Why the Fed Should Have an Instrument Equivalent to Fiscal Policy

Nicolaus Tideman

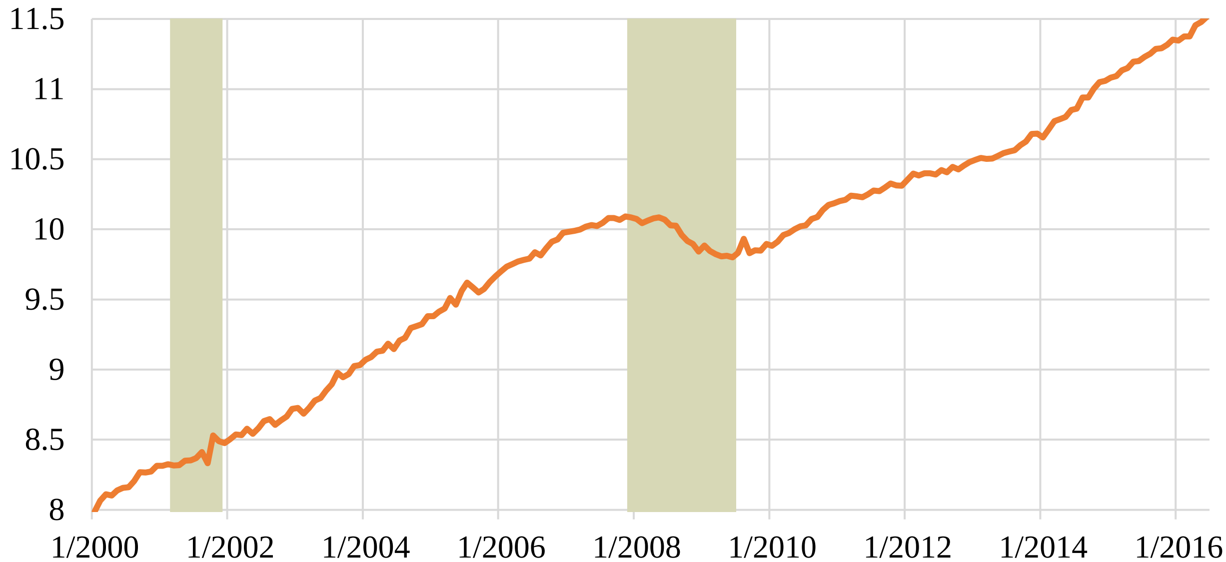
Abstract

It is hard to make fiscal policy an effective instrument of macroeconomic stabilization because it takes a long time to implement fiscal policy and because, when contraction is needed, it is implausible to expect politicians to raise taxes or cut public spending just because economists tell them that macroeconomic stability requires it. However, there is an equivalent to fiscal policy that could be implemented by the Fed, namely interest-free loans to taxpayers in proportion to the federal income and payroll taxes they pay. Such a policy could be implemented without delay and could readily be reversed. The Fed should have this policy instrument.

I. Introduction

The demand for cash balances fluctuates, and there are times, such as 2008, when people become very scared and the demand for cash balances rises rapidly. When people experience an increase in their demand for cash balances, they adjust by cutting back on their consumption spending. Figure 1 shows the reduction in consumption spending that occurred in 2008.

Figure 1: U.S. Real Personal Consumption
Seasonally Adjusted Annual Rates, Monthly (Trillions of 2009 $)



Calculated as personal consumption (National Income and Product Accounts, Table 2.6, line 29), times the ratio of chained 2009 dollars to current dollars (lines 39 and 38 of Table 2.6). NBER-defined recessions are shaded.

The economic problem with this adjustment process is that it causes recessions. When people cut back their spending to increase their cash balances, goods and services that producers had expected to sell go unsold. Employers lack the revenue with which to pay their employees and lay workers off. The increasing unemployment rate further increases the desire for the safety of cash balances, moving the economy into a downward spiral.

At the aggregate level, the effort to increase cash holdings is problematic because the total supply of money to be held increases only when the government finances a deficit by printing money or when banks increase their loans. But financing a deficit by printing money is generally frowned upon, and banks become reluctant to lend when economic prospects are unpromising. In the absence of any ameliorating policy intervention, equilibrium occurs when there is enough deflation and/or enough of a fall in incomes that people are satisfied with their existing cash balances.

The downward spiral caused by an increase in the demand for cash balances is ironic because there is no resource cost to increasing the quantity of cash balances. Cash balances are numbers we see when we look at our bank accounts; they can be increased whenever those who control the banking system decide to increase them. Of course, we do not want them to be increased on a mere whim. The result would be uncontrolled inflation.

Still, when there is a problem of a downwardly spiraling economic conditions caused by an unwillingness to buy what the economy can produce, it is worth considering a temporary increase in cash balances, generated by a decision by those who control the money supply.

The traditional Keynesian solution to the problem of unwillingness to spend is deficit spending by the government. There are two reasons why that is a relatively unattractive way of dealing with the problem. First, government spending decisions tend to take a long time. Second, it is best for government spending decisions to be based on the value of the activity supported by the spending. It is true that the costs of projects are lower when they are undertaken with resources that would otherwise be employed. But it is quite difficult to know which resources would otherwise be unemployed when evaluating projects.

Deficit spending can also be accomplished by reducing taxes. This generally operates faster than increases in government spending, but it has the difficulty that, if taxes are lowered to stabilize the economy, a time can be expected to come when they will need to be raised again, and politicians cannot reasonably be relied upon to raise taxes just because economic stabilization requires it.

While tax reductions can in principle be accomplished quickly, in practice they tend to take a long time. By December 2008 the Effective Federal Funds rate had fallen to 0.16% (Board of Governors, 2020), reflecting the recognized need for economic stimulus and accomplishing as much as could be accomplished by standard monetary policy. But $14.2 billion in stimulus checks for disabled veterans and Social Security, SSI and Railroad Retirement recipients (Gravelle et al., 2009, p. 8) did not go out until May 2009 (Weltman, 2010, pp. 77-78). The "Making Work Pay" tax credits of up to $400 per person per year for 2009 and 2010 came in the form of reduced withholding throughout 2009 and 2010 (Topoleski, 2013, Summary), delaying their impact. If there were no other way than deficit spending to deal with inadequate aggregate demand, it would probably be worth using deficit spending to some extent. But there is a better way.

When considering variations on fiscal policy to deal with inadequate demand, it will be important to have a policy that is reversible. If the money supply is increased to deal with an increase in the demand for cash balances caused by fear, there is a reasonable likelihood that the fear will eventually subside. If people then still have the cash that was put in their hands to deal with the fear, an end to the fear will lead them to spend the extra money, causing inflation. Thus, any system of putting money in the hands of people to deal with their fear should include a provision for retrieving the money from them once their fear has subsided.

For this reason, discretionary increases in the money supply should take the form of loans. That way, there can be discretionary reductions in the money supply through required repayment of the loans. The way that the Fed customarily manages the economy by adjusting the interest rate involves a version of this. When the interest rate rises, the demand for loans falls and the quantity of money in the economy falls. When the interest rate falls, the demand for loans increases, and the money supply increases, as long as banks respond by increasing the amount that they lend. However, sometimes, as in the Great Recession, banks are unwilling to increase their lending.

In the Great Recession, the Fed engaged in "quantitative easing" by buying mortgage backed securities. But this is inefficient because it requires the significant costs of refinancing, and it is inequitable because the benefits go to those who have the equity and the initiative to refinance.

II. The Proposal

I propose that the Fed support interest-free "tax-deferral" loans to all taxpayers. The purpose of the loans would be to provide taxpayers with enough cash reserves that they would be willing to continue to buy what the economy is able to produce. The amount of each taxpayer's loan would be an adjustable fraction of the federal income and payroll taxes that the taxpayer had paid in the past five years. Taxpayers would sign up for loans with financial institutions that had accounts with the Fed, the financial institutions would extend the loans, and the Fed would buy them. The loans would persist in good times and bad, with the Fed varying the amount lent to stabilize the path of consumption. Stimulus or contraction could be effected overnight. In the case of contraction, the Fed would want to give taxpayers notice of perhaps a month or two that loan repayments would begin to be required, and the repayments would be spread over enough months to avoid putting taxpayers in financial distress or causing too rapid a fall in the rate of growth of consumption.

People who pay no federal income or payroll taxes would not receive loans. This is not necessarily inappropriate. The proposed program is not designed to reduce inequality. We need other programs to do that. The tax-deferral loans are designed to stabilize the economy. If people who pay no federal taxes are so poor that they are unable to increase their cash balances when bad economic times are forecast, then there is no stabilizing need to increase their cash balances in bad times. If people who pay no federal income taxes do increase their cash balances when bad economic times are forecast, then they should be included in the loan program.

At the other end of the income distribution, it may be appropriate to place an upper limit on the size of loans, to avoid granting shockingly large loans to the rich. This would be entirely consistent with the philosophy of the proposal if it happens that the very rich do not increase their cash balances when bad economic times are forecast.

The loans would be available to anyone who:

1. Filed tax returns
2. Had an account with an institution that had an account with the Fed
3. Was legally able to sign binding contracts
4. Was not institutionalized.

Participation would not be automatic. A person would need to sign up to participate.

Some might object that the prospect of default is too great to permit such a policy. A possible response to this concern would be to specify that in the event of a default on a tax-deferral loan, the Fed would be permitted to collect the money due from the IRS, which would then collect from the delinquent borrower. There are always some persons in default on their taxes, but the IRS is quite experienced in collecting debts. There would still be some unpaid debts, but these might be small enough to be as tolerable as unpaid taxes are.

It would be unreasonable to expect the Fed to be able to estimate exactly how much tax-deferral lending was needed to stabilize consumption in any perceived crisis. Fortunately, it would be possible to revise the amount of lending up or down easily when data revealed the direction in which a correction was needed.

It would be good to include corporations in the loan program. They pay federal taxes and have demands for cash balances that are likely to increase when economic difficulties are forecast.

III. Analysis

It is reasonable to expect that if tax-deferral loans had been available to the Fed in 2008, any downturn could have been held to something that was brief and mild. High unemployment that persisted six years after the shock could almost certainly have been avoided. There would never have been a difficulty of policy being constrained by the impossibility of reducing interest rates below zero.

One efficiency justification for tax-deferral loans is that they would internalize an externality. A person who increases her cash balances generates a positive externality for the issuer of money. An increase in cash balances means that more money can be created, without inflation. To internalize the externality would be to provide cash balances at their marginal cost, which is zero. It is not practical to do this at an individual level, because it would require giving people money they could not spend, and cash balances are useful only if they can be spent. But increasing cash balances at zero cost is practical at an aggregate level, by providing citizens in the aggregate with the amount of cash that would make them want to consume and invest, in the aggregate, as much as the economy is able to produce.

The proposal has something in common with the “social credit” proposal of C. H. Douglas (1920). However, where Douglas’s proposal was for cash payments to all citizens, representing some standard fraction of output, my proposal is for loans to taxpayers in proportion to the taxes they pay, calibrated in a discretionary way to stabilize aggregate consumption. My proposed policy action is easy to reverse, where Douglas's proposed policy was not.

Comparing the proposed policy with the policy of buying mortgage-backed securities and with fiscal policy, all three operate by inducing greater spending. The purchase of mortgage-backed securities puts cash in the hands of those who previously owned the mortgage-backed securities. This presumably induces them to seek other investments, increasing spending on capital goods. It also lowers interest rates, which increases spending by those who refinance their mortgages at those lower interest rates, while decreasing spending by those whose incomes come from interest payments.

Fiscal policy either involves greater spending by the government or it induces greater spending by those who pay lower taxes. With tax-deferral loans financed by the Fed, there is more spending by all eligible taxpayers, because they find that they do not need to add to their savings to satisfy their desire for additional precautionary balances.

The two policies that can maintain spending in the face of an increase in the demand for cash balances are immediate tax rebates and tax-deferral loans. The other policies operate more slowly. The difficulty with relying on a policy of tax rebates is that it lacks a workable alternative in the reverse direction. Politicians tend to be extremely reluctant to raise taxes just because economists say that macroeconomic stability requires it. On the other hand, having the central bank tell taxpayers that it is time for them to begin making payments on their interest-free loans seems much less problematic.

The policy of purchasing mortgage-backed securities has drawbacks that do not apply to tax-deferral loans. The operation of the policy of purchasing mortgage-backed securities requires that homeowners refinance their homes, a process that is time-consuming and expensive, which delays the impact and reduces the efficiency of the policy. With stimulus from mortgage-backed securities, the set of taxpayers who can benefit from the policy is restricted to the relatively small set of those who are credit-worthy, have enough home equity to refinance, and are economically knowledgeable enough to understand the value of the opportunity to do so. With tax-deferral loans, on the other hand, a much wider set of taxpayers benefits from the stimulus program.

Macroeconomists have often commented that it is not possible to achieve two goals with one instrument. Tax-deferral loans would give the Fed a new instrument to add to their current primary instrument of adjusting the federal funds interest rate. The two goals that the Fed might reasonably pursue with their two instruments are stabilizing the path of consumption and stabilizing the path of investment. In approximate terms, the tax-deferral loans would be used to stabilize the path of consumption, while the federal funds rate would be used to stabilize the path of investment. However, because both instruments could be expected to have some effect on both goals, optimal policy would need to take account of their interactions.

IV. Conclusion

Fluctuations in the savings rate that are generated by changes in the demand for cash balances are a major cause of economic crises that increases unemployment. These increases in unemployment could be avoided if cash balances fluctuated to compensate for fluctuations in the demand for cash balances. The most straightforward way to achieve the desired fluctuations in cash balances would be to have the Fed expand and contract the money supply through tax-deferral loans to taxpayers, increasing and decreasing in phase with the demand for cash balances. Distributing such loans among non-delinquent taxpayers in proportion to the taxes they pay has the virtue of providing the loans to persons who, because they are current on their taxes, are relatively unlikely to default.

It seems constitutionally strange that decisions that are so much like taxing decisions should be made by a body other than Congress. However, the proposed policy is quite continuous with previous policies and more equitable in the distribution of its consequences. When the Fed was given the power to print money, it was given the power to determine the real cost of satisfying debts and therefore to affect equity between persons who had borrowed and persons who had lent money. When the Fed took control of interest rates, it determined the relative incomes of those who wished to borrow and those who wished to lend. When it bought mortgage-backed securities it increased the incomes of those who refinanced their houses and decreased the income of those who lived on interest. The policy of buying tax-deferral loans is like buying mortgaged-backed securities, but it is more diffuse in its impacts, and it is based on seeking to maintain stability throughout the economy.

A policy of buying tax-deferral loans ought to be feasible. The next steps in evaluating it are to embed the concept in a general equilibrium macroeconomic model, to undertake empirical work on the relationship between taxes paid and the demand for cash balances, to have the idea evaluated by a variety of economists, and to have lawyers comment on its legal feasibility.

References

Board of Governors of the Federal Reserve System (US) (2020), Effective Federal Funds Rate [FEDFUNDS], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/FEDFUNDS, January 20, 2020.

Douglas, C. H. (1920). *Economic Democracy*, Harcourt Brace and Howe.

Gravelle, J. G., Hungerford, T. L., & Labonte, M. (2009, November). Economic stimulus: issues and policies. LIBRARY OF CONGRESS WASHINGTON DC CONGRESSIONAL RESEARCH SERVICE.

National Income and Product Accounts, https://www.bea.gov/products/national-income-and-product-accounts

Topoleski, J.J. (2013, January). Withholding of Income Taxes and the Making Work Pay Tax Credit. LIBRARY OF CONGRESS WASHINGTON DC CONGRESSIONAL RESEARCH SERVICE.

Weltman, B. (2010). *J.K. Lasser's New Tax Law Simplified 2010: Tax Relief from the American Recovery and Reinvestment Act, and More*, Wiley.