CONGRESSIONAL BUDGET OFFICE
U.S. Congress
Washington, DC 20515

Peter R. Orszag, Director

January 15, 2008

Honorable Kent Conrad
Chairman
Committee on the Budget
U.S. Senate
Washington, DC 20510

Dear Mr. Chairman:

The economy has recently been buffeted by several interlinked shocks, and the risk of recession is significantly elevated compared with normal economic conditions. Housing activity has declined sharply, and house prices are falling in many areas, reducing household wealth and the outlook for consumer spending. Turbulence in the subprime mortgage market has spread to other parts of the financial markets. Lenders' losses on mortgage-related assets and lower tolerance for risk have constrained the supply of credit, particularly for the riskiest borrowers. The high price of energy is also likely to restrain spending by households and businesses in 2008.

Given the elevated risk of a recession, policymakers may choose to proceed with a stimulus package to bolster a weak economy and as insurance against a possible recession. At your request, I am therefore providing information about the potential economic effects of alternative policies for stimulating the economy in the short run, including individual and business tax cuts, and various types of increases in government spending. In this analysis, the Congressional Budget Office (CBO) examined the ability of those alternatives to provide a timely and effective stimulus. The report also examines options for addressing specific problems in the mortgage markets.

CBO finds that:

- 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 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.
- 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 to bolster an economy suffering from weak aggregate demand and thereby help to reduce the risk and severity of a recession.
- The most effective types of short-term 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 attached paper updates and expands upon a CBO analysis of various tax options for stimulating the economy that was released in January 2002 (see *Economic Stimulus: Evaluating Proposed Changes in Tax Policy*). It expands upon that earlier work in a number of ways. First, it considers a broader range of policy options, including options specifically geared toward the housing and mortgage markets as well as options for stimulating the economy by increasing government spending. Second, it includes a broader range of criteria for evaluating the options. Whereas the earlier report focused mainly on the cost-effectiveness of the various tax options, this report includes more discussion on the practical aspects of implementing them, including administrative feasibility and timing considerations. Finally, this analysis reflects new evidence on the cost-effectiveness of various tax options in light of the experience with how recent changes in tax policies have affected the economy in the short run.

Please feel free to call me at 202-226-2700 if you have any questions about the analysis, or have your staff contact Robert Dennis at 202-226-2750 or Tom Woodward at 202-226-2687.

Sincerely,

Peter R. Orszag
Director

cc: Honorable Judd Gregg
Ranking Member

Identical letter sent to the Honorable John M. Spratt Jr.