

EXECUTIVE SUMMARY OF ECONOMIC POLICY WORK

Economic Recovery Plan

- In the absence of fiscal stimulus the economy is projected to lose 3 to 4 million jobs in 2009. Together with the jobs we have already lost and population growth, we will be 7 million jobs short of full employment. The unemployment rate is projected to rise above 9 percent and not projected to start falling until 2011.
- We believe that \$600 billion in stimulus over two years would create 2.5 million jobs relative to what would happen in the absence of stimulus. However, this falls well short of filling the job shortfall and would leave the unemployment rate at 8 percent two years from now. This has convinced the economic team that a considerably larger package is justified.
- The core of the package being recommended – investments and targeted tax cuts for energy, infrastructure, health, education, protecting the most vulnerable, and other priorities – totals only about \$225 billion over two years and nearly \$300 billion when it fully spends out. We do not believe it is feasible to design sensible proposals along these lines that go much beyond this total size.
- As a result, it may be necessary to consider two other elements for your plan: state fiscal relief and tax cuts for individuals and businesses. Although these are not as important to your priorities and are not as effective as stimulus, it is impossible to achieve your macroeconomic objectives without them.
- The memo outlines four alternative plan ranging from \$550 billion to \$890 billion with the difference between them being the state fiscal relief and tax proposals.

Four Illustrative Plans (Cost in \$ billions)				
	#1	#2	#3	#4
Core Package of Investments				
Energy	62	62	62	62
Infrastructure	60	60	60	60
Healthcare	36	36	36	36
Education	50	50	50	50
Protecting the Vulnerable	68	68	68	68
Other Priorities	22	22	22	22
Subtotal	300	300	300	300
Sources of Additional Stimulus				
State Fiscal Relief (incl FMAP)	130	175	200	200
Making Work Pay	70 (1 year)	140	180	140
Business Investment Incentives	50*	50*	50*	50*
New Jobs Tax Credit	-	-	80	-
Employer Payroll or Sales Tax Cut	-	-	-	200
Subtotal	250	365	510	590
TOTAL	550	665	810	890
Memo				
Jobs Created by 2011-Q1 (millions)	2.0 – 2.5	2.5	2.9	3.2
Unemployment Rate in 2011-Q1	7.8 – 8.0	7.8	7.5	7.3

*Table shows ten year cost. The two year cost is over \$180 billion.

Reforms and Budget Savings

- You will likely have to submit or sign several large pieces shortly after taking office (the Economic Recovery Plan, the CR, the Iraq/Afghanistan supplemental and something TARP related).
- Given that, it is imperative to establish serious reform and fiscal discipline credentials well before you submit your budget blueprint in late February.
- The memo recommends committing to a responsible budget and suggests a variety of options to that end. One set of options focuses on waste and abuse (e.g., eliminate ten programs or convene a “War on Waste” Summit) and other options focus on process (e.g., indicate your interest in budget process reforms).
- The memo also recommends another option which is releasing a detailed package of proposed health savings in January or early February.

The Medium-Term Budget Outlook and Options

- The unified deficit, including the economic recovery, is projected to average 5 percent of GDP over the next decade, higher than any decade except during major wars. The debt (net of financial assets) is projected to rise continually, passing 70 percent of GDP, which is well above any period since the 1950s.
- Your campaign proposals add about \$100 billion per year to the deficit largely because rescoring indicates that some of your revenue raisers do not raise as much as the campaign assumed and some of your proposals cost more than the campaign assumed.
- There are a variety of goals you could set for the medium-term fiscal picture. A minimally plausible goal of bringing the deficit down to the 3 to 3-1/2 percent range, which is consistent with stabilizing the debt at about 60 percent of GDP, would require us to identify \$300 billion in annual spending reductions or revenue increases relative to your campaign proposals.

Policy Changes Required To Achieve Alternative Deficit Targets in 2014			
<i>Goal in 2014</i>	<i>Necessary Spending Cut or Tax Increase in 2014</i>	<i>Deficit in 2014</i>	<i>Debt as a % of GDP in 2014</i>
Pay for All Campaign Proposals	100	775	62%
3.5% of GDP Deficit	225	640	61%
2.5% of GDP Deficit	396	460	58%
Balance the Unified Budget	826	0	53%

- The memo presents several illustrative options to have a sense of what it would take to come up with these savings.
- We recommend you set an overall fiscal goal and then the economic team will work together with the other policy teams to develop more specific options and packages to achieve this goal.

Financial Issues

- **Housing.** We expect to propose a housing package involving legislative elements and the use of the TARP or its successor. Essential elements are likely to include:
 - A general program with eligibility based on debt service to income ratios, hardship, and loan-to-value ratios. Eligible households would get mortgage modifications with partial government financing and possibly guarantees for servicers providing an incentive.
 - Make it easier for servicers to modify mortgages without fear of legal liability.

- We are considering proposals to use the GSEs more aggressively in support of the mortgage market.
- Strengthen Hope for Homeowners, which passed over the summer but has only received 111 applications to date.
- Reform the bankruptcy code to give lenders more of an incentive to modify mortgages.
- Focus on housing and community/neighborhood issues.
- **Autos.** The Administration is currently considering how to provide immediate assistance to the auto industry. They face a number of near-term constraints, including (i) remaining TARP resources are likely insufficient to meet the autos' need for funds in the coming months; (ii) the economic impact of a bankruptcy filing under different contingencies is highly uncertain, and will introduce substantial complications; and (iii) the broader industry environment is fragile, with growing weakness in the supplier base and the captive finance companies. Given these constraints, we believe there are three approaches that the Administration can realistically take:
 - Provide remaining TARP funds as the first tranche of DIP funding into an organized filing sometime around the New Year;
 - Provide remaining TARP funds explicitly as a bridge loan to a pre-arranged bankruptcy filing;
 - Provide funding sufficient to get GM and Chrysler through the end of January without pre-determining whether our Administration will pursue an out of court restructuring or a bankruptcy filing.
- We will be discussing with you how, if at all, we wish to engage with the current Administration on their plans; how specific and stringent we would want the Administration to be about either forcing a filing or applying specific conditions to receipt of funds pre-inauguration; and how much independent oversight we would like to see in guiding difficult decisions going forward.
- **Financial Stabilization and Recovery.** The scale of potential future losses for the banking sector alone is substantial, and appears to be escalating dramatically as the economy worsens and more sectors are affected.
- Our judgment is that effectively stabilizing the financial system will ultimately require more resources than those currently authorized under the TARP.
- Our approach should be guided by clear policy goals: to decisively stabilize core financial institutions and dramatically increase support to restart the flow of credit to households and businesses and restore the healthy functioning of capital markets.

- This will likely require substantial additional capital injections and dramatic expansion of programs designed to support the functioning of asset backed securitization markets, as well as other steps.
- We will need to make decisions about whether to support an early January request by the Bush administration for the second tranche of TARP funds or to replace TARP with a program of our design.
- We are undertaking a full analysis of policy approaches to achieve these objectives. Our plan is to have a specific set of options and recommendations for you in early January, with an eye towards a comprehensive speech and coordinated announcement with the Fed and FDIC shortly after your Inauguration.
- **Financial Regulation.** Reform of the financial regulatory system, building on the principles you outlined in your Cooper Union speech and over the course of the campaign, will be a significant part of your economic agenda. Timing and sequencing will be critical particularly given two issues: (1) we will be in crisis-fighting mode and (2) some of the necessary regulatory reforms could be good in the long run but the greater conservatism in leverage and risk management could intensify problems in the short run. One question is whether we want to package all of our reforms together somewhat later in the year or do a first stage as part of a post-TARP financial recovery plan with more comprehensive legislation to follow. Administrative actions will be an important part of our response, specifically encouraging the regulators to use the authority they already have. However additional statutory changes are also necessary, as discussed in the longer memo.

December 15, 2008

TO: President-Elect Obama
FROM: Larry Summers
SUBJECT: Update on Economic Policy Work

The following memo is background for our meeting on Tuesday. It includes a discussion of our work in several areas: the Economic Recovery Plan, reforms & budget savings, the medium-term budget outlook & options, and financial issues including housing, autos, financial stabilization, and financial regulation. Portions of the memo were contributed by your CEA, OMB and Treasury designees. The memo is also informed by extensive discussions with your DPC designees, the energy team, the health team, and others inside and outside the transition.

Note that the different parts of this memo address different issues separately, like Economic Recovery Plan, the TARP, and housing. But in reality, in terms of scale and comprehensiveness it will provide greater macroeconomic stimulus and stability if these different efforts are conceived and presented as a massive, coordinated approach to the economic crisis. The rule that it is better to err on the side of doing too much rather than too little should apply forcefully to the overall set of economic proposals.

There is also a significant global coordination issue that is not addressed in this memo.

I. THE ECONOMIC RECOVERY PLAN

We have been working to develop an Economic Recovery Plan that helps jolt the economy out of its short-term weakness, provides relief to those hurt by the recession, and begins to make investments that will benefit America for years and decades to come. In addition to our internal policy development process we have consulted extensively at the staff and member level on the Hill, with different groups through the Office of Public Liaison (e.g., the leadership of all the major Hispanic organizations, the AARP, progressive groups, and other meeting planned for the future) and the Intergovernmental Affairs (several governors, mayors, the National Governors Association and others), and with outside economists and policymakers.

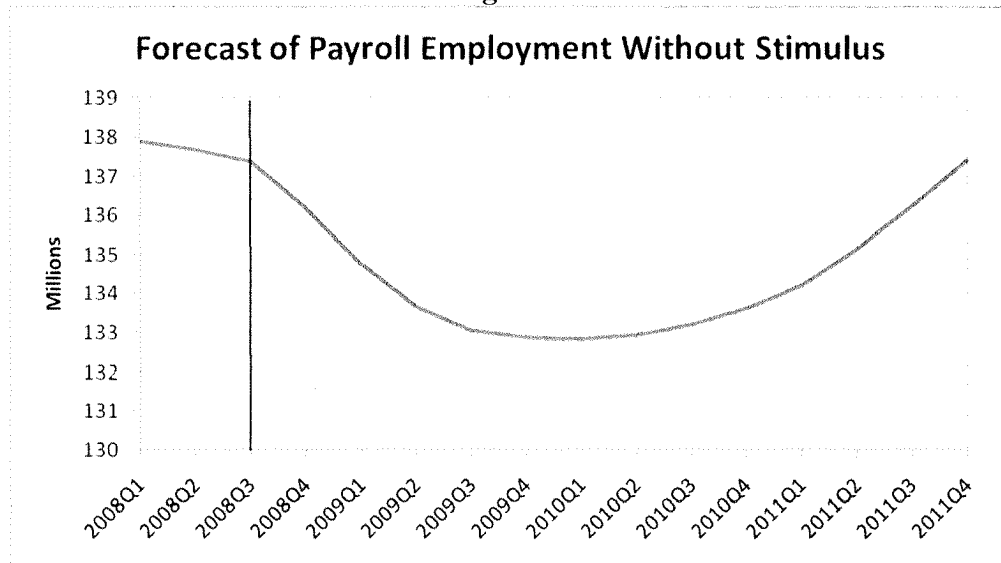
As the economic outlook has deteriorated, consensus judgments of appropriate size of two-year packages have risen sharply. We have become convinced that there is a compelling case for a recovery package considerably larger than the \$500 to \$600 billion that we were originally contemplating in order to have a reasonable prospect of keeping unemployment in the 7 percent range and hopefully declining two years from now. This is, of course, an economic judgment that would need to be combined with political judgments about what is feasible.

Constructing a package of this size, or even in the \$500 billion range, is a major challenge. While the most effective stimulus is government investment, it is difficult to identify feasible spending projects on the scale that is needed to stabilize the macroeconomy. Moreover, there is a tension between the need to spend the money quickly and the desire to spend the money wisely. To get the package to the requisite size, and also to address other problems, we recommend combining it with substantial state fiscal relief and tax cuts for individuals and businesses.

A. Economic Outlook

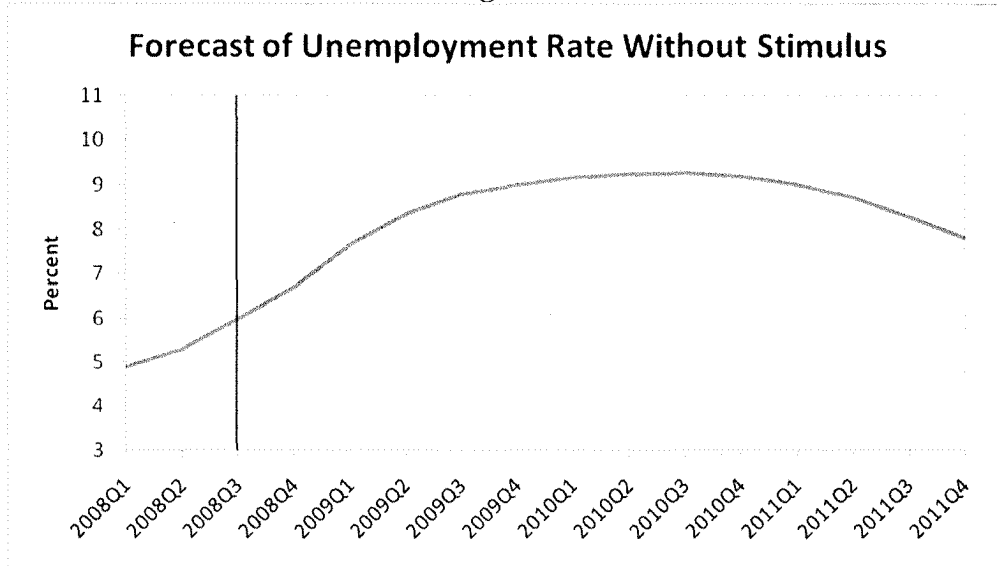
The economic outlook is grim and deteriorating rapidly. Forecasters now expect output to contract at least a 5 percent annual rate in 2008-Q4 (the government will release this data on January 30th), which would be the worst contraction since the early 1980s. The economy has already lost 1.9 million jobs since its peak in December 2007. Most forecasts suggest that, without stimulus, we will lose another 3 to 4 million jobs over the next year (see Figure 1, derived as a synthesis of what private and public forecasters are saying as of December 12th, 2008). Thus, at its likely trough, the economy will have lost a total of at least 5 million jobs. By comparison, in a normal period the economy would have gained 2 million jobs over this period – so we will be 7 million jobs short of full potential.

Figure 1



Most analysts are predicting that in the absence of stimulus, unemployment will rise over 9 percent. Moreover, during the last two recessions the unemployment rate continued to rise for about 18 months following the end of the recession. Based on that experience, unemployment is expected to return only very gradually to its normal pre-recession level, remaining close to 8 percent through the end of 2011, as shown in Figure 2.

Figure 2



Forecasts have become decidedly more pessimistic in recent days. Macroeconomic Advisers reported the largest negative forecast revision in its history on December 8th, and on the 11th they revised down their forecast of growth in the current quarter by another percentage point. The driving factors for the negative revisions were the extremely negative employment report from December 5th and the trade deficit and unemployment claims report from December 11th.

The fundamental factors driving the deterioration of both the current economy and forecasts of future performance are continued financial market disruptions, housing and asset price declines, extremely pessimistic expectations, and accelerating decline in the rest of the world.

In thinking about the risks to the forecast, further negative revisions seem more likely than positive revisions. A significant worry is that the accelerated real decline in output could cause further deterioration in asset prices and further financial market distress. While less likely, positive revisions are also possible. Consumer confidence rose slightly in the last report and retail sales reported on December 12th, though dismal, were less bad than expected. So, it is possible that improvement in expectations could lead to increased consumer and business investment spending and hence a less severe downturn.

B. Effects of Fiscal Stimulus

Changes in government purchases and taxes have important effects on output and hence on employment and unemployment. The effects of fiscal stimulus, however, vary with the type of fiscal action:

- Research suggests that an increase in government purchases of 1 percent of GDP increases real GDP relative to what it otherwise would have been by approximately 1.5 percent after two years.
- A permanent tax cut of 1 percent of GDP increases GDP by 0.4 percent after one year and 0.8 percent after two years. The smaller effect is due in large part to the fact that a significant fraction of a tax cut is typically saved, while spending, by definition, is spent. The size of the effect of a permanent tax cut tends to be larger if it is received by lower-income, liquidity-constrained consumers. The behavioral response can also be influenced by perceptions of the deficit. If consumers are very aware of the effects of the tax cut on the deficit, this can lead to increased saving out of fear of a fiscal crisis or in anticipation of higher future taxes.
- A temporary tax cut has even smaller effects because consumers typically save a larger fraction of transitory gains.
- When money is sent to the states, they use some of it to maintain spending, some to avoid tax increases, and some to supplement rainy day funds. Although there is less research on this topic, it is not unreasonable to assume that a permanent increase in transfers to the states of 1 percent of GDP increases GDP by about 1 percent after two years.

For a plausible package of fiscal stimulus, a useful rule of thumb is that a legislated stimulus of \$150 billion (or 1 percent of GDP) for each of two years (or \$300 billion or 2 percent of GDP total) will increase GDP after two years by 1 percent. This increase of GDP of 1 percent will lower the unemployment rate by approximately $\frac{1}{2}$ of 1 percentage point and increase employment by roughly 1 million. Of course, these rules of thumb are just approximations. And, there is considerable uncertainty about the effects of fiscal stimulus on output and on unemployment and jobs. We could be surprised in either direction.

C. Needed Size of Fiscal Stimulus

How much effective fiscal stimulus is called for depends on the goals of policy, as shown in Table 1:

- Creating 2.5 million jobs (relative to the no-stimulus baseline) by 2011Q1: \$550 to \$670 billion of legislated stimulus. Given the likely job losses, this is a relatively modest goal. How much legislated stimulus it will take to achieve this depends on the composition of the package. If the package is geared toward high impact spending, it is possible that this could be accomplished with the lower amount of spending. This amount of stimulus, however, would leave the economy significantly depressed, with unemployment just under 8 percent.
- Close just under half of the output gap by 2011-Q1: about \$850 billion of legislated stimulus. This is a more ambitious option. It would shave approximately two percentage points off the unemployment rate, to 7.4 percent. It would close the output gap from roughly 7 percent to 3.5 percent.

Notice that neither of these packages returns the unemployment rate to its normal, pre-recession level. To accomplish a more significant reduction in the output gap would require stimulus of well over \$1 trillion based on purely mechanical assumptions – which would likely not accomplish the goal because of the impact it would have on markets.

Recall also, the goal of the stimulus package is not just to reduce unemployment and create jobs. It is also designed to be an insurance package against catastrophic failure of financial institutions and other key industries.

Table 1. Fiscal Stimulus and Outcomes in 2011Q1

Headline Stimulus	GDP Gap	Jobs Created	Unemployment Rate
\$655 billion	4.3%	2.5 million	7.8%
\$880 billion	3.6	3.4 million	7.3

This is standard macroeconomic analysis and it has led most leading economists to call for substantial stimulus packages. Based on our consultations and published accounts:

Progressive Economists:

- Robert Reich believes it should be \$1.2 trillion over two years, but also indicated it could be larger.
- Joe Stiglitz believes it should be \$1 trillion over two years.
- Paul Krugman: at least \$600 billion in one year
- Jamie Galbraith: \$900 billion in one year
- Institute for America’s future (signed by Dean Baker, Andy Stern, Leo Gerard, John Sweeney, and others): at least \$900 billion

Republican Economists:

- Marty Feldstein was an early proponent of a spending-only package and currently believes it should be \$400 billion in the first year.
- Larry Lindsey, a former Federal Reserve Governor and NEC Director, estimates that \$800 billion to \$1 trillion is desirable.

- Ken Rogoff (widely respected macroeconomist, former chief economist of the IMF, former McCain adviser): \$1 trillion over two years
- Mark Zandi (widely quoted economist, former McCain adviser): at least \$600 billion in one year
- Greg Mankiw is the only economist we have consulted with who refused to name a number and was generally skeptical about stimulus.

Others:

- Senior Federal Reserve officials appear to be of the view that a plan that well exceeds \$600 billion would be desirable.
- Adam Posen (Deputy Director of the Peterson Institute): \$500 to \$700 billion in one year
- Goldman Sachs: \$600 billion in one year
- Open Letter signed by 387 economists including Nobel Laureates Robert Solow, George Akerlof, and Joe Stiglitz on November 19th [note that most economists, including Stiglitz, support higher stimulus numbers today than they did a month ago]: \$300 to \$400 billion per year

D. Other Considerations on the Size of Stimulus

From the perspective of raising demand and creating jobs there is a case for a very large program of stimulus. Considerations on the other side include:

- It may be possible to achieve some stimulus in other ways such as through financial policy actions. However the forecasts all assume reasonably aggressive behavior on the part of the Fed and likely are too optimistic about demand coming from the rest of the world.
- An excessive recovery package could spook markets or the public and be counterproductive. Given where the public discussion is moving and given the “flight to treasuries” present in markets at this point, we do not believe this should deter escalation well above \$600 billion – a view shared by senior Federal Reserve officials. It does speak to the importance of accompanying recovery actions with strong measures to reinforce medium term fiscal credibility.
- The economy can absorb only so much “priority investment” over the next two years. Inevitably as the quantity of fiscal stimulus increases its quality declines, and the package tilts more heavily towards tax cuts and other lower priority measures. On the other hand, insufficient fiscal impetus could put recovery at risk with catastrophic consequences.

- It is easier to add down the road to insufficient fiscal stimulus than to subtract from excessive fiscal stimulus. We can if necessary take further steps. However, this is a key moment to get ahead of the curve in responding to economic distress.

E. The Core Package: Major Investments and Campaign Priorities

We have been working to design alternative options for economic recovery packages in the \$550 billion to \$900 billion range. The following three sub-sections lay out this work. Section D begins with the “core package” – which is essentially the largest amount we believe can reasonably be invested through outlays or targeted tax cuts on energy, infrastructure, health, education, protecting the most vulnerable and other priorities. These are generally key campaign priorities, major investments, and high-quality stimulus. Then Section E discusses how to add additional stimulus, either through state fiscal relief or across-the-board tax cuts for individuals or businesses. Finally, Section F draws these together into three illustrative packages.

Peter Orszag and OMB career staff, together with NEC staff, have worked with the policy teams to identify as much spending and targeted tax cuts as could be undertaken effectively in six priority areas: energy, infrastructure, health, education, protecting the vulnerable, and other critical priorities. The short-run economic imperative was to identify as many campaign promises or high priority items that would spend out quickly and be inherently temporary. The long-run economic imperative, which coincides with the message imperative, is to identify items that would be transformative, making a lasting contribution to the American economy. In all of these cases we had to balance various tensions, including incorporating serious reforms versus fast passage and implementation, and making the disparate components of the package coherent.

The spending and targeted tax cuts we identified represent the “core package” that we recommend as part of any of economic recovery options. This package totals about \$300 billion, with about \$225 billion of the money spending out over the first two years. This entire core package would represent highly effective fiscal stimulus, either because it is direct government purchases or because it is refundable tax credits or transfer payments to low-income households (e.g., EITC and food stamps) that will likely spend the money.

We will continue to refine this package to make sure it meets our goals and reflects your input and priorities. **But it is important to recognize that we can only generate about \$225 billion of actual spending on priority investments over next two years, and this is after making what some might argue are optimistic assumptions about the scale of investments in areas like Health IT that are feasible over this period.** The core proposals are shown in Table 2. More details in all of these areas are provided in the Appendix, including discussions of critical reforms to accompany these proposals (e.g., a use-it-or-lose-it rule for infrastructure subsidies).

Table 2: The Core of the Economic Recovery Plan	
<u>PUTTING AMERICA ON THE PATH TO ENERGY INDEPENDENCE</u>	Cost (\$billions)
Jumpstarting a SmartGrid	14
Launching New National Efficiency Effort	20
Spurring Wave of Next-Generation Clean Technologies	13
Establishing Tax Incentives for Green Investments and Purchases	15
<i>Subtotal</i>	62
<u>RESTORING AND STRENGTHENING AMERICAN INFRASTRUCTURE</u>	
Repairing our Roads and Bridges	20
Creating New Infrastructure Bank	10
Safeguarding Drinking Water and Wastewater Systems	5
Modernizing Federal Buildings and Lands	8
Modernizing Airports and Air Traffic Control	1
Providing New, Clean Transportation Options	5.5
Increasing Availability of Affordable Public Housing	5
Restoring U.S. Leadership on Broadband Access	6
<i>Subtotal</i>	60
<u>TRANSFORMING HEALTHCARE AND PROTECTING FAMILIES</u>	
Shifting to Paperless Health System Through Health IT	20
Investing in Comparative Effectiveness, Prevention, Research	5
Protecting Vulnerable Populations and CDC Infrastructure	1.5
Cobra Subsidies [Note: we are working on developing this]	10
<i>Subtotal</i>	36
<u>SUPPORTING THE SUCCESS OF OUR CHILDREN AND YOUNG ADULTS</u>	
Modernizing Thousands of Schools	7
Making Necessary Investments to Support Student Achievement	0.5
Stopping Teacher Layoffs and Improving Teacher Training	4.2
Preventing a 25 percent Cut in Pell Grants and Short-term Increases	13.6
Supporting Proven Job Training Programs	1
Increasing Short-term Childcare and Early Childhood Funds	3.7
Instituting the American Opportunity Tax Credit	20
<i>Subtotal</i>	50

<u>PROTECTING THE MOST VULNERABLE</u>	
Extending Unemployment Insurance	29.5
Modernizing Unemployment Insurance	7
Increasing Food Stamps Temporarily	11
Protecting WIC, TANF and Other Programs from Shortfalls	5
Increasing SSI Benefits Temporarily	3.4
Increasing the EITC & Childcare	10
<i>Subtotal</i>	68
<u>OTHER PRIORITIES</u>	
Hiring 7,000 Cops	1.4
Installing Homeland Security Interoperable Communications Networks	10
Jumpstarting Social Entrepreneurship	2
Increasing International Assistance	5
Expanding Short-term Scientific Research Grants	3
Improving the Federal Census	1
<i>Subtotal</i>	22
TOTAL	\$300

The core of your economic recovery package would result in several major, lasting accomplishments that would achieve ambitious short-term goals and jump-start critical long-term goals. The core package achieves the following short-term goals:

- Doubling renewable energy production, and reducing energy costs for 2 million newly-weatherized homes
- Largest investment of infrastructure funds to eliminate backlog of needed repairs
- Ensuring the newly uninsured have affordable health coverage
- Preventing teacher cuts across the nation

And it jumpstarts the following long-term goals:

- Creation of a Smart Grid, which will reduce energy costs, improve security, and allow the widespread deployment of renewable technologies
- Development of a National Infrastructure Reinvestment Bank to identify and fund the most important infrastructure projects nationally
- Facilitating the Near-Universal Adoption of Health IT Records

- Widespread Deployment of New Measures of Student Achievement to Improve School Accountability and New Teacher Pay Systems

We have also worked to make sure that this package includes reforms to ensure that the money is spent wisely. There is some tension between the goal of reforms and several practical objectives: some reforms slow the passage of the legislation, other reforms would be better if they were developed over time and introduced later (e.g., include teacher reforms in the No Child Left Behind reauthorization rather than the economic recovery plan), and finally other reforms could slow the delivery of money. We have attempted to strike a balance in developing the plan but look forward to more discussion and guidance around this balance. Here are some of the reforms we are considering including:

- Use-it-or-lose it and no earmarks with core infrastructure spending;
- Demanding accountability for infrastructure projects, including new federal oversight for all funds and ensuring long-term rigorous cost-benefit analysis of all projects;
- Enacting serious energy efficiency reforms, which have been long-neglected despite being the fastest, cheapest and most efficient way to reduce energy costs;
- Adopting a prevention and “what works” first health care agenda that will reduce costs for the federal government and consumers in future years;
- Providing significant federal incentives for new teacher compensation systems, coupled with new resources for schools to achieve strong goals;
- Enacting new countercyclical policies that will protect the uninsured and help minimize the impact of future recessions by adding a permanent countercyclical component to FMAP.

F. Sources of Additional Stimulus: State Fiscal Relief and Tax Cuts

As noted above, it is not possible to spend out much more than \$225 billion in the next two years with high-priority investments and protections for the most vulnerable. This total, however, falls well short of what economists believe is needed for the economy, both in total and especially in 2009. As a result, to achieve our macroeconomic objectives – minimally the 2.5 million job goal – will require other sources of stimulus including state fiscal relief, tax cuts for individuals or tax cuts for businesses. All three of these areas, however, raise tradeoffs because they are not as economically effective as stimulus, do not represent a down payment on a campaign promise (with the exception of the Making Work Pay credit), and do not have a lasting impact on the economy beyond protecting against a deep recession. These issues are discussed below.

State Fiscal Relief

State deficits alone are projected to total \$200 to \$250 billion over the next two and a half years, excluding local government deficits. Under the balanced budget rules that apply in every state (except Vermont), states are undertaking large reductions in spending and several states, including California, are actively considering tax increases. These steps would not only be macroeconomically contractionary, but would also damage health and education systems.

The 2003 fiscal stimulus included \$20 billion in state fiscal relief, half of it delivered by temporarily raising the federal matching rate for Medicaid (FMAP) and half in block grants distributed proportionately based on states' population. The need for both aggregate fiscal stimulus and state fiscal relief is considerably larger today. The health team is particularly concerned about likely cuts to Medicaid because of tight state budgets. The economic team recommends \$150 billion to \$200 billion over two years for this purpose. We would recommend including as much of this as possible in FMAP – around \$85 billion. A condition of receiving the FMAP increase is that states do not reduce eligibility; as such, it has an effect on health coverage as well. The remainder of the state fiscal relief would be provided in the form of a general block grant or a block grant under another label, like preventing cuts to teachers and cops. Recall that the estimates suggest that transfers to the states have a reasonably large macroeconomic bang for the buck.

State fiscal relief is likely to be unpopular with some, especially Republicans, who view it as letting states off the hook for their profligacy.

Individual Tax Cuts

We believe that additional tax cuts are required to achieve the degree of fiscal stimulus we are seeking. Note that in designing these tax cuts one important consideration is that the economic evidence shows that tax cuts for lower-income households, including refundable tax credits, are more likely to be spent and thus more likely to generate macroeconomic stimulus.

- **Targeted tax cuts.** The core package already includes several targeted tax cuts that you proposed in the campaign (e.g., for college, the EITC and childcare).
- **Making Work Pay (\$140 billion for two years).** This is a core campaign commitment to cut taxes for 95 percent of workers and their families, providing a \$1,000 refundable tax cut to a middle-class working couple. Although tax cuts are generally less effective than government spending in terms of stimulus, the perception that you would make this tax cut permanent would help stimulus. Some, however, are likely to view this as a “rebate” which they view as not having worked last time. Although our main proposals envision proposing Making Work Pay in the identical form to the campaign proposal, you could consider temporarily increasing it in 2009 and 2010 to achieve stimulus – although it might be a challenge to subsequently lower it.
- **Temporarily cutting sales taxes (\$100 to \$250 billion over two years).** Several economists have proposed providing grants to states that would require them to cut their

sales taxes. Arguably this is the most economically stimulative form of tax cuts because it encourages households to spend now rather than later to take advantage of the temporarily lower taxes. Also it has the least risk of becoming permanent and hurting the long-run fiscal situation. It does, however, raise administrative complications because it would require fifty states to pass laws and would limit their flexibility in responding to their deficits. A bigger challenge is overcoming the perception that your single largest economic proposal is about encouraging people to spend more, which goes against the investment and responsibility themes you have stressed.

Business Tax Cuts

Finally, the package could include business tax cuts that go beyond the targeted business tax cuts (e.g., incentives for renewables) already included in the core package. Here are some of the options we have considered:

- **Extending small business expensing for two years (\$2 billion over two years and \$0.1 billion over ten years).** The stimulus that passed in 2008 temporarily raised the amount small businesses could expense (i.e., deduct immediately) to \$250,000 through the end of 2008. In the campaign you proposed to extend this temporarily higher limit through the end of 2010. Treasury estimates that would cost \$2 billion over two years. Note that much of that money would be recouped in the following years because the small businesses that took the expensing would lose their future depreciation allowances, resulting in them paying higher taxes in future years (although still lower taxes overall). We recommend including this proposal in your package.
- **Extending 50 percent bonus depreciation for two years (\$144 billion over two years and \$28 billion over ten years).** The 2008 stimulus bill also allowed all businesses to deduct 50 percent of their investments in 2008, a provision that was included largely at the insistence of Republicans. You could extend this for two years. That would have a large up-front cost but most of the money would be recouped in future years as firms shift from smaller annual savings from depreciation deductions to larger upfront deductions from the bonus depreciation. The economic evidence that this will increase investment is weak and economists generally consider the experience with it in 2002-2004 and 2008 relatively disappointing. But it is administratively simple and has commanded strong Republican support in the past. (Note, we are also studying variants of this proposal, including 100 percent bonus depreciation – a step supported by several Republicans – or a proposal like 67 percent bonus depreciation in 2009 followed by 33 percent bonus depreciation in 2010.)
- **Extending Net Operating Losses (\$33 billion over two years and \$6 billion over ten years).** Currently firms are allowed to get a de facto refund for tax losses (or for tax benefits like bonus depreciation) up to the amount of taxes they have paid in the previous two years. In addition they can carry these losses forward for seven to ten years. With the weak economy, however, many firms have losses and moreover cannot borrow money to sustain themselves until they can monetize these losses against future taxes. As a result, this proposal would extend the carry back period from two years to five years. This

proposal would also enhance the potential stimulus to investment that comes from bonus depreciation. It is strongly supported by Republicans and we recommend you include it in the package.

- **New Jobs Tax Credit (up to \$80 billion over two years).** The “Rescue Plan for the Middle Class” you released in the campaign included a tax credit for each new job. Such a tax credit could be designed, for example, to give employers \$3,000 for each net new hire in 2009 and 2010 – perhaps above a base of 80 percent of previous employment to also give them an incentive, at the margin, to retain workers. We have not scored these proposals with Treasury but believe they could be dialed up to about \$80 billion.
- **Cutting Employer Payroll Taxes (\$140 billion or more over two years).** Finally, you cut give employers a credit against their payroll taxes to lower the cost of hiring and encourage them to expand employment. One way to do this would be to extend Making Work Pay to the employer share of the payroll tax. This could strengthen our message specifically around jobs. The downsides are that it could raise some administrative issues, some Republicans would not perceive it to be a business tax cut, and some Democrats would criticize it for being a business tax cut.

G. Combining These Elements into Four Illustrative Plans

Here are three illustrative packages based on the proposals outlined above:

- **Illustrative Plan #1 (\$550 billion):** This would supplement the core package with \$130 billion in state fiscal relief (of which \$85 billion would be delivered via FMAP), one year of Making Work Pay, and business investment incentives. This might be just enough to just reach your 2.5 million jobs goal, although some forecasts could show it falling short.
- **Illustrative Plan #2 (\$665 billion):** This would take Illustrative Plan #1 and add an additional \$45 billion more in state fiscal relief in the form of a block grant (bringing the total state fiscal relief to \$175 billion) and a second year of Making Work Pay. It would create 2.5 million jobs but still leave the unemployment rate at about 8 percent.
- **Illustrative Plan #3 (\$810 billion):** This plan would build on the previous two by adding another \$25 billion in state fiscal relief, another \$40 billion in temporarily higher Making Work Pay Credit, and an expanded New Jobs Tax Credit. This proposal largely sticks to policies you outlined over the course of the campaign without adding major new ones. The net result would be about 2.9 million jobs and the unemployment rate would be 7.5 percent.
- **Illustrative Plan #4 (\$890 billion):** Unlike Plan #3, this proposal adds a major, new \$200 billion tax cut – either in the form of an employer payroll tax credit or a sales tax cut. This has the advantage of scalably achieving more stimulus. It has the disadvantage of introducing a brand new and large policy that may not be consistent with your overall

themes. The net result would be about 3.2 million jobs and the unemployment rate would be nearing 7 percent.

Table 3: Four Illustrative Plans (Cost in \$ billions)				
	#1	#2	#3	#4
<u>Core Package of Investments</u>				
Energy	62	62	62	62
Infrastructure	60	60	60	60
Healthcare	36	36	36	36
Education	50	50	50	50
Protecting the Vulnerable	68	68	68	68
Other Priorities	22	22	22	22
Subtotal	300	300	300	300
<u>Sources of Additional Stimulus</u>				
State Fiscal Relief (incl FMAP)	130	175	200	200
Making Work Pay	70 (1 year)	140	180	140
Business Investment Incentives	50*	50*	50*	50*
New Jobs Tax Credit	-	-	80	-
Employer Payroll or Sales Tax Cut	-	-	-	200
Subtotal	250	365	510	590
TOTAL	550	665	810	890
<u>Memo</u>				
Jobs Created by 2011-Q1 (millions)	2.0 – 2.5	2.5	2.9	3.2
Unemployment Rate in 2011-Q1	7.8 – 8.0	7.8	7.5	7.3

*Table shows ten year cost. The two year cost is over \$180 billion.

H. Key Questions and Considerations

In the meeting with you on Tuesday we will discuss some of the key questions:

- How to trade off the message of the package against the desire for more stimulus?
- How to trade off the desire for reform vs. the desire for quick passage and implementation?
- How many Republican proposals should be included at the outset?
- How much do we want to start with an ideal plan vs. having a strategy to get from our starting point to a final plan?

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- Are there any useful guideposts in developing the plan (e.g, 50 percent tax cuts and 50 percent spending increases) that we should consider?
- How do we ladder from the Economic Recovery Plan to the February budget blueprint?

II – REFORMS AND BUDGET SAVINGS

In the first few months of your Administration, we will submit or sign a more than \$500 billion economic recovery package, a more than \$100 billion Iraq/Afghanistan supplemental, potentially a request for \$350 billion from the second half of TARP, and a \$410 billion omnibus appropriations bill for the FY 2009 budget. This could come as a considerable sticker shock to the American public and the American political system, potentially reducing your ability to pass your agenda and undermining economic confidence at a critical time.

You will likely submit an economic and budget blueprint to Congress in the second half of February which details your overall budget framework and given the budgetary pressures created by the actions above, a key focus of this blueprint will be the major choices you are making to put America on a fiscally sustainable course.

This section of the memo discusses some ideas that could potentially be developed or released before the February budget blueprint to convey that you take fiscal discipline seriously and are not just focused on big spending and big tax cutting items. A key factor to consider will be ensuring that these proposals do not just seem quantitatively small compared to all the new spending and some would argue miss the source of the long-run deficit.

A. Proposals Focused on Waste and Inefficiency

Attacking waste and inefficiency within government programs is not only an important symbolic step but also can help to create more confidence in government overall despite the relatively small savings from this approach. While the full line-by-line review of the government you have proposed will take time and could be reflected in the FY 2011 budget, there are a number of immediate ways to make a down payment on this pledge:

- Releasing a “Top Ten” cuts/eliminations list. In advance of the budget release, we could release a Top Ten cuts and/or program eliminations list that would demonstrate that we are focused on finding cost savings and eliminating waste throughout the federal budget. Potential candidates include:
 - Subsidies to large farmers, like the uncapped agricultural commodity payments
 - “Reading First”, a program you identified for termination during the campaign
 - Contracts that have come in late and over budget
 - Duplicative programs such as HUD “economic development” programs
- Establishing a unit to examine waste, fraud, and abuse – and require cabinet officers to report back on the steps they are taking to address these problems. This new unit – potentially placed at OMB – would investigate and expose wasteful spending by examining internal documents and conducting interviews of officials. The unit would also issue reports on the degree to which agencies followed the recommendations contained in IG and GAO reports, an idea supported by Congressman Waxman. You could announce the creation of this unit with an immediate order to your Cabinet officials to report on outstanding IG and GAO reports about their agencies.

- Convening a “War on Waste” summit. You could meet with top government watchdogs responsible for targeting waste and inefficiency within federal programs with a directive to provide their top recommendations on what to either cut or eliminate within thirty days. This proposal has been supported by Senator McCaskill.
- Endorsing a Corporate Subsidy Reform Commission. You could endorse a proposal similar to the one suggested by Senator McCain establishing a commission with BRAC-like powers to review inequitable federal corporate subsidies and make recommendations for the termination, modification, or retention of such subsidies. Senator Kerry and the CATO Institute have endorsed the concept, arguing that a BRAC-like process is the only way to remove the entrenched interests supporting various subsidies. This process could also be used to review inefficient tax loopholes like those you proposed to close during the campaign, as well as corporate tax expenditures.

Congressional leadership would likely oppose, given reluctance to establish procedures that bypass the traditional committee process, and rank and file members would be concerned about protecting their “subsidized” interests. There is also potential that some of the programs that you have advocated would be construed as subsidies.

- Executive Pay Freeze. You could issue a directive or initiate legislation that would institute a pay freeze for certain senior executive branch employees while the economy remains in recession. This could be a quick demonstration of your awareness of the struggles of working Americans, though it could also highlight the relatively high salaries of federal executives.
- Earmark Reform. Phil and the ethics team are working on a set of measures, likely via Executive Order, to tackle earmarks by both defining and publicizing how we will manage them in the administration, and using this effort as leverage with the Congress.

B. Proposals Focused on Reducing Health Spending

Although reducing waste and inefficiency within government programs is an important component of an overall fiscal discipline package, the key to our fiscal future is spending on Social Security, Medicare, and Medicaid. As we have already discussed with you, we believe it would be helpful to get out early in January with a “down payment” on health care cost savings totaling about \$225 billion over ten years. We would clearly explain that these policies would be part of a larger plan to expand health coverage and make it affordable for all Americans. These proposals include:

- Medicare Advantage Competitive Bidding: ~\$160 billion
- Mandatory Adoption of Health Information Technology: ~\$10 billion
- Part D Income-Related Premium for Seniors with Income > \$85,000: ~\$8 billion
- Medicare Accountable Health Organization: ~\$6 billion

- Reduce Medicare Payments for Hospitals with High Readmission Rates: ~\$5 billion
- Reduce Medicare and Medicaid Fraud: ~\$5 billion
- Expand Hospital Incentive Quality Demonstration: ~\$3 billion
- Reduce Medicare Payments to Physicians Who Do Not Meet Flu Vaccine Benchmarks: ~\$2 billion
- Establish Prior Authorization for Imaging: ~\$1 billion
- Increase Medicaid Brand-Name Drug Rebate to 22.1 Percent: ~\$5 billion
- Family Planning in Medicaid: <\$1 billion

In addition to these “scoreable” savings, we would also pair this announcement with the investments in the Economic Recovery Act: our support for a substantial comparative effectiveness and health IT effort, a process for making long-run cost containment decisions (see next section), and a prevention agenda. These steps may not immediately score, but we believe would ultimately improve the efficiency of the health system substantially.

C. A New Approach to Long-Run Fiscal Issues

Whatever specific policy steps we endorse could be supplemented with a commitment to a new process for other changes to long-run health policy, Social Security and taxes. There are two possibilities for making tough decisions on the long-run budget, which could be done either separately or together: creating an executive-branch “health board” (which focuses on one part of the issue) and a Congressionally chartered commission (which could focus more broadly). These approaches could also be done together, although a key point is that they currently have different champions in the Senate.

The health board idea, proposed by Sen. Daschle in his book, allows for timely and often-times difficult policy changes to be made to Medicare and Medicaid and possibly other parts of the health system with a degree of independence from the Congressional process and special interests. This idea is included in Sen. Baucus’s white paper on health reform. The Health and Economic Teams consider a Board an essential ingredient to improving the value of health care in the long run.

Another possibility is to support the creation of bipartisan commissions to study entitlement reform. For example, Senators Conrad and Gregg have proposed the Bipartisan Task Force for Responsible Fiscal Action. Under the Conrad-Gregg bill, a 16-member bipartisan task force would make recommendations on how to substantially improve the long-term fiscal balance. The recommendations would be fast-tracked in both houses, with final passage requiring a three-fifths vote. The proposal has been endorsed by House Majority Leader Hoyer, former GAO Comptroller General David Walker, Leon Panetta, and AARP CEO Bill Novelli. It has been opposed by Speaker Pelosi, Senators Reid and Baucus, and various chairs in House as unnecessary and unlikely to produce the results intended.

Other commission ideas come from Representatives Tanner and Castle, and from Senators Hagel and Webb. They have called for a bipartisan, eight-member Medicare and Social

Security commission. The commission would submit a final report within one year and ideally Congressional hearings would review the commission's recommendations. The Tanner commission does not bypass normal Congressional procedures, and is therefore less controversial but also viewed as not having much potential impact.

The Health Policy and Economic Team recommend that we commit to a process and provide examples of a commission or board, but not commit to either of these approaches in January. This allows us to tell supporters of the different approaches that we agree with their premise but want to work with them on the best method of implementation.

III. THE MEDIUM-TERM BUDGET OUTLOOK AND ISSUES

Section II just discussed some of the reforms you could roll out prior to the February budget blueprint. The goal of the reforms discussed in that section is to establish upfront that you are about changing the way Washington does business. But these reforms do not alter the challenge you will face in developing a comprehensive set of policies underlying the February blueprint – they are either relatively small in terms of their overall impact or they are already assumed in your budget.

And the challenge of developing a February budget blueprint is considerable. As you know, the budget outlook over the next ten years has deteriorated. Even without any new proposals, the budget deficit averages about 5 percent of GDP over the coming decade – an unsustainable course that is particularly troubling given the even larger deficits, driven primarily by rising health care costs, that are projected to occur thereafter.

The net impact of the campaign’s proposals is to expand the budget deficit over the next ten years – so the budget path including all those proposals is even more ominous for the medium term. For both substantive and political reasons (given the concerns of Senator Conrad and the Blue Dogs), it will therefore be necessary to do some combination of scaling back on campaign promises and making new choices to raise revenues or reduce spending. The following analysis proposes that you set a provisional budget goal to guide our internal efforts to develop specific options for a sustainable medium-term fiscal outlook. Based on your guidance we would then work with the full range of policy teams to develop options for your consideration to achieve the budget goal.

A. The Deficit Outlook

We now have preliminary budget estimates from Peter Orszag and OMB staff using updated economic assumptions developed by Christina Romer. Although they are not final, they seem reasonably close to the estimates that would form the basis of the budget blueprint to be released in mid to late February.

With a short-term economic recovery package, the deficit in fiscal year 2009 is likely to be about \$1.3 trillion, which at 9 percent of GDP will be by far the largest deficit in American history excluding the two world wars and the Civil War. Most economists are not concerned about the near-term deficit deterioration, but the public may be more concerned. As noted above, it is therefore crucial in early January that we make it clear to the American public that you inherited this large deficit rather than created it.

The more troubling development is shown in Figure 3. Since January 2007 the medium-term budget deficit has deteriorated by about \$250 billion annually. If your campaign promises were enacted then, based on accurate scoring, the deficit would rise by another \$100 billion annually. The consequence would be the largest run-up in the debt since World War II and the highest debt as a share of the economy since the 1950s. Figure 4 shows the projected increases.

Figure 3

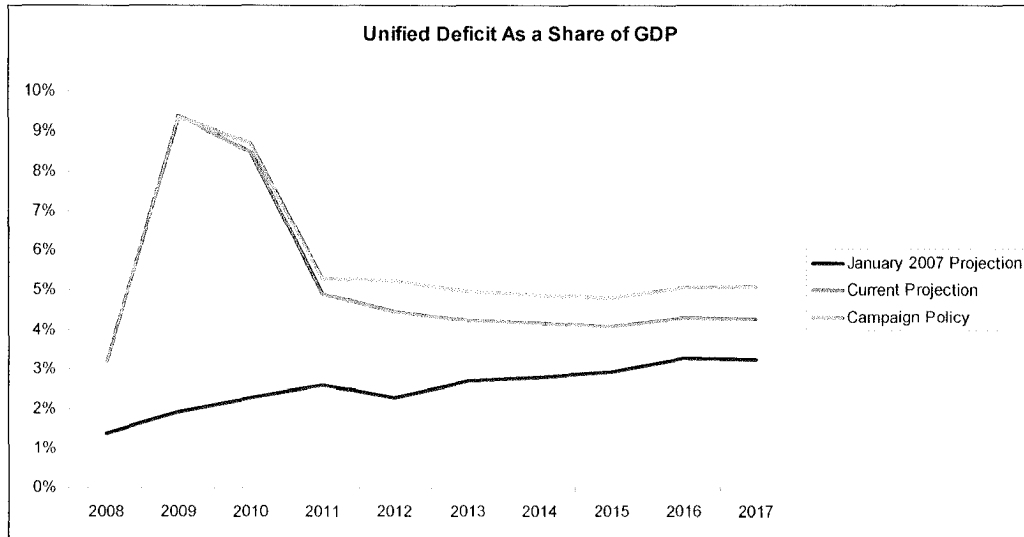
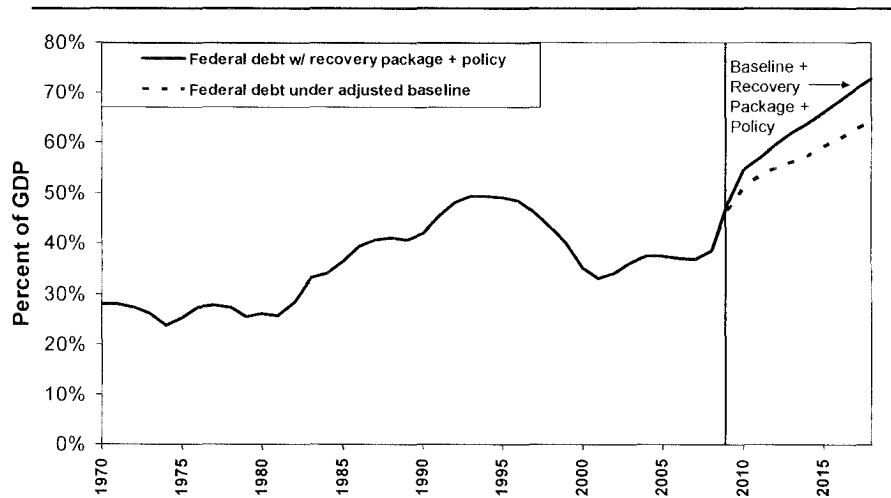


Figure 4

Historical and Projected Publicly Held Debt/GDP Ratios



Notes: Debt levels from 2008-2018 are net of financial assets.

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Note that all of the figures in these charts differ from the official CBO baseline, which will be presented in January, because the numbers here assume that all expiring tax cuts are continued, that the AMT patch is continued and adjusted for inflation and that the Medicare doctors' payment fix is extended. This is similar to the baseline used by your campaign, Goldman Sachs, the Concord Coalition and other independent analysts. This baseline is useful for understanding a realistic budget outlook and the impact of your proposals, although it is not

consistent with the official baseline that has been used in Congress and is particularly controversial with some on the Hill, particularly the Budget Committees and the Blue Dogs. (The official baseline shows a better fiscal picture – for example, by assuming that all the tax provisions expire. This approach may be useful for official scorekeeping purposes, but as the tax example illustrates it makes policy assumptions that are widely viewed as unrealistic.)

The question of how you present your budget and what baseline you adopt is an important strategic one that we will discuss with you in the future. For now, the important point to note is that the choice of a baseline does not affect the actual deficit – it just affects the framing of the extent to which your campaign proposals add to the deficit. For the purposes of this memo, we will rely on the baseline deficit projections shown above.

B. Campaign Policy Commitments

Your campaign policies were intended to be fully paid for: any additional costs were designed to be fully offset by other explicit savings. The result of full offsets would be a deficit identical to the baseline deficit shown above. Preliminary estimates from OMB, Treasury, and more realistic independent estimates, however, indicate a gap of about \$100 billion a year as shown in Table 4.

Table 4: Campaign Proposals in 2014 – (Cost: \$ billions)			
Campaign Proposals		Campaign Offsets	
Taxes			
Making Work Pay	75	Repeal tax cuts above \$250,000	96
Seniors, mortgage, childcare & other	43	Loopholes & other	20
Patriot employer, small businesses, etc.	8		
Health			
Plan Subsidies [Note: Health team working to lower]	190	Savings [Note: Health team working to raise]	30
		Pay-or-play revenue	35
Energy			
Investments	15	Carbon auction revenue	135
Carbon Auction Compensation	120		
Domestic Spending			
0-5 Education	10	Explicit spending reductions	10
K-12 Education	19		
Infrastructure	6		
Scientific Research	10		
Service, Urban, Rural & Other	11		
Security			
Veterans	25	CBO assumed Iraq/Afghanistan*	145
International Assistance	25		
Counterterrorism	5		
Additional Troops	5		
TOTAL	\$567		\$471

*The average of CBO’s two assumed Iraq/Afghanistan policies does not reflect the President-elect’s policy.

The principal revisions relative to the campaign’s estimate are:

- Treasury estimates that the repealing the tax cuts above \$250,000 would raise about \$40 billion less than the campaign assumed. (The campaign’s estimates are consistent with the Tax Policy Center and appear consistent with the Joint Committee on Taxation.)
- Treasury’s preliminary and incomplete estimates indicate that the corporate loopholes and other revenue raisers total closer to \$20 billion than the campaign’s estimate of \$75 billion.

- The health plan is about \$10 billion more costly than the campaign estimated and the health savings are about \$25 billion lower than the campaign estimated.
- The above estimates include only “explicit” spending reductions, whereas the campaign assumed additional savings from efficiencies, contracting reform, and other measures.

C. Alternative Fiscal Goals

Closing the gap between what the campaign proposed and the estimates of the campaign offsets would require scaling back proposals by about \$100 billion annually or adding new offsets totaling the same. Even this, however, would leave an average deficit over the next decade that would be worse than any post-World War II decade. This would be entirely unsustainable and could cause serious economic problems in the both the short run and the long run.

The following presents four other alternative fiscal goals. The first goal is to pay for all campaign proposals. The second goal is to keep the deficit to 3.5 percent of GDP, which roughly corresponds to the *largest* deficit as a share of GDP under President Bush. The third goal is to keep the deficit at 2.5 percent of GDP, which would be consistent with stabilizing and starting to lower the debt-to-GDP ratio by the end of the five year window. This is also above the average deficit under President Bush or the last 50 years, both of which are about 2.0 percent of GDP. The final goal is to balance the unified budget, a typical goal in normal times but something that would be very difficult to achieve given the current budget outlook. Table 5 shows what would be required to achieve these four goals:

<i>Goal in 2014</i>	<i>Necessary Spending Cut or Tax Increase in 2014</i>	<i>Deficit in 2014</i>	<i>Debt as a % of GDP in 2014</i>
Pay for All Campaign Proposals	100	775	62%
3.5% of GDP Deficit	225	640	61%
2.5% of GDP Deficit	396	460	58%
Balance the Unified Budget	826	0	53%

Note that all of these goals are shown relative to the budget that includes the campaign’s policy proposals. So, for example, the roughly \$350 billion in spending cuts or tax increases required to stabilize the debt as a share of GDP could include new proposals or scaling back existing campaign promises.

D. Illustrative Options to Achieve Your Desired Budget Goal

We believe we should set, on a provisional basis, the goal of developing options that have at least \$300 billion of programmatic savings in 2014 so that we would be near the goal of stabilizing the debt as a share of the economy. Both the goals and the savings are, however, likely to be refined.

To help give you a sense of what this would entail, Table 6 shows a set of illustrative policy options together with the savings they would generate in 2014, the final year of the five-year budget window. Note that these options are not based on extensive consultations with all of the relevant policy groups – they are simply provided to give you a sense of scale for the goals you might choose to try to achieve.

Table 6. Illustrative Budget Options – Savings in 2014	
	(Cost: \$ billions)
<u>Scale Back Campaign Plans</u>	
Drop all tax cuts except Making Work Pay	44
Index health subsidies to a rate slower than premium growth	5
Use 50% of cap-and-trade revenue to pay for Making Work Pay	68
Phase in discretionary proposals over 8 years rather than 4 years	53
<u>Revenue Options</u>	
Allow all tax cuts to expire except child credit, 10% rate & marriage penalty	109
Limit the deductibility of employer-provided health insurance	30
Tax dividends at income rates above \$250K	16
Institute a \$0.50 tax on cigarettes	3
Tax investment income from life insurance	29
Additional IRS enforcement	25
Additional corporate loopholes not already in the campaign’s \$20 billion	10
Implement VAT at a 5 percent rate	368
<u>Spending Options</u>	
Limit domestic discretionary growth to inflation	68
Cut domestic discretionary spending by 10%	114
Use chained CPI [Note – affects revenues and outlays]	23
Reduce Medicare/Medicaid payments to disproportionate share hospitals	25
<u>Continue Bush Administration / Congressional Budget Practices</u>	
Offset fully the cost of AMT reform	129
Assume miscellaneous tax cuts expire (excluding R&D credit)	50
Assume no Iraq/Afghanistan expenditures after 2012*	55
Spending neutral Medicare doctors fix	31

*Note: this is a different budgetary assumption, not a different national security choice.

E. Next Steps

In our meeting with you on Tuesday we will discuss next steps on the budget based on your preliminary feedback on the alternative budget goals and the types of options that could be considered to achieve these goals.

We hope to get your guidance on what budgetary goal you would like to achieve and a very initial sense of the types of options you are interested in seeing. Based on your feedback we will work with all of the policy teams to develop and define a menu of individual options, and illustrative packages, to achieve the goals you set.

IV. FINANCIAL ISSUES

The following is a discussion of four financial issues: housing, autos, the TARP and financial regulation.

A. Housing

Starting more than a year ago, you have expressed great concern with the dramatic rise of foreclosures and wanted a policy to do something about it. There were more than 2 million foreclosures in 2008, but with the deteriorating economy and further decline of the housing market, analysts expect there to be 5 million more non-GSE foreclosures in the next two years.

Here we outline a five-part strategy for foreclosure prevention, based on work led by Austan Goolsbee in close consultation with Tim Geithner and your NEC Director, that is aggressive but targeted. The main component of the program focuses on reducing monthly payments to make mortgages affordable. We forecast that this effort will successfully prevent 1.5 million foreclosures and cost between \$20 to \$40 billion, to be funded through TARP (and thus not require legislation). Additionally, we suggest four other policies to supplement the main program—protecting servicers from legal suit, changing the Hope for Homeowners Act, changing the bankruptcy code, and more support for neighborhoods—many of which would require actual legislation. This memo walks through our recommendations and some key decisions we reached in order to arrive at them.

In formulating the approach we had extensive discussions with a wide variety of people: the transition housing agency review teams, officials from Treasury, the FDIC, Fannie and Freddie, the heads of several servicers, lending banks, Wall Street economists, academic real estate experts, the staffs of the banking committees, several senators, several governors or their staffs, and numerous nonprofit organizations concerned with housing.

1. Main Component: Encouraging Restructurings that Reduce Payments.

The primary way we recommend you prevent foreclosures is by giving direct incentives to lenders to reduce the interest rate and the monthly payments of at-risk borrowers to make them affordable.

1. **Mechanics.** For borrowers qualifying as being at risk of default, a lender agrees to reduce the interest rate on the mortgage to a level that gets the mortgage debt down to 38 percent of income (DTI) and then the government provides a 50 percent subsidy for any further interest rate reductions needed to get the payment down to 31 percent DTI (so long as the interest rate required does not fall below 3 percent). Modified loans that remain current after three years would receive a fixed payment from the government to the borrower and the lender as an added incentive. There would be about 2.5 million loans that could be profitably modified in this way (i.e., save the lender money relative to actually foreclosing on the property) but something like 1 million might redefault later, resulting in 1.5 million successful modifications.

2. **Basic Eligibility.** The program would be designed for people at serious risk of default. We would define this generally as any borrower whose house value has fallen below the value of the mortgage and where the borrower has DTI in excess of 31 percent. In determining eligibility, there would be accelerated treatment for those that can document economic distress events (like job loss or major medical expenses) or victims of loan fraud or predatory mortgage practices. We recommend making only primary residences eligible and forbidding participation by any borrower with total debt exceeding 50 percent of their income (because restructurings are unlikely to prevent them from ultimately foreclosing).
3. **Taxpayer protection,** In return for participating in the program, the borrower would agree to a shared payback in the event of future appreciation. If they sell their house for a gain, the government would get 50 percent of the appreciation up to a maximum of the amount the borrower received as a subsidy.
4. **GSEs.** The GSEs could enact this program without the subsidy since they are in receivership.

2. Address Legal Issues Relating to Servicers.

The government should pursue a two-track legal strategy to immediately help resolve the uncertainty over servicer rights vis-à-vis their investors, which has prevented many from modifying mortgages in a way to prevent foreclosures. On the first track, the GSEs would declare that the eligibility criteria in the new government foreclosure plan (stated above) is also their official standard of “at serious risk of default.” This would help clarify an industry standard around reasonable modifications, liberating servicers to interpret their own contracts accordingly. The second track would organize a servicer summit to explore other legal options to help servicers. One option to be discussed would be conditioning REMIC tax status on whether securitization trust agreements follow the government protocols for modification. Another option to be discussed would be indemnification for servicers who participate in the government program.

3. Strengthen Hope for Homeowners Act to Temporarily Enable Write-Downs.

You were an original co-sponsor of the Hope for Homeowners Act- a foreclosure mitigation policy which sought to encourage principal write-downs among investors by splitting the cost with the government. Unfortunately, largely due to the unwillingness of lenders to write down principal, the program completely failed: 400,000 mortgages were eligible for write-downs but only 111 applied.

Our conversations with industry and community groups have led us to believe that lenders will continue to resist the idea in most cases (and hence our core proposal is the affordability program outlined in Part 1). However, there were some flaws in H4H that remain—fees that push interest rates up for borrowers, fees that deter lenders, and requirements that lenders eat too much of the mortgage losses for them to be willing to participate. We recommend

fixing these flaws so that the program is more attractive and can function as a “last resort” for the deeply underwater mortgages that do not qualify for the affordability restructurings in the main plan. Moreover, keeping H4H on the backburner is a good idea so that if house prices fall further and walk-away defaults become a bigger threat, it can be ramped up.

4. Reform Bankruptcy Code to Begin When Hope for Homeowners Ends.

The next step in the housing plan is responsible bankruptcy reform along the lines of the Durbin bill you cosponsored. This would allow bankruptcy courts to write down the principal of primary residences to the current market value. We recommend announcing this reform to begin immediately following the close of the enhanced Hope for Homeowners period. This would give lenders an even stronger incentive to actually write down principal under H4H because of the prospects they would face in bankruptcy court.

5. Put a Focus on Other Housing and Community/Neighborhood Issues.

An important complement to the specific plans to fight foreclosures is to strengthen the organizational safety net for communities under threat and to help invest in the kinds of assistance that can help get the anti-foreclosure policies to succeed. There are many individual policies we have considered including: protecting renters forced to exit foreclosed homes, expand and enhance pre-purchase and default counseling, strengthen HUD’s Neighborhood Stabilization Program, make the federal government an active partner with leading private and nonprofit “responders,” and invest in conversion of existing units into rental housing

Key Decisions Made in Reaching this Approach.

In coming to support the five-part strategy above – and particularly the main program – we dealt with several important judgment calls:

- **Targeted Foreclosure Prevention as the Right Approach:** We rejected two alternatives to the basic approach we recommend. The first was the argument that foreclosure policy is pointless and merely delays the inevitable expulsion of millions of people from homes that they cannot afford. We think this case is too extreme, and ignores both economic reality and human suffering. There are in fact many people being foreclosed from homes that they can afford – with temporary help – which is what our policy seeks to achieve. We have a reasonable goal of preventing 1.5 million foreclosures, but understand that there are still 3.5 million foreclosures that we cannot prevent.
- We also rejected the argument on the other side that we should have a broad policy to help the housing market - not just one for those at risk of foreclosure. A targeted policy will, undeniably, leave some out, and picking a boundary is difficult. Designed poorly, it could even encourage negative behavior for people trying to qualify (such as if you conditioned qualifying on being delinquent). Realistically, though, there are about 5 million non-GSE mortgages in threat of foreclosure but around 55 million total mortgages. To broaden the program away from targeting the risk of foreclosure would

be dramatically more expensive and the government would spend most of the subsidy on people that would not have been in danger of losing their homes. We have spent significant attention on making the design as streamlined and fair as possible. It is easy to go too far, however, and insist on such tight criteria to ensure every recipient is completely deserving that the aggregate impact on the foreclosure crisis is small. We tried to strike a defensible line between the extremes.

- **Affordability Modifications Rather than Principal Write-Downs.** We recommend putting the main focus on getting monthly payments down through lower interest rates rather than trying for principal write-downs.
 - First, historically, the main driver of foreclosure has been economic distress, rather than borrowers just walking away because the mortgage is underwater (less than one fifth of owner-occupied foreclosures right now are assumed to be due to walk-aways). . Reducing the size of the payments so that the borrower can afford them will keep many from foreclosure. Writing down principal is an inefficient way of reducing monthly payments (since it gets amortized over thirty years).
 - Second, principal write downs are likely to be extremely costly. There is something like \$1 trillion of negative equity in the U.S. today so the prospect of trying to significantly reduce it, even if the cost were split between lenders and the government, would be daunting. Making the monthly payments affordable is much cheaper if the people are willing to stay on their own volition.
 - Third, it is easier, legally, for servicers to justify modifying interest rates than writing down principal. And the lenders themselves are utterly averse to write downs because they believe it sets a terrible precedent for other borrowers.
- It is important to raise the prospect, however, that the current foreclosure crisis which is largely driven by economic distress and affordability, could morph into a new foreclosure crisis driven by walk-aways. If that happened, we would have to contemplate a policy geared explicitly toward negative equity.
- **Reducing Interest Rates Rather than Guarantees Against Redefault as in FDIC/Bair Plan.** Our recommended plan is based on the government subsidizing lenders to reduce the interest rate, rather than asking them to reduce the interest rate on their own in exchange for a guarantee of half the loss in the event the restructured mortgage redefaults. The guarantee is especially attractive to lenders but we found it problematic given the enormous uncertainty it puts on the cost to the government from redefault risk, the scary redefault numbers coming out of the IndyMac experience thus far and the incentives it gives lenders to modify the worst performing loans and pass the costs on to the government. In a typical case, the government could end up paying something like \$25,000 to \$50,000 to a lender for restructuring mortgages that redefault in rapid order thus leaving almost none of the money going to help the troubled homeowners.

- We are still very much in the spirit of the FDIC/Bair plan, though, in that we are aiming at making the mortgages affordable so that we can get a lot of them done quickly and we take advantage of the basic fact that the people we want to keep from losing their homes are exactly the ones that want to stay in them and will do so as long as we can get their payments down.

B. Autos

Given that immediate assistance for the auto industry now relies on a decision by the Administration, Tim Geithner has been in regular contact with Secretary Paulson, and Treasury staff briefed members of our economic team on Sunday about their current thinking. In addition, we have over the past three days reached out to restructuring and bankruptcy experts to solicit views about the viability of various options being contemplated.

The Administration is currently considering two broad options (though their thinking is preliminary and no decisions have been made):

- **Provide DIP financing if the companies file for bankruptcy.** Under this approach, the Administration would announce a willingness to extend TARP funds as a DIP loan once a company has filed for bankruptcy. Given GM and Chrysler's current cash positions, it is overwhelmingly likely that one or both would be forced to file before or immediately after the New Year. Treasury currently estimates that the companies would require \$100bb of DIP financing. We believe that number may be inflated.
- **Bridge funding with conditions similar to those debated in Congress.** Under this approach, the Administration would extend short-term bridge financing contingent on the companies' achieving certain restructuring benchmarks. The Treasury said they were looking at both the broad conditions contained in the House legislation (i.e. stakeholders negotiating a viable plan) and the proposals offered by Senator Corker (i.e. specific debt reduction targets and substantial accelerated wage concessions from the UAW). Under this plan, Treasury believes they would need to provide approximately \$30bb to get the GM, Chrysler and their respective finance companies through January.

In assessing these options, it is important to recognize the near-term constraints that the Administration faces, which include:

- **Limited availability of funds to pledge:** The Administration's capacity to provide near-term funds without Congressional action is substantially limited. If the Administration decides to provide assistance, they will need to use the \$15 billion in remaining unpledged TARP as well as the \$20bn in pledged but yet-to-be-spent TARP resources. This amount is unlikely to meet the full need over the coming months and would leave the government with no TARP funds for other purposes. Therefore, your Administration would need to seek (i) specific auto legislation post-January 6, or (ii) Congressional authorization to draw the next tranche of the TARP funds.

- **Time needed to facilitate a bankruptcy filing:** There are effectively four types of bankruptcy filings: 1) unplanned (generally fairly chaotic especially so in the case of the auto industry); 2) orderly (allows better communication with major stakeholders such as suppliers, but still potentially highly disruptive); 3) pre-arranged (stakeholders agree to term sheet for restructuring that they use as a basis for negotiations in bankruptcy); and, 4) pre-packaged (stakeholders make binding agreements that are submitted to court in advance of filing). If forced to file immediately, GM and Chrysler would fall into the first category resulting in potentially severe disruption to the entire industry. With a couple of weeks planning, they could achieve an orderly filing. A pre-arranged filing, would take at least several months to negotiate while a pre-packaged bankruptcy would take many more months and would be very difficult to achieve.
- **Economic impact of a bankruptcy filing:** There is substantial disagreement about the impact of an orderly bankruptcy filing on consumers, suppliers and the capital markets. Our tolerance for this risk is an important consideration in assessing the two options under review by the current Administration.
- **Limited ability to get back the full value of any funds that go into GM and Chrysler pre-bankruptcy:** Given legal constraints, government money that goes into these companies outside of bankruptcy will have limited protections in the event of a bankruptcy. This is not terribly surprising given that the government would be given securities that trade, in the case of GM, at anywhere from \$0.15-0.40 on the dollar. While there may be ways to mitigate the government's loss in the context of an eventual bankruptcy filing, the government is unlikely to recover the full value of any bridge investment. This issue most closely highlights a point we have made in previous memos concerning the conflict between actions that offer the greatest chance for economic stability (bridge financing on terms that reassures suppliers, customers and the markets) and those that offer the best chance for recovery of invested funds (DIP lending into bankruptcy).
- **The captive finance companies play a crucial part of the story and have their own distinct challenges:** For example, GMAC finances approximately half of GM's retail sales. Given their capitalization and the state of the financing markets, they cannot provide meaningful amounts of credit on attractive terms to consumers. Efforts to restructure GMAC as a bank holding company will require close coordination between the Fed, FDIC and Treasury as well as a meaningful restructuring of its balance sheet.
- **A significant number of observers doubt Chrysler's viability as a standalone company:** This raises complex questions about whether the government should differentiate between Chrysler and GM as well as the amount of financing the government should provide to Chrysler outside of bankruptcy. Ford continues to reiterate that barring an uncontrolled bankruptcy by GM and Chrysler it does not need immediate financing although it may face competitive disadvantages if its competitors go through government assisted reorganizations.

Given these constraints, our view is that there are three approaches that the Administration can realistically take in the immediate term:

- *Provide remaining TARP funds as the first tranche of DIP funding into an organized filing sometime around the New Year (even this option may require some level of bridge funding).*
- *Provide remaining TARP funds explicitly as a bridge loan to a pre-arranged bankruptcy filing.*
- *Provide funding sufficient to get GM and Chrysler through the end of January with conditions designed to make as much restructuring progress as possible without pre-determining whether your Administration will pursue an out of court restructuring or a bankruptcy filing of some kind.*

In summary, these are the questions that we will be discussing with you on Tuesday:

- How, if at all, do we wish to engage with the current Administration on their plans?
- If there is a substantial likelihood that an eventual bankruptcy filing will be necessary to effectuate a successful restructuring of GM and/or Chrysler, how do we balance the desire to get that process started against the possible disruption a filing could cause?
- If the Administration does not force a bankruptcy before January 20, how specific and stringent would we like them to be about the conditions necessary to receive additional funds in your Administration?
- What oversight structure (e.g. board comprised of cabinet secretaries; independent Car Czar; advisory panel to government decision-makers) will be most effective at achieving our preferred goal, and how far would we like the current Administration to go in putting this structure into place?

C. Stabilization, Repair and Recovery of the Financial System

This section outlines our strategy for stabilizing the U.S. financial system based on work led by Tim Geithner. Our judgment is that we need to move quickly to put in place a program that satisfies the critical imperative of decisively restoring public confidence in the health of our financial institutions and improving overall market functioning. Doing so will require more resources--potentially considerably more--than those authorized under the TARP. An effective program for stabilizing the financial system is a necessary complement to your Economic Recovery Plan and to more targeted efforts to support the housing market. Without healthy institutions and robust markets, our efforts toward repair and recovery for the broader U.S. economy are likely to be compromised.

Current Situation

With the recent sharp deterioration in the already weak economic outlook, there is considerable potential for a severe adverse feedback loop between economic activity and the stability of the financial system. Despite the dramatic actions already undertaken to strengthen our financial institutions and improve the functioning of our financial markets, nearly every segment of our financial system remains under extraordinary strain. The public has deep concerns about the health of both banks and non-bank financial institutions as uncertainty grows about the size of future losses across a wide range of asset classes. Liquidity and functioning of our financial markets continues to be severely impaired, and the nearly complete breakdown in the functioning of securitization markets threatens to severely constrain access to credit for households, businesses and state and local governments.

The scale of potential losses in the pipeline for U.S. financial institutions is substantial, particularly when considered relative to the current capital stock and to the remaining funds allocated for financial stability purposes under TARP. The most recent estimates available were computed back in October, when the outlook for the real economy overall was stronger, and asset classes such as commercial real estate had not begun to deteriorate to the extent we are now witnessing. At that time, the total need for new capital at banks alone was seen to be in the range of \$250 to 500 billion. We now believe these estimates represent the low end of what will be needed. Private capital seems unlikely to fill the gap.

At present, \$335 billion of the first \$350 in TARP funds has been committed for capital injections in healthy and distressed financial institutions and for use in Federal Reserve program to support consumer and business. However, not all of the committed \$335 has been disbursed. We estimate that to the extent Treasury has any flexibility to redirect these funds, they could at most do so for \$20 billion of the \$335. This leaves a maximum of \$35 billion in available funds from the first \$350 tranche for potential use for a bridge loan to auto makers or other contingencies.

Policy Objectives and Strategy

Our judgment is that policy initiatives to date have been undermined by the absence of any meaningful communication about objectives or the framework being used to achieve those objectives. Escalation generally occurred too late and decision making proved too erratic to have sustained positive effect on either financial conditions or on confidence. Ultimately the rapid deterioration in the U.S. and global economy overwhelmed what, by historical standards, were significant government actions. Some specific examples of where policy has been ineffective are as follows:

1. Policy responses to large distressed firms have been inconsistent, in part because of the absence of a clear authority and in part because of conflicts across agencies over how to balance the political and moral hazard concerns with the potential damage caused by default of large institutions.

2. The capital injections and FDIC guarantees were essential, but while policy makers recognized at the time that substantial additional capital would be necessary, they failed to act quickly enough on that knowledge.
3. Government assistance to financial institutions was seen to occur without sufficient conditions/restrictions, and the absence of a clear regime for oversight and accountability further undermined public support for the program.

Our aim is to depart in both substance and appearance from the mistakes of the past year and a half, by providing the public a clear statement of our policy objectives and strategy.

Policy Objectives

- **Decisively stabilize core financial institutions** to help create the conditions for recovery and growth.
- **Support the flow of credit** to households and businesses and restore the healthy functioning of capital markets.
- Develop a clear **mechanism for dealing with distressed firms** whose default would potentially disrupt the functioning of the system.
- **Support well-designed initiatives in the housing sector**, including a program to avoid preventable foreclosures.
- **Take great care with taxpayer's money** by coupling support with meaningful and clear conditions and strong oversight.
- **Plan for a careful exit strategy** that will withdraw government support from the financial sector in a manner that leaves the system stable and attractive to private capital.

Strategy

Clearer communication with the public about our strategy requires a number of high level decisions to be made at the outset, including the breadth of access we will grant to our program and whether the disbursement of funds will be triggered by distress at an individual firm or whether it would occur preemptively to alleviate system-wide distress. Beyond these high level decisions, there are a number of critical design elements to be worked out.

- Our current assessment is that we will need to use a mix of options that will definitively recapitalize the core financial institution while also potentially providing some form of relief from the threat of outsized losses on troubled assets, either in form of purchases or insurance.

In addition to actions to stabilize financial institutions, we will need to use TARP funds to improve broader market functioning and target specific sectors most acutely affected by the current strains. This will include:

- Dramatically expanding programs that support overall market functioning in order to ensure the smooth flow of credit markets to households and businesses.
 - These programs should leverage both TARP and FDIC funds by deploying it in structures that use long-term financing provided by the Federal Reserve.
- Providing targeted support, either in the context of the type of structure described above, or in other forms, for small business lending, student loans, and other non-bank financial firms to support those sectors directly.
- Exploring changes to reserve, capital, accounting and disclosure practices that can both improve confidence in bank balance sheets and avoid adding to pressures to deleverage.
- Developing a resolution regime for systemically-significant firms to allow policymakers to avoid disorderly bankruptcies.
- Designing a governance/oversight framework that improves confidence in oversight and controls designed to reduce risk to the taxpayer by:
 - Setting expectations for firms that benefit and comes with metrics for tracking and communicating about lending and developments in capital markets,
 - Imposing conditions designed to make sure that shareholders and senior executives do not benefit inappropriately from government support,

Process

As part of our policy development process, we have consulted extensively with private sector and academic experts, current government officials, and economists. We will continue to consult broadly as we develop our specific recommendations during the next several weeks.

Our read is that the credibility of the TARP program itself may be so damaged that it will be very difficult to secure the second \$350 billion tranche and achieve our goals within this program. Phil Schiliro suggests that we consider repealing TARP and replacing it with a new program that we design and propose as part of the Economic Recovery Plan. This requires us to weigh the benefits of a revised and expanded financial rescue package against the potential for delay or complication of the passage of the Economic Recovery Plan.

We envision outlining a broad strategy shortly after Inauguration with a comprehensive speech and coordinated announcement with the Fed and FDIC. Over the next two weeks, we will

be working on alternative approaches, and will plan to present you with options and recommendation in early January.

Key Questions and Issues for Discussion

In the meeting with you on Tuesday we will discuss the following key questions:

- **Positioning:** Should we seek to repeal TARP and replace it with a new program of our own design and branding, perhaps recast as an Economic Recovery and Stabilization Fund?
- **Timing:** Should the request for the remaining funding be proposed as a part of the Economic Recovery Plan, or would such a strategy complicate passage of necessary legislation?
- **Sizing:** Given our assessment that the need is likely to exceed \$350 billion, should the additional funding be sought immediately or after some period? How should we prepare Congress and the American people for the likelihood of additional requests?
- **Expectations:** The TARP has been framed for Congress and the public as a program that will generate a positive financial return for taxpayers. The deteriorating economic and financial situation is raising the probability that investments made under TARP will incur losses. Are there steps we should take in the near term to reset expectations?
- **Escalation:** In an effort to get ahead of the curve, should we conduct substantial capital injections in the near term or follow the current approach of relying on capital injections already undertaken, husbanding additional capital for contingencies and using a limited amount of resources to support lending and securities markets?
- **Conditioning:** How should we resolve the tension between imposing strong conditions on the entities that take advantage of TARP funds and the need for flexibility to ensure effectiveness?

D. Financial Regulation

Reform of the financial system will be a significant part of the economic agenda during the next one to two years. It is necessary for restoring consumer and investor confidence in the short term and promoting stability and growth in the long-term. The current crisis reveals serious failures in traditional areas of regulation such as bank supervision, market integrity, and consumer and investor protection. In particular, it underscores the need for a more stable financial system—one that is more able to withstand shocks and distress and less vulnerable to crisis. The general public and members of Congress have an appetite for meaningful regulatory changes in light of the damage to the real economy and the scale of fiscal resources required to stabilize the system. The new Administration has an opportunity to lead forcefully on this issue

right away, and we will have to move quickly to shape the important international dimension of a credible reform agenda.

The challenge, however, will be to balance the imperative of early progress in outlining a comprehensive agenda for reform with the reality that we are likely to be still in crisis management mode. We have to get this right. The technical challenges are enormous, apart from the political difficulty of legislating meaningful reform. If not managed carefully, the central reform imperative of inducing more conservatism in leverage requirements and risk management will risk intensifying the ongoing de-leveraging process.

With those qualifications, we want to be in a position where, within thirty to forty-five days of taking office, the new Administration can present the broad outlines of a reform plan that would offer the prospect of a more stable financial system, with greater protections for consumers and investors and a simpler and integrated oversight structure. As part of this process, we need to explore whether to proceed in a two staged approach, with an early round of initial reforms, perhaps as part of the post-TARP financial recovery plan, followed by a more comprehensive package, or to move the full agenda in one step somewhat later in the year..

Principles

The starting point for regulatory reform is the set of principles outlined in the March 2008 Cooper Union address and elsewhere on the campaign. These principles establish a baseline for a system that is safer and more just for all participants. In short,

1. We need a more effective approach to mitigating systemic risks to the financial system.
2. Any institution that is sufficiently significant that it could borrow from government liquidity facilities in a crisis should be subject to appropriate government oversight and supervision.
3. We need to reform and strengthen capital, liquidity, and disclosure requirements for all regulated institutions and must work with international arrangements to address similar problems abroad.
4. We must streamline overlapping and competing regulatory agencies to provide better oversight of increasingly interdependent and complex institutions.
5. We must regulate institutions for what they do rather than the precise legal form they take.
6. We must crack down on activity that crosses the line to market manipulation.
7. Consumers and borrowers must be protected in financial transactions by improving consumer education and product transparency while also prohibiting predatory practices.
8. What ever we do in the United States will have to be complemented by a consensus among other major and emerging economies.

Over the next three weeks we will be adding more detail and definition to these principles, and explore their application to the assessment and redesign of the TARP and other programs.

Administrative Actions

A significant cause of the current crisis lies in the failure of regulators to exercise vigorously the authority they already have. Because considerable discretion is required in the financial regulatory process to deal with the specific circumstances of different financial institutions or market conditions, a first important step towards reform is to appoint strong regulators who share your basic principles and will use existing (and new) authorities to implement them. They should also be oriented towards a dynamic process for streamlining the regulatory structure, even at the potential jurisdictional expense of the agencies to which they are appointed. Finally, enactment of these principles will require greater coordination of regulatory initiatives through the President's Working Group on Financial Markets, the Financial Stability Forum, and other relevant international fora.

Statutory Changes

In the near term, the main elements of regulatory reform legislation are expected to include the following:

- Strengthening authority for mitigating systemic risks. The Federal Reserve will be primarily responsible, but Treasury will play a coordinating role in defining the full range of policies and regulations that are relevant to this challenge, from capital requirements to taxes and accounting.
- Increasing the level of consumer protection related to mortgage fraud prevention and mortgage transparency, abusive credit card practices, and student loan abuses.
- Centralizing regulatory authority over payment systems and other aspects of market infrastructure, including the derivatives markets.
- Establishing new authority for crisis resolution. This includes greater flexibility for FDIC interventions in institutions in crisis, as well as the creation of a special insolvency regime—modeled on the existing one for commercial banks—for bank holding companies and, where necessary, systemically significant non-bank financial companies.

A process to flesh out the substance of these proposals as well as choreograph the sequencing and packaging of necessary legislation is underway. We want to avoid the risk of over-legislating while at the same time providing sufficient leadership and direction to Congress to instead provide all the legal powers needed to build a stronger regulatory framework.

We also need to decide the future structure and mandate of the GSEs. Finally, of course, we will want to propose changes to consolidate and rationalize the panoply of federal financial regulators. With the possible exception of a consumer financial services agency, this step should

probably come later, rather than sooner, since the turf politics among agencies, regulated market actors, and Congressional oversight committees are likely to deflect attention from substantive regulator reforms.

Next Steps

We recommend taking an early lead on these issues with a definitive address that outlines the broad objectives and strategy. Some elements of this agenda could be announced early. Among the candidates for early introduction are campaign promises such as the Credit Cardholder bill of rights, which bans certain practices, some of which have already been banned by the Federal Reserve, and the STOP FRAUD Act, which, among other things, creates a federal definition of mortgage fraud and allocates additional law enforcement resources to combat fraud and increase consumer protection. Other options include stepping out early in favor of simple anti-usury legislation (capping all consumer lending interest rates at 36 percent) or the Consumer Credit Safety Commission expected to be proposed by Senator Durbin.

APPENDIX – ECONOMIC RECOVERY PACKAGE DETAILS

- I. Energy—Submitted by Energy Policy Team
- II. Infrastructure—Submitted by the NEC
- III. Health—Submitted by the Health Policy Team
- IV. Education—Submitted by the DPC
- V. Protecting the Most Vulnerable—Submitted by the NEC
- VI. Other Priorities Under Consideration—Submitted by the NEC

I. NEW ENERGY FOR AMERICA

“...we have the opportunity now to create jobs all across this country, in all 50 states, to repower America, to redesign how we use energy, to think about how we are increasing efficiency, to make our economy stronger, make us more safe, reduce our dependence on foreign oil, and make us competitive for decades to come, even as we're saving the planet.” -- President-Elect Obama, December 2008

The stimulus package is a key tool for advancing clean energy goals and fulfilling a number of campaign commitments. Our plan will give a critical jolt to America's economy by investing nearly \$50 billion to develop clean energy and create green jobs in communities across the country by:

- Doubling renewable energy -- wind, solar and geothermal
- Saving taxpayers nearly \$1 billion annually by greening the federal government
- Lowering energy costs for 2 million working families through a massive weatherization program to put unemployed workers back on the job.
- Creating first of a kind \$5 billion competition to rebuild the national electricity grid network to better meet renewable energy targets

Transforming the way our nation uses and generates energy is one of the greatest challenges of our time - - vital to the future of our economy, our security and our environment. From the instability and terror bred in the Middle East to the rising oceans and record drought and spreading famine that could engulf our planet. We know that we cannot sustain a future powered by a fuel that is rapidly disappearing.

We also know that we have been talking about this issue for decades. We have heard promises about energy independence in State of the Union addresses since the oil embargo of 1973. Back then, we imported about a third of our oil. Now, we import more than two-thirds. Back then, global warming was the theory of a few scientists. Now, it is a fact that is melting our glaciers and setting off dangerous weather patterns. Then, the technology and innovation to create new sources of clean, affordable, renewable energy was a generation away. Today, you can find it in the research labs of universities and the wind and solar farms across America. But capitalizing on a clean energy future will require an all-hands-on-deck effort. And one that we must begin today.

II. TRANSFORMING THE FEDERAL COMMITMENT TO OUR NATIONAL INFRASTRUCTURE

President Elect Obama will make the single largest investment in our nation's infrastructure since the creation of the federal Interstate Highway System. The Obama-Biden Administration will transform federal infrastructure policy by demanding greater accountability for infrastructure projects, ensuring that our focus is on projects that expand opportunities for economic growth, and fostering innovation to ensure our infrastructure policy helps America achieve critical national goals including energy independence and bottom-up economic growth.

OVERVIEW

The President Elect's economic recovery plan will create millions of new jobs by focusing on three critical infrastructure areas: immediately restoring crumbling infrastructure neglected by years of failed policies; jumpstarting construction of new capacity projects that will allow American businesses to grow; and targeting federal funds to high-priority projects that have strong potential to spur regional and national economic growth.

The President Elect's plan will meet these important goals by implementing new, tough accountability measures that will allow the President, Congress and the American people to track the progress of funded projects:

- *No Earmarks.* Under the President Elect's plan, Members of Congress will not be allowed to "earmark" recovery package funding for specific pet projects.
- *Use it or Lose it.* The President Elect and his Secretary of Transportation will require that federal funds for ready-to-go projects are obligated within a reasonable timeframe – 120 days – to maximize job creation and productivity during this recession. Funds that are not obligated will be reassigned to other projects that are truly ready-to-go.
- *Oversight.* All states will be required to send detailed progress reports for all initiatives supported under this plan to the Inspector General of the Department of Transportation every six months. These progress reports will be made available to President, Congress and the public.

RESTORE NEGLECTED INFRASTRUCTURE

After decades of underfunding, too many components of our national infrastructure system are in disarray, creating tens of millions in economic costs to American workers and businesses and adding tremendous pressure to our global competitiveness. The President Elect's plan immediately tackles the backlog of repair and restoration projects across the country by making nearly \$40 billion in immediate investments in these areas:

- *\$20 billion to reverse state and local government funding cuts* to infrastructure repair, safety and capacity projects on our roads and bridges, and incentivizing states to spent money in first year by fully eliminating state match requirement in the first year, followed by an increasing match that fully restores existing requirement in subsequent years.

- *\$5 billion to strengthen the safety and efficiency of our overtaxed wastewater and drinking infrastructure systems* across the country, including in rural areas which have been especially underfunded in federal appropriations processes
- *\$8 billion to restore and improve the efficiency of federal buildings* and institutions, including research facilities, office buildings, and border ports-of-entry
- *\$5 billion to increase the availability of affordable housing* by making necessary repairs to public housing units across the country
- *\$500 million to clean up hazardous waste in industrial sites* across the country and create new opportunities to use these spaces for economically productive purposes

ENHANCE ECONOMIC GROWTH BY JUMPSTARTING 21ST CENTURY INFRASTRUCTURE PROJECTS

The President Elect's plan makes critical, short-term investments in bold initiatives that have strong potential to ensure decades of new economic growth. The President Elect transforms existing infrastructure policy by no longer relying on failed Washington politics to meet our short and long-term economic goals, and instead implementing new mechanisms to ensure federal funding is meeting our highest priorities in a timely manner without unnecessary pork or waste. The economic recovery plan jumpstarts exciting infrastructure projects around the nation by:

- *Creating a new, independent National Infrastructure Reinvestment Bank* to select and finance the highest-priority infrastructure projects in the country. The Bank will receive an infusion of \$10 billion from the federal government over 2 years to use innovative financing mechanisms to support projects that enhance national economic, energy, safety and transportation objectives.
- *Requiring states to set up rigorous economic analysis units for all state-supported transportation proposals* to ensure efficient project selection in the years to come (\$100 million)
- *Making an unprecedented new investment in public transit systems* to enhance capacity in our nation's busiest transportation centers (\$5.5 billion)
- *Modernizing our airports and air traffic control system* to minimize airline delays and improve runway safety by beginning to replace the decades old computer systems that are used by our air traffic controllers and shifting to performance-based navigation (\$1 billion)
- *Jumpstarting restoration of American leadership on broadband access* by enacting creative incentives to increase the availability of broadband networks across the country (\$6 billion)

III. PRELIMINARY HEALTH CARE COMPONENTS OF THE ECONOMIC RECOVERY PLAN

Medicaid and SCHIP Matching Rate (FMAP) Increase. Both Chambers have proposed using an increase in the FMAP as a way to direct Federal funds to states and protect existing coverage. They are coming closer to consensus on a proposal that would provide all state with an equal, roughly 5 percentage point increase in the FMAP. States who facing greater economic distress (measured through three factors: state unemployment data, food stamps and foreclosure rates) would receive an additional increase. The trigger for the higher increase would be based on the most recent data, so that some states that may not qualify now could in the future. Both would last for 27 months (9 quarters) and make a condition of receiving new funding maintenance of eligibility rules in place as of July 1, 2008. We are also considering options so that this increase is counter-cyclical – turning on automatically when the next economic crisis hits. **Cost: ~\$87.5 billion (displayed as state relief).**

Expand Adoption of Health Information Technology. The economic recovery plan may establish two trust funds at HHS for Health Information Technology totaling \$20 billion. The first trust fund would be spent in the first two years and would allocate \$1-2 billion on health IT infrastructure through existing authorities. These funds would go towards standard development, pilot projects, and grants to safety net providers, states, and other entities. The second trust fund would lock in \$18-\$19 billion that, beginning in 2011 would be spent on payment incentives in Medicare and Medicaid for information technology adoption. The speed of the spend-out depends on our aggressiveness at setting a deadline for full adoption. **Cost: ~\$20 billion**

Prevention. Large-scale community-based prevention efforts are needed to reduce obesity/overweight and tobacco use, which are the two main contributors to chronic disease and drivers of health care costs. A Wellness Trust would be established at the CDC to provide dedicated funding for the implementation of community-based prevention programs across states, evaluation of such programs, and expansion of the public health workforce. Over time, this Trust would fund clinical prevention services as well. **Cost: ~\$1-2 billion**

Comparative Effectiveness Research. This research would help identify effective drugs and treatment strategies that would improve health care quality and safety and, over time, reduce costs. Further, a national investment in medical research will lead to a 50-fold return to the economy. Funding could be appropriated to the Agency for Healthcare Research and Quality which would have the authority to transfer it to the National Institutes of Health and other agencies, as well as to federally-funded research and development centers. Priorities, methods, and dissemination strategies would be governed by a public-private advisory council. **Cost: ~\$1.5 million to \$2 billion**

Strengthen the Health Workforce. The nation is facing dramatic shortages of doctors and nurses and expanding loan repayment programs is one way to address this challenge and create jobs. For example, additional funding would be provided for the National Health Services Corps loan repayment, the Nursing Loan Repayment and Scholarship Program, and the Nurse Faculty Loan Repayment Program. Oral health providers would be increased, including mid-level dental health practitioners. **Cost: ~\$1 billion (note: displayed with other workforce investments)**

IV. EDUCATION AND ECONOMIC RECOVERY: INVESTMENTS TO GROW THE ECONOMY AND MAKE AMERICA MORE COMPETITIVE

The economic recovery plan provides an opportunity to create jobs by modernizing schools so that they can meet the challenges of the 21st century, reform schools and improve teaching so that students have the skills they need to succeed in the technology and information-driven economy, and ensure more Americans can afford to attend college.

I. Modernize Schools for the 21st Century

The economic recovery package modernizes our schools to meet the technology, environmental and academic demands of the 21st century by tackling the enormous existing backlog in maintenance and construction for public schools, including charter schools.

At present, there are two distinct school modernization proposals under consideration.

The first option provides \$6.9 billion in funds to States for school modernization to create safe, up-to-date, and green schools. Funds would generally support renovations to:

- Repair and refurbish schools, including charter schools and community colleges;
- Make schools energy efficient;
- Update technology in classrooms, including broadband.

In addition, this option provides about \$100 million for targeted investments in the repair and renovation of K-12 schools serving military bases or Indian lands.

Alternatively, a second option is to base funding for school modernization on a specified goal. Specifically, the \$x billion proposed for the stimulus bill would be sufficient to (1) clear X% of the backlog of identified, necessary repairs and assist Y schools and colleges in making green renovations, (2) provide enough funding to repair X schools and colleges and help another Y schools and colleges go green, and (3) provide sufficient funding to pay for emergency renovations to ensure schools meet health and safety code requirements, and are accessible to individuals with disabilities. We are working to establish parameters that will create several options that meet these goals.

The school modernization proposal will also provide schools with better data to track outcomes and improve student learning. The plan increases funding for longitudinal data systems by \$500 million, which would ensure States and districts can measure growth by tracking individual students over time and providing real help for teachers in tailoring their instruction and to administrators in targeting interventions and funding.

II. Strengthen Teaching and Learning to Improve American Competitiveness

The economic recovery package will improve teaching and learning in America's public schools and early childhood education centers.

The plan would transform the teaching profession in three ways: first, providing funds to states to develop innovative approaches to recruit, retain and pay teachers by directing funding to the such State activities as set-aside within Title II of NCLB; increasing funding for the Teacher Incentive Fund and tying its receipt to the use of other Federal dollars (especially Title II dollars) for similar reforms to how teachers are evaluated and compensated; and expanding TEACH grants to cover up to \$25,000 in tuition, which is similar to the campaign's Service Scholarship program.

Additionally, the recovery package will target resources where they are needed most to improve schools. The plan increases funding by \$1 billion for, and revising, School Improvement Grants by: 1) targeting funds to serve the lowest performing schools (schools in restructuring and corrective action); 2) allowing the Department of Education and States to use funds to establish effective school support teams, implement school improvement audits, and share best practices; 3) establishing partnerships between effective and low-performing schools and technical assistance providers, as needed; and 4) requiring participating schools to implement data use best practices (provide funds through data systems grants if necessary). Also, provide \$1 billion for the base Title I program to fund schools low-income schools impacted by the economic downturn.

The package also provides for (1) an increase in IDEA funding by increasing the federal share of the excess costs of educating 6.8 million students with disabilities by \$1.8 billion and (2) an investment in early childhood by increasing funding by \$2 billion in additional child care assistant for low-income working families, doubling Early Head Start, and increasing funding for IDEA infants and toddlers by 70 percent.

III. Get More Americans Enrolled in College and Job Training Programs

The plan sets forth measures to assist more Americans enroll in college and job training programs during this economic downturn. The plan will help ensure that every academically qualified student can realize the potential of a postsecondary education.

Specifically, the proposal increases the maximum award for Pell Grants to encourage low-income individuals to use this period of economic downturn to upgrade their skills or obtain a postsecondary credential. The plan pays off the estimated \$8.3 billion shortfall resulting from the increased numbers of students receiving Pell Grants, and invests an additional \$5.3 billion to increase the maximum award by \$500, from \$4,731 to \$5,231, in the upcoming academic year to help speed up the Pell Grant increase in future years that was passed by Congress this past year.

Finally, as a complement to the Pell increase, which will fund training for those who do not yet have college degrees, the plan makes targeted investments in training programs to serve vulnerable populations that will be most affected during this economic downturn. Specifically, the plan includes:

- a Vocational Rehabilitation program, which provides \$500 million in one-time additional funding for Vocational Rehabilitation (VR) State Grants and the American Indian VR program, to provide job training to individuals with disabilities;

- Dislocated Worker Formula Grants, which provides a one-time \$500 million increase for Dislocated Worker formula grants, funding training, job search, and placement assistance for individuals who have lost their jobs;
- YouthBuild proposal, which provides an additional \$40 millions for low-income youth with opportunities to obtain education, employment skills, and on-the-job work experience in the construction of affordable housing;
- Youth Formula Grants, which provides a one-time \$500 million increase for WIA Youth Formula grants, which fund education and training services for low-income, at-risk youth aged 14-21 who also face barriers to employment; and
- Green Jobs proposal, which funds two competitive grant programs authorized in the Green Jobs Act of 2007.

V. OVERVIEW OF STIMULUS PROPOSALS TO PROTECT THOSE HARDEST HIT BY THE RECESSION

While all Americans are struggling with the difficult economic climate, low-income families and the unemployed are being particularly hard hit. The proposed plan delivers \$58 billion in immediate relief now and also strengthens the automatic-stabilizer safety net for the future.

- *Assistance for the unemployed.* This plan extends the Emergency Unemployment Compensation (EUC) program through December 2009 (\$24 billion). It would also temporarily increase the weekly UI benefit payment by \$25 (\$5.3 billion), and provide a temporary increase in UI administrative funding to help states make prompt benefit payments while dealing with substantially higher workloads (\$0.2 billion).
- *Modernize the UI system.* This proposal would provide \$7 billion in financial incentives for states that modernize their UI systems to expand coverage. In addition, the plan would reform the triggers for the permanent extended benefit program to make the system more responsive to future economic downturns.
- *Temporarily increase SNAP benefits (Food Stamps).* The proposal provides for a 10 percent increase in monthly SNAP benefits. Households would receive an average of \$34 increase in monthly benefits in the first year (\$7 billion). The proposal phases out after 24 months by suspending price indexing of benefits for two years. It would also provide a one-time SNAP “bonus” payment in March equal to a household’s monthly allotment (\$4.2 billion), temporarily modify the SNAP participation time limit for childless adults to 6 months out of every 12, and provide a temporary increase in SNAP administrative funding to prevent enrolment delays in light of rapidly rising caseloads.
- *Increase spending on other nutritional programs.* The plan will provide \$500 million in contingency funds for WIC to deal with projected shortfalls in FY09 and FY10. Additional funds could also be provided for food banks (TEFAP) and for state food authorities to procure new equipment to replace old and worn out equipment, thereby enabling them to serve more nutritious meals, but there are concerns that states do not have the capacity to spend this money quickly and effectively.
- *Replenish the TANF Contingency Fund.* Because of rising unemployment and food stamp caseloads, the contingency fund will likely run out in FY09 and states may not be able to provide all of their needy families with cash assistance or other critical work supports needed during a recession. This proposal provides \$4 billion to ensure that states can continue to meet these needs, but up to \$5.4 billion could be provided to replenish the entire shortfall.
- *Additional cash assistance to Supplemental Security Income (SSI) recipients.* This proposal would provide \$450 per recipient in additional cash assistance to the 7.5 million blind, disabled, and aged SSI recipients for a total cost of \$3.4 billion

- *Program Performance and Integrity.* The proposal provides funds to make sure the government can determine eligibility accurately and pay benefits promptly. This proposal provides \$400 million to build SSA's New National Computing Center in time for it to be in operation by 2012 – when the current center will no longer be able to meet capacity. This proposal would also provide administrative funding for SSA to hire additional staff, including ALJs, to reduce disability insurance claims-processing backlogs. The plan would create a new federal-state partnership for program integrity to incentivize states to modernize administrative processes for state-administered means-tested programs in order to (1) reduce error and improve accuracy of eligibility determinations and payments; and (2) improve and simplify the delivery of services.
- *Bolster child support enforcement activities.* In 2006, the federal government cut support for state child support enforcement efforts by 20 percent. As a result, an estimated \$1 billion in child support funds goes uncollected each year. This proposal would enact a 2-year moratorium on the 2006 federal funding cut (\$1.1 billion over 2 years) to help ensure that mothers and children receive funds to assist their daily needs.

VI. ADDITIONAL STIMULUS OPTIONS UNDER CONSIDERATION

In addition to developing strong proposals in our key focus areas – energy, infrastructure, health, education and direct relief to families – we have also been working with a number of transition policy advisors to examine the potential for stimulus proposals in other subject areas. This section contains information about the options we are currently analyzing.

Providing Immediate Support to Law Enforcement. We have been working closely with the Vice President-Elect’s staff to develop options to support local law enforcement agencies across the country. The largest challenge we face is structuring a proposal that does not require significant amount of funding in the out years. For example, while there is a desire to immediately hire more police officers through the COPS program, this would require a long-term funding increase rather than just ramping up funding for one or two years that expires in years 3 or 4. We are working to determine if there are short-term projects (implementing new computer systems, developing new crime prevention strategies, etc) that we could include in the stimulus package to avoid this issue.

Creating an Interoperable Communications Network for First Responders. The existing federal effort to build a national interoperable communications network for first responders across the country has stalled, and the transition technology team is working with a number of other policy groups to determine short-term proposals to jumpstart the construction of this network. In addition to bolstering our preparedness for natural disasters or terrorist attacks, building this network would also help bring broadband access to underserved areas across the nation. Complications potentially include new regulatory schemes and gaining buy-in of local law enforcement agencies to move from the existing federal effort.

Increasing the Availability of Short-term Research Funds. Given the high rejection rates of federal scientific institutions for high-quality grant applicants, there exists a strong demand for additional funding for scientific research to strengthen our international competitiveness. There are several short-term grant programs that could be phased up for one or two years, and then potentially reduced in later years but the optics of reducing science funding poses complications. We are working with the innovation policy group to explore additional options, including short-term investments to upgrade our federal and academic research institutions.

Supporting Our Nation’s Nonprofit Institutions. Nonprofit service organizations across the country are considering job layoffs and reducing services in response to declining revenue streams, just as demand for their services is increasing. We are working with public service leaders to determine the best mechanism to provide support to these critical institutions, while also catalyzing the reforms in the nonprofit sector that you proposed on the campaign trail. Limitations to including this set of proposals in the stimulus package include no existing federal program to distribute funds to a wide group of nonprofits, a potentially long start-up time for a Social Investment Fund, and accountability concerns.

Bolstering International Assistance. There are several proposals to include an international component to the stimulus plan, including some ideas that would include spending federal funds in the United States such as renovations of the UN buildings in New York. We are working to

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identify ideas that will help directly stimulate the U.S. economy, while also helping address campaign foreign policy commitments.