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# The Bottom Line

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## An Irresistible Opportunity for Successful U.S. Fiscal Stimulus

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While everyone knows that the American consumer has been the weak link in this recovery, in one sector the fiscal stimulus has opened consumer wallets. The cash-for-clunkers vehicle trade-in program has been wildly successful, so much so that it exhausted the initial \$1 billion funding limit less than a week after the program began, leading Congress to add another \$2 billion to keep it going. Now that, too, has run out, so the program will officially end on Monday, August 24<sup>th</sup> at 8 pm. Not only have car sales surged, depleting new car inventories, but automakers in response are increasing production and employment. Some laid-off workers have been called back and overtime payments have risen sharply. The Canadian auto sector, and therefore the Canadian economy, have benefited significantly.

Some of the success of this program is attributable to the ease with which many of these buyers are getting financing. Rather than hanging onto a clunker because owners couldn't afford anything better, Mike Jackson, the CEO of AutoNation—the U.S.'s largest automotive retailer—says that most of these owners have very good credit scores. Additionally, there has been a knock-on effect. All the talk about getting rid of gas guzzlers seems to be encouraging other potential buyers to visit their local auto showrooms.

The plan offers buyers discounts of as much as \$4,500 to trade in older cars and trucks for new, more fuel-efficient vehicles. Under the initiative, participating retailers cover the discount and are to be paid back by the U.S. government. Auto dealers, however, are complaining about slow government reimbursement. The Transportation Department says it has processed only about 40% of the dealer applications it has received, encouraging a pick up in government hiring of processors to speed up the payback to cash-crunched dealers. GM said it will advance cash to dealers to cover the government rebate until it arrives.

But progress has been slower for another fiscal program intended to stimulate consumer durables consumption. The **first-time homebuyers tax credit** was introduced to help on-the-fence buyers take the home-purchase plunge. It got off to a lukewarm start, however, because buyers couldn't collect the \$8,000 credit until tax time, rather than at closing time when the money is needed.

The program allowed first-time buyers to claim a refundable credit worth \$8,000 (or 10% of the home's value, whichever is lower). To qualify for the credit, the purchase must be

made before December 1<sup>st</sup> of this year. To be considered a “first time” buyer, the purchaser may not have owned a home during the past three years. They must also live in the house for at least three years, or they will be obligated to pay back the credit. Additionally, there are income restrictions: to qualify, buyers must make less than \$75,000 for singles or \$150,000 for couples.

After a disappointing early response, the program was sweetened in May to allow first-time homebuyers to get an advance on the \$8,000 tax credit and apply it toward their down payments or closing costs.

It is clear we are seeing a boost from the homebuyer tax credit. New and existing home sales have been rising over the past few months, the inventory of unsold homes relative to sales is finally falling, and house price declines have slowed. In addition, these first-time buyer sales have a domino effect, allowing sellers to trade up or down, either way boosting the overall housing market.

But if the program does terminate as planned on December 1<sup>st</sup>, potential buyers are already running out of time. Lenders are reportedly taking at least 60 days to close (even with a great credit record and nothing going wrong), which means that for qualifying buyers who haven’t started searching for a home, the window of opportunity is closing fast. That is what home builders, real estate agents, mortgage lenders and everyone else who is trying to stay afloat this year are worried about. If all this cash being thrown at the housing market is only helping the market find a bottom, what’s going to happen when the program expires?

Senator Johnny Isakson (R-Ga.), who used to be in the real estate business, has commanded a lot of media attention as he continues to introduce legislation<sup>1</sup> to increase the maximum amount of the tax credit from \$8,000 to \$15,000, expand the credit to apply to any buyers regardless of income or first-time status, and to extend the tax credit for one year from the date of enactment. His proposal would still allow homebuyers to claim the credit on their 2009 tax return for purchases made in 2010.

Senator Isakson has picked up a bipartisan group of co-sponsors for his proposed legislation. The *National Association of Realtors*, the *Housing Working Group* of the *Business Roundtable* (a group of CEOs of large U.S. Corporations), and the *Mortgage Bankers Association* have endorsed Sen. Isakson’s bill.

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<sup>1</sup> This proposed legislation was first introduced by Senator Isakson in January 2008. He has subsequently re-introduced the amendment repeatedly, attempting to attach it to the fiscal stimulus legislation passed in February 2009 and most recently on August 6<sup>th</sup> to the legislation that expanded the cash-for-clunkers program.

Enhanced direct demand-side support for the U.S. housing sector has a good chance of passage. Homeownership is the great American dream, and the public has always supported government subsidization of the sector. Support continues despite the effect that such subsidization has had in triggering the subprime mania and ensuing housing collapse. Supporters argue that these measures will jumpstart the housing market and stimulate the broader economy.

With its strong Republican backing, there is nary a word about the cost of the program and its impact on the budget deficit. The Joint Committee on Taxation provided a revenue estimate for Isakson's bill assuming an enactment date of July 1, 2009 (which, of course, will not be the case). The committee estimates that the proposal would reduce cumulative federal budget receipts for fiscal years 2009-2014 by about \$38.5 billion.<sup>2</sup> Arguably, the impact on the federal deficit would be smaller to the extent the tax credit boosts economic activity sufficiently to reduce the economically sensitive components of government spending such as welfare payments or unemployment insurance.

**Bottom Line:** The cash-for-clunkers program has been so successful that we can expect to see expanded positive incentives for targeted consumer spending. The opportunity to extend the expiring first-time homebuyer tax credit would be a huge political win for the Republicans and hardly a Democrat will stand in its way.

An expanded and enlarged homebuyer tax credit could well trigger an unexpectedly large boost to housing demand at a time when mortgage rates are still low and pent-up demand is high. It would not only boost first-time buyer demand, but would also jumpstart the move-up and retirement home markets as well. Housing is the most interest-sensitive sector of the economy and it has long been the traditional transmission mechanism for monetary policy. It could well be an important transmission mechanism for fiscal stimulus through a broadened and extended homebuyers' tax credit.

Home buying also leads to housing-related expenditures like furniture and appliance purchases, painting and other upgrades, and energy-efficiency spending. The positive impact on the overall U.S. economy could be large and of course U.S. trading partners would benefit. Canada could stand to benefit the most as U.S. demand for lumber, copper and other building materials, as well as the multiplier effects on U.S. demand for all Canadian exports, could be substantial.

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<sup>2</sup> A tax credit is considered a reduction in tax revenues.

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