

The Future of Fiscal Policy¹

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There are of course many important issues about the future of fiscal policy, especially long-term issues about the size of the national debt and the structure of taxes.

But Vitor asked me to focus on the following question: At the zero lower bound, can fiscal policy be more effective than monetary policy in stimulating investment without the potential risks associated with quantitative easing?

So that is the question that I will answer, leaving broader issues to other times and places.

I think it is useful to separate the question into two parts:

1st, Can fiscal policy be more effective than monetary policy in stimulating investment?

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2nd, Can fiscal policy stimulate investment without the financial risks associated with quantitative easing?

Financial sector risks associated with quantitative easing

I'll start with the second of these questions, which is also the easier one to answer. The answer is clear: fiscal policy does not entail the financial risks associated with QE.

Experience in the United States and Europe shows that QE – the combination of large scale asset purchases and a long period of low short-term interest rates – leads investors and lenders to strategies of reaching for yield that involve substantial risk.

For investors we see a bidding up of equity prices, as well as low yields on long-term bonds and a narrowing of yields between high-risk bonds and Treasuries. There has also been a large increase in the supply of junk bonds that now carry much lower interest rates than traditionally prevailed.

Banks and other lenders are extending credit to lower quality borrowers, they are increasing their portfolios of leveraged loans to borrowers with large amounts of pre-existing debt, and extending credit with fewer conditions, so called covenant light loans.

In principle the resulting financial risks could be limited by macroprudential policies. But in practice we are not seeing the introduction of such policies in the United States except for the increased capital requirements that have been placed on commercial banks. There are essentially no new macroprudential policies targeted at insurance companies, shadow banking firms, and others.

The Financial Stability Oversight Council (FSOC), the U.S interagency group charged with the responsibility for macroprudential policies, has done very little to reduce financial sector risks. In contrast, it has actually moved to increase financial instability by recommending that money market funds be allowed to “gate” their deposits – i.e., to limit withdrawals – when they fear that market conditions will lead to investor runs. The Securities and Exchange Commission accepted this recommendation to allow gating, thereby increasing the probability that such runs will occur.

In addition, the increased capital requirements imposed by the Dodd-Frank legislation reduces the willingness of banks to hold inventories of corporate bonds and to purchase those bonds when there is selling pressure in those markets. The risk of such selling pressure has increased because the low interest rates has induced a very large increase in the issuance of corporate bonds which have been purchased by exchange traded funds (ETFs). Investors in the ETFs have essentially immediate liquidity but when investors exercise that liquidity option

the funds must sell the bonds in order to raise cash to meet the demands of their investors. It is not clear who would step forward to buy those bonds.

Risks have also been increased in the housing market when Fannie Mae and Freddy Mac dropped the requirement that mortgage originators keep five percent of the value of the mortgages that they originate in order to increase their caution in lending. And it is now again possible for some borrowers to get a mortgage with a 97 percent loan to value ratio. Fannie and Freddy have shifted some of the resulting risk to private investors by issuing bonds that finance different tranches of the three percent downpayment. If house prices fall, some of those homeowners who will then have negative equity may choose to default on their mortgages, leading to foreclosures and house sales that drive down house prices more generally.

In short, the QE policies involve financial risks that have not been offset by macroprudential policies.

In contrast, fiscal policies aimed at stimulating investment would not carry such financial sector risks.

Effectiveness of Fiscal Policy in Stimulating Investment

That brings me to the first part of the overall question: can fiscal policy be more effective than monetary policy in stimulating investment?

It's not clear why the attractiveness of fiscal policy should require it to be more effective than monetary policy. Wouldn't fiscal policy be attractive in this context if it were just as effective as QE without creating financial risks? In any case, the impact of fiscal incentives depends on the magnitude of the fiscal incentive policy.

Before discussing the impact of fiscal policy on private investment let me summarize my view about the impact that QE has had on the U.S. recovery. I believe that QE did succeed in stimulating GDP and bringing about the stronger recovery that we observed in the second half of 2013 and since then.

I think Ben Bernanke was correct in his prediction that the QE policy would raise the value of equities and the prices of owner-occupied homes. The increase in these values raised household wealth by more than \$10 trillion in 2013. That led to an increase in consumer spending which then contributed to a strong increase in nonresidential fixed investment. The lower interest rates produced by QE also appear to have increased nonresidential fixed investment in 2011 and the first half of 2012.

So I am not disputing that QE can and did contribute to increased investment. But I believe that fiscal policy can also stimulate investment and can do so without the accompanying financial sector risks.

It is useful to distinguish two types of fiscal stimulus. The first is tax cuts that increase fiscal deficits and raise GDP through traditional Keynesian channels. These could be cuts in personal income taxes, payroll taxes, or corporate taxes. By raising GDP they stimulate investment through higher capacity utilization and higher profits.

The second type of fiscal stimulus includes specific investment incentives, like the investment tax credit or accelerated depreciation, that increase the profitability of investment. There is a large body of research that confirms that such targeted incentives have been effective in raising business investment.

There is of course a potential concern about using such investment incentives at a time when the economy already has a large fiscal deficit or national debt. In that context, it would be possible to pay for these fiscal incentives with a concurrent increase in the corporate tax. More specifically, a revenue neutral fiscal incentive would combine an investment tax credit for (say) the next two years with a temporary increase in the corporate tax rate during those same two years that would raise enough revenue to pay for the investment tax credit.

The key point is that the investment tax credit would reduce the tax on new investment while the higher corporate tax rate would fall on existing capital. Businesses would have an increased incentive to invest during the two years when the investment tax credits are available. The

higher corporate tax rate would also increase the tax value of depreciation, further stimulating investment.

The Issue of Timing

There is of course an issue of timing in the effect of both fiscal and monetary policies. I have long believed and continue to believe that the problem of timing makes it unwise to use fiscal policy to stimulate demand in a traditional recession and that it is better to use monetary policy in those circumstances.

The traditional recession in the past half century lasted only an average of ten months from peak to trough. This is almost certainly less than the time it takes for the political process to recognize the need for a significant stimulus, to enact the changes in tax rates or tax rules, to then implement those tax changes and to experience the impact of the changes on the economy. The impact of the fiscal change can therefore come well after the economy has passed the trough of the cycle and is expanding.

I have therefore believed that expansionary fiscal policy should only be used when the economic downturn is expected to be deep and long so that timing is not important. Those conditions prevailed in the recession that began at the end of 2007.

The problem of timing also affects monetary policy. The experience in 2006 through 2008 shows the difficulty of moving quickly to ease monetary policy. The minutes of the Federal Reserve show that it took considerable time to recognize the seriousness of the downturn and to decide how large a stimulus should be. That continued to be true after the interest rate reached the zero lower bound and the Fed shifted to a variety of different QE formulations. And even after those policies were put in place, it inevitably took time before they caused the desired increase in demand.

My basic conclusion, therefore, is that although fiscal incentives do involve problems of timing they can be used effectively in the context of deep and long-lasting downturns to stimulate investment without the adverse effects on financial stability that result from quantitative easing.

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