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Issue Brief

New Economic Challenges, New Supply-Side Playbook: How Congress Can Fight the Next Recession

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Introduction

Despite the persistence of a strong job market, the conventional wisdom among business and academic economists forecasts a recession in 2023. Even as supply-chain disruptions fade, other inflationary pressures are proving more durable, most notably a tight labor market that has contributed to an acceleration in wage growth. Given the Federal Reserve's stated commitment to lowering inflation, it is not unreasonable to anticipate that it will continue raising interest rates, even if that means sparking an economic contraction. The question for Congress, then, is how exactly to prepare for the next economic downturn.

In recent years, Congress has followed a straightforward playbook for fighting recessions: unleash a flood of federal spending. In the aftermath of the 2007–08 global financial crisis, Congress enacted $1.8 trillion in fiscal stimulus, disbursed gradually from 2008 to 2012. During the Covid-19 crisis, Congress passed a series of federal stimulus measures that in total added $5 trillion to federal deficits, much of it spent over a much shorter interval. While this extraordinary infusion of federal funds may have helped avert a sharper, more prolonged downturn, there is little doubt that it contributed to the recent sharp increase in inflation.

The current inflationary environment means many in Congress are reluctant to revisit the post-crisis playbook of the recent past. For one thing, it's not at all obvious that a surge in federal spending would be well-advised in light of the Fed's anti-inflationary efforts. Moreover, rising

interest rates have forced lawmakers to confront the rising cost of servicing surging federal debt, a challenge that will only grow more pronounced in the years to come as entitlement shortfalls mount.

Congress needs a fresh approach to tackling the next recession, one that limits deficit spending in favor of a supply-side approach that would help mitigate inflation rather than exacerbate it. In this study, we offer a series of incremental policy measures that could foster economic growth in the face of a looming recession, all at relatively low cost to the taxpayer. This is not, to be clear, a comprehensive agenda for fiscal consolidation or revitalizing long-run economic growth, but it does aim to point lawmakers in the right direction as the U.S. economy enters what could be a painful downturn.

Investment Tax Reform

Despite recent reforms, burdensome taxes are still one of the greatest barriers to U.S. dynamism and growth. To avert the upcoming economic downturn, Congress must remove taxes that penalize investment and productivity. Stimulus bills in the 2008 crisis and the 2020 pandemic provided large tax rebates and credits to individuals, which increased spending but did not change incentives or spur production. In this crisis, the need for supply-side tax reform is obvious.

Business Equipment and Expenses

The most important supply-side stimulus would be to return to the full expensing of business equipment and research investment. The 2017 Tax Cuts and Jobs Act allowed businesses to deduct 100% of their qualified equipment purchases.[1] That, however, decreased to 80% in 2023, and it will keep decreasing 20 percentage points a year until the ability to expense is eliminated in 2026. Also beginning in 2022, businesses no longer receive a 100% deduction equal to their research and development expenses in the year the expenditure took place. Instead, research expenses are amortized over five years. Slower depreciation schedules for both types of investment are particularly painful for businesses in inflationary times when the costs of delayed income are higher.

To incentivize investment, and to bring future investment into the present, Congress should keep full expensing at 100% of qualified purchases for at least 2023 and 2024. It can also, at least for those same two years, return to the full expensing of research and development, which is especially important for increasing productivity.

Incentivize Construction

Finally, Congress should accelerate the depreciation of building structures. Real property depreciation saw little reform in the 2017 tax act, and real estate still has very long depreciation schedules. Commercial property is depreciated over 39 years, and residential rental properties are depreciated over 27.5 years.[2] To incentivize more building, these schedules should be reduced by 10 years, which would help increase construction in a period when that industry is particularly hard hit.

Full expensing is one of the most powerful options imaginable for spurring the economy. The Tax Foundation estimates that a complete and permanent expensing of all equipment, research, and buildings (a more expansive reform than proposed here) would increase Gross Domestic Product by over 5% and lead to over 1 million new jobs.[3]

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Such expensing carries revenue costs for the federal government, but many of these costs are bringing forward future deductions into the present. To pay for the upfront costs of reform, there are several options. Congress can continue the ceiling on the State and Local Tax (SALT) deduction at $10,000 beyond the current end date of 2025. Congress could also reduce the high capital gains exemption for housing sales, cutting the present $500,000 exemption maximum in half. Both of these tax deductions largely benefit wealthy individuals in a few expensive states. They also encourage states and local governments to increase taxes on their own citizens and place restrictive regulations on home building to incur more capital gains. Such negative, anti-growth incentives are exactly what the economy does not need now.

Trade Reform

Another way to grow the economy is to increase trade, which has traditionally both lowered inflation and increased economic growth.[4] Despite contemporary political concerns about trade, there is little doubt that trade has been a huge benefit for the U.S. and will be an essential part of any economic resurgence. Since the U.S. is the world's second-largest goods exporter, as well as the world's largest service exporter, we do not have the option of retreating from a globalized economy in a recession.

Attempts to inhibit trade through tariffs drive up inflation by increasing import prices, reduce U.S. competitiveness, and risk alienating our trade partners, who will add their own tariffs and subsidies and decrease our exports. Although the government can respond to trade abuses by other countries, and can protect industries vital to national defense, the vast majority of today's tariffs have no plausible connection to either trade abuses or national security.

Therefore, the Trump/Biden tariffs should be rolled back, along with other long-standing policies that discourage trade and increase inflation. Over both the short and the long run, this would increase growth and the competitiveness of the U.S. economy.

Repeal the Jones Act

The Jones Act requires that goods shipped between U.S. ports be transported on ships that are built, owned, and operated by U.S. citizens or permanent residents. This makes shipping much more expensive, especially for Hawaii, Alaska, and Puerto Rico. For example, a vessel from Japan heading to Los Angeles cannot stop in Hawaii and engage in any commerce. The result of this restrictive law is that only 2% of U.S. freight is transported by sea, despite our long coasts, our many ports, and our island states and territories. In 2012, the New York Federal Reserve Bank estimated[5] that it cost more than $3,000 to ship a 20-foot container from the East Coast of the U.S. to Puerto Rico. Yet the same shipment cost half that to the Dominican Republic and Jamaica—where the Jones Act does not apply. Higher shipping costs make goods more expensive, and the costs are passed on to consumers. It should be eliminated.

Rollback the Trump/Biden Tariffs

Several specific tariffs imposed by both President Donald Trump and President Joe Biden are inhibiting U.S. growth. Trump introduced tariffs on Canadian lumber during his presidency. The Biden administration took it to another level, increasing the tariffs on Canadian softwood lumber to 11.64% after Trump reduced them during the pandemic. In 2018, the Trump administration applied 25% and 10% tariffs, respectively, on certain steel and aluminum imports, which the Biden administration replaced with a complex tariff-quota system that has a similar distortionary

effect. The World Trade Organization recently ruled that these tariffs violate global trade rules, but the Biden administration defended them.[6] Keeping these restrictions in place risks upending global trade agreements.

Biden also renewed or expanded tariffs covering items such as washing machines, appliances, shelving units, iron, steel pipe, steel sinks, cement, plywood, hand tools, kitchen racks, wood flooring, wood moldings, steel wire, quartz, ceramic tile, and wood cabinets.[7] In a period of supply-chain driven shortages, such tariffs cause destructive ripples throughout the U.S. economy.

All the tariffs adopted over the last six years should be eliminated. Reducing or eliminating these tariffs would not only reduce inflation and return the abundance that so many Americans are accustomed to, but it would also enhance growth and create jobs. The Tax Foundation estimates[8] that repealing the steel and aluminum tariffs would increase long-run GDP by 0.02% and create about 4,000 jobs. The Peterson Institute for International Economics estimated that just a 2-percentage point reduction in tariffs could lower inflation 1.3% and save $800 per household.[9] And that is just in the short term. Lowering tariffs on steel and wood and ending "Buy American" requirements, described below, would make intermediate inputs cheaper and make American companies using these goods as inputs more competitive in the long run.

Re-Engage and Join Trans-Pacific Trade Agreements

Before Trump took office, the U.S. was participating in negotiations to form a trade agreement, the Trans-Pacific Partnership (TPP, now called the Comprehensive and Progressive Agreement for Trans-Pacific Partnership, CPTPP) agreement with Australia, Brunei Darussalam, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, and Vietnam.[10] The goal of the partnership was to open markets, set high-standard trade rules, and address 21st-century issues in the global economy. It would have lowered or eliminated some tariffs, removed restrictions on traded services, and set rules and enforcement mechanisms for intellectual property and e-commerce, the environment, and labor practices.

TPP was not perfect, and the U.S. could revisit the investor-state dispute settlement (ISDS) provisions.[11] But rather than increasing tariffs and subsidies, the U.S. should reinvigorate our trading relationships by re-engaging and renegotiating CPTPP and joining it.

During the pandemic, the extent to which our supply chains are dependent on international trade became apparent. This is seen as a weakness, but a well-diversified supply chain is safer, since any one country, including our own, can be vulnerable to disruption. More trade in Asia and Latin America not only provides more resilience, it offers more possibilities for growth, The U.S. International Trade Commission estimated that TPP would have created 128,000 jobs and increased real wage rates 0.19% by 2032.[12] Joining and re-engaging with this agreement would both boost our economy and protect our place in international supply chains.

Workforce Reform

Strengthening a soft economy and encouraging economic growth without worsening inflation requires prioritizing the economy's supply curve instead of its demand curve. Nowhere is this more obvious than in the need to get more workers into the workforce.

Workforce reform can prioritize the labor supply and productivity level that is needed (along with capital) to expand economic growth. Unfortunately, labor supply and productivity are trending in the wrong direction. Labor force participation rates have long been slated to dip as

74 million Baby Boomers retire. However, a decline in labor force participation among prime-age (25–54) males—driven by factors such as industry instability, substance abuse, disability claims, and delayed family formation—has left nearly 10 million working-age men jobless.[13] Productivity growth rates have also been sluggish since 1973, near-zero since 2006, and negative for several quarters in 2021 and 2022.[14]

Without reform, labor supply and productivity rates may continue to drag down the economy. Baby Boomer retirements will slow labor force growth, and the long-term decline in work rates for prime-age men may continue.[15] Rising budget deficits may drive up taxes (reducing incentives to work and for businesses to invest) and crowd out the capital investment that can aid worker productivity.

In short, workforce reform is both a short-term necessity in a fragile economy and a top long-term priority to build a prosperous future that leaves fewer families behind.

The labor force decline among working-age individuals has many causes, but the leading drivers include family and child responsibilities, ill-health, lack of available jobs matching worker skills, tax disincentives, drug addiction, and employer reluctance to hire ex-prisoners. Productivity growth has also been reduced by some of these factors, as well as by job churn, less capital investment, technological adjustments, and trouble in dysfunctional sectors such as education and health care.

Earned Income Tax Credit

The Earned Income Tax Credit (EITC) encourages work by raising after-tax pay. However, the inflation-adjusted benefit has been relatively flat for nearly 25 years. Moreover, the maximum credit for childless adults is just $560—compared to $3,733 for an adult with one child, and $6,164 for an adult with two children. Both former President Barack Obama and former Republican House Speaker Paul Ryan endorsed EITC expansion. Reforms such as nudging up the benefit level and expanding benefits for childless adults could bring 8 million people into the labor force, according to an analysis by the American Action Forum.[16] Congress could create a temporary boost for EITC payments, as has been done in past stimulus bills. A $560 additional payment per year for all participating adults, childless or otherwise, would keep the EITC up with spiraling inflation and incentivize more workers back into the workforce.

Reduce Secondary Earner Penalties

Lawmakers could also encourage work by enacting a tax benefit for secondary earners. Under the current tax code, a family's second earner typically pushes the family combined income into a higher tax bracket (and may reduce EITC benefits), which imposes a significant tax penalty on that marginal income. Typically, this penalizes wives and mothers, who are often pushed into a secondary earner status within a family because of parenting roles. A secondary earner tax credit can reduce this penalty on spousal work. An alternative reform would allow secondary earners to be taxed in their own bracket (rather than a bracket that combines family income).[17]

Social Security Reforms

Reforming the Social Security earnings test can encourage work for those near retirement. Under current law, workers who claim "early" Social Security benefits before the full retirement age will have some of their benefits withheld if they continue earning income above a certain threshold. These withheld benefits are repaid after full retirement; most partially retired workers do not understand that aspect, however, and thus treat the withheld benefits as a steep "tax"

on working. Lawmakers can encourage work by reducing the earnings test for semi-retired workers, while also adding reforms to encourage more workers to wait until the full retirement age to collect benefits.[18]

Social Security Disability Insurance (SSDI) reform is also necessary. Nearly 8 million Americans currently receive disability benefits,[19] and caseloads have soared in recent decades despite national disability rates not rising and the typical job becoming less physically intensive. Some estimates suggest that disability claims account for one-quarter of the decline in labor force participation for prime-age men since the 1960s.[20] Much of the increase in disability caseloads have come from mental disabilities (such as depression) and musculoskeletal disorders (such as back pain), which are easy to claim and do not always offer measurable signs of being cured. Lawmakers could fix the binary "on" or "off" disability system (which traps people in the program long term) by offering partial or temporary disability awards that encourage work. They could also consider creating an employer-funded program to cover short-term employee disabilities if the employer cost does not prove burdensome.[21]

Childcare and Family Leave Reforms

Childcare reforms to lower costs and expand access can also remove a major barrier to labor force participation. While consolidating existing benefits into a single refundable tax credit may aid families,[22] adding large new subsidies may not be realistic in this budget environment and may risk pushing up prices. Instead, economist Michael Strain noted research that "found … increasing the ratio by one infant reduces the cost of care by between 9% and 20%, saving families between $850 and $1,890 per year."[23] Additionally, lawmakers can ensure that childcare subsidies may be used for informal care arrangements, such as through grandparents or neighbors.

Family leave policies can also encourage workers to remain employed, although the expansion of employer-created policies means that a universal federal program is not likely necessary (or affordable) at this time. Targeted assistance and tax-advantaged savings accounts may be more responsible ways to fill in the cracks in employer-provided policies.

Employment Among Ex-Felons

Prisoner re-entry into society requires finding stable employment. With more than 10 million ex-felons in America, previous incarceration has been shown to be a significant factor in lower labor force participation.[24] Improving job training during incarceration can build skills, as can stronger efforts to place newly released prisoners in apprenticeships and jobs. Finally, limiting the time during which ex-felons must inform prospective employers of past convictions can address employer hiring hesitancies in cases where the individual is no longer a threat to society.[25] Relatedly, lawmakers must take stronger steps to reduce opioid dependency, which is responsible for as much as one-fifth of the prime-age labor force decline between 1999 and 2015.[26]

Improving job training, education, and apprenticeships are also important for long-term workforce development, while labor productivity requires capital investment, technology, research and development, and the reform of sluggish sectors.

Regulatory Reform

Regulatory and government reform can push out the economy's supply curve, reducing prices and expanding production. While some basic regulation is necessary and even pro-growth, too many regulations can worsen inflation and limit output. Business regulation often diverts

resources to unproductive uses and raises costs that are passed on to consumers. Americans are willing to sacrifice some output and accept higher price levels in return for basic environment, health, safety, and consumer protections. However, reining in excessive or unnecessary regulations can approximate the proverbial free lunch, by expanding economic production and lowering costs. After all, the economic sectors enduring many of the highest price increases and quality stagnation over the past few decades—such as health care, higher education, and housing—are also among the most subsidized and regulated.

Congress and regulatory agencies need better tools for assessing the costs and benefits of regulations. Trump-era requirements to pair any new regulations with a repeal of existing outdated and unnecessary regulations slow the number of new regulations and limit their collective burden.[27] Congress should pass legislation codifying this policy.

Repealing long-standing regulations is a long and arduous process, which is why limiting new regulations can be more successful in the short-term. However, Congress should also address recent regulations that are contributing to rising inflation.

"Buy American" Constraints

For example, Congress should revisit Buy American rules. Each year, Washington spends $600 billion directly purchasing goods and services. Buy American rules require that the vast majority of federally procured goods be "Made in America," defined as having 55% of the value of their parts manufactured in the United States. During Biden's first week in office, he signed an executive order establishing a "Made in America Office" and reviewing federal Buy American policies. The result was a policy to gradually raise the qualifying threshold to 75% by 2029.[28] In his 2023 State of the Union address, Biden doubled down on these constraints, vowing that construction materials used in federal infrastructure projects be made in the United States. While encouraging American manufacturing is popular, barring the federal government from purchasing cheaper imports means higher prices for the government, and either higher federal spending or fewer government purchases. Repealing this expansion would encourage lower prices and a more cost-efficient federal government.

Davis-Bacon Rules

Davis-Bacon rules require government contractors pay their employees at a so-called "prevailing wage," set by the U.S. Department of Labor.[29] These laws have historically been used to shield unions from competition, particularly competition from minorities who were not admitted into unions but willing to work anyway. Today, Davis-Bacon adds billions of dollars to construction costs and is administered with antiquated rules that do not accurately reflect local prevailing wages. Yet the Biden administration is restoring a long-repealed policy known as the "30% rule" that would affect 94,000 contractors and add an average of $3.65 per hour to wage costs.[30] The result will be a combination of higher costs to government, higher costs to contractors, a reduction in contractor employment, and a reduction in construction and related projects. Repealing all of Davis-Bacon may be a heavy lift, but blocking the 30% rule is realistic.

Energy and Environment Red Tape

Encouraging domestic oil and gas production is an obvious way to create jobs and bring down energy prices. America's oil reserves are now the largest in the world when including shale oil,[31] which can be tapped through fracking and new technologies. While the Biden administration has approved a healthy number of oil and gas permits, much of the growth in oil production has been in private and state lands that are mostly outside administration control.[32] The amount of federal acres leased for new drilling has collapsed to a 75-year low under President Biden, and while the Inflation Reduction Act requires more federal lands to be made available, possible

loopholes still exist.[33] Overall, domestic oil production remains one million barrels per day (or 8%) below pre-pandemic levels.[34] Opening up federal lands and giving domestic producers peace of mind that the federal government is not trying to strangle their industry can encourage the investments needed to add production and lower prices.

Expensive and anti-growth infrastructure delays are driven in large part by Environmental Impact Statements. These necessary-but-sluggish reviews are required by the 1969 National Environmental Policy Act (NEPA) and are intended to ensure that new projects do not overly damage the environment. Yet impact statements commonly exceed 1,000 pages and require on average seven years to complete[35]—with some taking 17 years.[36] Columnist Megan McArdle drew our attention to one particularly egregious example: "The Southeastern High Speed Rail Corridor was proposed in 1992. You will be thrilled to learn that in September 2017, the Department of Transportation announced the completion of the project's Tier II Draft Environmental Impact Statement."[37] There is no reason the environmental review process must be this expensive and prohibitive. In fact, these reviews are completed in no more than one to two years in Canada and 3.5 years in the European Union.[38]

NEPA environmental reports are often delayed because the draft reviews can be challenged in court by a wide range of stakeholders. These challenges can take years or even decades to adjudicate, and developers are unable to break ground until the project has survived the legal process, including appeals. Other countries use faster, non-judicial options to enforce these regulations, rather than expensive and time-consuming lawsuits that essentially become a project veto.[39] NEPA is not even operationally pro-environment; it is simply anti-development. The law has been used to block or delay clean energy projects as well as congestion pricing, light rail, bike lanes, wind power, solar power, hydropower, and wildfire prevention projects.[40]

Rather than modernize and improve this archaic system, the Biden administration is finalizing a new rule to tighten NEPA's grip and give regulators several new tools to delay and cancel infrastructure projects.[41] Permitting reform has gained prominence in the Senate, with both Democratic and Republican lawmakers offering innovative proposals to speed up the review process and better balance environmental and development interests. Now is the time for such reform.

These are just a sample of the regulatory policies that can be reformed to aid a high-inflation and weak economy. While the executive branch typically leads in regulatory policy, Congress can enact legislation rejecting or amending rules that the Biden administration is hesitant to reform.

Conclusion

Developed nations responded to the Covid-19 pandemic with policies intended to keep families, businesses, and the economy afloat. These policies also guaranteed a degree of inflation. However, the U.S. drove its own inflation rate higher than necessary through excessive stimulus spending, tariffs, and pro-union regulations. As Congress and the president continue to make inflation worse, the Federal Reserve must push down harder on the economy's brake pedal, thus risking a recession. In other words, continuing with demand-side stimulus may ultimately weaken the economy.

Instead, Congress can reduce inflation with pro-growth and disinflationary policies that ease the pressure on the Federal Reserve. This requires throwing out the old stimulus playbook and adopting supply-side policies to encourage investment, open up trade, encourage work, and reduce the burden of red tape. Many of these policies do not fit neatly into partisan categories

and thus present opportunities for bipartisan reform. Congressional lawmakers and the White House must start crafting a low-cost, supply-side stimulus proposal now so it is ready to deploy if the economy falls into a widely expected recession.

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