

Economic Turmoil: A New Opportunity to Examine a National Tax Rebate

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In 1974, Leonard Greene turned his innovative mind to public policy. At that time, the policy setting was defined by a truce that ended the hostilities in Vietnam, a severe recession sparked by the Arab oil embargo, and a rising crime rate. There was a sense of drift and a feeling of vulnerability. The nation seemed to be losing control of its destiny.

Leonard understood that the nation's market system, its social institutions, and its tax and regulatory framework are interdependent. He believed that with the proper incentives, the pieces could work in synergy and improve the nation's social and economic outcomes. To promote his vision he established the Institute for SocioEconomic Studies.

Today, thirty five years later, the U.S. again finds itself in challenging times. The U.S. is engaged in a war against the Al Qaeda terrorist organization. Its economy is mired in the grips of what could become its longest and deepest recession of the post-World War II experience¹. Its unemployment rate has risen to 7.6%² and its economy has lost more than 500,000 jobs in 4 of the last 6 months.³ Home prices have fallen by 27%⁴ and housing starts are at the lowest level on record.⁵ Consumer confidence has also fallen to a record low.⁶ Stock prices have fallen nearly 50% from their October 2007 highs.⁷ More than \$7 trillion in household wealth has disappeared.⁸ The earlier euphoria that drove real estate and stock prices ever higher has given way to a sense of fear.

The grim economic news notwithstanding, a crisis often brings with it the seeds of opportunity. The current economic turmoil presents a fresh chance for policy analysts and policy makers to give new attention to Leonard's central idea of a universal "National Tax Rebate."

Briefly, a National Tax Rebate would provide Americans with a guaranteed income stream. It would be financed by cashing out myriad federal programs and tax expenditures. Its proceeds would be taxable. That would allow lower- and middle-income Americans to retain a greater share of the National Tax Rebate, even as the rebate itself would be universal.

The size of the rebate would depend on who received it and what programs and tax expenditures were eliminated to finance it. Using 2008 budget and population figures, if a tax rebate were provided to every person, the amount would range from about \$3,500 to \$7,700 per person. If the National Tax Rebate were provided only to those aged 21 and older, the amounts would come to \$4,900 to \$10,770 per person.⁹ If one designed the National Tax Rebate to provide a full benefit for adults and a half-benefit for each child, with a child defined as anyone under the age of 18, a household of four could receive \$11,900 to \$26,285 a year. Treating the rebate as taxable income would result in pre-tax figures that would be higher than the amounts I just mentioned.

What is important is that the National Tax Rebate could provide a significant income stream and that the current economic situation might present a fresh opportunity to examine such a concept. A brief sketch of the present economic environment highlights that opportunity.

In summer 2006, the nation's enormous housing bubble that had literally begun to consume its savings¹⁰ finally burst. For a time, there was little visible macroeconomic fallout from the housing market's "Big Bang."

During the two years following the collapse of the housing bubble, an increasing range of policy steps taken by the Federal Reserve, including aggressive interest rate reductions and the creation of new temporary liquidity facilities, helped stave off the kind of severe credit crunch that has typically followed the destruction of large asset bubbles. However, that respite proved temporary. By late 2008, both the supply of available credit and demand for loans eroded.¹¹ Outstanding consumer credit began to decline.¹² In the third quarter, outstanding mortgage debt fell for the first time on record.¹³

The magnitude of the current recession is consistent with the historic experience concerning real estate bubbles. Research conducted by the IMF has revealed that housing busts that follow the collapse of real estate bubbles typically last twice as long as equity price busts that follow a crash in stock prices.¹⁴ Housing busts also result in output losses that are twice as large.¹⁵ The amount of debt involved with real estate bubbles can wreak havoc on a nation's banking system. The amount of time required to repair the financial system and restore an appetite for risk can lead to prolonged credit crunches and economic downturns. Finally, economic crises with origins at a regional or global financial center like the United States can rapidly spread across borders leading to synchronized regional or global downturns, disruptions in regional or global capital flows, and even sovereign debt defaults.¹⁶

Research on the National Tax Rebate could be focused in at least three areas. First, one could study whether the National Tax Rebate could mitigate the destructive

consequences that follow the collapse of a housing bubble. Second, one could examine the National Tax Rebate's potential for helping reduce the increased federal debt accumulated from efforts to revive the economy during the current recession. Third, one could research whether the means of financing a National Tax Rebate could reduce the risk of future real estate bubbles.

Contrary to the rational expectations hypothesis that predominated in the 1980s and 1990s, markets contain random inefficiencies, and market participants can suffer from bouts of irrationality.¹⁷ In general, it is the combination of psychology¹⁸ and easy credit¹⁹ that leads to the formation of asset bubbles. Once such bubbles collapse, psychology can lead to a hazardous rush for the exits, as fearful market participants cut spending and try to reduce debt. A panic can occur, sometimes weeks after the initial economic shock and sometimes several years later.²⁰ The two-year lag between the collapse of the U.S. subprime market and the onset of a vicious credit crunch is one example of a delayed response. Negative psychology can give rise to self-reinforcing feedback loops that damage economic activity.

Presently, the nation is in the midst of a self-reinforcing decline in national housing prices and rising foreclosures. However, the more benign experience in Alaska where the state provides every resident with an annual dividend²¹ offers a hint that a National Tax Rebate might mitigate the consequences of a collapsed housing bubble.

In 2008, Alaska had a foreclosure rate that was 38% of the national rate.²² Alaska's foreclosure rate has been increasing much more slowly than the national rate.²³ Alaska has enjoyed this more favorable outcome even as 75.4% of Alaska's homeowners

hold mortgages vs. 70.0% nationwide and despite Alaska's homeowners having a median monthly cost almost 21% higher than the national average.²⁴

The Alaska dividend may be playing a role by boosting personal incomes. In 2007 and the first quarter of 2008 for which the latest figures are available, the personal income of Alaskans continued to grow faster than the national average. Alaska's government suggested that the dividend has contributed to that more favorable trend.²⁵ The role played by the Alaska dividend provides an opportunity for additional research.

Since the start of the acute phase of the economic crisis that began in autumn 2008, the federal government has undertaken two major programs. In October, it enacted legislation for a \$700 billion Troubled Asset Relief Program.²⁶ In February 2009, it enacted a \$787 billion economic stimulus package.²⁷ If the experience in Japan is representative, the most recent stimulus package likely will not be the last.

What all this means is that the U.S. is likely to emerge from its severe recession with a dramatically larger national debt. For Fiscal Year 2009, the OMB projected a \$1.752 trillion deficit.²⁸ For Fiscal Year 2010, the OMB expects another \$1.171 trillion deficit.²⁹ For Fiscal Years 2009-2011, OMB estimates a cumulative deficit of just over \$3.8 trillion.³⁰

This added debt will further increase the nation's challenges associated with financing its long-term mandatory spending programs. Social Security is forecast to begin running deficits in the 2014-2020 timeframe while Medicare's Hospital Insurance program is already running deficits.³¹ Dallas Federal Reserve President Richard Fisher estimated that the infinite horizon unfunded liabilities for Medicare Parts A, B, and D and Social Security amount to a combined \$99.2 trillion.³²

A National Tax Rebate could provide a mechanism for putting the federal government on a more sustainable fiscal path. The National Tax Rebate could replace the fast-growing entitlement programs with immediate up-front cash and, because the National Tax Rebate would be indexed for inflation, it would grow more slowly than the rate at which the nation's entitlement spending has been increasing. AEI scholar Charles Murray estimated that if a similar concept had been adopted in 2005, it would have begun to produce savings over the existing budgetary framework by 2011.³³

In the context of lowering the risk of future real estate bubbles, a policy that would eliminate the preferential tax treatment of home sales and eliminate the mortgage interest deduction to help finance a National Tax Rebate would make sense. First, such an approach would reduce tax incentives that divert capital flows from the productive sectors of the economy into real estate, by reducing the after-tax returns on real estate. Second, from the standpoint of consistency, mortgage interest would be treated the same as interest on most other forms of consumer borrowing. Given the amount of leverage that is typically involved in the purchase of homes, any damping of mortgage lending activity could reduce the risk of future real estate bubbles. Historically, many of the manias that led to asset bubbles have been fed by a surge in credit.³⁴ When euphoria is widespread and credit is abundant, economic historian Roger Babson observed, "extravagance...runs riot on the part of many."³⁵ When that happens, asset valuations depart radically from levels justified by underlying fundamentals. Third, far from killing home ownership prospects, elimination of the mortgage interest deduction might lead to a more sustainable model of real estate ownership, as it would provide prospective buyers with a greater incentive to take on less debt. Nevertheless, the availability of mortgage

credit would not collapse. For example, the Tax Reform Act of 1986 eliminated the deductibility of interest payments on credit cards.³⁶ Yet, in the 20 years following enactment of that law, consumer credit expanded in real terms at about the same rate as it did during the 20 years prior to that law.³⁷ Finally, mortgage interest is not tax-deductible in Canada.³⁸ Nonetheless, more than two-thirds of Canadians own their homes.³⁹

In conclusion, thirty five years after Leonard Greene embarked on a journey into public policy, the nation's economic crisis provides an opportunity for a renewed examination of his central idea of a National Tax Rebate. The early experience in Alaska, the possibility of using the National Tax Rebate to eliminate real estate tax privileges that lead to a misallocation of capital flows, and its ability to serve as a possible social compact for bringing the nation's long-term finances into balance provide avenues for additional research.

Appendix

Financing a National Tax Rebate:

<i>Major Tax Expenditures:</i>	(billions)
Health Care Tax Exclusion	\$ 160.2
Exclusion of Pension Contributions	\$ 104.3
Mortgage Interest Deduction	\$ 89.4
Accelerated Depreciation	\$ 64.7
Capital Gains	\$ 52.0
Charitable Contributions	\$ 45.8
State and Local Taxes	\$ 27.9
Capital Gains Exclusion (Homes)	\$ 38.9
Child Credit	\$ 32.3
Step-up Basis Capital Gain at Death	\$ 35.9
Exclusion of Rental Income (Owner-Occupied Homes)	\$ 35.7
Total:	<u>\$ 687.1</u>

<i>Social Welfare Spending (Ex. Entitlement Programs):</i>	
Retirement and Disability Insurance (Railway workers)	\$ 7.9
Federal Employee Retirement and Disability	\$ 111.4
Unemployment Compensation	\$ 36.7
Housing Assistance	\$ 33.5
Food and Nutrition Assistance	\$ 60.6
Other Income Assistance	\$ 127.9
Total:	<u>\$ 377.9</u>

<i>Agriculture:</i>	
Farm Stabilization	\$ 15.5
Agricultural Research and Services	\$ 4.6
Total:	<u>\$ 20.1</u>

<i>Community and Regional Development:</i>	
Community Development	\$ 5.0
Area and Regional Development	\$ 2.4
Total:	<u>\$ 7.5</u>

<i>Health Care:</i>	
Health Services	\$ 249.8
Total:	<u>\$ 249.8</u>

<i>Major Mandatory Spending Programs:</i>	
Medicare	\$ 395.5
Social Security	\$ 614.6
Total:	<u>\$1,010.1</u>

Note: Minor rounding errors explain differences between items and totals.

Amount of Funding for the Various Options:	(billions)
1: Tax Expenditures + Social Welfare	\$1,065.0
2: Tax Expenditures + Social Welfare + Agriculture	\$1,085.1
3: Tax Expenditures + Social Welfare + Agriculture + Community & Regional Development	\$1,092.6
4: Tax Expenditures + Social Welfare + Agriculture + Community & Regional Development + Health Care	\$1,342.4
5: Tax Expenditures + Social Welfare + Agriculture + Community & Regional Development + Health Care + Social Security	\$1,957.0
6: Tax Expenditures + Social Welfare + Agriculture + Community & Regional Development + Health Care + Social Security + Medicare	\$2,352.5

Annual Tax Rebate:

Financing Option	Universal	Only Age 18 and Older	Only Age 21 and Older
Option 1	\$3,486	\$4,601	\$4,876
Option 2	\$3,551	\$4,688	\$4,968
Option 3	\$3,576	\$4,720	\$5,002
Option 4	\$4,393	\$5,799	\$6,146
Option 5	\$6,405	\$8,455	\$8,959
Option 6	\$7,699	\$10,163	\$10,770

Annual Tax Rebate: Adult receives full tax rebate; Children (< age 18) receive half the rebate; Households are defined as having two adults and two children:

Financing Option	Per Adult	Per Child	Per Household
Option 1	\$3,966	\$1,983	\$11,899
Option 2	\$4,041	\$2,021	\$12,124
Option 3	\$4,069	\$2,035	\$12,207
Option 4	\$4,999	\$2,500	\$14,998
Option 5	\$7,288	\$3,644	\$21,865
Option 6	\$8,761	\$4,381	\$26,284

Annual Tax Rebate: Adult receives full tax rebate; Children (< age 21) receive half the rebate; Households are defined as having two adults and two children:

Financing Option	Per Adult	Per Child	Per Household
Option 1	\$4,065	\$2,032	\$12,195
Option 2	\$4,142	\$2,071	\$12,426
Option 3	\$4,170	\$2,085	\$12,511
Option 4	\$5,124	\$2,562	\$15,372
Option 5	\$7,470	\$3,735	\$22,409
Option 6	\$8,979	\$4,490	\$26,938

Note: Tables contain minor rounding errors

Sources of Information:

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Endnotes:

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⁴ Case-Shiller 20-City Index

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⁵ David Goldman, "Housing starts plummet to lowest on record," CNN.com, February 18, 2009

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⁸ U.S. Federal Reserve, "Flow of Funds Accounts of the United States," December 11, 2008, p.102—Table B.100.

⁹ Charles Murray's plan proposed eliminating a substantial share of the nation's social welfare programs and came to a figure of \$10,000 per person aged 21 and older (Charles Murray, *In Our Hands*, Washington, DC: The AEI Press, 2006, p.10).

¹⁰

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¹⁶ Carmen M. Reinhart and Kenneth S. Rogoff, "This Time is Different: A Panoramic View of Eight Centuries of Financial Crises," April 16, 2008, pp.34-36.

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¹⁸ Robert J. Shiller, *Irrational Exuberance* (Second Edition), Princeton, New Jersey: Princeton University Press, 2005, pp.106, 150, 152-154, 159.

¹⁹ Charles P. Kindleberger and Robert Aliber, *Manias, Panics, and Crashes* (Fifth Edition), Hoboken, New Jersey: John Wiley & Sons, Inc., 2005, p.15.

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²⁵ In 2007, the personal income of Alaskans rose by 6.7% vs. the national average of 6.2%. In the first quarter of 2008, Alaskans' personal income rose 1.5% vs. the 1.0% national average. (Alaska Department of Labor & Workforce Development, "Retail Trade in Alaska," *Alaska Economic Trends*, December 2008 at <http://labor.state.ak.us/trends/trends2008.htm>).

²⁶ http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_public_laws&docid=f:publ343.110.pdf.

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²⁸ Office of Management and Budget, "A New Era of Responsibility: Renewing America's Promise," February 26, 2009, p.114

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