THE NEW HOMESTEAD ACT:

A plan to revive US economic growth

August 16, 2011 version

Carl Goldsmith
Senior Vice President
Delta Asset Management
(a member of BMO Global Asset Management)
213-626-1644
carl.goldsmith@micorp.com

Ed Yardeni
President
Yardeni Research, Inc.
eyardeni@yardeni.com
516-972-7683

Standard & Poor's downgraded US Treasury debt from AAA to AA+ on Friday, August 5. The rating agency is simply not convinced that the latest deal between Congressional Democrats and Republicans to lower the deficit over the next few years will put a lid on the rapidly rising ratio of US government debt to GDP. "The political brinkmanship of recent months highlights what we see as America's governance and policymaking becoming less stable, less effective and less predictable than what we previously believed. The statutory debt ceiling and the threat of default have become political bargaining chips in the debate over fiscal policy," S&P said in its report. The concern is that the increasingly acrimonious atmosphere in Washington between the two parties and the resulting political gridlock reduce the chances of reviving any fiscal discipline.

That's obviously true. There is a huge rift between the Democrats and the Republicans on how to reduce the deficit. One of the ways to narrow this divide, in our opinion, is to focus on policies that can revive self-sustained economic growth. In other words, a better way to reduce the debt to GDP ratio might be to boost the growth rate of the denominator. Doing so has a very positive feedback loop on the numerator, which would grow less rapidly as rising tax revenues attributable to faster economic growth immediately reduce the deficit, thus slowing the pace of debt accumulation.

Reducing the deficit directly is also important. However, it can be risky in the short run because spending cuts and tax increases can depress economic growth. In other words, focusing just on the numerator of the debt to GDP ratio may have a negative feedback loop. So what can be done? Much has already been done to stimulate growth with both fiscal and monetary policies over the past two and a half years. However, these measures haven't worked because they haven't effectively targeted the weakest sector of our economy.

One of the main drags on the US economy is the housing industry. In the past, it always rebounded from recessions with V-shaped recoveries, which would boost overall economic growth. This time, the industry remains in a deep recession, which is weighing on the overall economy's recovery.

Housing starts have been hovering between 475,000 and 690,000 units per month, at seasonally adjusted annualized rates, since the end of 2008. That's the slowest pace on record, which starts in 1959. Payroll employment in the construction industry has plunged 2.22 million from a record high of 7.73 million during April 2006 to 5.51 million during June. There must be lots of construction workers among the 6.3 million Americans who have been without a job for more than 27 weeks, i.e., the long-term unemployed.

We believe that the best way to revive economic growth is to quickly reduce the huge overhang of unsold homes that is depressing both home prices and construction activity. During June, the inventory of single-family existing homes on the market totaled 3.31 million units. There may be another million houses that are in the process of foreclosure or are heading in that direction. Our plan is simple and cost effective:

(1) *The federal government should provide a matching subsidy toward a down payment of up to $20,000 on single-family homes to any homebuyers who are approved for a mortgage loan.* The program would be capped at two million existing single-family homes. So the cost of the

program would be $40 billion. The purchased property would have to be the primary residence of the buyers. The program would be limited to those who do not currently own a home. To reduce the incentive to flip houses, the subsidy could be structured as an interest-free loan reduced by a one-fifth every year for five years.

(2) *This program could be paid for by slashing the corporate tax rate on repatriated foreign earnings from 35% to 10%.* We estimate that doing so could easily raise the $40 billion necessary to finance the program. Moody's research recently estimated that at least half of US companies' record $1,240 billion in cash balances is held overseas. It's over there and not here because of the large repatriation tax. In recent conversations with top executives of several major US technology companies with cash overseas, we were assured that lowering that tax to 10% would bring most of the money to the US.

(3) *Rental income would be tax free for 10 years for homebuyers who purchase existing single-family houses as rental properties.* They would not be eligible for the down payment subsidy. The 10-year tax-free status of the rental income would be transferable to new owners during that period. The number of rental units under the program would be capped at one million. To reduce the incentive to flip taxable into tax-exempt rental properties, purchasers would be prohibited from participating in the program if they sold any rental property during the three months prior to the introduction of the program and until its termination when the one-million-unit quota has been filled.

Those who are opposed to lowering the repatriation tax argue that a similar program during 2004, when $300 billion returned to the US, was paid out to shareholders rather than invested in job creation. Our proposal would use the tax revenues from repatriated corporate profits to fund the down payment subsidy program. Combined with the incentive to new landlords, we believe that the overhang of unsold homes could be eliminated within a year. That should set the stage for a significant revival in home building and construction employment. Of course, the cash flow from the repatriated profits should also stimulate the economy.

On May 20, 1862, Congress passed the Homestead Act, which accelerated the settlement of the western territory by granting adult heads of families 160 acres of surveyed public land for a minimal filing fee and five years of continuous residence on that land. Our New Homestead Act should be a win-win for all of us by stimulating a solid recovery in the housing market and boosting GDP growth. That along with serious long-term deficit reduction should convince the rating agencies that US debt is AAA.

***