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The Case for Fiscal Policy to Forestall Economic Slowdown

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The U.S. economy has continued to expand but faces headwinds from the effects of the housing downturn, credit market disruptions, and higher energy prices. The Administration anticipates continued growth in 2008, albeit at a slow pace in the first half of the year, consistent with most private forecasts. Recent economic data have been mixed, however, and suggest an elevated risk of an economic downturn. Although consumer spending continued to grow in late 2007, declines in housing prices and stock market wealth are cause for concern. Credit difficulties are affecting businesses and households, with bank loan officers reporting that lending standards for a variety of consumer and business loans were tightened in 2007, and the availability of some mortgage products has been sharply reduced. House prices slowed or declined in many regions of the country during the first three quarters of 2007, and home sales continued the contraction that began in the second half of 2005. Although core inflation remains contained and inflation expectations remain well anchored, high energy prices are a drag on household finances, with consumer energy prices up 17.4 percent in the twelve months through December 2007.

Although the economy is most likely to remain on a growing trajectory, the risks of a broader slowdown in economic activity have increased. These risks could lead to higher unemployment and slower growth of real wages and incomes. Effectively-timed and temporary fiscal policy measures could help reduce the risk of a broader economic downturn as housing and credit markets continue to adjust. Although the economy retains a solid foundation, fiscal action could boost near-term economic growth and can be done in a way that does not harm the economy's long-run, sound fundamentals.

Fiscal policy should satisfy several criteria. First and foremost, action must be effective. Fiscal policies with negligible economic impacts should be avoided. Second, action must be well-timed. A key challenge for fiscal policy aimed at boosting near-term growth is ensuring

that the policy affects the economy as quickly as possible. Third, action must be direct and reliable. The near-term impact of fiscal policy would be lessened if the action involves additional layers of bureaucracy with the potential to delay spending and investment decisions. Fourth, action should be neutral in promoting overall spending and investment across all sectors, rather than seeking to favor certain activities or parts of the economy. Fiscal policy aimed at particular activities or preferred sectors of the economy could create economic distortions that detract from the intended gains of the policies. Finally, fiscal action should rely on markets and promote positive incentives for investment, work, and consumption.

Tax relief for individuals and investment incentives for businesses would meet these criteria. Well-designed tax relief for individuals would support consumer spending and reward work. Investment incentives would encourage firms to increase their capital spending before the end of the year. Such fiscal actions would boost near-term growth and support increased job creation.

Current Economic Conditions

Real gross domestic product (GDP) appears likely to have risen at a considerably slower pace in the fourth quarter of 2007, following the strong 4.9 percent pace in the third quarter. Many private-sector forecasters expect sluggish growth in the first half of 2008, and concerns about the risk of an economic slowdown have risen. Households and firms are facing economic challenges on several fronts.

Labor market conditions have softened. In particular, the pace of job growth slowed sharply in December, and the unemployment rate rose to 5.0 percent. Although this is the highest rate in just over two years, it remains below the average of each of the 1970s, 1980s, and 1990s. Energy and food price increases are also a drag on households' finances. Nominal average hourly earnings rose 3.7 percent over the 12 months through December. After adjusting for inflation, however, real wages are no longer growing at the solid rate experienced in prior months, but are instead down 0.7 percent over the past 12 months. Data on retail sales for December suggest consumer spending slowed toward the end of the year after having held up reasonably well through the fall; slower job growth, falling house prices, and higher consumer

prices might dampen consumption expenditures going forward. Businesses have benefited from strong export growth, but worries about weak consumer spending may crimp production and investment. Industrial production fell 1.0 percent at an annual rate in the fourth quarter. Strong growth among U.S. trading partners continues to support exports, but a slowdown in the United States would affect other nations and their demand for U.S. exports.

The downturn in housing markets has been a drag on real GDP growth since the start of 2006, and elevated inventories of unsold homes suggest that a prolonged adjustment period remains during which home prices may decline and construction activity will remain subdued. Delinquency and foreclosure rates have been rising for several reasons. In some cases, homeowners who stretched their budgets to buy homes in rapidly appreciating markets are finding that their equity cushion is evaporating as home prices decline and that refinancing is becoming more difficult just as interest rates on their adjustable mortgages reset. In other cases, slower economic activity and weak job markets in some parts of the country have made it difficult for homeowners to meet their monthly mortgage payments.

The Administration's actions to address problems in housing markets—including facilitating the creation of the HOPE NOW alliance, introducing the *FHASecure* program, and enacting changes to the tax code that help homeowners in distress—are important to many homeowners. The near-term macroeconomic effect of these policies, however, is likely to be modest. These actions will matter enormously to the families who are helped, but the policies will not result in immediately lower housing inventories or in higher economic growth. Housing market policies focused on helping to prevent avoidable foreclosures are not designed to reduce the risk of a general economic downturn.

Monetary policy plays an important role in affecting economic activity. Financial market participants appear to have factored in further cuts in the Federal funds rate. The Federal Reserve is an independent institution, however, that must balance its mandated objectives to promote maximum employment and stable prices. Moreover, research indicates that monetary policy affects the economy over time rather than immediately, with the greatest impact in the year following rate cuts, not in the year in which the cuts are made.

The Economic Boost from Previous Fiscal Policy Actions

In 2001, the Treasury Department issued advance refund checks to reflect the tax relief created by the introduction of the ten-percent bracket as part of the Economic Growth and Tax Relief Reconciliation Act of 2001. A special provision enacted in 2001 authorized the Treasury Department to issue advance checks in the amount of credits resulting from that rate reduction. The amount was computed on the basis of 2000 tax returns, but reconciled with the filing of 2001 tax returns. In 2002, the Jobs Creation and Worker Assistance Act allowed firms to expense 30 percent of the cost of new capital goods placed in service between September 11, 2001 and September 11, 2004. In 2003, the Jobs and Growth Tax Relief and Reconciliation Act increased first-year depreciation to 50 percent for eligible investment acquired after May 5, 2003, and extended it to investments made before January 1, 2005.

Research indicates that consumers spent a substantial fraction of the rebate checks they received in 2001, and that they boosted consumer spending. The 2001 rebates were down payments on a more-lasting tax reduction, so some consumers may have been more willing to spend them than they would for a temporary tax reduction. Nonetheless, this research suggests that a temporary tax reduction, distributed through rebate checks, would provide a moderate boost to consumer spending.

Research also indicates that the bonus depreciation provisions enacted in 2002 and 2003 provided a modest boost to investment spending, GDP, and employment. Bonus depreciation has only limited budgetary costs in the long-run – firms get the immediate benefit of lower taxes when they invest, but will be able to claim less in depreciation in the future, thus raising future tax payments. An important consideration regarding the effectiveness of bonus depreciation is that this policy is likely to be more valuable to firms in 2008 than was the case when temporary bonus depreciation was used in 2002 to 2004. This is because the strong economic performance of the past several years has been accompanied by strong performance of firm profits, and has meant that firms are likely to have few loss and credit carryforwards with which to offset these earnings than in the past. In contrast, the economy was coming out of a recession in 2002 when expensing was previously implemented, so that firms might have had sufficient carryforwards at

the time and did not need to use bonus depreciation to reduce their tax liability. This implies that bonus depreciation could induce more investment than was the case previously.

Conclusion

The economy has proven resilient in the face of several challenges, experiencing more than six years of uninterrupted growth, and it retains inherent strengths as exemplified by flexible and deep labor and capital markets. These strengths are likely to keep the economy on a path toward continued growth, although near-term growth is likely to be slower than that witnessed in recent quarters, and several headwinds have elevated the risks of a broader economic downturn. Evidence suggests that effectively-timed fiscal policy would provide a near-term boost to economic growth and help insulate the economy from downside risks. Policy actions should be well-timed, temporary, direct, neutral, and substantial enough to promote investment, work, and consumption.