rate from 100 to 50 basis points.

The Federal Reserve has continued to act since then. With money market conditions still under stress in the fall of 2007, the Federal Reserve reduced the target federal funds rate three times—in September, October, and December—to its current level of 4.25 percent. In December, the Federal Reserve also created a Term Auction Facility (TAF) to auction $40 billion of short-term financing to depository institutions that are eligible to borrow from the Federal Reserve's discount window.[6] The Federal Reserve has scheduled two additional auctions this month (January 2008), each of $30 billion in short-term credit. These actions, plus possible further reductions in the federal funds rate over the next few months, may stabilize financial institutions and markets enough to obviate the need for changes in discretionary fiscal policy.[7]

Coordinated actions between the Federal Reserve and foreign central banks have also helped stabilize short-term credit markets since the turmoil began in the summer of 2007. Reciprocal currency swap lines were established with the European Central Bank (ECB) and the Swiss National Bank to allow these central banks to provide funding in dollars to non-U.S. institutions that would

6. The TAF accepts the same types of collateral as the Federal Reserve's discount window in exchange for funds. However, because the TAF lets bidding determine the interest rate, the TAF rate may be—and in bidding up to now, has been—lower than the discount rate. Of the $40 billion of credit extended in December 2007, $34 billion was auctioned through the Federal Reserve Bank of New York, suggesting that the biggest banks are taking advantage of the facility.

7. The Federal Home Loan Bank System has also played an important role in stabilizing mortgage markets. It made $184 billion in new loans to member institutions in the third quarter of 2007. Remarks by Henry Paulson Jr. on housing and capital markets before the New York Society of Securities Analysts (January 7, 2008), at www.treasury.gov/press/releases/hp757.htm.

normally obtain such funding in the interbank (or Libor) market.[8] To help alleviate funding pressures at the end of the year, the Federal Reserve also made greater liquidity available. The ECB has provided liquidity to European money markets, including a massive short-term funding of about $500 billion. The international interbank market and the domestic commercial paper (short-term business loans) market—the short-term markets most affected by the problems with subprime mortgages—have both recovered somewhat, although interest rate spreads relative to the federal funds rate are still above normal levels, reflecting a persistent lack of confidence among market participants.

The Federal Reserve will continue to provide the necessary liquidity to credit markets, but the amount of additional support it provides to economic activity will depend on the outlook for real growth and inflation. If the outlook for inflation worsens, the Federal Reserve may tend to be conservative about making further reductions in the federal funds rate. Most forecasts assume that inflation will be contained this year even though it spiked up late last year. For the fourth quarter of 2007, the consumer price index for all urban consumers (CPI-U) is estimated to have grown at about 4¼ percent, primarily sparked by a jump in motor fuel prices, but the consensus forecast calls for CPI-U inflation of 2.4 percent over the four quarters of 2008. Measures of inflation that exclude energy and food prices ("core" inflation) have been more stable, running about 2½ percent at the end of last year, and the slowing of economic growth is likely to undercut inflationary pressures. That 2.4 percent forecast for the CPI-U is at the high end of the Federal Reserve's apparent "comfort range" for inflation, which applies to a different measure of consumer price inflation.

However, if the information over the next few months indicates that inflation this year is likely to be significantly higher than currently expected, the Federal Reserve may decide not to lower its target for the federal funds rate much farther. The two major concerns about the inflation outlook stem from the increase in the prices of a wide variety of commodities over the past two years and the possible repercussions of the decline in the dollar on the prices of tradable goods. Inflation may well become a more serious problem this year than currently anticipated if commodity and import price increases set off a sustained increase in overall price growth. The consensus forecast assumes that those inflationary pressures will be attenuated by the overall weakness in the economy, but that assumption may not be borne out. Discretionary fiscal stimulus, it should be noted, would also put some upward pressure on the inflation rate relative to a scenario with no such stimulus, although the degree of such pressure depends on the size and structure of any stimulus package.

The bottom line is that the risk of recession is elevated, even though the economy may avoid a recession without any discretionary fiscal policy actions. Indeed, based on current macroeconometric forecasts, that is the most likely scenario. Given the elevated risk of a recession, however, targeted policies in mortgage markets or a well-designed and well-timed discretionary fiscal policy may have larger economic benefits than costs, whereas poorly designed or substantially delayed fiscal policy interventions may do more harm than good.

Fiscal Stimulus

Fiscal stimulus aims to boost economic activity by increasing short-term aggregate demand. The purpose is to generate sufficient demand to engage more of the economy's existing productive capacity. This approach is in contrast to policies designed to improve long-term economic growth: Such policies work by increasing the economy's capacity to produce. Because short-term stimulus is focused on demand, its efficacy depends on a different set of principles than those underlying long-term supply-based policies, and it is often in tension with those principles. Some of the most effective changes in tax law in terms of short-run stimulus provide little aid to and may even retard long-run economic growth if made permanent. At the same time, many options that promote long-term growth provide little short-term stimulus.

Fiscal stimulus may increase demand directly, as in the case of direct government spending on goods and services, or it may do so indirectly, by increasing household consumption or business investment. Consumption by households is generally stimulated when either after-tax income or expected lifetime wealth rises (which can occur

8. A currency swap is an exchange of a given amount in one currency for the equivalent amount in another currency. A swap would be for a specified period of time, and the parties would then return the original amounts to each other. A reciprocal swap agreement between the Federal Reserve and a foreign central bank gives either central bank the right to initiate a currency swap. Libor refers to the London Interbank Offer Rate.

because of a reduction in taxes or an increase in transfer payments from the government). Investment by businesses can be stimulated directly by boosting the after-tax return on capital (for example, through a reduction in taxes) sufficiently to make additional investment profitable. Also, any policy that succeeds in increasing the overall level of economic activity (even if it is directed at consumers) is likely to increase business investment (because it would raise the expected pretax return on capital).

Principles for an Effective Fiscal Stimulus

The most effective fiscal stimulus policies share two common features:

- They focus on the time period when stimulus is most likely to be needed, and
- They are designed to increase economic activity as much as possible for a given budgetary cost.

During a period of economic weakness, the key constraint on economic growth is demand for the goods and services that firms could produce with existing resources. In that context, additional spending (by households, businesses, or governments) created by a stimulus policy can engage some unemployed resources, and that new activity has further effects. In particular, households whose income increases as a result of the stimulus subsequently consume more, adding to demand. That process, by which an initial stimulus sets in motion further bouts of consumption, is referred to as a "multiplier" effect. Furthermore, some of the firms that supply goods to satisfy the additional demand are encouraged to invest to add to their capacity, further increasing demand.

The magnitude of the multiplier largely depends on how much of the additional increment to their income households spend. The higher that proportion, the more powerful the ultimate boost to demand. If the additional income put into consumers' wallets through stimulative policies is saved rather than spent, it will generate little extra demand and bring few resources into production. In a period of high uncertainty, when households may be seeking to retrench, fiscal stimulus may have a more modest effect because households are reluctant to spend. On the other hand, during such periods the impact of a fiscal stimulus package may be accentuated if the policy intervention boosts consumer confidence.

The degree of stimulus that a policy can provide to the economy also depends on how much of the resultant spending goes to purchase domestically produced goods. If the additional consumption (or investment) demand is satisfied by imported goods, the income of foreign producers will rise, and the stimulus essentially will be exported. In general, it is difficult to determine whether a particular policy is more or less likely to generate demand for domestic as opposed to foreign goods. But in an open economy, some of the stimulus typically will boost demand in economies abroad instead of in the domestic economy.

Estimates of the size of the multiplier differ considerably, so any estimates of the effects of fiscal stimulus will be quite uncertain. The multipliers estimated by econometric models depend on the type of stimulus and the response of the Federal Reserve, among other things. Those estimates suggest that a multiplier of one is roughly the right order of magnitude. That is, a spending increase or tax cut of a dollar, if it is well timed and directs the money to people who will spend it quickly, adds about a dollar to GDP in the short run in times of economic weakness.

Timing. The timing of fiscal stimulus is critical. If the policies do not generate additional spending when the economy is in a phase of very slow growth or a recession, they will provide little help to the economy when it is needed. (Over the long term, the key constraint to economic growth is the rate at which the capacity of firms to produce goods and services is expanded—not aggregate demand.) Poorly timed policies may do harm by aggravating inflationary pressures and needlessly increasing federal debt if they stimulate the economy after it has already started to recover.

For numerous reasons, discretionary fiscal stimulus may not be properly timed, and it has often been mistimed in the past. The failure to forecast a coming slowdown or contraction in economic activity is generally thought to be the most important reason for poor timing and is referred to as a "recognition lag." Additional problems can arise if the policy change that is adopted does not affect spending immediately or if there are lags in enacting or implementing policies.

The historical record on the effectiveness of efforts to provide discretionary fiscal stimulus is mixed.[9] Much of the research indicates that fiscal policy in the 1960s and 1970s was poorly timed and, in some instances, destabilizing. By contrast, the tax rebate in 2001 provided stimulus during the recession of that period.

The recognition lag is a major challenge in applying discretionary fiscal policy, but it may not be as critical as it was before the 1990s. One of the most severe recognition lags occurred in the 1974 recession, when economists generally did not perceive the economy to be in a recession until well after it had begun. This meant that the tax rebates ultimately adopted to spur the economy did not take effect until March 1975, after the economy had already started to recover. During the two most recent recessions (in 1990 and 2001), by contrast, economic weakness was recognized relatively quickly. Concerns about slow growth—a slowing that subsequently was dated as a recession that started in August 1990—were raised in September 1990. Similarly, the stock market crash that started early in 2000 alerted economists to the possibility of a recession, and by January 2001 economists generally expected very slow growth. The 2001 recession was subsequently dated to have begun after March of that year. One of the problems that made it difficult to recognize the poor state of the economy during the 1974 episode—a high rate of inflation that distorted the perception of the underlying weakness in real economic activity—has not been a problem in recent decades.

The experience of the past two recessions suggests that recognition lags need not always impede effective stimulus. If the policy is well designed, and if the lags in enacting and implementing it can be kept short, a moderate fiscal stimulus could well attenuate the depth of an incipient contraction or severe slowdown in economic activity. Economic data and economic forecasts can provide relatively reliable and timely indications of the likelihood of an extended period of very slow growth. Policymakers still have to be aware, however, that these measures may falsely indicate the need for stimulus. The economy may quickly bounce back without stimulus, and latent inflationary pressures may be greater than currently perceived.

Given the inherent uncertainty about the economic outlook and the lags in enacting fiscal policy, policymakers may want to develop a fiscal stimulus package before the need for such a policy is certain but include in the legislation a "trigger" to implement the stimulus. A trigger could take various forms, such as a decline in the level of employment over a three-month period or an increase of 0.4 percentage points over 12 months in the three-month moving average of the unemployment rate. The purpose of such a trigger would be to reduce the likelihood that the policy is implemented when it is not necessary. Specifically, it is not now known whether the weakness in the current economic data is foreshadowing a deep and prolonged recession or a transitory period of weakness as the economy adjusts to the housing and financial market shocks. Legislation that included a trigger would "pre-position" a stimulus package, making it more timely if the trigger point was hit, but it would reduce the likelihood that additional demand was added to a recovering or strong economy. To concentrate stimulus when it was most needed, the policies would have to turn off when the economy had sufficiently recovered. (In some sense, such a pre-positioned stimulus package would represent a new automatic stabilizer.) However, economic data can send mixed signals around a recession, which raises uncertainty about choosing the appropriate indicators to turn the stimulus on and off. Moreover, a number of economists have argued that the economy has already weakened by enough to justify a modest and temporary stimulus and that an explicit legislative trigger is therefore not currently needed.

Cost-Effectiveness. In general, stimulus may be generated through policies that affect the spending of households, businesses, or government. The cost-effectiveness of stimulus varies within those categories of policies as well as across them. The same dollar amount of spending increases or tax reductions can have significantly different effects on overall demand, depending on how it is provided and to whom.

Households. In general, tax cuts or increases in transfer payments from the government to people (such as Food Stamps or unemployment insurance benefits) increase household demand by providing consumers with additional spending power. The bigger the chunk of that

9. See John Taylor, "Reassessing Discretionary Fiscal Policy," *Journal of Economic Perspectives*, vol. 14, no. 3 (Summer 2000), pp. 21–26; Alan J. Auerbach, "Fiscal Policy, Past and Present," *Brookings Papers on Economic Activity*, no. 1 (2003), pp. 75–122; and Alan J. Auerbach, "The Effectiveness of Fiscal Policy as Stabilization Policy" (paper presented at the Bank of Korea International Conference on the Effectiveness of Stabilization Policies, May 2005).

additional income that consumers are willing to spend instead of save, the more stimulus there will be from a particular tax reduction or increase in government transfer payments. But households do not predictably spend a fixed proportion of the extra income left in their hands when taxes are reduced or transfers are increased. Rather, a household's propensity to consume appears to vary with its income and depends on expectations of the household of what will happen to that income over the longer term. A household's consumption also varies for other reasons that are little understood.

Households are particularly likely to spend a greater share of a temporary reduction in taxes or additional transfer payments if they are credit constrained (that is, they have borrowed as much money as creditors will lend them). Given that these households would probably borrow additional money if given the opportunity, they are unlikely to save additional income. They are therefore likely to spend a greater proportion of a tax reduction or a transfer increase than other people who have access to credit. Lower-income households are more likely to be credit constrained and more likely to be among those with the highest propensity to spend. Therefore, policies aimed at lower-income households tend to have greater stimulative effects.

Two recent studies that evaluate household spending following the 2001 tax rebate offer historical evidence consistent with this view. In one study, the authors examine households categorized by income and liquid assets. Although the results are not definitive, low-income households and those with few liquid assets appear to have increased their consumption far more in response to the tax rebate than households with higher income or more liquid assets.[10] For example, low-income households were estimated to have increased spending on nondurable goods by more than the amount of the rebate in the three-month period during which it was received, while middle-income households increased the same type of spending by less than 20 percent of the rebate amount. Households with few liquid assets were also estimated to increase spending on nondurables by more than the rebate amount, while those with a medium or higher level of assets were estimated to have decreased such spending.

10. David Johnson, Jonathan Parker, and Nicholas S. Souleles, "Household Expenditure and the Income Tax Rebates of 2001," *American Economic Review*, vol. 96, no. 5 (December 2006), pp. 1589–1610.

The other study, which looked at households' credit card usage, concluded that households with lower credit card limits, those with credit card balances near the limit, and those that used their cards intensively increased credit card spending much more than other households in the nine months after receiving their rebates.[11] For example, households with credit limits under $7,000 increased spending by more than $140 after receiving the rebates (which were typically between $300 and $600), while those with credit limits above $10,500 increased spending by only $40. Households with balances above 90 percent of their credit limit increased spending by more than $330, while those with balances between 1 percent and 50 percent of their credit limits increased spending by less than $20.

Businesses. The mechanism used to stimulate business demand is to reduce the costs associated with investment in new plant and equipment. Increasing the after-tax income of businesses typically does not create an incentive for them to spend more on labor or to produce more goods and services, because production depends on the ability to sell output.[12] But since taxing business income essentially lowers the return that firms earn from capital investment, reducing taxes on the income from new investment increases that return and, therefore, firms' willingness to acquire more capital—that is, to invest. Tax cuts can also stimulate investment less directly, by making more internally generated funds available to firms that might otherwise have difficulty obtaining outside financing for investment; this effect tends to be relatively more important for smaller firms than for larger firms, because smaller firms often have a harder time accessing outside financing. In general, however, the more a business tax cut is focused on the return to new investments rather than the return to existing capital, the more effective it will probably be in stimulating new investment.

11. Sumit Agarwal, Chunlin Liu, and Nicholas S. Souleles, *The Reaction of Consumer Spending and Debt to Tax Rebates: Evidence from Consumer Credit Data*, NBER Working Paper 13694 (Cambridge, Mass.: National Bureau of Economic Research, December 2007).

12. Higher after-tax income for businesses should, in principle, lead to increased spending by households that own stock, either because stock prices go up or because the households get more income in the form of dividends. However, that increase in consumption is likely to be spread over a very long time and, thus, in any given period to be small relative to the federal tax cost of boosting business income.

Tax cuts for business investment may be more effective in boosting short-term demand if they are temporary than if they are permanent. Firms may view them as one-time opportunities for tax savings, which may induce firms to move up some of their future investment plans to the present. They might not take that step if they knew that the tax advantage would remain in place and be available to them later.

Government. A final type of stimulus involves government purchases of goods and services (such as infrastructure spending). That type of government spending affects demand directly because the government is actually purchasing goods and services from the private sector. The effect of such government purchases on the economy is different from the effect of government spending on transfer payments to people, such as unemployment insurance benefits or Food Stamps. Transfer payments to people do not increase demand when the government provides income or benefits to people; instead, such payments increase demand only when the people receiving the payment increase their consumption by purchasing goods and services. For federal purchases, the primary issue in targeting the spending is that of timing. Some kinds of direct expenditure can be undertaken much more rapidly than others. For example, because many infrastructure projects may take years to complete, spending on those projects cannot easily be timed to provide stimulus during recessions, which are typically relatively short lived.

Federal grants to state and local governments are transfers between governments. The transfer itself does not increase demand for goods and services. However, the grant may affect the budgetary decisions of the government receiving the grant, which in turn could stimulate the economy. The federal subsidy would increase demand if it actually led to an increase (or prevented a decrease) in state and local spending or if it triggered a tax reduction (or avoided a tax increase) at the state and local levels. By contrast, if federal assistance merely provides fiscal relief by paying for spending that would have occurred anyway and does not affect state and local revenues in the short run, then it provides no economic stimulus.

Consistency with Long-Run Fiscal Objectives. Because fiscal stimulus boosts aggregate demand through increases in government spending or reductions in taxes, such policies raise budget deficits in the short term. That effect is desirable for short-term stimulus because it reflects the increased demand being delivered to the economy. Contemporaneous changes elsewhere in the budget—tax increases or cuts in spending—designed to offset these short-term deficit effects would serve to reduce or eliminate the stimulative effect.

These higher deficits, however, tend to slow economic growth in the long term if they are allowed to persist, because they tend to reduce capital accumulation and the growth in the economy's capacity to produce. Given the existing projected shortfall of revenues below outlays over the long term, any policy designed to provide short-term fiscal stimulus must reckon with the long-term consequences of making any such spending increase or tax decrease permanent.[13] The more temporary a stimulative policy, the more likely that it will not significantly exacerbate the nation's long-term fiscal imbalance. (Offsetting the cost of those policies with deficit reductions in later years may also be desirable.)

How Much Stimulus Is Appropriate?

The appropriate size of any fiscal stimulus would depend on the goals that policymakers wanted to pursue. One such goal might be to provide sufficient stimulus so that economic forecasts do not project a recession. However, only a few professional forecasters are sufficiently confident in the likelihood of a recession that they have made it their central forecast. If that goal were the test, it appears that no fiscal stimulus would be necessary at this point.

A second goal might be for policymakers to stimulate the economy by enough to reduce the chance of recession to an acceptable value. Most forecasters admit to considerable uncertainty about their projections. Forecasters' perceptions about the probability of recession are substantial. The January 2008 *Blue Chip* survey, for instance, puts that probability just below 40 percent. Recognizing that uncertainty, policymakers might seek to reduce the chance of recession to some acceptable value, say 20 percent. Given the level of uncertainty in the typical year-

13. See Congressional Budget Office, *The Long-Term Budget Outlook* (December 2007). Some evidence also suggests that policies that expand the nation's long-term fiscal imbalance could push up interest rates and thereby offset some of the incipient stimulus. See Douglas W. Elmendorf and David Reifschneider, "Short-Run Effects of Fiscal Policy with Forward-Looking Financial Markets," *National Tax Journal*, vol. 55, no. 3 (September 2002), pp. 357–386.

ahead forecast, the fiscal stimulus to achieve this objective would need to be large enough to add about three-quarters of a percentage point to growth in 2008.

The budgetary cost of such a fiscal stimulus depends on its details. Estimates using econometric models suggest that an assumption that a dollar's worth of stimulus at a time of economic weakness produces roughly a dollar's worth of additional economic activity is about the right order of magnitude. A multiplier of one would imply that to add three-quarters of a percentage point to the growth rate of GDP over a year, it might be necessary to increase the budget deficit for the year by close to three-quarters of 1 percent of GDP, or about $100 billion.[14] It may be possible to improve somewhat on that cost-effectiveness ratio by focusing the stimulus in ways that are most likely to increase consumer or business spending in the short run; it is also possible to spend a great deal more with less impact if the stimulus is poorly designed. The discussion in the following sections focuses in part on the criteria for designing cost-effective and timely stimulus.

A third objective might be to address the sharp drop in economic growth that began at the end of last year. Achieving that goal, however, would require policymakers to act almost immediately. Many forecasters expect that the economy will remain weak through the first half of 2008. The January 2008 *Blue Chip* consensus, for instance, puts growth at about 1.3 percent in the first quarter of 2008 and 1.9 percent in the second quarter (at annual rates). Adding a percentage point to the economic growth rate for the first half of the year would cost only half as much as adding a percentage point to growth for a whole year, but it would also be considerably more challenging to implement a stimulus program that would affect the economy so quickly.

Approaches to Reducing Personal Taxes

Proposals for reducing personal taxes can be classified into two broad categories: a lump-sum rebate of taxes paid or a reduction in taxes that would be realized in smaller amounts over a longer period of time, such as by lower withholding from paychecks. In addition, a decision might be made to alter tax increases that are currently scheduled to occur in the future.

14. These figures do not include any feedback effect from the change in GDP on revenues or spending.

Lump-Sum Rebate

A lump-sum rebate of taxes puts cash directly in consumers' wallets. As a matter of nomenclature, a true rebate is limited to what a household has already paid in taxes. In practice, however, rebates may be larger than the household's tax liability. In those cases, the "rebates" are actually transfers administered through the tax system.

Rebates can be designed and implemented in a variety of ways. For example, they may be the same for all recipients (or subject to a ceiling), or they may vary in amount according to the size of the tax liability. In addition, they may be based on income tax returns or on some other tax, such as payroll taxes.

Linking the size of the rebate to tax liability—such as returning a fixed proportion of taxes paid—substantially reduces the cost-effectiveness of the stimulus. It would place much of the government's revenue loss in the hands of households likely to save much of the rebate. Fixing the rebate's size or setting a relatively low maximum amount per household or person would concentrate more of the aggregate cut among lower-income households, who are more likely to be up against credit constraints and thus to spend any additional resources. Making the rebate refundable would further boost the cost-effectiveness of the stimulus.

To the extent that the rebate depends on incurring tax liability, the choice of tax base is significant as well. A rebate based on income tax liability would, for instance, reach fewer families likely to spend it than a rebate based on payroll tax liability. A large number of lower-income families incur no income tax, and many others pay more in payroll taxes than income taxes. As a result, their income tax liability alone may be insufficient to be eligible for the full rebate even though their payroll tax liability is. (Of more than 134 million returns filed in 2005, for example, 26 million were from households that paid more than $500 in payroll taxes but paid less than $500 in income tax liability.)

Rebates based on income tax information could be relatively straightforward to administer. Through the tax-filing process, the Internal Revenue Service (IRS) has readily accessible information on the income tax liability of each household that files a return. That information enables the IRS to calculate the size of a rebate and send it to addresses (or, frequently, deposit it directly into bank accounts) that have been recently updated. The rebates

issued in 2001 were issued relatively quickly and with few hitches.

One way to provide more rebate money to low-income families would be to issue refundable income tax rebates. A rebate of a fixed size would be distributed to all households who filed returns, regardless of the size of the underlying tax liability. Such a rebate would still be based on data from income tax returns and would thereby avoid potential administrative problems with a rebate based on the payroll tax. It could, without too much difficulty, be restricted to returns that reported some labor income, or to filers who cannot be declared a dependent on someone else's return. A refundable rebate would place money in the hands of a substantial number of households that otherwise would not have been eligible to receive the rebate (or to receive the entire potential rebate). The number of households added in this way would significantly outnumber those that are still missed because they do not file income tax returns. (To reach those households, it would be necessary to base the rebate on W-2s rather than returns, which is administratively a somewhat more complicated task.)

The timing of the delivery of the rebates to households would partly depend on the details. Because it is currently tax filing season and the IRS is currently processing returns, it may not be possible to issue tax rebates based on 2007 returns until toward the end of the second quarter of 2008 at the earliest. Basing the rebates on 2006 tax returns could speed the initiation of the process but would increase the number of recipients whose addresses and circumstances have changed. In addition, the process of sending checks out takes time. In 2001, it took about 10 weeks to issue all the rebates, and a similar delivery time should be expected now, although a larger proportion of them might be delivered more quickly via direct deposit.

Most studies of purely temporary, one-time changes in taxes have suggested that they have only a moderate effect on household consumption. Theory predicts that households not facing liquidity constraints will not alter consumption very much in response to a temporary change in income because it has a relatively small effect on lifetime wealth. For example, studies of the 1975 rebate (and earlier tax changes) suggested that only 12 percent to 24 percent of the rebate was consumed in the quarter that it was received.[15]

The experience of the 2001 tax rebate appears to differ from the findings of these earlier studies, although the 2001 rebates did not represent a one-time reduction in taxes, and therefore the experience with them may not be fully applicable to a truly temporary rebate. The 2001 rebate stemmed from provisions of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001, which reduced the lowest tax bracket from 15 percent to 10 percent, among other things. Although EGTRRA was signed into law in June 2001, the change in the lowest tax rate was applied retroactively to income that was earned from the beginning of 2001. (The rebate amount was based on each tax filer's 2000 return.) The rebate was essentially an advance credit for the reduction of taxes in 2001 and represented an early lump-sum payment of amounts that otherwise would have been accounted for through reduced withholding in 2001 or increased refunds in 2002. Under EGTRRA, the reduced tax bracket corresponding to the rebate was scheduled to remain at 10 percent through 2010, so although the rebate was a one-time payment, it did not represent a one-time reduction in taxes. Most households received rebate checks of either $300 or $600 over a 10-week period from late July 2001 to the end of September 2001. The economy was in recession during this period: the peak of the expansion was March 2001, and the trough, November 2001.

Most analysts agree that the 2001 rebate stimulated the economy, although there is some debate about the magnitude of the effect. Consumption did jump sharply in the following quarter (see Figure 2); however, because longer-lasting tax cuts were announced at the same time, it takes careful research to tease out the effect of the rebate. One widely cited study relied on quarterly data from the Consumer Expenditure Survey to provide estimates of the average propensity to consume the 2001 tax rebate.[16] The study's authors estimated that households spent between 20 percent and 40 percent of their rebate

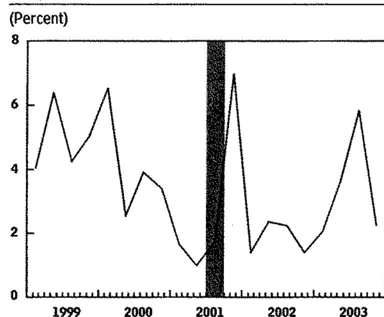
15. Alan Blinder, "Temporary Income Taxes and Consumer Spending," *Journal of Political Economy*, vol. 89, no. 1 (February 1981), pp. 26–53; Franco Modigliani and Charles Steindel, "Is a Tax Rebate an Effective Tool for Stabilization Policy?" *Brookings Papers on Economic Activity*, no. 1 (1977), pp. 175–209; James Poterba, "Are Consumers Forward Looking? Evidence from Fiscal Experiments," *American Economic Review*, vol. 78, no. 2 (May 1988), pp. 413–418.

16. Johnson, Parker, and Souleles, "Household Expenditure and the Income Tax Rebates of 2001."

Figure 2.

Growth of Real Personal Consumption Expenditures

(Percent)



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Note: Rates reflect quarter-to-quarter annualized growth. The shaded area indicates the months in which the 2001 tax rebates were distributed. Data are plotted through the fourth quarter of 2003.

amount in the quarter in which the rebate was received and about two-thirds of the rebate cumulatively by the end of the subsequent quarter. According to the study, the rebate increased total consumption by about 0.8 percent in the quarter that the rebates were received and by about 0.6 percent in the subsequent quarter. The authors also found strong evidence that households that were young, had low income, or held few liquid assets consumed a substantially larger fraction of the rebate than did households that were older, had high income, or had large holdings of liquid assets.

Researchers using credit card data to examine the effects of the 2001 rebate on consumption found a similar impact.[17] Households' credit card debt immediately dropped upon receipt of the 2001 rebate. However, subsequent credit card spending rose. The researchers have access to data on the primary credit card for only a subset of cardholders, but among those households, spending increased by $200, or about 40 percent of the rebate on average. The study also found that consumption rose the most for consumers who were likely to be credit constrained. By contrast, unconstrained consumers responded to the rebate by paying down their debt (which increases saving).

By contrast, another study based on a survey of households found that only about 22 percent of them felt that the rebate would lead them to "mostly increase spending," as opposed to mostly saving it or paying down debt.[18] However, because that study did not include quantitative estimates of the impact on consumption, it is difficult to compare it with the two studies mentioned above. On balance, it appears that the 2001 rebate may have had a greater effect on the economy than earlier, purely temporary rebates or surcharges.

Temporary Tax Reduction

A variety of approaches have been suggested for reducing tax rates. Those approaches include temporary across-the-board cuts in income tax rates and a "payroll tax holiday" that would cancel employee payroll tax withholding during a specific interval. One general advantage of such proposals is that they increase weekly take-home pay, which tends to be spent somewhat more readily than lump-sum rebates. But other considerations can make them less effective in other respects.

Across-the-board reductions in income tax rates have the disadvantage of placing much more of the tax reduction in the hands of upper-income taxpayers, who, although they have a much larger tax liability, are less likely to spend the additional money. A payroll tax holiday that applied to the employees' share of the tax would have the advantage of directing more of the reduction to households more likely to spend it, even reaching taxpayers who could not qualify for a rebate on the basis of income tax returns. A holiday for the employers' share of that tax would have a very different effect. Suspending the employers' portion of the tax for a short period of time is unlikely to alter wage rates by very much and so would not alter consumers' resources very much. Its effects would be somewhat like those of a temporary reduction in the corporate tax, discussed below.

17. Agarwal, Liu, and Souleles, *The Reaction of Consumer Spending and Debt to Tax Rebates.*

18. Matthew D. Shapiro and Joel Slemrod, "Consumer Response to Tax Rebates," *American Economic Review*, vol. 93, no. 1 (March 2003), pp. 381–396.

Any rate reduction aimed at lowering tax withholding for a specific interval is likely to face greater administrative difficulties than changing withholding tables for the entire tax year. In general, tax withholding tables can be changed relatively easily, but any change in withholding takes time for employers—especially smaller ones—to implement. Turning withholding on and off introduces more opportunity for error, and significant penalties can attend the failure to remit the proper amount of payroll taxes. Consequently, payroll administrators may take greater time in ensuring that payroll tax changes are undertaken properly.

Another disadvantage of the holiday approach is that only workers employed at the time of the holiday would receive the benefit; even if they had been employed for the previous 11 months, they would receive nothing if they were unemployed for the month of the tax reduction. Workers who have already reached the taxable maximum for Social Security taxes would also be differentially affected, although that could help boost the cost-effectiveness of the policy. And the holiday option might encourage some firms to alter the timing of certain compensation in order to maximize the benefit for their workers. Modifications to the proposal to deal with some of these issues could delay its implementation.

Deferring or Eliminating Scheduled Tax Increases

A number of taxpayers are currently scheduled to pay higher taxes on their 2008 income because of the alternative minimum tax (AMT). Although temporary "patches" have been enacted over the past several years that provide higher exemption levels under the AMT and thereby postpone this increase, the most recent extension applies only to the 2007 tax year. In addition, provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003 are scheduled to expire at the end of 2010. If taxes are not to be reduced from their current levels to provide stimulus, it may be desirable during a period of economic weakness to avoid tax increases that tend to dampen demand.

Whatever the long-term effects on work incentives and investment, permanently extending EGTRRA or JGTRRA after 2010 is unlikely to provide much demand stimulus to the economy in 2008. Some taxpayers may be consuming less now in anticipation of the scheduled tax changes in 2011. If so, removing the expectation of future higher taxes could cause taxpayers to boost current spending. However, extending the current lower rates would probably not boost spending in the short run to any noticeable degree for various reasons. For example, to the extent that sophisticated taxpayers take prospective future tax rate changes in 2011 into account in their current spending habits, they may also be taking into account the imbalance between current tax rates and projected government spending. That notion suggests that extending the current rates may not significantly alter taxpayers' expectation of the possibility of higher taxes at some point in the future, thereby attenuating any effect on current spending.

Another effect of permanently extending the tax provisions enacted in 2001 and 2003 would be to keep lower tax rates in place for businesses that do not pay the corporate income tax. The income of businesses such as sole proprietorships, partnerships, corporations organized under subchapter S, or limited liability companies is not taxed at the entity level but rather passes through to the owners, partners, or shareholders, where it is taxed as individual income. These so called "pass-through" entities earned about half of net business income in 2004.[19] Even though the certainty of permanently extended lower tax rates could provide some added investment incentives to these pass-through business entities and increase the after-tax return on their investments, those incentives would probably not result in any significant short-term economic stimulus.[20]

Because the expiration of the AMT is closer at hand, there is greater likelihood that extending the patch will have near-term effects on demand than extension of EGTTRA or JGTRRA. Although the AMT is primarily aimed at higher-income taxpayers and such taxpayers receive the bulk of the benefit from AMT relief, the reach of the tax without the patch does extend lower into the

19. See Department of the Treasury, Treasury Conference on Business Taxation and Global Competitiveness, Background Paper, July 23, 2007, Table 3.1, p. 13.

20. For example, permanently extending the 2001 and 2003 tax provisions would have little effect on short-term investments that disproportionately pay off before the lower rates expire after 2010. Many pass-through entities also qualify for special tax benefits for small businesses, such as the Section 179 expensing rules, which allow small businesses to write off (expense) up to $125,000 of the cost of qualified new investment each year. The higher expensing limits expire after 2010; permanently extending those limits might cause businesses to delay investment that they would have undertaken sooner.

income distribution and can be expected to adversely affect consumption demand at least somewhat. To the extent that taxpayers expect that the patch would not be extended again, fixing the AMT for another year could boost consumer demand in 2008 as taxpayers avoid having to adjust withholding and estimated tax payments in calendar year 2008 to reduce what they will have to pay with their tax returns in 2009. More likely, though, any impact from a new patch would not be experienced until the beginning of 2009.

Approaches to Providing Incentives for Businesses

Tax cuts for businesses may also take two forms. They may be general, such as reducing the corporate tax rate, or they may apply only to new investment, such as the investment tax credit. That distinction materially influences the effectiveness of the proposed approaches. Although a general business tax cut may leave a corporation with higher cash flow, which can affect investment decisions in some cases, its stimulative effect comes principally from how much it increases the attractiveness of new investment. Because a general tax cut applies to income generated from a firm's productive assets regardless of when they are placed in service, only part of the cut affects a firm's decision to undertake new investment.

Even business tax reductions focused on new investment, however, may have only a limited effect on decisions to invest. For one thing, they may apply to investment that would have been undertaken anyway. In addition, like general business tax cuts, their stimulative effect depends on firms' having tax liability in the first place; without such liability, tax cuts generate no cost reductions for firms. The portion of investment by firms with no tax liability varies, but it is significant. By one measure, the share of investment among firms subject to the corporate income tax ranged over the past few years from a little less than 30 percent to more than 45 percent. Moreover, the efficacy of some types of investment stimulus (such as accelerated depreciation) may be muted by the corporate alternative minimum tax, which can effectively undo cuts in regular corporate taxes.

Policymakers have several options for countering these drawbacks. Making incentives incremental by limiting them to investment above a certain amount could help focus them more narrowly on additional investment. However, past attempts to design incremental tax incentives have not been especially successful, perhaps because of their complexity. More firms might respond to investment incentives if the incentives were refundable or if the period over which firms could carry back the value of the tax benefit and apply it against profits in earlier years was lengthened. (The current carryback period is two years; the current carryforward time is 20 years.) And the corporate AMT could be modified to make other incentives more effective.

Cut in Corporate Tax Rates

The most common form of a general cut in business taxes is a reduction in the corporate tax rate. This approach, however, is not a particularly cost-effective method of stimulating business spending: Increasing the after-tax income of businesses typically does not create an incentive for them to spend more on labor or to produce more, because production depends on the ability to sell output.

But because taxes on business income essentially lower the return that firms earn from capital investment, reducing such taxes can increase firms' willingness to acquire more capital—that is, to invest. As a result, the principal influence of taxes on a firm's decision about investing depends on the prospective profits from its new investments, not on current profits made from old investments. However, a substantial effect of reducing current corporate tax rates is to increase the returns from past investments rather than increase the attractiveness of new investments.

Secondary effects on investment demand may arise from the impact of taxes on a firm's cash flow. Some firms cannot readily borrow to make their investments; others may face relatively high interest rates in borrowing. Because taxes reduce cash flow, they limit the amount of investment that such firms might undertake. Reducing taxes can improve cash flow and thus boost investment. Some researchers have found that, within manufacturing, more than 90 percent of investment is done by firms facing only relatively mild financial constraints.[21] Even so, the constraints on those firms, according to one estimate, are important enough that each dollar of additional cash flow produces about 24 cents of additional investment. However, other authors have suggested that this estimate of the effect of cash flow is significantly overstated because

21. Stephen M. Fazzari, R. Glenn Hubbard, and Bruce C. Petersen, "Financing Constraints and Corporate Investment," *Brookings Papers on Economic Activity,* no. 1 (1988), pp. 141–206.

of measurement error.[22] The effects of taxes on investment that stem from their impact on cash flow are generally believed to be weaker, dollar for dollar, than those that stem from the direct effects of taxes on the cost of capital.

Consequently, a general cut in business tax rates will tend to generate significantly less investment demand for each dollar of revenue than a cut that applies only to new investment. A cut in corporate rates is also less effective because it does not apply to businesses that are not subject to the corporate tax (sole proprietorships, partnerships, and corporations organized under subchapter S). Business entities not subject to the corporate income tax earned about half of net business income in 2004. Thus, tax stimulus that applied only to corporations would be less broadly applicable than stimulus that applied to all businesses—for example, through accelerated depreciation, expensing, and investment tax credits. Finally, a *temporary* reduction in corporate tax rates could encourage some firms to delay investment, because the value of being able to depreciate investments is higher when corporate tax rates are higher.

Incentives for New Investment

Taxes on new investment can be reduced by means of accelerating depreciation or expensing new investment, or with an investment tax credit (ITC). The first two encourage investment by helping to postpone a business's tax liability when it invests in additional plant and equipment. Taxpayers benefit from any mechanism that defers tax liability, so deferral makes that investment more attractive. An investment tax credit permits a firm to reduce its tax liability in a given tax year by a percentage of the qualifying investment it places into service during that year. The effect on the attractiveness of new investment is much the same as in the other two options. Questions have also been raised about the ability of capital goods production to respond to additional demands in the short run, a shortcoming the ITC would share with other investment incentives.[23]

Depreciation and Expensing. Determining taxable income requires subtracting expenses, most of which are outlays made during the tax year, from receipts. But outlays for capital investment during the year are not a current expense; rather, the corresponding expense is the value of the capital that is used up, or depreciated, during that year. Actual economic depreciation and depreciation allowed for tax purposes may differ, however. When depreciation reported for tax purposes is faster than actual economic depreciation, it is said to be accelerated. Accelerated depreciation is an advantage to firms because it reduces their reported taxable income in the near term, pushing it below their actual economic income.

The extreme case of accelerating depreciation is allowing the entire cost of an investment to be deducted as an expense in the year it is made. Under current law, expensing is generally aimed at small businesses. Currently, businesses can expense up to $125,000 for the cost of equipment placed in service in that year. However, those deductions are reduced by the amount that the firm's total qualifying investment expenditures exceed $500,000.

In the early 2000s, policymakers expanded the depreciation rules to provide partial, but temporary, expensing of a number of capital assets, most of which had a depreciable life of 20 years or less. In 2002, the Jobs Creation and Workers Assistance Act allowed businesses to expense up to 30 percent of qualified investments purchased between September 10, 2001, and September 11, 2004 (and placed in service before January 1, 2005). The Jobs and Growth Tax Relief Reconciliation Act of 2003 increased the deduction to 50 percent of qualified investments purchased after May 5, 2003, and before January 1, 2005. The provisions for partial expensing expired on January 1, 2005.

When these laws were enacted, many analysts expected that the partial-expensing provisions would provide a large and effective stimulus. However, subsequent evidence suggests that their impact on investment has been

22. Timothy Erickson and Toni M. Whited, "Measurement Error and the Relationship Between Investment and *q*," *Journal of Political Economy*, vol. 108, no. 5 (2000); Steven N. Kaplan and Luigi Zingales, "Do Investment-Cash Flow Sensitivities Provide Useful Measures of Financing Constraints?" *Quarterly Journal of Economics*, vol. 112, no. 1 (1997), pp. 169–215.

23. Austan Goolsbee, "Investment Tax Incentives, Prices, and the Supply of Capital Goods," *Quarterly Journal of Economics*, vol. 113, no. 1 (February 1998), pp. 121–148.

relatively modest.[24] Researchers have used two features of the policy to estimate its effect on investment. First, certain types of assets qualified for partial expensing, but other types of assets did not. By comparing firms' investment decisions in the two classes of assets, researchers can identify the amount by which the tax subsidy increased investment. Second, the expectation that the policy would expire should have created incentives for firms to increase their investment before the expiration date but reduce it after that date. Examining the timing of investment decisions around the expiration date is another way that researchers can infer the impact of partial expensing.

Estimates suggest that the total effect of partial expensing on business activity has been modest. One study found that it increased output by only 0.1 percent to 0.2 percent and increased employment by only 100,000 to 200,000 jobs.[25] Another study also suggested very modest effects.[26] Although research on partial expensing suggests that it may have encouraged more investment in capital assets that qualified for the tax subsidy than in assets that did not qualify, finding solid evidence showing that it affected the timing of investment around the expiration date has been difficult, and the evidence on whether it disproportionately affected the type of investment most subsidized is mixed. The overall small effect may be due to expectations that the provisions would be extended or to circumstances that are largely unique to business conditions in the last contraction. It may also reflect the fact that some investment projects involve long planning lags, extending well beyond a year or more. In any case, the experience has made many analysts less sanguine about the efficacy of such business tax incentives.

24. See Darrel S. Cohen and Jason Cummins, "A Retrospective Evaluation of the Effects of Temporary Partial Expensing," Federal Reserve Board, Finance and Economics Discussion Series Working Paper No. 2006-19 (April 2006); Christopher House and Matthew Shapiro, *Temporary Investment Tax Incentives: Theory with Evidence from Bonus Depreciation,* NBER Working Paper 12514 (Cambridge, Mass.: National Bureau of Economic Research, September 2006); Matthew Knittel, "Taxpayer Response to Partial Expensing: Do Investment Incentives Work as Intended?" Department of Treasury Working Paper (2005); and Matthew Knittel, "Small Business Utilization of Accelerated Tax Depreciation: Section 179 Expensing and Bonus Depreciation." Department of Treasury Working Paper (2005).

25. House and Shapiro, *Temporary Investment Tax Incentives.*

26. Cohen and Cummins, "A Retrospective Evaluation of the Effects of Temporary Partial Expensing."

Investment Tax Credit. The ITC provides incentives that are similar to those of accelerated depreciation and expensing. Like them, it increases the after-tax return on investment by reducing the present value of taxes on the income the investment generates, and it increases the after-tax cash flow immediately realized by the firm that does the investing. There are several differences, however. First, an incremental ITC—one that applied only to investment above a specific base level—would generally be easier to design than incremental versions of the other investment incentives. Second, an ITC has a much greater differential effect on short- and long-lived investments; that is, a given credit would increase the after-tax return on short-lived investments much more than on longer-lived ones. Finally, in general, an ITC would have little or no effect on the revenues of state governments compared with accelerated depreciation or expensing.

The ITC was part of the tax code from 1962 through 1985. In general, firms were permitted to offset as much as 50 percent to 90 percent of their tax liability with the credit. Before the ITC was repealed in 1986, firms received credits at a rate of 10 percent on qualifying equipment purchases. The ITC was also complex, and not all investment qualified. Furthermore, the limitations placed on its scope created a variety of legal ambiguities regarding its application. Several analyses indicate that the ITC, as it was applied in the past, was not successful as a tool for stabilizing the economy.[27] This has partly been due to its timing. In addition, over much of its existence, the ITC was permanent; that is, it had no specific expiration date. Given the relative permanence of the ITC in its earlier incarnation, persuading businesses that it is temporary might be difficult, which in turn could undercut its effectiveness.

Incentives for new investment do not have to be general. Restricting the incentive to certain business segments is also possible; it can be done on the basis of the nature of the investment, such as by providing incentives to invest in ethanol production or other energy-related projects. It may also be done on the basis of the nature of the firm, by limiting incentives to small businesses, for example. As a general rule, however, these kinds of restrictions tend to reduce the effectiveness of the incentive. For example, incentives to invest in new energy production tend not to

27. See Alan J. Auerbach and Kevin A. Hassett, "Tax Policy and Business Fixed Investment," *Journal of Public Economics,* vol 47, no. 2 (1992), pp. 141–170.

generate much short-term demand. Most business investment has a long lead time. The main effect of investment incentives designed to boost demand, therefore, comes from accelerating investment that was already planned. As a general rule, the investments that can take advantage of the incentive are those on the shelf, not new projects.

Smaller businesses are currently eligible to expense qualifying investment up to an amount of $125,000. Under current law, this ceiling will fall to $25,000 in 2010. Proposals have been advanced in the past to raise the ceiling and make it permanent. Extending the current ceiling could, if anything, reduce incentives to invest in the nearer term, because it would mean that firms could wait to invest to take advantage of the incentive. A higher ceiling would increase the incentive somewhat, but the increase would affect demand only among smaller firms. Moreover, small firms are probably less aware of and responsive to tax incentives than larger firms that pay close attention to the tax consequences of their decisions.

Finally, investment incentives may be designed to be incremental. One of the biggest shortcomings of investment incentives is that although they may apply only to new investment, they still may accrue to new investment that would have been made anyway. Consequently, the cost-effectiveness of the stimulus is undercut because the tax reductions apply to all new investment, but the fiscal stimulus comes only from that which has been undertaken in response to the incentive.

Some proposals have been advanced to make the incentive apply only to investment above a certain baseline amount. Though conceptually appealing, this approach introduces an additional level of complexity. Moreover, it may not be very effective. The existing credit for research and experimentation is incremental. Problems with it have required changing the design. Some analysts conclude that incremental incentives are not practical.[28]

Operating Losses and Carryback Provisions

Whether in the presence of new investment incentives or just as a stand-alone policy, investment demand can also be influenced by provisions in the tax code regarding the use of net operating losses (NOLs) in other tax years. A firm that is losing money does not incur tax liability. Because more firms incur losses when the economy slows, they are therefore less able to reap the tax deductions associated with new investment. Depreciation—accelerated or otherwise—does not reduce tax liability until there are gross profits from which to deduct it. The lack of tax liability therefore reduces the after-tax return on the investment. The tax code permits firms to carry back their losses to previous years and reclaim taxes previously paid. The carryback provision not only increases the after-tax return on the investment but also increases cash flow. But the carryback is limited to two years. Any remaining net operating losses may be carried forward for 20 years.

Extending the carryback period beyond two years could increase the incentive to invest (or, more accurately, ameliorate the reduction in the incentive caused by the economy's effect on after-tax returns). It would also increase cash flow to firms that might be especially constrained in borrowing, which could boost investment. The length of carrybacks and carryovers may be more of a long-term issue than one of stimulus policy, however. By themselves, carryback and carryover effects are unlikely to generate substantial changes in investment in the short run. They can, though, be more important in the short run as a complement to such investment incentives as accelerated depreciation or an investment tax credit, so that money-losing firms receive the full benefit of those incentives.

Spending Proposals

Increasing government spending could also stimulate the economy in the short term, although the degree of stimulus and its timing varies considerably among different types of spending. Spending proposals can be classified in two broad categories: transfer payments to households, such as unemployment insurance benefits and Food Stamps, and government purchases of goods and services, such as public works programs.

Direct Transfer Payments to Households

Direct transfer payments to households are, in terms of stimulating demand, essentially indistinguishable in principle from personal tax cuts. All of the same characteristics that make such tax cuts effective or ineffective also apply to transfers. More disposable income in the hands of consumers can be expected to increase demand. Because many transfer programs are currently targeted toward lower-income families, increases in the benefits the programs pay are likely to be spent and therefore pro-

28. See Jane Gravelle, *Incremental Investment Credits*, CRS Report for Congress 93-209 S (Congressional Research Service, February 1993).

vide a relatively effective fiscal stimulus. Possible policy changes could include extending or expanding unemployment benefits and temporarily increasing Food Stamp benefits.

Unemployment Benefits. The unemployment insurance (UI) program provides temporary income support to workers who lose their jobs. In most states, eligible unemployed workers can receive up to 26 weeks of benefits that are funded by the states through payroll taxes on employers. A second level of benefits is available in states with especially high unemployment. UI recipients in those states can receive up to 13 additional weeks of benefits under the federal/state extended benefit program, which is financed equally by federal and state payroll taxes. CBO does not anticipate that many unemployed workers who exhaust their entitlement to regular benefits will be in states that will have met the criteria for triggering the extended benefit program in 2008.

One approach would be to enact a temporary increase in the maximum duration of UI benefits, as was done in previous downturns. For example, in March 2002, the Congress enacted the Temporary Extended Unemployment Compensation program, which provided up to 13 weeks of additional UI benefits to unemployed workers who had exhausted their entitlement to regular UI benefits and an additional 13 weeks in states with especially high unemployment. That program, which was amended several times, provided benefits to unemployed workers totaling roughly $1 billion per month during its two-year life.

A new program to extend unemployment insurance to those who exhaust their regular benefits could cost about $1 billion to $2 billion per month, depending on the number of additional weeks provided. Based on CBO's analyses of the family income of long-term UI recipients in previous periods, it seems likely that recipients would quickly spend most of those benefits. For example, an examination of the experiences of long-term UI recipients in 2001 and early 2002 who had not found work soon after their benefits ended—that is, the people for whom extensions of UI benefits are intended—indicated that their average family income was about half of what it had been when they were working. Moreover, more than one-third of the former recipients who had not returned to work had a family income below the poverty line (measured on a monthly basis), and about 40 percent lacked health insurance.[29]

Other options to temporarily expand UI benefits could involve changes in benefit levels and eligibility rules. For example, UI benefit levels vary across states, but the federal government could fund a temporary increase in UI benefit levels across all states. Another possibility includes temporary expansions in eligibility for UI, with the additional beneficiaries financed by the federal government. Such expansions might include use of more recent work histories of unemployed workers to establish eligibility and coverage of part-time job seekers who were laid off from part-time jobs.[30] Because these options would also tend to boost income among families very likely to spend most of the additional money rapidly, the options would be relatively cost-effective.

The availability and size of UI benefits may, however, somewhat discourage recipients from searching for work and from accepting less desirable jobs. Extending the duration of benefits or increasing their size means that at least some recipients may remain unemployed longer than they would have without that aid.[31] The effect is probably most pronounced when jobless rates are relatively low; when joblessness is high and work is especially hard to find, extensions of UI benefits appear to lengthen spells of unemployment by a smaller amount.

Food Stamps. Another approach would be to temporarily increase Food Stamp benefits for households already receiving them. In general, to be eligible for Food Stamp benefits an applicant's monthly household income must

29. Congressional Budget Office, *Family Income of Unemployment Insurance Recipients* (March 2004), pp. 1–3.

30. Most states determine an applicant's eligibility for benefits on the basis of their work during the first four of the last five completed calendar quarters before the claim is made, although several states include the most recent quarter for workers who would not otherwise qualify for benefits. Many states require workers to be available for full-time work to qualify even if the job lost was a part-time job.

31. A rough rule of thumb is that making benefits available to all regular UI recipients for an additional 13 weeks increases their average duration of unemployment by about two weeks and that increasing UI benefit levels by 10 percent increases the average duration of unemployment by about one week. Those estimates are based on surveys of the relevant literature, reported in Stephen A. Woodbury and Murray A. Rubin, "The Duration of Benefits," and Paul T. Decker, "Work Incentives and Disincentives," in Christopher J. O'Leary and Stephen A. Wandner, eds., *Unemployment Insurance in the United States: Analysis of Policy Issues* (Kalamazoo, Mich.: W.E. Upjohn Institute for Employment Research, 1997), pp. 211–320.

be at or below 130 percent of the poverty guideline (currently $2,238 for a family of four in the contiguous United States), and countable assets must be less than $2,000. Once eligibility has been determined, the amount of the monthly Food Stamp benefit is calculated. A household is expected to contribute 30 percent of its net income (gross income minus deductions for certain expenses) toward food expenditures. In 2008, the maximum amount that an eligible four-person household with no income in the contiguous United States can receive is $542 per month.

During fiscal year 2006, approximately 27 million people received Food Stamp benefits each month. Nearly all benefits went to the 87 percent of Food Stamp households that were in poverty. Over half of all benefits went to the 39 percent of Food Stamp households whose income was less than or equal to half of the poverty line. The vast majority of Food Stamp benefits are spent extremely rapidly. And because Food Stamp recipients have low income and few assets, most of any additional benefits would probably be spent quickly.

Aid to State and Local Governments

During downturns, state and local governments experience a reduction in revenues resulting from the effect of lower economic activity on sales, income, and other tax bases. Unlike the federal government, which can freely borrow to finance its fiscal shortfall and faces no requirement to balance its budget, these entities have to reduce spending and increase taxes (or some combination of both) to address the resulting fiscal problem. Consequently, the behavior of state and local governments often serves to reduce aggregate demand further.

Recent evidence indicates that many states respond relatively quickly to a downturn in the economy, even if it occurs after their budgets have been enacted for the year. Although states generally wait until their normal legislative sessions before raising taxes in response to a weak economy, most governors have administrative authority to cut spending if revenues fall, and many of them have used those powers in the past. During the last recession, for example, 37 states reduced their spending by a total of $13 billion (about 2.6 percent of total expenditures) between July 2001 and June 2002, after their budgets had been passed.[32]

One option for giving federal aid to state governments during an economic downturn is to temporarily increase the federal matching rate for the Medicaid program. Medicaid is a joint federal/state program that pays for health care services for a variety of low-income individuals. In 2007, the federal government spent $172 billion on benefit payments under Medicaid, and states spent $128 billion. The federal government's share of spending on the program is determined by a statutory formula that sets the matching rate for each state at no lower than 50 percent and no higher than 83 percent (according to a formula based on each state's per capita income relative to the national average). The current federal matching rates average 57 percent nationwide and vary across states from 50 percent to 76 percent. A temporary increase in the federal matching rate for Medicaid would reduce the amount of funding that states needed to spend on Medicaid to provide the same level of Medicaid services.

To ease budgetary pressures facing the states in 2003, the Congress passed legislation that temporarily increased each state's federal matching rate for Medicaid by 2.95 percentage points: CBO estimated the cost of the higher matching rates, which remained in effect for five quarters, at $10 billion. That legislation also provided the states with $10 billion in grants that they could use for specified purposes. To receive the higher matching rate, states were not permitted to lower their eligibility thresholds. More than half of the states reported that the increased matching rates enabled them to avoid or delay making cuts—or to make smaller cuts—to their Medicaid program.[33]

In general, the extent to which federal aid to state and local governments helps arrest the decline in demand depends on the degree to which those governments alter their behavior. If they cut spending less or raise taxes less as a result of federal aid, the policy will help keep demand from falling as much in the economy. The cost-effectiveness of federal aid to states and localities will also depend on exactly how the recipients use the aid. Policies can have very different effects on the economy, and the principles of an effective federal stimulus that were discussed earlier generally apply to stimulus carried out by states and localities as well.

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32. National Association of State Budget Officers, *The Fiscal Survey of States* (November 2002).

33. Kaiser Commission on Medicaid and the Uninsured, "Financing the Medicaid Program: The Impact of Federal Fiscal Relief," April 2004, available at www.kff.org/medicaid/7073.cfm.

The cost-effectiveness of the aid could also depend on how it is distributed geographically and on whether the aid is accompanied by maintenance-of-effort requirements. Recessions tend to have uneven effects across the country. Some states may be in deep recessions, while other states may still be growing at a comparatively healthy pace. Additional federal aid to states that are facing fiscal pressures or are already in recession would probably stimulate the economy. However, federal aid to states whose budgets are relatively healthy may provide little stimulus, especially if those states use the aid to build up their "rainy-day" funds instead of increasing spending or reducing taxes.

Public Works Projects

In addition to stimulating firms' investment in plant and equipment, the government can invest in capital itself as a means of boosting demand. Federal, state, and local governments are responsible for large swaths of the economy's capital stock, which includes ports, bridges, and roads. Those responsibilities also include various forms of reconstruction, such as in areas badly damaged by natural disasters. Proposals also exist for large-scale government investment in new technologies, such as new-generation power plants, facilities that produce alternative fuels, and automobiles that use alternative fuels.

Conceptually, spending on these kinds of projects seems to offer an appealing way to counteract an economic downturn and has the potential to enhance long-term economic growth. Because these projects are capital projects, their timing can be flexible. When demand is not sufficient to fully employ productive resources in the economy, a backlog of such projects is available that can employ workers and use capital. If those resources were indeed not being used fully, the social cost of the projects could be substantially reduced.

Practically speaking, however, public works involve long start-up lags. Large-scale construction projects of any type require years of planning and preparation. Even those that are "on the shelf" generally cannot be undertaken quickly enough to provide timely stimulus to the economy. For major infrastructure projects supported by the federal government, such as highway construction and activities of the Army Corps of Engineers, initial outlays usually total less than 25 percent of the funding provided in a given year. For large projects, the initial rate of spending can be significantly lower than 25 percent.

Some of the candidates for public works, such as grant-funded initiatives to develop alternative energy sources, are totally impractical for countercyclical policy, regardless of whatever other merits they may have. In general, many if not most of these projects could end up making the economic situation worse because they would stimulate the economy at the time that expansion was already well under way.

Assessing Different Types of Fiscal Stimulus

The foregoing discussion of various proposals for fiscal stimulus suggests three main criteria for comparisons between proposals:

- Are the proposals likely to be cost-effective, in the sense that they produce a significant amount of stimulus relative to their budgetary cost?
- Are they likely to be timely, in the sense that once the decision is made, they would produce stimulus quickly?
- How uncertain are the economic effects of the proposals?

Another important consideration is whether implementation of the proposals would involve significant administrative difficulties.

CBO has summarized the impact of the major stimulus alternatives according to those three criteria (see Table 1). Those comparisons cannot be made with any precision, however. For that reason, in Table 1 CBO has indicated the characteristics of the various options with general terms. Any administrative issues are discussed in the "Comments" column of that table.

Proposals for Home Mortgage Markets

Because problems in the housing and home mortgage markets have contributed to weaker economic activity and concerns about a recession, some current actions and proposals to address economic weakness are tied

Table 1.

Characteristics of Various Policies as Short-Term Economic Stimulus

Policy	Cost-Effectiveness[a]	Length of Lag from Enactment to Stimulus[b]	Uncertainty About Policy's Effects	Comments
			Individual Tax Proposals	
Lump-Sum Rebate	Large	Medium	Large	A rebate is generally likely to be more effective the more it is focused on people who are likely to spend it. A rebate whose size increases for people with larger tax liabilities is likely to be less effective than a uniform refundable one. Experience is mixed with respect to effectiveness, introducing some uncertainty about the rebate's effect. Processing and mailing the rebate checks would take some time.
Temporary Tax Reductions				
Withholding Holiday for the Employee Payroll Tax	Large	Medium	Large	Some evidence suggests that consumers spend more of a dollar rise in take-home pay than of a dollar rebate. But a brief holiday, such as a month, might be viewed the same as a rebate, which could reduce the stimulus. Particularly complex variants may introduce some delays in implementation. Applying a holiday to the employer side of the payroll tax is unlikely to be cost-effective.
Across-the-Board Tax Rate Cut	Small	Short	Small	Much of the tax reduction goes to upper-income people, who are less likely to spend it.
Deferring or Eliminating Scheduled Tax Increases				
Extending the AMT Patch	Medium	Long	Medium	Taxpayers may expect, on the basis of experience, that the patch will be extended, so failure to extend it may weaken consumption. However, affected taxpayers are likely to be in upper-income groups and therefore are not likely to change their spending much in response to a temporary delay of higher taxes. In addition, they may not know they are affected—in which case the growing AMT liability will not affect their behavior in 2008.
Deferring or Eliminating Tax Rate Increases Under EGTRRA or JGTRRA	Small	Long	Small	Whatever its long-term effects on work incentives and investment, changing the schedule of tax rates in 2011 and beyond is unlikely to have much effect on short-term demand in 2008.

Continued

Table 1.

Continued

Policy	Cost-Effectiveness[a]	Length of Lag from Enactment to Stimulus[b]	Uncertainty about Policy's Effects	Comments
			Business Tax Proposals	
Cut in Corporate Tax Rates	Small	Long	Small	Corporate tax rate reductions have only a limited effect on new investment decisions and may take time to affect business investment because capital spending decisions are often made in advance. Improved cash flow may, however, have some effect on investment decisions, especially among smaller firms.
Incentives for New Investment	Medium	Medium	Large	Most of the stimulus appears to come at the end of the period of the incentive. But a short incentive period may not be effective if it does not allow businesses enough planning time. The last time such incentives were employed, the results were not encouraging. Analysts are consequently less confident in them.
Extending Operating Loss and Carryback Provisions	Small	Medium	Large	These provisions have little effect by themselves, although improved cash flow may have some effect on firms facing difficulty in accessing outside capital. Perhaps more important, these provisions can enhance the effectiveness of investment incentives.

Continued

specifically to the housing market.[34] Effective stimulus need not be directed specifically at the source of economic weakness, however. Indeed, actions and proposals to bolster housing and financial markets are not fiscal stimulus in the traditional sense as discussed above. They do not directly affect large numbers of consumers and businesses, nor do they involve sums of money that would probably be necessary to push the economy out of recession should it enter one. Nevertheless, by addressing specific problems in those markets that private participants might find difficult to resolve, they could play an important role in reducing the severity of a potential recession.

34. Traditional fiscal stimulus also would help stabilize housing and home mortgage markets, but targeted actions would probably be more efficient.

The end of the housing boom in 2005 has led to declining house prices and the reduced availability of mortgage credit. As house prices began to soften and fall, delinquencies and foreclosures on subprime adjustable-rate mortgage loans (ARMs), which were 6.6 percent of total residential mortgages at the end of 2006, began to increase unexpectedly, a consequence of the lax credit standards, weaker house prices, and higher interest rates on ARMs whose interest rates had reset to higher rates as scheduled in the terms of their loan contracts. The unexpected losses on subprime mortgages have created considerable uncertainty about the eventual size of the losses. Lenders with exposure to losses on subprime mortgages, held either directly or indirectly in mortgage-backed securities, have tightened their lending standards and

Table 1.

Continued

Policy	Cost-Effectiveness[a]	Length of Lag from Enactment to Stimulus[b]	Uncertainty about Policy's Effects	Comments
			Spending Proposals	
Direct Transfer Payments to Households				
Extending or Expanding Unemployment Benefits	Large	Short	Small	These benefits are regularly extended in recessions, and most of any additional benefits are likely to be spent quickly.
Temporarily Increasing Food Stamp Benefits	Large	Short	Small	Additional benefits are likely to be spent rapidly by recipients, who tend to be experiencing periods of economic difficulty.
Providing General Aid to State and Local Governments	Medium	Medium	Large	States vary in their response to revenue shortfalls. Aid to states could be implemented through an adjustment to the federal Medicaid matching rate.
Investing in Public Works Projects	Small	Long	Small	These projects are likely to involve expenditures spread out over a long time and also take a long time to get under way.

Source: Congressional Budget Office.

Note: AMT = alternative minimum tax; EGTRRA = Economic Growth and Tax Relief Reconciliation Act of 2001; JGTRRA = Jobs and Growth Tax Relief Reconciliation Act of 2003.

a. The impact on aggregate demand that the policy would generate in a given quarter, relative to its lifetime budget cost.

b. Approximate time between enactment and when the policy would have achieved the bulk of its effect on aggregate demand. "Short" means less than about a half year. "Medium" means from about a half year up to a year. "Long" means more than a year.

pulled back from subprime lending, preferring to conserve capital and hold less risky assets.[35]

35. The problems in the subprime mortgage market have spilled over into the broader financial markets. The use of new and complex investments to fund subprime lending, such as collateralized debt obligations, has made it difficult for participants in financial markets to identify the magnitude of the exposure of other participants to subprime mortgage losses. Financial institutions, not knowing the exposure of other financial institutions to subprime losses, are reluctant to lend to each other, reducing the liquidity of the interbank market. Financial institutions also have pulled back from all risky assets, reducing the availability of credit and raising the price of risky lending from its unusually low level of recent years.

Consequently, some homeowners facing higher interest rates on their subprime ARMs and lower house prices are having trouble refinancing into more affordable loans. With about 1.7 million subprime ARMs worth $367 billion facing their first interest rate reset during 2008 and 2009, analysts are concerned that mortgage foreclosures will climb significantly higher and, along with falling housing prices, overwhelm the ability of mortgage markets to restructure or refinance loans for creditworthy borrowers.[36] In the worst case, a breakdown of mortgage markets could put the economy on a self-reinforcing downward spiral of less lending, weaker economic

36. The number of resets comes from Sheila C. Bair, "The Case for Loan Modification," *FDIC Quarterly*, vol. 1, no. 3 (2007), pp. 22–29.

activity, lower house prices, more foreclosures, even less lending, and so on, either causing or significantly worsening a recession.[37]

Many of the losses in housing markets cannot be avoided because they are the result of lax credit standards and otherwise excessive underpriced risk taking in the past. Policymakers cannot undo all those losses, and attempting to do so would reward the excessive risk taking, which could encourage excessive risk taking in the future, and shift the losses from borrowers and lenders to taxpayers.

A possible role for policymakers is to help the housing and mortgage markets cope with the aftereffects of the end of the housing boom. Some actions (described below) have already been taken.[38] Policymakers may consider other proposals for helping mortgage markets overcome impediments to changing terms of troubled mortgage loans, which could both reduce lenders' losses and help homeowners. Policymakers may also consider increasing opportunities for subprime borrowers to refinance mortgage loans. Both actions would help avoid foreclosures, eliminating one source of downward pressure on house prices. Finally, policymakers might be able to help stabilize the subprime mortgage market by establishing or empowering an agency to buy subprime loans. Such an option, however, could significantly shift mortgage losses from current lenders and investors to taxpayers.

Important factors to note, however, are that house prices are likely to fall farther before the housing correction is complete and that misguided policies can make matters worse. Policies that work against the market's necessary adjustments may delay the recovery of financial markets and impair the pace of economic activity. One example is the forbearance policy of Japanese bank regulators during Japan's recession of the 1990s. By allowing Japanese banks to delay recognizing losses on real estate and other loans after Japan's real estate boom ended in 1990, the policy helped delay the recovery of Japan's banks.

37. The problems are not limited to subprime ARMs. Analysts are also concerned about potential problems with prime ARMs and so-called alt-A mortgage loans. Alt-A loans are believed to be less risky than subprime loans but more risky than prime loans.

38. For example, the Congress excluded from taxation the gains on certain mortgage debt forgiven on principal residences and extended the deduction for private mortgage insurance in the Mortgage Forgiveness Debt Relief Act of 2007 (P.L. 110-142).

Overcoming Impediments to Changing the Terms on Troubled Mortgages

One way to help stabilize housing markets and, consequently, the mortgage markets is to promote modifications in the terms of existing loans so that the loans become more affordable to borrowers and more valuable to holders. Lenders have a strong incentive to renegotiate loan terms that have become onerous to borrowers, because doing so may avoid even larger losses that are likely to be incurred in a home foreclosure and sale.[39] And keeping homeowners in their homes would help stabilize neighborhoods and could prop up house prices a bit by putting fewer homes on the market.[40]

Opportunities to renegotiate mortgage terms were more prevalent when lenders held most of their loans in their own portfolios. Today, however, lenders hold few loans directly but instead sell them into pools for mortgage-backed securities. Those securities have been further divided into pieces as backing for other securities such as collateralized debt obligations. Consequently, a mortgage loan can be owned by a large number of investors, meaning that, among other obstacles, it is costly to obtain the agreement of investors to change the contractual terms of a loan.

In these circumstances, policymakers have sought ways to facilitate more affordable terms on existing mortgage contracts. One way is to encourage lenders to take full advantage of existing opportunities to restructure loan terms and help them to do so. Another proposal calls for changing the treatment of residential mortgages in personal bankruptcy.

39. For example, lenders can lose between 30 percent and 60 percent of the value of their loans in a foreclosure because of legal fees, lost interest, property expenses, and lower sales prices. State foreclosure laws also can affect the size of the losses. See Karen M. Pence, "Foreclosing on Opportunity: State Laws and Mortgage Credit," Finance and Economics Discussion Paper 2003-16 (Board of Governors, Federal Reserve System, May 13, 2003). Anthony Pennington-Cross, in "The Value of Foreclosed Property," *Journal of Real Estate Research*, vol. 28, no. 2 (2006), pp. 193–214, finds that the value of property in foreclosure falls by slightly more than 20 percent.

40. For estimates of how foreclosures affect neighbors' property values, see Dan Immergluck and Geoff Smith, "The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values," *Housing Policy Debate*, vol. 17, no.1 (Washington, D.C.: Fannie Mae Foundation, 2006), pp. 57–79.

Promote the Restructuring of Mortgage Loans. This approach is embodied in the "moral suasion" efforts of federal agencies that regulate banks, thrifts, and credit unions to encourage financial institutions to work with homeowners whose mortgages they hold and who are unable to make their mortgage payments. The goal is to facilitate as many restructurings as possible within the bounds of the terms of the loan contracts. Promoting loan restructuring by mandating changes in loan terms through legislation could create the appearance of abrogating existing contracts. The adverse consequences for financial markets of such a policy could be severe.

Federal regulators could also encourage other actions to avoid sales of foreclosed properties, such as renting defaulted homes back to the homeowners. This approach could minimize the disruption for homeowners and provide an income stream for investors.[41] Like renegotiated terms, however, such agreements were probably more feasible when mortgages were held by the issuers. Moreover, ensuring that previous homeowners take proper and sufficient care of their homes may prove difficult.

Promoting maximum use of existing authority to modify loan terms, as specified in the pooling and servicing agreements of mortgage-backed securities, is also an apparent objective of the Administration's plan for "fast track" loan modifications. That plan explicitly addresses the complexities created by the widespread securitization of subprime mortgages. It attempts to facilitate a standardized modification that is consistent with the terms of existing contracts in order to expedite mortgage restructuring for eligible borrowers, that is, a temporary interest rate freeze on adjustable-rate mortgages that are likely to default if the interest rate is adjusted upward.[42]

To be eligible for a freeze under this proposal, borrowers must be current on their mortgage payments; that is, they cannot be more than 30 days late at the time their mortgage would be modified, and they must not have been more than 60 days late at any time within the previous 12 months. This provision is intended to ensure that borrowers could afford their current mortgage if the interest rate was frozen at the initial rate. As proposed, the plan applies only to certain types of ARMs that have their first interest rate reset between January 1, 2008, and July 31, 2010.[43] The plan also excludes borrowers who are judged to be capable of making their mortgage payments at the higher reset rates.[44] In general, furthermore, modifications are legal only if they cost the lenders less than foreclosure. Some analysts estimate that the proposal may benefit between roughly 10 percent and 20 percent of borrowers with subprime ARMs.

Change Bankruptcy Law. A legislative approach to facilitate the modification of existing terms on mortgages would expand the authority of bankruptcy judges to do so in cases filed under Chapter 13 of the bankruptcy code (title 11).[45] Several bills before the Congress propose changing Chapter 13 to allow bankruptcy judges some leeway to modify mortgage debts, including reducing the amount of a homeowner's mortgage debt to the value of the underlying collateral. This approach would make the treatment of mortgage debt consistent with the treatment of secured debt on consumer goods such as motor vehicles. The rationale for the current differential treatment of residential mortgages is that exempting mortgage debt from reduction would lower mortgage interest rates and encourage home ownership.

Allowing bankruptcy judges to modify the terms of mortgage loans would give distressed homeowners another avenue for shedding burdensome debt. It might also give mortgage lenders a greater incentive to restructure debts outside of the bankruptcy court system. From one perspective, furthermore, it would eliminate a current prefer-

41. See Dean Baker and Andrew Samwick, "Save the Homeowners, Not the Hedge Funds," *Providence Journal*, August 31, 2007.

42. In November 2007, Governor Schwarzenegger reached an agreement with subprime lenders to adopt streamlined procedures to assist borrowers in California.

43. Foreclosures started on subprime fixed-rate mortgage loans are substantially lower than on subprime ARMs. They were almost 1.4 percent of the outstanding number of subprime fixed-rate loans in the third quarter of last year, up from about 1.1 percent in 2005, according to data collected by the Mortgage Bankers Association. By contrast, foreclosures started on subprime ARMs were 4.7 percent in the third quarter of last year, up from about 1.5 percent for all of 2005.

44. Initial interest rates for subprime ARMs that were originated between 2003 and 2006 averaged between 6.85 percent and 8.23 percent and are typically scheduled to rise by about 2½ percentage points at the reset date. By contrast, "teaser" interest rates in the prime market were as low as 1 percent to 2 percent. See Sheila C. Bair, "The Case for Loan Modification," Table 1.

45. Chapter 13 of the bankruptcy code covers the rescheduling of an individual's debt. Most individuals file under Chapter 7 of the bankruptcy code, which deals with the liquidation of assets as payment for outstanding debts.

ence for mortgage debt relative to other types of debt among lenders and thereby possibly help avoid future excesses in the mortgage markets. It could, however, add to the caseload of the bankruptcy court system, causing delays in resolving cases. (Restricting the new authority to mortgages originated after the date of the legislation would mitigate this effect, but it would also defeat the purpose of providing relief to currently troubled borrowers.) Another cost to this type of policy could be higher mortgage interest rates, although the magnitude of the increase is difficult to predict and could depend on the exact change in policy.

Expanding Opportunities to Refinance Subprime Mortgages

The effects of securitization in complicating the ability of lenders to negotiate loan modifications suggests that policymakers might more fruitfully focus on creating favorable opportunities for borrowers to refinance. That is, borrowers may be able to avoid default by paying off existing mortgages with the proceeds from new, more affordable loans. Policies to do so quickly might focus on making increased use of existing federal credit programs and the housing government-sponsored enterprises (GSEs). Alternatively, the Congress could consider new or expanded programs to increase federal assistance to community-based organizations that provide services, counseling, and foreclosure protection to households. The Administration has also recommended that the Congress pass legislation that would allow state and local governments to issue tax-exempt bonds to help troubled borrowers.

Expand Authority of the FHA, Fannie Mae, and Freddie Mac. One option is to expand the Federal Housing Administration's (FHA's) authority to guarantee refinanced loans. Using the FHA's existing authority, the Bush Administration has initiated a new offering called FHASecure, which modifies the existing rules for the agency's mortgage insurance and increases opportunities to refinance for borrowers who are in default but had been making timely mortgage payments before their loans reset. Eligible borrowers also must have at least 3 percent equity in the home, sufficient income to make the mortgage payments, and loans that have reset or will reset between June 2005 and December 2008. The Administration estimated in August 2007 that 240,000 homeowners would be eligible to participate in the program. In fiscal year 2007, the dollar volume of loans that were refinanced into FHA loans nearly doubled, to $16 billion. Some of that increase may be due to FHASecure, but market conditions may also be making FHA loans more attractive. Although the details of the bills differ, both the House and the Senate have passed legislation that would substantially increase the size limit on mortgages eligible for FHA's guarantees, change FHA's guarantee fees, and allow more flexible options for down payments.

The Congress could also consider a proposal mandating that Fannie Mae and Freddie Mac, two GSEs created to support housing finance, play a larger role in supporting the financing of subprime mortgages.[46] Even though financial markets are distressed, the GSEs are likely to be able to raise new funds for subprime mortgage lending. With the support of an implicit federal guarantee of their debt and other liabilities, Fannie Mae and Freddie Mac have privileged access to funds in the capital markets. During times of financial turmoil and uncertainty, when there is often a "flight to quality" by investors, the securities issued by those entities tend to be favored investments. Various legislative proposals also have been made to have Fannie Mae and Freddie Mac contribute to affordable housing funds, which would support lower-income subprime borrowers.[47]

Adopting these proposals could increase the supply of subprime mortgages (including refinance loans) and could lower mortgage interest rates. However, the proposals also raise concerns about an increase in risk to the financial system (and perhaps implicitly to the federal budget) from further concentrating mortgage holdings in enterprises that have experienced problems with financial controls and accounting. Using a federal agency such as FHA, rather than the for-profit housing GSEs, would

46. Lawrence Summers, "This Is Where Fannie and Freddie Step In," *Financial Times*, August 26, 2007; and statement of Alex Pollock, resident fellow, American Enterprise Institute, "Legislative and Regulatory Options Regarding Mortgage Foreclosures," before the House Financial Services Committee (September 20, 2007).

47. Moreover, legislation passed by the House increases the maximum mortgage size that the housing GSEs are permitted to purchase—from the current limit of $417,000 to the lesser of the median home price in the area or 150 percent of the conforming loan limit—in designated high-cost areas. The Senate version would make the increase in the maximum loan size temporary. That change would increase the supply of jumbo mortgages, for which the availability of funds has been limited and for which interest rates have risen in recent months.

allow the government to determine the assistance given to borrowers.[48]

Increase Federal Assistance to Community-Based Organizations. Another proposal would increase federal assistance to community-based organizations, such as community development corporations and community development financial institutions that provide services, counseling, and foreclosure protection to households.[49] Among other things, counseling may help steer borrowers to prime markets and away from subprime markets and may also be used to make delinquent borrowers aware of alternatives to foreclosure. In 2008, the Congress appropriated $50 million for the Department of Housing and Urban Development's Housing Counseling Assistance Program. The program provides housing counseling services to eligible homeowners and tenants, including home purchase, financial management, and rental counseling. (The Home Ownership and Equity Protection Act of 1994 has no provisions requiring counseling; however, some states require lenders to notify borrowers of counseling opportunities.) In addition, the Congress provided $180 million to the Neighborhood Reinvestment Corporation for mortgage mitigation activities.[50] A bill passed by the House and one pending in the Senate would require lenders to alert delinquent borrowers to counseling opportunities, some of which could be provided by housing advocacy groups.

Allow State and Local Governments to Issue Tax-Exempt Bonds for Refinancing. Policymakers might also consider passing legislation permitting state and local governments to help troubled borrowers by issuing tax-exempt bonds for refinancing home mortgages. Such aid is currently available for first-time home buyers or home buyers in areas designated as economically disadvantaged. Proposed legislation would temporarily allow state and local governments to refinance troubled mortgages with the proceeds of tax-exempt bonds. Those governments would have to take care in hiring and monitoring mortgage originators to handle the refinancing of those mortgages so that the refinancing did not lead to net losses for the program. There are concerns that such a tax-subsidized effort would hurt first-time home buyers, for whom this legislation was originally intended, by propping up home prices. There are also concerns about whether the proposed legislation would bring sufficient benefits to homeowners to justify the impact that the increase in tax-exempt issuance would have on federal revenues.

Government Purchases of Subprime Mortgages

Efforts to encourage the restructuring and refinancing of subprime mortgages may be insufficient to stabilize this mortgage market, and the market may not begin to function effectively again until some of the current uncertainty about the value of subprime mortgages has been dispelled. Some analysts have therefore proposed that the federal government buy subprime mortgages.[51] Under such proposals, the federal government would create or empower an agency to establish a schedule of prices for different tiers of loans. The prices would be steep discounts from the estimated values of the loans in the tiers. The agency would evaluate and classify the loans it was asked to buy. Proponents believe that such a program would put a floor on the prices of subprime mortgages and allow market participants to price the assets of financial institutions. The agency would aim to sell the mortgages at higher prices when financial markets were better able to price them and were more amenable to undertaking the risk.

This type of policy has some historical precedent. The Resolution Trust Corporation (RTC) sold the assets of failed thrift institutions beginning in 1989 to clean up the thrift crisis of the 1980s. The Home Owners' Loan Corporation (HOLC), created in 1933 during the Great Depression, exchanged bonds for defaulted mortgages with lenders and investors at a discount and adjusted the loan terms to help borrowers.[52] The circumstances of the events leading up to the creation of those agencies, however, are different from those today. In the case of the RTC, the federal government had a claim on the assets of the failed institutions through the deposit insurance system. In the case of the HOLC, the loans were defaulting not because they were poorly underwritten, as were some

48. See Douglas W. Elmendorf, "What Should Be Done to Help Households Facing Foreclosure?" (2007), available at www.brookings.edu/opinions/2007/11_mortgages_elmendorf.aspx.

49. Edward M. Gramlich, ***Subprime Mortgages: America's Latest Boom and Bust*** (Washington, D.C.: Urban Institute Press, 2007).

50. Consolidated Appropriations Act of 2008 (P.L. 110-161).

51. Mark Fisch and Benn Steil, "Root Out Bad Debt or More Pain Will Follow," *Financial Times*, December 20, 2007.

52. See Alex J. Pollock, "Crisis Intervention in Housing Finance: The Home Owners' Loan Corporation," American Enterprise Institute, December 2007, and references cited therein, available at www.aei.org/docLib/20071231_22557FSODecg(2).pdf.

of the subprime loans of today, but because many of the borrowers became unemployed in the Depression.

But such an approach could expose the government to large costs. An important element of the proposal is pricing the subprime ARMs. They vary in quality, and their values critically depend on local real estate prices. Because the subprime ARMs are a recent innovation, there is little historical experience to guide their pricing, particularly because many of the loans were poorly underwritten. Moreover, lenders would have an incentive to keep the good loans and sell the bad ones to the government. If the government mispriced the loans, the program would essentially shift the risks from the holders of the subprime loans to taxpayers at too low a price.[53] The cost of such a program could be very high if the government consistently overestimated the value of the mortgages or if it were more generous than necessary to avoid defaults and promote participation in the program. Moreover, some of the purchased loans would probably default under more favorable terms, and the government would probably suffer losses on those foreclosures.

In any event, intervention by the federal government could displace private initiatives that would not impose costs on taxpayers. For example, Berkshire Hathaway recently acted on an opportunity to enter the bond insurance market after that market had experienced financial difficulties. Another example is the recently announced purchase of Countrywide Financial, a major mortgage lender with a large exposure to losses on subprime mortgages, by Bank of America. Others may find similar opportunities to buy subprime assets.

53. The proposal essentially gives put options to the owners of the subprime loans (that is, it gives the owners an option to sell the loans at known prices). The owners will exercise the put options when the payoffs are most favorable to them, and conversely, most costly to the government. If the owners have better information about the value of the loans than the government evaluators have, exercising these options would expose the government to underpriced risks and greater costs.

Macroeconomic Effects

Although the actions and proposals to help stabilize home mortgage markets do not have large macroeconomic effects in and of themselves, their contributions could nonetheless be significant. In the case of the proposals for restructuring and refinancing mortgages, the main effects come from the help given to creditworthy borrowers who can avoid foreclosure and the attendant losses for both borrowers and lenders. The number of those borrowers appears to be relatively modest. Nonetheless, these options, by keeping some houses off the market, would help limit declines in prices in some housing markets. They also would reduce losses by lenders, which would give lenders greater capacity to make new loans. Moreover, keeping people in their home could improve their welfare, both directly and indirectly by helping to limit the deterioration of their neighborhoods as a result of a large number of foreclosures.

By itself, the option to create an agency to buy subprime loans would probably have a larger impact on economic activity than any of the restructuring or refinancing options. It would help to increase not only the supply of mortgage credit but also the supply of nonmortgage credit by giving financial institutions a better sense of the adequacy of their capital levels and those of other financial institutions. However, that option could be very costly for taxpayers.

Even if the individual options have small effects, some of the options taken together may help the economy by reducing the risks of a self-reinforcing downward spiral (of less lending, weaker economic activity, lower house prices, more foreclosures, even less lending, and so on). Such a spiral could further impair economic activity and potentially turn a mild recession into a long and deep recession. Consequently, some of the options may therefore lessen the load now being placed on monetary policy to relieve the stresses in the financial system from the subprime turmoil and reduce the chance of recession.

Opening Statement
Senator Ken Salazar
Finance Committee Hearing
"Strengthening America's Economy: Stimulus That Makes Sense"
January 22, 2008

Thank you, Chairman Baucus and Ranking Member Grassley, for holding this morning's hearing. On the first day of the 2008 session, I'm glad we are gathering to more closely examine the state of the economy – an issue that has received a lot of attention over the past several weeks and is causing people in my state of Colorado and across the nation a great deal of concern.

I want to start by listing a few pertinent facts.

After one of the worst holiday retail seasons in years, consumer spending, which accounts for two-thirds of the national economy, is experiencing a sharp pullback.

Economists are now predicting that GDP growth for 2008 will barely exceed 2% for the year.

Home values are plummeting in many areas, and foreclosures are on the rise. In the third quarter of last year, my state of Colorado ranked sixth in the nation in foreclosure rate, with one in every 326 households in some stage of foreclosure during the month of September.

The December unemployment rate in Colorado was 4.5%, up nearly half a percentage point from November.

A barrel of oil costs almost $90. On average, a gallon of gas costs $3.07; in Colorado, it's almost $2.90.

But this is about more than just statistics. Across Colorado, I hear stories of families feeling squeezed by the growing costs of energy, education, and health care. Those costs are eating into what used to be disposable income and savings, and are putting middle-class Americans into an increasingly precarious position. I know what it feels like not to know whether you will have enough money to provide your family with the things they need or the future they deserve.

There is no better way we can start the important work of the second session of the 110th Congress than by providing some measure of relief to Americans who are struggling financially, and by doing whatever we can to reinvigorate the slumping economy.

But before those of us on this Committee and in Congress start offering specific prescriptions to our economic troubles, we need to be honest with our constituents. The

economic facts and trends I just listed are not things that a temporary stimulus package can completely solve. We may be in for several months of very slow growth or even a recession. A temporary increase in investment in our infrastructure or assistance for cash-strapped Americans won't make our problems go away.

Having said that, if we act quickly and if we target temporary assistance to Americans who need it most, I strongly believe that stimulus legislation can do two important things. First, it can relieve the pressure that many families are feeling as a result of plummeting home prices and soaring energy costs. Second, it can give the economy a needed shot in the arm and put it back on the right track. Our economy is extremely resilient; if we help it get over a few bumps in the road now, it can right itself sooner.

Finally, given that a number of tax-related proposals are under consideration to be included in a stimulus package, this Committee will play an important role in dictating both the substance and the timing of what is ultimately passed by Congress. In light of the fact that the effectiveness of stimulus legislation rests on directing the right kind of assistance to the right people at the right time, we have a serious challenge in front of us – we need to do it right, and we need to do it quickly.

With that goal in mind, I look forward to a good discussion this morning and over the coming days and weeks. I also look forward to working with my colleagues on a bipartisan basis to enact meaningful economic stimulus as soon as possible.

Thank you.

Opening Statement
Senator Ken Salazar
Finance Committee Hearing
"Strengthening America's Economy: Stimulus That Makes Sense"
January 24, 2008

Thank you, Chairman Baucus and Ranking Member Grassley, for holding this morning's hearing. I am eager to follow up on the discussion we had at Tuesday's hearing, and to hear from today's panel about their views on the current state of the economy and how best to craft economic stimulus.

This is an issue that has received a lot of attention over the past several weeks and continues to cause people in my state of Colorado and across the nation a great deal of concern.

As I did at Tuesday's hearing, I want to start by listing a few pertinent facts.

We just experienced the worst holiday retail seasons in years, and consumer spending, which accounts for a vast majority of the national economy, is showing signs of pulling back sharply.

According to most economists, we're looking at GDP growth for 2008 that will barely exceed 2% for the year.

Home values are plummeting in many areas, and foreclosures are on the rise. In the third quarter of last year, my state of Colorado ranked sixth in the nation in foreclosure rate.

The December unemployment rate in Colorado was 4.5%, up nearly half a percentage point from November.

A barrel of oil costs almost $90. On average, a gallon of gas costs over $3.00; in Colorado, it's not much better, at $2.85.

The economy is on thin ice.

But economic indicators and the technical definition of a recession are one thing, and the financial pressures that middle-class families are feeling is another. Families across Colorado and the nation are feeling squeezed by the growing costs of energy, education, and health care. Savings are melting away, and disposable income is a thing of the past for many Americans.

As I have stated, there is no better way we can start the important work of the second session of the 110th Congress than by providing some measure of relief to Americans who are struggling financially, and by doing whatever we can to reinvigorate the slumping economy.

At Tuesday's hearing, and over the course of the past few days, we have had the opportunity to discuss legislative options to provide economic stimulus in greater detail. In my view, we have to answer two questions. First, how do we get money, as soon as possible, into the hands of people who will put it right back into the economy? Second, what do we need to do in the longer term to spur investment in our most important industries and to address the economy's deeper flaws in an effort to put our economic fortunes back on the right track?

We have heard a lot of discussion on the first question, and I remain committed to working with my colleagues to craft a package that includes a targeted rebate for Americans who are feeling squeezed, enhanced benefits for the poor and unemployed, and tax relief for small businesses.

But we also need to think hard about whether additional steps are warranted to bolster the nation's longer-term fiscal health. With that goal in mind, I support efforts to provide incentives for businesses to invest, particularly in the renewable energy industry; to boost investment in our nation's infrastructure; and to do more to help address the crisis in the housing and real estate.

It may not be practical or desirable to try and tackle all of these issues in the economic stimulus package that is currently under consideration. But, by the same token, the effort to address our economic troubles is not a one-step process. Accordingly, I would encourage my colleagues to do what we can now to put money right back into the economy, but also pledge to continue to work to enact policies that could make a real difference to our economy's long-term health.

Thank you.

COMMUNICATIONS

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Statement
of the
American Hospital Association
before the
U. S. Senate Committee on Finance

"Strengthening America's Economy: Stimulus That Makes Sense"
January 24, 2008

On behalf of our nearly 5,000 member hospitals, health systems and other health care organizations, and our 37,000 individual members, the American Hospital Association (AHA) appreciates the opportunity to submit this statement for the record as the Committee on Finance examines the need for a short-term economic stimulus legislative package to stave off a deep economic recession.

A weak economy means fewer jobs with employer-based health care coverage and, consequently, greater numbers of uninsured individuals and families. Medicaid is *the* public program designed to assist vulnerable populations in times of economic hardship. As state revenues decline and Medicaid enrollment increases, state governments will struggle to meet the health care needs of their residents. It is estimated that over the next two fiscal years 24 states will face budget shortfalls. A fiscal relief package for states is important before the economy worsens and should include two critical health care initiatives: an extension of the moratorium on several Centers for Medicare & Medicaid Services' (CMS) regulations that would drastically cut federal funds to state Medicaid programs; and a temporary increase in Medicaid's federal medical assistance percentage (FMAP).

The temporary FMAP increase should allow states to use such funds to support their Medicaid programs and maintain their current levels of enrollment. States also should not be forced to radically transform their programs in order to receive such fiscal relief.

In addition to increasing FMAP, states should not be subjected to budget-cutting regulatory policy changes. Since early 2007, CMS has issued a half dozen regulations, in either proposed or final form, that, if implemented, will significantly affect the Medicaid program's financial support for hospitals and, ultimately, the patients we serve. The majority of these regulations have been described by CMS as necessary to root out problems, particularly with the financing

of the program. However, in the written justification for these regulations, CMS failed to identify any significant or widespread problems. Despite concerns raised by Congress, the states and the provider and advocacy communities, CMS continues to take steps to implement these regulations.

REGULATIONS UNDER CONGRESSIONAL MORATORIUM

Of critical importance are two regulations upon which Congress has imposed a year-long moratorium secured by P.L. 110-28: the cost-limit proposed and final rule, and the graduate medical education (GME) proposed rule.

Cost-limit Rule. This regulation would restrict payments to financially strapped government-operated hospitals, narrow the definition of "public" hospitals, and restrict state Medicaid financing through intergovernmental transfer and certified public expenditures. It would limit reimbursement for government-operated hospitals to the cost of providing Medicaid services to Medicaid recipients. In addition, the rule would restrict states' ability to make supplemental payments to providers with financial need by setting the Medicaid upper payment limit (UPL) for government-operated hospitals at the individual facility's cost. The rule's restrictive definition of government-operated hospitals would have significant practical implications for public hospitals, particularly those that have restructured to achieve gains in efficiency. This regulation effectively amounts to a cut in funding for those public and safety-net providers that – as CMS has recognized – are in stressed financial circumstances and are most in need of enhanced payments. These cuts would undermine the ability of states and hospitals to ensure quality of care and access to services for Medicaid beneficiaries, as well as to continue their substantial investments in health care initiatives to promote the Department of Health and Human Services' policy goals, including adoption of electronic health records, reducing disparities in care provided to minority populations, and enhancing access to primary and preventative care.

GME Rule. This proposed rule would eliminate any federal Medicaid support for GME. CMS claims this rule is a clarification, when, in fact, it is a reversal of over 40 years of agency policy and practice recognizing GME as medical assistance. This rule will result in a cut of nearly $2 billion in federal funds from the Medicaid program. The finalization of this new policy would put many safety-net hospitals in financial jeopardy, ultimately harming the most vulnerable of our citizens covered by the Medicaid program and served by these hospitals.

The net impact of the implementation of these two rules would be a reduction in Medicaid funding of $700 million over the next year, according to the Congressional Budget Office. The existing moratorium on implementation of these rules expires May 25.

REGULATIONS THAT SHOULD BE UNDER A MORATORIUM

In addition, the AHA believes two other CMS proposed rules should be placed under moratoria: the proposed outpatient and provider tax rules.

Outpatient Rule. This proposed rule substantially departs from long-standing Medicaid policy regarding the definition of Medicaid outpatient hospital services and how costs for such services are treated for the purposes of calculating the hospital outpatient UPL. Under the proposed rule, the types of services that are at risk for not being reimbursed through hospital outpatient programs include Medicaid's: early and periodic screening and diagnostic treatment dental services for children; physician emergency department services; physical, occupational and speech therapies; outpatient clinical diagnostic laboratory services; ambulance services; durable medical equipment; and outpatient audiology services. CMS stated that it based its dramatic shift in policy on the need to align Medicaid outpatient policies with Medicare outpatient policies. However, these programs serve very different populations. Medicaid serves a largely pediatric population, while Medicare serves an elderly population. Yet despite these differences, CMS proposes to narrowly define Medicaid hospital outpatient services to align Medicaid with Medicare. The effect of aligning the hospital outpatient policies for these two programs would be to limit Medicaid federal spending for hospital outpatient programs and state Medicaid programs overall and, ultimately, the patients served by Medicaid.

Provider Tax Rule. This proposed rule would make changes to Medicaid policy on health care-related taxes used by the states to help support their share of Medicaid expenditures. The AHA specifically objects to CMS' changes to the standards for determining whether an impermissible hold-harmless arrangement exists within a health care-related tax. The rule represents a substantial departure from long-standing Medicaid policy by imposing largely subjective, overly broad standards for determining the existence of hold-harmless arrangements. These proposed policy changes would create great uncertainty for state governments and providers making it difficult for them to adopt or implement Medicaid health care-related tax programs with reasonable assurance that they are compliant, leaving them unreasonably open to after-the-fact challenges. In addition, the vaguer and broader standards CMS proposes would unduly limit states from implementing legitimate provider tax programs that are consistent with the Medicaid statute and congressional intent.

CONCLUSION

Hospital and state Medicaid programs are reeling under the weight of these new regulatory policy decisions, and Congress and the general public have been largely excluded from the decision making process. The effect of these regulations will be to limit federal spending rather than to protect access to much-needed services. The most significant impact of the agency's actions will be felt by the poor children and mothers, the elderly and the disabled that are served by the Medicaid program.

The AHA believes that the current fiscal crisis faced by states demands immediate and meaningful federal support. The combination of no federal fiscal relief and CMS' unrelenting regulatory budget-cutting policies will have a devastating effect on state Medicaid programs, the hospitals and physicians serving this vulnerable population and, most importantly, patients themselves. Meaningful federal support should include extension of the current moratorium, as well as the application of additional moratoria to rules resulting in deep reductions in Medicaid spending and an increase in the federal Medicaid matching percentage.

Association of Fundraising Professionals (AFP)

Statement for the Record

U.S. Senate Committee on Finance

Regarding

Strengthening America's Economy: Stimulus That Makes Sense

January 22 and 24, 2008

Association of Fundraising Professionals
4300 Wilson Boulevard, Suite 300
Arlington, VA 22203

The Honorable Max Baucus
Chair
Senate Committee on Finance
U.S. Senate
Washington, DC 20510

Dear Chairman Baucus:

On behalf of the Association of Fundraising Professionals (AFP), I am writing to urge you to include an extension of the IRA Rollover provision in the economic stimulus package.

AFP represents over 29,000 members in more than 195 chapters throughout the world, working to advance philanthropy through advocacy, research, education and certification programs. AFP members work for a wide variety of charities—from large multi-national institutions to small grassroots organizations—engaged in countless missions and causes. In 1960, AFP was created to promote good stewardship, donor trust, and ethical and effective fundraising. AFP members are required annually to sign our *Code of Ethical Principles*, the only enforced code of fundraising ethics in North America.

One way of spurring economic prosperity in our country is to enhance the charitable sector's ability to provide its philanthropic programs and services that add so much to the nation's economy. In fact, the sector plays a unique role in bolstering America's prosperity and productivity. Education, workforce training, environmental protection and healthcare, to name just a few, all support the human and natural resources which are at the heart of our economic productivity.

However, to provide its essential services and programs, the charitable sector needs resources. The government and the nation's economy both benefit when the charitable sector receives the necessary resources because private donations can help leverage the impact of government investments and allow charities to provide the programs and services that do much to augment the work of the government.

Prior to its expiration on December 31, 2007, the IRA Rollover provision was providing such vital resources to the charitable sector on a very large scale.

As an organization that represents individuals responsible for generating philanthropic resources, AFP has firsthand knowledge and understanding of charitable giving. We hope that our thoughts and perspective will prove helpful to you as you craft the economic stimulus package.

The IRA Rollover

The charitable giving provisions in the Pension Protection Act have helped our nation's charities to thrive. In particular, the IRA Rollover provision is a powerful incentive, allowing donors to transfer funds directly and tax-free from an IRA to a charitable organization. This provision encourages potential donors to draw upon a new source of assets in support of charitable organizations that serve the public good.

Under the current provision, a donor who has reached the age of 70½ is allowed to exclude from his or her income any IRA funds up to $100,000 that are withdrawn and transferred to a charity when filing a tax return for the year of the transfer.

Tax incentives such as the IRA Rollover provision play a vital role in encouraging donors to make gifts, especially as the contribution amounts become larger. In fact, the IRA Rollover provision has brought in over $136 million in new gifts for the charitable sector according to a recent National Committee on Planned Giving survey. It is worth noting that the survey, while instructive, is not comprehensive and does not cover the entire charitable sector. It merely represents a fraction of the positive impacts of the IRA Rollover provision.

In fact, it is estimated that there is more than $2.7 trillion in retirement funds like IRAs. The individuals and communities served by the nation's charitable sector can benefit from the IRA Rollover provision because it encourages a significant amount of new contributions from individuals who would no longer have to pay tax on a charitable gift of IRA funds. These contributions support programs for those less financially well-off through important services, such as those provided by health, education, social service, and cultural organizations.

Unfortunately, the IRA Rollover provision expired on December 31, 2007. It is imperative that Congress revive this powerful giving incentive by passing an extension.

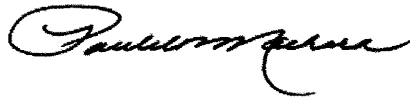
Many in the charitable sector believe that this single provision alone has had the greatest demonstrable positive impact for all charities of any recent changes to federal gift tax proposals.

AFP appreciates the opportunity to provide comments to the Senate Finance Committee and again urges you to include an extension of the IRA Rollover provision in the economic stimulus package.

I look forward to working with you and the committee on this vital charitable giving incentive and other issues related to the tax-exempt sector.

Thank you for your time and consideration.

Sincerely,



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Before the United States Senate Committee on Finance
"Strengthening America's Economy:
Stimulus That Makes Sense," Part II

January 24, 2008

Statement of Diana Aviv
President and CEO
Independent Sector

I am writing on behalf of Independent Sector to commend the Senate Committee on Finance for holding these hearings on the state of the economy and encourage you to consider the full range of interests, including those of the charitable community and those it serves, as you develop an appropriate economic stimulus package.

To address the initial question raised by these hearings – whether a stimulus package is needed – I state emphatically that the experience of many in the charitable community indicates that people are indeed struggling in this economy and that stimulus is truly warranted. Charitable organizations have a unique perspective on the economy as institutions and as service providers.

As institutions, charitable organizations are also experiencing higher costs, particularly for fuel, that reduce the resources available to support their programs, and they face greater challenges in raising funds when Americans are struggling to meet their own increased costs of living. As service providers, charities witness the effects of an economic slowdown in the increasing numbers of ordinary Americans who are coming to their doors seeking meals, shelter, health care, job training, and a host of other services to address their immediate needs.

As this Committee and all of Congress consider the best approaches to alleviate the effects of this downturn, we urge you to remember the charitable organizations working to improve our communities and serve the American people. Specifically, we are asking the Committee to include in its package of economic stimulus components two measures that could help charities to raise funds and resources that would be put to use immediately: the extension of the IRA charitable rollover provision and the food donation incentive which expired at the end of last year.

Independent Sector is a national, nonpartisan charitable organization with approximately 600 members, including public charities, private foundations, and corporate giving programs, collectively representing tens of thousands of charitable groups in every state across the nation. Our coalition leads, strengthens, and mobilizes the charitable community to fulfill our vision of a just and inclusive society and a healthy democracy of active citizens, effective institutions, and vibrant communities. IS members represent a broad cross-section of our nation's nonprofit community, which exists to meet society's needs, frequently in partnership with government, in diverse areas such as the arts, education, human services, community development, and health care.

The Nonprofit Sector and the Economy

The nonprofit sector plays a pivotal role in the U.S. economy as an employer and purchaser of goods and services, and as providers of critical services benefiting individuals and communities. More than 170 years ago, Alexis De Tocqueville marveled in *Democracy in America* at how Americans came together to solve problems through voluntary associations. He came to see these efforts as one of America's most distinctive features.

Today, America's charitable community plays an even more indispensable role in improving lives across the country and around the world. We now encompass more than 1.5 million organizations, of all sizes and in every community, that help secure basic needs, create opportunities, offer hope, foster creative expression, and nurture our spirits. We are religious and secular relief organizations. We are therapy centers for disabled children, inner-city free clinics, and after-school programs. We are community and family foundations that fund services for the most vulnerable, creative arts programs, and economic development. We are small neighborhood groups that clean the roadsides, protect our children, and fight for the causes we believe in. Every American's life is improved by the work of nonprofit organizations.

The nonprofit sector has also become a major component of our economy. In 2004, 501(c)(3) organizations employed 9.4 million individuals, or approximately 7.2 percent of the U.S. economy.[1] This is greater than the number of people collectively employed in finance, insurance, and real estate.[2] If volunteers are included, the total workforce of 501(c)(3) organizations climbs to the equivalent of 14.1 million full-time employees. The total combined assets of public charities and private foundations are estimated at $3 trillion for 2004.[3]

As this Committee considers its next steps, we urge you to recognize the effects of a downturn on the nonprofit community. The experience of the 2001 recession, when charities noted a sharp drop in donations after a seven-year climb, gives an indication of what may soon happen. According to *Giving USA*, an annual survey on the state of philanthropy, corporate donations fell by more than 14.5 percent and social service and health care charities saw, on average, a 19 percent cut in their funding. The *New York Times* reported last week that "steep drops in the stock market and consumer confidence, rising inflation, falling retail sales and pessimism about the economy do not bode well for fund-raising this year."

Declining resources come at the worst time – when an economy trending toward full scale recession increases the strains on people in need and increases the demand for the services

[1] Lester Salamon and S. Wojciech Sokolowski, "Employment in America's Charities: A Profile," (Baltimore: The Johns Hopkins Center for Civil Society Studies, December 2006) p. 3 http://www.jhu.edu/~ccss/research/pdf/Employment%20in%20Americas%20Charities.pdf accessed 4 January 2007.

[2] US Department of Labor Bureau of Labor Statistics, "Employment, Hours, and Earnings from the Current Employment Statistics survey (National): Financial Activities," http://data.bls.gov/PDQ/servlet/SurveyOutputServlet?&series_id=CEU5500000001 accessed 3 Nov 2006.

[3] Thomas Pollack and Amy Blackwood, "The Nonprofit Sector in Brief: Facts and Figures from the Nonprofit Almanac 2007," (Washington, D.C.: Urban Institute 2006) p. 2.

that charities provide. Last month, the *Washington Post* reported, "With gasoline prices and utility rates rising and the economy softening amid a mortgage crisis, many of the region's working families are struggling to pay their bills and are seeking help at food banks and soup kitchens." John Ziraldo, CEO of the Lighthouse of Oakland County in Michigan, says that "more than a third" of his clients have never asked for assistance before. Similarly, even the $2 million that the Good Shepherd Food Bank in Auburn, Maine raised in 2007 was not enough to offset a 25 percent increase in the requests for food from hungry families.

Stimulus That Makes Sense

As the Committee considers the many components that could stimulate the economy, we request that you consider a provision that could help the nonprofit community tend to the needs of individuals and communities adversely affected by the economy. Specifically, we urge the Committee to extend the IRA charitable rollover provision that expired at the end of last year. This measure simultaneously injects needed resources into the economy and strengthens the safety net of services for those adversely affected by the downturn.

From its enactment in August 2006 until its expiration last month, the IRA rollover tax incentive helped nonprofits enrich lives and strengthen communities. By eliminating the barrier in the tax law that had previously discouraged transfers from individual retirement accounts to charities, the rollover enabled Americans aged 70½ and older to make millions of dollars of new contributions to nonprofits – including hospitals, human services charities, and religious organizations – that serve people every day.

This provision is not just directed to the wealthiest Americans. While some donors made gifts at the maximum allowed amount of $100,000, the average gifts have been much smaller. Our members report that the vast majority of gifts that were a direct result of the IRA rollover came from people of moderate means who saved over a lifetime and found that they have more in their retirement accounts than they need to address their own needs. One of our members, the YMCA of the USA, which provides a wide range of services to families and at-risk youth, reports that its average IRA charitable rollover donation was under $1,000, and that typical gifts were much less. Another Independent Sector member, United Jewish Communities, estimates that its average donation from IRAs is less than $20,000.

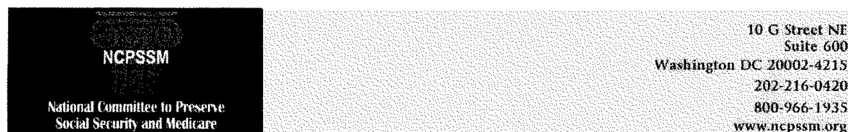
Donations to charities from individual retirement accounts can serve an important stimulus to the economy by taking money from passive investment accounts and injecting it into the economy. Although comprehensive statistics do not exist, examples demonstrate that previous donations provided significant benefits to communities. For instance, a donation from an IRA has accelerated the building of a new Jewish Community Center in Baltimore one year ahead of schedule. The PenBay Medical center in Rockland Maine received an IRA donation earmarked for the purchases of bassinets, OB/GYN materials, and specialty wheel chairs, while the Children's Hospital of Arkansas and the Mary Bridge Children's Hospital in Tacoma, Washington received IRA contributions for equipment, renovations, and capital projects. In tens of thousands of towns and cities, IRA charitable rollovers have produced investments that generate high-quality jobs.

Perhaps more importantly, the IRA charitable rollover already has a track record in helping charities help their communities in times of need. For example, when the Southwestern Virginia Second Harvest Food Bank received a contribution of $3,275 as the result of the IRA rollover provision, it was able to distribute an additional 13,100 pounds of food, which had a wholesale value of $19,650, in the Salem, Virginia area. A $15,000 donation to Lutheran Social Services of North Dakota enabled that organization to continue and improve economic-self-sufficiency aid and education, counseling for at-risk youth, and aid and services to area farmers and ranchers. Goodwill Industries of Southeastern Wisconsin received $20,000 to support its adult day care enrichment programs, particularly an art-therapy program for the developmentally disabled.

In short, when the needs of our citizens increase due to economic troubles, charities are there. Extending the IRA rollover for 12 to 24 months will provide thousands of charities with the extra resources they need to respond to the growing demand for their services caused by the economic slowdown. Adding an extension of the IRA charitable rollover provision to the stimulus bill will have the double effect of helping the economy and serving the needs of the people who are directly, adversely affected by the downturn.

We also urge the Committee to consider including in its recommendations for a stimulus package a second provision that would directly address human needs: the extension of the enhanced charitable deduction for contributions of food inventory. Food banks strive to serve every hungry American who seeks their services. The food donation provision, which expired at the end of last year, permitted grocery stores, farmers, ranchers, small businesses, and restaurateurs to donate wholesome food for hungry Americans and have the same access as corporations do to the enhanced tax deduction for contributions of food inventory. An extension of this giving incentive would have an immediate impact on the lives of persons struggling to get by in a slowing economy, and give essential assistance to the charities that are dedicated to serving their needs.

In conclusion, as the Committee considers proposals that "can really rev our economy's engines," as Chairman Baucus said last week, we urge you to include extension of the IRA charitable rollover and the food inventory provisions, both of which benefit the economy, as well as the individuals and communities that are struggling.



Senate Finance Committee
Strengthening America's Economy: Stimulus that Makes Sense
January 22 and 24, 2008
Testimony for the Record
Barbara Kennelly, President
National Committee to Preserve Social Security and Medicare

Mr. Chairman:

On behalf of the millions of members and supporters of the National Committee to Preserve Social Security and Medicare, I would like to take this opportunity to deliver one simple message to Congress today: any measure to stimulate the economy that includes checks to individuals should **remember America's 23 million seniors**. According to the Bureau of Labor Statistics, consumers over age 65 are responsible for 14 percent of all consumer spending. *They should not be left behind* as Congress attempts to restore our nation's economic health.

The National Committee to Preserve Social Security and Medicare is a grassroots advocacy organization dedicated to preserving and promoting the financial security and health of maturing Americans. Our primary means to achieve this end is through the preservation and strengthening of Social Security and Medicare, but our support for these programs is rooted, in part, in a broader concern for the economic vitality of seniors.

As the economy has slowed over the past months, Congress has begun an important discussion on the need for an economic stimulus and the composition of such a measure. During this conversation, much has been said about the need to target relief to those most likely to spend any benefit they receive quickly. Most measures under consideration would provide needed assistance to workers and their families who are struggling under the current economic conditions. However, little has been said about the importance of including retired Americans in any such relief package, even though seniors are high on the list of demographic groups *most likely to spend any benefit they receive*.

According to the most recent Consumer Expenditure Survey by the Bureau of Labor Statistics, the average household headed by someone over age 65 had just under $38,000 in pre-tax income in 2006. Of that amount, *92 percent*, or $35,058, was spent that same year. That spend-out rate is *higher than any other demographic group* with the exception of those under age 25. In fact, households headed by an individual over age 75, who are most likely not to be working and filing income tax returns, *spent 98% of their income* in 2006. In contrast, the average household headed by consumers of any age spent 80 percent of their income that year.

While it is true that older consumers spend a higher portion of their incomes on health care than other demographic groups, in fact seniors spend 88 percent of their incomes on the same types of goods and services that are purchased by those under age 65. Food consumes over 11 percent of an older household's expenditures, compared with 10 percent for all age groups; housing expenses, including

utilities, furnishings and supplies represent over 31 percent of expenses for older households compared with 27 percent overall; and transportation (including public transportation) are roughly equal at 14 percent and 15 percent respectively.

Not only do these expenses represent a significant portion of the older household's income, they represent an equally significant percentage of aggregate consumer spending. In 2006, according to the Consumer Expenditure Survey, consumers over age 65 were responsible for 14 percent of all consumer spending. Almost 14 percent of the nation's aggregate expenditures on food were made by households headed by someone age 65 or older. These older households were also responsible for 14 percent of the nation's housing expenditures, 13 percent of national spending on transportation, and almost 10 percent of spending on apparel.

In total, households headed by someone over age 65 purchased over $800 billion worth of goods and services in 2006, even though they only earned $863 billion in income.

Clearly this is a segment of the economy that must not be forgotten when designing a stimulus measure, yet seniors are the least likely group to receive assistance from any of the traditional methods under discussion. Those who do not file tax returns or have a positive tax liability because they are solely or primarily living on their Social Security benefits would not be included in any form of check delivery that is based on income tax filings. Those over 65 are not eligible for the Earned Income Tax Credit; therefore making a tax "rebate" refundable would not include them either. And millions are not eligible for food stamps, Low-Income Heating Assistance or other low-income assistance programs under consideration for increases.

At the same time, seniors represent a group that should be easily reachable by the government as they receive Social Security checks every month. In fact, their addresses are more likely to be current than taxpayers who typically have contact with the government once a year when they file their tax returns.

Although America's seniors may not be working, they face many of the same economic strains that working families do every day. In fact, they frequently confront increased prices for goods and services with little ability to increase their existing incomes. They are important contributors to economic growth but in past stimulus measures they were largely forgotten. *We believe this must change.* On behalf of America's seniors, we urge you to **ensure non-working seniors are included in any stimulus relief package**.

Senate Committee on Finance

"Strengthening America's Economy:

Stimulus That Makes Sense"

Statement for the record submitted by

United Jewish Communities

William C. Daroff, Vice President for Public Policy &

Director of the Washington Office

February 6, 2008

United Jewish Communities applauds the Senate Finance Committee for holding hearings on the state of the economy and the need to develop an appropriate economic stimulus package. In recent weeks a growing number of economists and government officials have stated that economic growth in the United States is slowing markedly and that a recession may be imminent. Enactment of fiscal stimulus policies is often the recommended solution to bolster the economic growth rate during such times. These policies can increase demand for goods and services either by individuals, businesses or governments, including within the charitable sector.

In addition to providing needed community services, often to those in the underclass, charities are an importance source of jobs as well as purchasers of goods and services throughout the country. Recent studies indicate that the nonprofit sector is one of the fastest growing segments of the U.S. economy. Charitable incentives, both for nonprofit entities and individual and corporate contributors, have proved to be effective fiscal policy tools. Such incentives take on increasing importance during economic downturns. Among the policies that deserve consideration by Congress are an expansion of the charitable tax deduction in general, and the reinstatement of the individual retirement account charitable rollover ("IRA charitable rollover"), in particular.

United Jewish Communities, Inc., ("UJC") is the national organization that represents and serves 155 Jewish federations and 400 independent Jewish communities ("Network communities") in more than 800 cities and towns across North America. In their communities, the Jewish federation and Network volunteers (collectively, the "UJC system") are the umbrella fundraising organizations and the central planning and coordinating bodies for an extensive network of Jewish health, education and social services. With thousands of affiliated agencies and schools, the UJC system is one of the United States' largest and most effective social service providers, serving well over one million clients each year in both the Jewish community and the general population. UJC knows first hand that charitable incentives are important to both our donor base and our

organizations and that the IRA charitable rollover has proved to be a successful stimulus for contributions during the short period of time it has been in the Internal Revenue Code.

Importance of the charitable sector

The charitable sector comprises a vast and diverse set of organizations. In addition to their primary role of providing critical human and community services, these organizations comprise one of the fastest growing sectors of the economy, representing one of the nation's largest employers as well as purchaser and consumer of goods and services. There are over 1.9 million tax-exempt organizations in the United States, according to the Internal Revenue Service. They employ almost 10 million individuals and have combined assets of almost $3 trillion. Other studies conclude that the nonprofit sector employs more than 17 million professionals and volunteers, and generates more than $670 billion, annually -- nearly one-tenth of the nation's gross domestic product. It is estimated that the asset base of the charitable sector would make the "nonprofit economy" the sixth largest in the world – larger than the economies of Brazil, Russia, Canada, Mexico, and South Korea. History has demonstrated that economic downturns have a direct impact on the financial viability of the charitable sector. For example, a number of organizations reported that donations declined precipitously during the 2001 recession. Recent press accounts state that many leaders within the charitable sector are already reporting that significant donors have begun to delay or decrease existing commitments to their organizations.

Importance of charitable incentives

Since 1917, the Federal income tax code has contained a charitable contribution deduction. The deduction subsidizes the activities of private organizations that provide vital and viable alternative to direct government programs. Traditional tax policy and economic theories underlying the charitable tax exemption are grounded on principles of economic efficiency. Such efficiency is based on a public benefit theory by which the government encourages organizations engaged in providing public goods to continue to do so. As the Supreme Court stated in *Bob Jones University v. United States*,

> Charitable exemptions are justified on the basis that the exempt entity confers a public benefit—a benefit which the society or the community may not itself choose or be able to provide, or which supplements and advances the work of public institutions already supported by tax revenues.

The importance of charitable incentives was most recently confirmed by a bipartisan commission tasked with studying the existing tax code and making significant tax reform recommendations. President Bush's bipartisan study group on overall tax reform (President's Advisory Panel on Tax Reform, *Simple, Fair & Pro-Growth: Proposals to Fix America's Tax System,* November, 2005) not only confirmed the importance of the existing charitable deduction on the grounds that it benefits the economy, but recommended expanding it in various ways including allowing tax-free gifts from individual retirement accounts, as well as extending the deduction to taxpayers who do not itemize. It is important to remember that one of the three charges to the Advisory Panel was to focus on tax reform options that would promote long-run economic growth

and job creation, and better encourage work effort, saving, and investment, so as to strengthen the competitiveness of the United States in the global marketplace.

The importance of the symbiotic relationship of the public-private partnership between government and charities, that has been a lasting and powerful relationship for 100 years, was underscored again most recently after the devastating natural disasters that struck the Gulf Coast. It was the charitable sector that was so effective in the 2005 hurricane response and remains a leading force in the long-term rebuilding of New Orleans and other communities economically, physically, and emotionally devastated by the disasters.

Importance of the IRA charitable rollover

Although it has only been in the tax code for less than 17 months, the IRA charitable rollover, enacted in the Pension Protection Act of 2006, has proven to be an important incentive for individuals who are considering transfers of assets to charitable organizations. Such rollover contributions have provided a wide variety of charities with an influx of funds that can be used to fund essential human services. Surveys confirm that the IRA charitable rollover has resulted in contributions well in excess of $100 million to charitable organizations during this 17-month period. In many cases, they represent "new gifts" from those who have not previously supported such nonprofits. In other cases, the contributions represent "accelerated contributions" that provide needed funds to charities sooner, enabling such organizations to either continue or expand needed social service projects. The permanent extension of the IRA rollover will provide both contributors and organizations with a sense of stability that is so important in strengthening the safety net that charitable services provide to those whose situation may be exacerbated during an economic downturn.

UJC experience with the IRA charitable rollover

UJC can report that during the period from the enactment in August, 2006 until this past year-end, the IRA charitable rollover has become an increasingly important funding source. Because the provision eliminates any tax disincentive that previously discouraged transfers from IRAs to charities, a significant number of contributors aged 70 ½ and older have accelerated such transfers and these funds have been utilized in a variety of manners including funding daycare centers and soup kitchens, as well as hospitals, nursing homes and educational institutions. Perhaps more importantly, these funds have provided UJC system officials with on-going commitments of funds that can be relied to help ease the strain on human service program budgets during difficult economic times. As noted above, certain "accelerated" contributions have also served to jump start important capital campaigns that have enabled certain organizations within the UJC system to begin projects, included needed buildings and infrastructure repairs sooner.

It is important to note that the IRA charitable rollover is not just a provision that is aimed at the most affluent in our communities. Although a small number of donors have made contributions of the statutory maximum amount of $100,000 (and such gifts have been instrumental in kick-starting or supplementing vital building and capital programs in a variety of communities throughout the country), the vast majority of contributions have been for much smaller amounts. For example, during the 4 ½ month period in 2006, the

UJC system reported total IRA charitable rollover contributions in excess of $10 million with an average contribution amount of just under $17,000. For 2007, two large Jewish Federations recently reported the following total and average IRA charitable rollover contributions:

UJC Federation	Total Amount	Average Contribution
Chicago	$2.59 million	$11,054
Cleveland	$3.28 million	$11,316

The permanent extension of the IRA charitable rollover has the potential to continue to "unlock" millions of dollars from individual retirement accounts and providing such funds to charitable organizations, which has proven to be one of the most dynamic sectors within the economy. Similar to the elimination of the "lock-in effect" on capital gains which results in increased realizations and an expanded tax base when capital gain rates are lowered, the elimination of tax disincentives to rollovers from IRAs translates into a demonstrated stimulus for taxpayers age 70 ½ and older to accelerate contributions from their retirement plans. In many cases, such distributions otherwise may have been delayed for many years. Perhaps more importantly, this stimulus transfers funds to a sector of the economy that is providing jobs and purchasing goods and services in virtually every community throughout the country.

In conclusion, UJC agrees with Chairman Baucus that "we can do even more to stimulate America's economy." We urge you to include the permanent extension of the IRA charitable rollover in the economic stimulus package. This provision has proved that it can directly stimulate individuals to act and these actions translate into needed funds which help charitable organizations provide help to the most vulnerable in our communities.