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ECONOMIC POLICY:  
RECOMMENDATIONS FOR THE NEXT ADMINISTRATION

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### Overview

The Nobel laureate and internationally-renowned American economist Milton Friedman once said that policies should be judged not by their intention but by their outcomes. Indeed, the current financial crisis is primarily the result of well-intentioned but economically unsound policies designed to increase the rate of homeownership in the United States.<sup>1</sup> The new administration has indicated that it is prepared to act boldly to restore health to the nation's economy. Although decisive action is necessary at this time, it must be done with recognition of the looming fiscal crisis brought about by a gross imbalance in government spending versus revenue. Failing to address the fiscal imbalance will have devastating long-term effects on the nation's economy. Thus, the new administration faces the daunting task of steering the nation's economy back to health in the short term, while moving the government toward a path of fiscal responsibility in the long term.

### *Recommendations for Addressing the Short-Term Financial Crisis*

- Refrain from increasing income taxes.
- Avoid policies aimed at insulating domestic producers from foreign competition.
- Leverage-to-capital ratios should focus on the market liquidity of assets as well as the maturity date of assets and debts.
- Create a Financial Product Safety Board.
- Improve financial disclosure and reduce the ability of firms to hold assets and liabilities in off-balance sheet accounts.
- Create a market for covered bonds in the United States as a means for financing mortgages and other infrastructure investments.
- Regulate financial innovation without being too restrictive.
- Plan an exit strategy to return government-owned shares of private banks and other institutions to the private sector.

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<sup>1</sup> John W. Diamond, "The Financial Crisis of 2008," Baker Institute for Public Policy, <http://bakerinstitute.org/publications/TEPP-pub-financialcrisisisspeech-103008.pdf>.

- Increase government spending in the short run by moving forward with projects that have larger public benefits than public costs, extending unemployment benefits, and encouraging increased private investment.

### *Recommendations for Addressing the Long-Term Fiscal Crisis*

- Reform the nation's entitlement programs, as they are financially unmanageable in their current state.
- Transform the role of unemployment taxes, and the benefits and training that workers receive in spells of unemployment, to help workers cope with increased competition from abroad.
- Reform the corporate tax system to reduce the burden of capital income taxation and tax compliance so as to increase the competitiveness of U.S. businesses at home and abroad. Recommended measures include broadening the corporate tax base and lowering the corporate tax rate.
- Reform the federal income tax system to promote economic growth and reduce administrative and compliance costs.
- In the long run, revenue increases should be derived from base-broadening tax policy changes as much as possible. The President's Advisory Panel on Federal Tax Reform<sup>2</sup> offers several good examples such as eliminating the deductibility of state and local taxes.
- Tax rate increases should be avoided in an effort to minimize economic distortions that shrink the level of production.
- Reduce the growth rate of government spending by minimizing increases in the cost of medical care, reduce Social Security and Medicare benefit payments by slowly increasing the retirement age overtime (for example increase the retirement age two to three months every year), and eliminating earmarks and ineffective government programs.

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<sup>2</sup> Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System. President's Advisory Panel on Federal Tax Reform. November 2005. Washington, D.C. <http://www.taxreformpanel.gov/final-report/>.

## **I. Short-Term Financial Crisis**

### **Background**

In order to combat the ongoing financial crisis it is important to understand the policies that led to the crisis. Following the recession of the early 1990s, incomes grew and mortgage interest rates fell resulting in an increase in homeownership relative to the late 1980s. In 1994, President Clinton initiated the National Homeownership Strategy, which aimed to substantially increase homeownership among low- and middle-income households by relaxing lending constraints and creating flexible and innovative financing options. The policy increased homeownership by reaching out to populations that would not have qualified for a mortgage based on standard financial practices, but were able to do so under less stringent financial restrictions. Financial institutions were eager to lend to new customers and thus were complicit in the government's plan to increase mortgage lending and, in turn, the homeownership rate. In order to facilitate mortgage lending to previously unqualified buyers, financial institutions implemented many questionable and unethical lending practices.

After the dot-com bubble burst and the attacks of September 11, 2001, market dislocations and the potential for a deflationary price spiral led the Federal Reserve to drastically cut short-term interest rates. This fueled a boom in mortgage refinancing and an increase in demand for owner-occupied housing. From 2001 to 2006, widespread credit mania ensued as the use of home equity loans, cash-out refinancing, exotic mortgage loans (adjustable-rate mortgages, balloon notes, interest-only, Alternative A-papers, 100 percent+ financing, etc.), and 0 percent financing for the purchase of many consumer goods skyrocketed. The widespread use of credit to consume beyond our means led to deterioration in the balance sheets of U.S. households. Business balance sheets also deteriorated over this period as investments were made in increasingly risky assets. The slowdown in the growth of housing prices that began in mid-2006 exposed the faulty belief that house prices would continue to increase indefinitely. Reduced housing values combined with the resetting of adjustable-rate loans rendered homeownership unaffordable to many, causing a spike in home foreclosures. As foreclosures mounted, mortgage lending companies registered monumental losses. The hemorrhaging in the mortgage-lending industry, in turn, led

to massive losses in the investment banking and financial sector, as both were heavily invested in mortgage-backed securities and other mortgage-related investments.

Significant action by the outgoing administration has already been undertaken to combat the financial crisis. In September 2008, the U.S. government seized control of Fannie Mae and Freddie Mac, pledging a total of \$200 billion to prop up the struggling companies. Out of fears that a collapse of insurer American International Group, Inc. (AIG) would have dire national and global financial consequences, the U.S. government seized control of the company, lending a combined total of \$150 billion to the institution. In October 2008, Congress passed the all-encompassing \$700 billion Troubled Asset Relief Program (TARP), which allowed the Treasury to buy troubled mortgaged-related assets from financial institutions. However, the Treasury quickly deviated from the original plan of buying mortgage-backed assets in favor of a \$250 billion infusion of cash into the banking system. In November 2008, the Treasury Department and Federal Reserve made \$200 billion available to the consumer credit market by guaranteeing securities backed by credit card debt, student loans, and other debt. The government also provided Citigroup with a \$45 billion loan along with a guarantee to back \$306 billion of Citigroup's loans. Additional smaller measures have also been carried out by the outgoing administration.

### *Automotive Crisis*

General Motors Corp., Ford Motor Co., and Chrysler LLC have also requested money from Congress during this financial crisis. The three firms are all facing serious financial turmoil, with General Motors and Chrysler indicating that they are on the brink of bankruptcy (Ford has stated that it can remain solvent for more than a year). Originally, the firms requested a \$34 billion bridge loan from Congress, which would allow the firms to continue operations, as well as to restructure and streamline operations. The House of Representatives passed a \$14 billion package that would have given substantial power to a government appointed car "czar" in order to insure successful transformation of the Big Three into competitive companies. The measure, however, stalled in the Senate. The Bush administration has since indicated that it will provide \$17.4 billion in short-term loans to the automobile makers. The funds are to come from the \$700

billion Troubled Asset Relief Program passed in October 2008. Companies receiving the money have until March 31, 2009, to produce viable business plans; otherwise, the loans must be repaid.

Providing direct government loans to the Big Three is unlikely to be effective in retooling the auto industry (no matter who is chosen as the car “czar”) as the problems facing the auto industry are multi-faceted, involving government regulations and tariffs, union inefficiency, current economic factors and general mismanagement. Gasoline prices, in particular, have played a major role in the current financial turmoil facing the Big Three. Although gasoline prices have recently subsided, elevated gas prices over the last few years were detrimental to the automakers, as each of the Big Three were heavily invested in the production of low fuel economy trucks and SUVs. The automakers have been publicly scolded for choosing to produce such vehicles, with many of the insults coming from the Washington, D.C., establishment. Production decisions, however, were the natural consequence of the 25 percent tariff Congress originally placed on the import of light trucks in 1963 and later expanded in 1980 and 1989. Given this pricing advantage, American producers were able to compete in the light truck market, which includes trucks, minivans, and SUVs. The heavy focus on the light truck market proved disastrous once gas prices increased and consumer demand shifted toward smaller more fuel-efficient vehicles. The recent financial crisis and ensuing credit crunch compounded the severity of the situation, putting a halt to the lion’s share of automotive lending, causing a dramatic decline in sales.

Also negatively impacting the Big Three automakers are contracts with the United Auto Workers (UAW) union. Although factory worker wages in union-operated plants are only slightly higher than wages in foreign-owned non-unionized plants, benefits are dramatically different, as union workers receive far more generous health insurance, job insurance, pensions and retirement healthcare. The three domestic companies are unable to delineate benefits based on competitive market factors, as union leaders control contract negotiations and possess a significant upper hand with the threat of organized strikes. And though the unions’ generous benefit contracts are not the sole reason for the companies’ financial troubles, unionization does hinder their ability to effectively and efficiently compete and operate in the market. Allowing GM and Chrysler to reorganize under Chapter 11 would provide the opportunity to restructure union contracts and

may be the best route to building a competitive American automobile industry; however, recent government actions indicate that this is unlikely to happen.

### **Recommendations for Addressing the Short-Term Financial Crisis**

History has taught that expansionary monetary policy is one of the most useful tools in aiding a fledgling economy. During the Great Depression, banks were allowed to fail, while reserve requirements were increased. These policies caused a freeze in lending and a drastic decline in the nation's money supply. Christina D. Romer's<sup>3</sup> research on the Great Depression indicates that expansionary monetary policy aided in the nation's economic recovery. Tyler Cowen<sup>4</sup> echoes this sentiment, noting that, "Roosevelt's best policies were those designed to increase the money supply, get the banking system back on its feet, and restore trust in financial institutions." We should follow the same types of policies now. Indeed, the Federal Reserve has been very aggressive in implementing a loose money policy and has vowed to use every tool in its arsenal. Additionally, the following policies could help restore confidence in the economy and trust to the banking sector:

- Leverage-to-capital ratios should focus on the market liquidity of assets as well as the maturity date of assets and debts. In doing so, banks would increase their financial stability and decrease the likelihood of short-term crisis induced collapse.
- Create a Financial Product Safety Board to provide investors with greater information. The board would protect investors and the economy by curbing unscrupulous investments.
- Improve financial disclosure and reduce the ability of firms to hold assets and liabilities in off-balance sheet accounts. The new rules would expose financially unsound companies and limit business fraud.
- Create a market for covered bonds in the United States as a means for financing mortgages and other infrastructure investments. Covered bonds function similarly to asset-backed securities; however, they provide two distinct advantages in that they stay

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<sup>3</sup>Christina D. Romer, "What Ended the Great Depression?" (Working Paper 3829, National Bureau of Economic Research, Cambridge, MA, 1991).

<sup>4</sup> Tyler Cowen, "The New Deal Didn't Always Work, Either," *New York Times*, November 23, 2008.

on the issuer's balance sheet and investors have recourse against the issuer and pool of assets.

- Regulate financial innovation without being too restrictive. Regulation of financial products is clearly necessary, as aggressive and unethical lending in the mortgage industry has had dire consequences on the entire economy. As innovation does need to be encouraged, regulation should aim to prevent unethical and economically detrimental financial products from entering the market.
- Plan an exit strategy to return government-owned shares of private banks and other institutions to the private sector. The government measures were put in place to steady the market, increase consumer confidence, and jump-start lending in the short term. An exit strategy is necessary, as it would be harmful and ineffective for the government to have long-term involvement in the decision-making and operations of private banks and institutions.
- Increase government spending in the short run by moving forward with projects that have larger public benefits than public costs. Engaging in public spending projects simply for the sake of economic stimulus without regard to a cost-benefit analysis is highly inefficient. As the government has already spent \$3 trillion to aid and stimulate the economy, further spending should be undertaken with prudence.

Policies that the federal government should avoid to keep from exacerbating the current crisis include:

- Increasing taxes. According to the empirical results presented by Mountford and Uhlig,<sup>5</sup> a surprise deficit-financed tax cut stimulates economic production more than a deficit-financed increase in government spending. This is at odds with the textbook Keynesian model, which predicts government spending would provide a larger stimulative effect.
- Protectionism. Policies aimed at insulating domestic producers from foreign competition are detrimental to innovation, competitiveness and profits. The automobile industry is a prime example of the harm caused by protectionist policies (tariffs). Further, as free trade agreements have been successful in encouraging domestic economic growth, new

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<sup>5</sup> Andrew Mountford and Harald Uhlig, "What are the Effects of Fiscal Policy Shocks?" <http://sfb649.wiwi.hu-berlin.de>.

agreements should be pursued with other democratic governments such as Columbia and South Korea.

## **II. Long-Term Fiscal Crisis**

### **Background**

The cost of the multiple government bailouts and other economic measures to combat the current financial crisis is well over \$3 trillion and increasing. This figure, however, pales in comparison to the funds needed to bail out the U.S. government. In fiscal year 2008, the government's annual budget deficit totaled \$455 billion, with that figure projected to potentially increase to over \$1 trillion in 2009. The total national debt stands at \$10.8 trillion as of September 30, 2008, while the government's total fiscal exposure, which includes explicit liabilities the government is legally obligated to fulfill, is more than \$53 trillion. Continuing on the path of fiscal irresponsibility is no longer viable and could have dramatic consequences in the next 20 years if actions are not taken to balance the federal budget.

The nation's most costly entitlement programs include Social Security, Medicare and Medicaid. Currently, these three programs account for approximately 42 percent of total annual government spending. The share of government spending on these entitlement programs is expected to increase dramatically in the coming years as a growing share of baby boomers retire and begin drawing Social Security and Medicare benefits. The fundamental problem facing Social Security is the system's pay-as-you-go design. Currently, there are ample employees paying into the system to cover the number of retirees receiving benefits. However, it is estimated that by 2017 the cash flow of the Social Security program will be negative, as obligated benefits will exceed receipts. Similarly, long-term financial problems face the Medicare and Medicaid programs. Though these programs are not systematically flawed, they are overly costly and painfully inefficient for the level of care they provide. In 2006, government outlays for the Medicare and Medicaid programs exceeded \$560 billion, a staggering 20 percent of all federal spending and 5 percent of gross domestic product. While spending on these programs has greatly increased, the Congressional Budget Office (CBO) has argued that the increased government payouts have not

resulted in improved quality of health for program enrollees. For example, CBO estimates that 30 percent of government health spending does not increase quality of care. Clearly, reforms of government-run healthcare programs, along with Social Security, are necessary to achieve long-term sustainability.

The imminent long-term fiscal crisis threatens to significantly decrease the welfare of future generations. To remedy the situation, revenue will have to increase and spending will have to decrease if fiscal balance is ever to be achieved. As the main source of government revenue is the income tax, raising revenue involves raising taxes, which can be done through broadening the tax base or increasing tax rates. Base broadening should be main source of raising additional revenue under the income tax since increasing tax rates would reduce economic growth because of the distortionary effects of marginal tax rates. The Obama administration has indicated it will not raise taxes at this time and will increase spending in order to stimulate the economy. Though this may seem necessary due to the current state of the economy, it will further exacerbate the fiscal imbalance and increase the national debt. Unfortunately, using government spending as a fiscal stimulus is often poorly timed and grossly inefficient. This is likely to especially be true given that a \$1 trillion fiscal stimulus package being discussed. We must avoid poorly timed and inefficient fiscal stimulus spending. We should focus on moving forward projects that can pass standard benefit-cost analysis and avoid increasing government spending just for the sake of stimulating the economy. We should also focus of fiscal stimulus proposals aimed at extending unemployment insurance and food stamps and increasing private investment.

The current tax system is in tatters and is in dire need of fundamental reform. It hampers U.S. businesses from competing in an increasingly integrated global marketplace. It is riddled with loopholes, haphazard provisions and often undermines our perception of fairness. Most importantly, it is often counterproductive in terms of promoting economic growth. It is also overly complex and largely temporary. Given that revenues already fall short of funding government operations and that additional revenue will likely have to be raised to balance the long term federal budget, serious consideration should be given to fundamentally reforming the US tax system. The goal should be a tax system that promotes economic growth and is simple and fair.

**Recommendations for Addressing the Long-Term Fiscal Crisis**

To move the nation toward a path of fiscal responsibility in the long term, the next administration should:

- Reform the Social Security, Medicare and Medicaid programs, as they are financially unmanageable in their current state.
- Transform the role of unemployment taxes and the benefits and training that workers receive in spells of unemployment. A focus on more effective job search techniques and the development of marketable new skills will help workers cope with increased competition from abroad.
- Reform the corporate tax system to reduce the burden of capital income taxation and tax compliance. Recommended measures include broadening the corporate tax base and lowering the corporate tax rate. Adopting these measures would increase the competitiveness of U.S. businesses at home and abroad.
- Reform the federal income tax system to reduce administrative and compliance costs and promote economic growth.
- Raise any additional revenue by broadening the income tax base.
- Refrain from increasing income tax rates that would increase economic distortions and reduce economic growth.
- Reduce the growth rate of government spending by minimizing increases in the cost of medical care, reduce Social Security and Medicare benefits by increasing the retirement age slowly, and eliminating earmarks and ineffective government programs.

**Conclusion**

Our nation's future is at stake if we continue on the path of fiscal irresponsibility. Thus, balancing the long-run federal budget through tax reform and drastic cuts in government spending should be a top policy priority for the next administration. Accomplishing this will require tough economic choices that are most likely to occur with strong presidential leadership and ample bipartisan support. In this time of economic crisis, it is of great importance that the new administration heeds Professor Friedman's sound advice and carefully considers the long-term implications of all new policy initiatives.