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COMMENTARY

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The State of the Stimulus Debate

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The odds that the American economy may encounter a recession this year have risen. And the odds that it might be longer and deeper than recent recessions are significant.

As the Federal Open Market Committee noted in the minutes of its December meeting, the biggest risk comes from a feedback developing between the availability of consumer credit and rising, recession-induced increases in credit defaults and delinquencies. While they will help over the long term, even rate reductions by the Federal Reserve will take time to have their salutary effects.

To be most effective, government action should aim directly at counteracting this feedback loop, and not simply throwing money at key constituencies and feel-good programs. For instance, Sen. Hillary Clinton's newly unveiled stimulus proposal does nothing to address the breakdown of consumer finance. Instead it gives money to states for housing assistance, and increases unemployment compensation and low-income energy assistance.

Moreover, the money will be expended much too slowly to have much economic effect. The centerpiece of her plan -- the Emergency Housing Crisis Fund -- would transfer money to states, taking precious time, which would then transfer money to local housing authorities, taking more time, which would then identify vacant housing properties to buy up, taking even more time, which would then rent them to working families, completing a long chain of bureaucratic action at three levels of government.

Mrs. Clinton's plan is also very political: Witness the promise that her new weatherization program would cut home energy costs by 20% *this* winter. It is almost impossible to pass a new program before the end of winter, which is already one-third past, much less implement one.

A middle-class tax cut involving a reduction in the lowest rate and an increase in the child credit would at least provide money to the right people, and could be implemented much faster than new government programs. But even a $1,000 check will not induce a middle-class family to use the cash for a down payment on a car if they can't get an auto loan to close the deal. This is why any solution must also focus on fixing the breakdown in consumer finance.

The government should facilitate the opening of new credit channels through which capital for consumer financing might flow. The existing securitization process has broken down for consumer credit, and this breakdown is what's starving the consumer sector of funds. Good quality auto loan paper has risen more than four percentage points in yield; securitization of consumers with even somewhat questionable credit has become nearly impossible.

One of the easiest things to do would be to allow manufacturers and retailers to open their own financial institutions, through which they could borrow and lend money. One such institution, the Industrial Loan Corporation (ILC), exists in limited form expressly for this purpose. Unfortunately, the union-led assault on Wal-Mart has caused the FDIC to place a moratorium on the approval of such institutions. Some existing financial groups who fear the potential competition have joined forces with the unions. Bad timing caused auto-company finance arms to be caught up in this political dispute as well.

These institutions could be limited to special purpose lending -- such as in-house credit cards or consumer installment loans like car loans. They are obviously subject to safety and soundness regulation as are other financial institutions. It is hard to see how either the taxpayer or the banking insurance system would be better off by blocking one of the few remaining potential consumer credit channels that remain, thereby risking a consumer-led economic recession.

In the interest of disclosure, I doubtless have a number of clients who would benefit directly from such a move. Indeed, nearly every manufacturing company and retailer that relies on consumer credit to move its product would be a potential direct beneficiary. But consumers, who would have their access to credit restored at reasonable rates, would also benefit, as would the workers who produce the goods these consumers would buy.

As Washington looks around for ways to stimulate the economy, it is ironic that politically-motivated regulatory inaction is a primary cause of our current problems.

Reopening the credit channels is a necessary condition for staving off a consumer-led recession, but it is probably not sufficient by itself. So, while Keynesian-style short term stimuli are usually not as effective as permanent rate reductions at stimulating the economy, given the deterioration in consumer balance sheets, some fiscal help might prove quite beneficial.

In 2001, President Bush quickly delivered tax rebate checks based on a new 10%

tax bracket. A temporary suspension of revenue from this tax bracket could essentially give $1,500 to every married couple that pays taxes and $750 to every single taxpayer. Coupled with a temporary $500 increase in the child credit, middle-income families would enjoy a significant increase in their household incomes, roughly the equivalent of two-and-a-half weeks' take home pay for a four-person family.

Longer term, fundamental tax reform remains the most sensible way of strengthening the American economy. The cumbersomeness of the current system, and the political inability to cope with it, reached truly embarrassing levels last year when Congress took more than 11 months to come up with an economically vital one-year patch to protect millions of taxpayers from liability to the Alternative Minimum Tax.

Our economic performance is increasingly being held to political ransom, as evidenced by the failure of the current Congress and the ad hoc nature of the so-called "stimulus" packages put together so far. The collateral damage caused by special-interest efforts like the anti-Wal-Mart campaign is further evidence that we are sliding in the wrong direction. While deregulation and tax simplification are not currently in vogue, ultimately they represent the best type of economic stimulus -- by allowing the people who actually create the jobs and wealth of this country to get about their business.

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