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# Fiscal Activism Would Speed a Recovery

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Economic conditions in the US and Europe require a rethinking of the roles of monetary and fiscal policy in reversing economic downturns. We must recognize that fiscal policy can stimulate demand by changing incentives as well as by increasing disposable income.

Monetary actions will remain the primary instrument of countercyclical policy in the years ahead. Central banks act faster and more flexibly than parliaments. High real interest rates and slower money growth have lost none of their power to reduce economic activity and damp inflation. And when reductions in real interest rates and increases in money growth are possible, they can be used to accelerate economic activity.

But the current relatively low rates of inflation and correspondingly low nominal interest rates restrict the ability of central banks to stimulate the economy by reducing nominal and therefore real interest rates. In this situation, monetary policy must be supplemented by fiscal policy.

In the US, the Bush administration has used fiscal policy to stimulate demand in three ways. First, reductions in income taxes increased households' ability to spend. Second, lower tax rates on future dividends and capital gains raised share prices, encouraging households to spend some of their new wealth and stimulating business investment by lowering the cost of equity capital. And third, new tax depreciation rules allowed companies to reduce their taxable incomes immediately by 50 per cent of the investment in new equipment carried out in 2003 or 2004, providing a strong incentive to accelerate investments that might otherwise have been made later.

These fiscal changes combined with continued easy monetary conditions should lift the economy on to a faster path of self-sustained expansion as rising outlays by households and businesses lead to increased production, employment and incomes. Statistics on US retail sales and industrial production in July provide encouraging evidence that this is beginning to happen.

An important feature of the recent fiscal package was the use of policies that stimulated demand with little or no increase in budget deficits. The temporary rise in the tax depreciation rate and the resulting tax cut are automatically offset by lower depreciation and therefore high tax liabilities in later years. This increases the budget deficit in 2003 and 2004 and then reduces it by roughly the same amount in the following years. But even without a net rise in the national debt, this type of fiscal policy encourages investment now when the economy needs the boost.

The ability to use fiscal incentives to stimulate the economy without increasing the national debt is particularly relevant to Europe, where traditional monetary and fiscal policies are of limited use. Because the cyclical situation differs sharply among the countries of the eurozone, a looser monetary policy would provide too much stimulus for some countries and too little for others. The scope for tax cuts to increase spendable income is also limited. The stability and growth pact restricts budget deficits in order to increase the credibility of the euro in countries where budget deficits were often a prelude to inflationary finance.

Those European countries that are growing too slowly or are in recession can use temporary fiscal investment incentives offset by temporarily higher profits taxes to spur business outlays. Similarly, a temporary cut in value added tax, balanced by a rise in personal taxes, could stimulate household spending. Both techniques would help to accelerate economic activity and neither would raise the budget deficit.

Persistent budget deficits crowd out investment and thus reduce long-term growth. Fortunately, some of the projected deficits of the next few years are explained by lower tax collections that result from cyclical weakness and will shrink as the economies grow. In the US the budget deficit is projected to fall to about 2 per cent of gross domestic product over the next five years and the ratio of national debt to GDP to stabilise at less than 40 per cent.

Bigger deficit problems lie in the decades ahead in both Europe and the US because the rapidly ageing population will bring a dramatic rise in pension and health spending. Reforms to avoid those deficits should be the highest fiscal priority over the next few years. But there is no reason why fiscal incentives cannot be used now to make sure that the economies on both sides of the Atlantic enjoy faster growth and rising employment.

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