The Fed's Needless Flirtation With Danger

Well-designed tax rules are a safe and effective alternative to quantitative easing.

By Martin Feldstein
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This week's good economic news—consumer spending up sharply in November over October, and a surge in third-quarter GDP growth to a 5% annual rate—give a clear signal of the likely economic strength in 2015. But it is worth remembering the unusual challenge of restarting the economy after the downturn in 2008 and the risks involved in the Fed's strategy of quantitative easing.

The Federal Reserve and other central banks traditionally respond to economic weakness by reducing short-term interest rates in order to stimulate spending by businesses and households. But when short-term rates dropped close to zero after 2008, the Federal Reserve and other central banks adopted a different strategy of unconventional monetary policy, combining very large purchases of long-term securities—"quantitative easing"—with the promise to keep short-term rates close to zero until demand recovers.

In the United States, QE reduced long-term interest rates and raised the prices of equities and real estate. The resulting increase in household wealth stimulated consumer spending and raised overall economic activity.

But extremely low interest rates also caused lenders and investors to reach for yield, for example by taking greater risks through lower-quality loans with fewer lender protections, and accepting narrower spreads on risky bonds. This increased risk-taking could have serious consequences for financial stability and economic activity in the future.

The risks brought about by unconventional monetary policy were unnecessary. Well-designed tax policies can change incentives by businesses and households to spend without increasing fiscal deficits. Although we cannot undo recent unconventional monetary policies, an alternative fiscal strategy is worth exploring, because there will be future occasions in the U.S. and elsewhere when economic stimulus is needed while short-term interest rates are already close to zero.

The place to begin is by noting that the Federal Reserve and other central banks focus on changing the market rate of interest. But the relevant cost of funds to businesses and households is not the rate of interest but the net-of-tax rate of interest or the net-of-tax cost of raising equity capital. Tax rules can crucially affect the cost of raising capital, and can stimulate investment and aggregate spending without raising government deficits.

For example, investment in plant and equipment can be stimulated by a temporary increase in the depreciation rate on new investments in plant and equipment or by an enlarged investment tax

credit. It would also be possible to reduce the net cost of funds by converting the deduction for business interest to a credit at a higher effective rate, for example by giving a credit of 50% of interest paid instead of the deduction against the 35% corporate tax rate. The cost of raising new equity capital could be reduced by allowing deductions for dividends on common or preferred equity.

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

There are also alternatives to lower mortgage interest rates as a means of stimulating new residential housing. A direct tax incentive to home builders would be passed through to prospective buyers. The current deduction of mortgage interest payments could be extended to non-itemizers or converted to an optional tax-credit at a higher rate—for example allowing an optional 35% tax credit for mortgage interest paid instead of the current deduction. The revenue cost could be offset by adjusting tax rates in a revenue neutral and distributionally neutral way.

Quantitative easing is now on the front burner in Europe. The European Central Bank is considering whether to expand its stimulus policy by buying the bonds of eurozone governments. This would push the currently abnormally low rates on eurozone bonds—now less than 1% in Germany—even lower, but increase risky behavior by investors and lenders.

To increase spending in the economy, the ECB is considering large-scale purchases of sovereign bonds because eurozone countries individually cannot change their interest rates or exchange rates. The peripheral countries such as Italy and Spain that are most in need of stimulus also cannot use government spending or tax cuts because they have very high national debts. Quantitative easing therefore seems to the ECB to be the only option.

It isn't. Individual eurozone countries could employ country-specific, revenue-neutral tax changes to raise private spending. In addition to the tax changes open to the U.S., a eurozone country could raise its value-added tax rate by two percentage points a year for five years while balancing the revenues with lower income-tax rates. This series of annual VAT-induced price increases would encourage consumers to spend before the increased value-added tax raises prices further.

Unconventional monetary policies such as quantitative easing increase the risk of financial instability. Traditional Keynesian policies attempt to raise aggregate demand by increased government spending and reduced tax revenue increase budget deficits and national debt. Instead, European governments should consider how changes in the tax structure could stimulate spending by households and businesses without raising fiscal deficits.

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