The Case for Tax-Deferral Loans as a Fiscal-Policy Substitute, Managed by the Fed

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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 economically by cutting back on their consumption spending to increase their money holdings. Thus Figure 1 shows the reduction in consumption spending that occurred in 2008.

The economic problem with this adjustment process is that it causes recessions. When people cut back their spending substantially to increase their cash balances, significant quantities of 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 bank loans increase, and banks become reluctant to lend when economic prospects are unpromising. In the absence of 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 caused by an unwillingness to buy what the economy is able to produce, it is worth considering a temporary increase in cash balances, generated simply 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 made on the basis of 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. 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 a direct, discretionary increase in the money supply 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 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 lots of mortgages. 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.

My proposal is that the Fed undertake to support "tax deferral" loans, to all taxpayers. The purpose of the loans would be to provide taxpayers with enough cash balances that they would be willing to consume what the economy is able to produce. The amount of each taxpayer's loan

would be some fraction of the federal income 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 fraction of taxes 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.

One efficiency justification of such loans is that they would internalize an externality. A person who increases his cash balances generates a positive externality for the issuers 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 as much as the economy is able to produce.

People who pay no federal income 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 actually do increase their cash balances when bad economic times are forecast, then they should be included in the loan program, perhaps by including federal payroll taxes as well as federal income taxes in the function that determines the size of loans.

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.

The proposal has something in common with the 1920 "social credit" proposal of C. H. Douglas.[1] 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.

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.

It is time for tax-deferral loans to be considered as a means of improving the capacity of the Fed to stabilize the economy.

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1 Douglas, C.H. 1920. *Economic Democracy*, Sudbury (UK): Bloomfield, 1974.