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Beyond quantitative easing in the eurozone

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The European Central Bank's expected purchase of large quantities of sovereign bonds may succeed in reducing eurozone interest rates and lowering the value of the euro, but it is unlikely to do enough to achieve substantial growth of income and employment.

Fortunately, there are alternative strategies that individual eurozone governments can pursue to stimulate their economic recoveries.

The missing piece in eurozone policy is the use of "revenue neutral fiscal incentives" — temporary tax incentives that would stimulate private spending without increasing budget deficits. This approach could reduce the relevant cost of funds to businesses and households — ie the net rate of interest, and the net cost of equity funds — and thus increase the return on investments.

Changing tax rules in this way can achieve the same incentive effects as lower interest rates, without the increased financial sector risks that result when abnormally low interest rates cause lenders and investors to reach for yield by accepting lower quality assets and lower credit spreads.

A further advantage of using fiscal incentives is that the changes in national tax rules can be enacted at the level of individual eurozone countries; there is no need for authorisation from a pan-European body or from other member states. Although the creation of the euro ended the possibility of separate monetary policies and separate exchange rates, it did not prohibit distinct tax rules. Fiscal incentives can therefore be tailored to individual national conditions.

There are many ways in which changing tax rules can increase aggregate spending without raising fiscal deficits. A temporary increase in the tax-deductible depreciation rate, or a large investment tax credit, for instance, could incentivise new investments in plant and equipment, by raising the net return on investment. There is substantial evidence that such policies have been effective in the US in stimulating investment during several previous downturns.

It would also be possible to reduce the net cost of funds by converting the deduction for business interest to a refundable credit at a higher effective rate. The cost of equity capital could be reduced by allowing deductions for dividends on common stock or preferred equity.

The resulting revenue loss could be balanced by a temporary rise in the corporate tax rate, effectively taxing the return on old capital while stimulating new investment. The necessary rise in the corporate tax rate could be adjusted after seeing the favourable effect of the policy on economic activity and tax revenue. Of course, specific changes would have to be implemented carefully to deal in an equitable way with unincorporated businesses.

Tax policies could also be used to stimulate the construction of new housing as a substitute for lower mortgage interest rates. A direct tax incentive to home builders could be passed through to prospective buyers. Alternatively, mortgage interest payments could be made deductible in calculating taxable income (as they are in the US), extended to non-itemisers where deduction is currently allowed, or converted to an optional tax credit at a higher rate. The revenue cost of these temporary stimulus measures could be offset by adjusting tax rates in a revenue neutral and distributionally neutral way.

Yet a further option for individual eurozone countries is to modify their value added taxes with revenue neutral offsets in the rate of income tax. For example, a government could decide to raise its VAT rate by two percentage points a year for the next five years, with the extra revenue returned in the form of lower income tax rates or income-related cash transfers. The prospect of future increases in VAT would stimulate consumers to spend before prices rise and would also raise the rate of consumer price inflation.

If any eurozone country succeeds in stimulating its economy by using one or more of these tax incentive policies, other countries are likely to follow. The ECB and the commission should therefore encourage such revenue neutral fiscal incentives.

Although the ECB's large scale purchases of sovereign debt may help the eurozone, QE is unlikely to be as successful as it was in the US. Large scale purchases of government debt stimulated the US economy largely by driving down long-term interest rates, leading to higher equity prices and higher house prices. The resulting $10tn rise in household net worth in 2013 triggered increased consumer spending and a broader recovery of demand. But interest rates are already extremely low in Europe, with the rate on 10-year German Bunds less than 0.5 per cent. Even the Italian and Spanish ten year bond rates are less than 2 per cent.

Individual eurozone countries should thus seize the initiative to stimulate their economies by introducing temporary changes in tax incentives. In doing so, they would help themselves and contribute through trade to increased activity throughout the region.