Let's Stimulate Private Risk Taking

Tax cuts are the way to nudge capital toward productive uses.

By ALBERTO ALESINA and LUIGI ZINGALES

In virtually all economics classes, including those taught by the many excellent economists on the Obama team, the idea of government spending as an engine for growth is not a popular topic. Yet despite their skepticism of Keynesianism in the classroom, when it comes to public policy, these economists happily endorse a large stimulus package that could bring our deficit to 10% of GDP. Why?

One explanation is that these economists think this recession is an extraordinary one. In normal recessions -- the argument goes -- an increase in discretionary government spending is unnecessary and even counterproductive. But in the event that a recession becomes a depression, a Keynesian stimulus package might work.

There are certainly economic models that show how government spending can shift the economy from a bad equilibrium (where people do not search for jobs because they do not expect to find them, and firms do not invest because they do not expect to sell), to a good equilibrium (where people search for jobs, and firms invest and generate demand for their goods).

But this particular recession is unique not in its dimensions, but in its sources. First, it is the result of a financial crisis that severely affected stock-market valuations. The bad equilibrium did not originate in the labor market, but in the credit market, where investors are reluctant to lend to risky firms. This reluctance is making it difficult for these firms to refinance their debt, forcing them to default on their credit, further validating investors' fear. Thus, the problem is how to increase investors' willingness to take risk. It's unclear how the proposed stimulus package would help inspire investors to do so.

The second reason this recession is unusual is that it was caused in large part by a significant current-account imbalance due to the low savings rate of Americans (families and government). Even assuming that more public spending would increase private consumption -- a big if -- such a measure would cause even more imbalance.

So how do we stimulate the economy without increasing the already large current-account deficit? It's not easy, but here is an idea: Create the incentive for people to take more risk and move their savings from government bonds to risky
assets. There is no better way to encourage this than a temporary elimination of the capital-gains tax for all the investments begun during 2009 and held for at least two years.

If we fear this is not enough, we can temporarily increase the size of the capital loss that is deductible against ordinary income. This will reduce the downside of new investments and increase the upside.

More savings need to be invested, and firms need an incentive to invest in order to help aggregate demand in the short term and promote long-term growth. The best way to do this is to make all capital expenditures and research and development investments done in 2009 fully tax deductible in the current fiscal year.

A large temporary tax incentive may be just enough to jolt investors from their current paralysis to take action. Such a switch will also be fueled by the temporary capital-gains tax cut mentioned above, which will motivate people to move their savings from money-market funds to stocks, increasing valuations, investments and confidence.

Many are concerned about what we can do to help the poor weather this crisis. Unlike during the Great Depression, we have an unemployment subsidy that protects the poor from the most severe consequences of this recession. If we want to further protect them, it is better to extend this unemployment subsidy than to invest in hasty public projects. Furthermore, tax cuts have a much better effect on job creation than highway rehabilitation.

No doubt, it is much easier to sell the public and Congress a plan for more public works than tax cuts, particularly while Main Street despises Wall Street -- with some good reason. But the role of a good economic team is to courageously propose the right economic policy, even when it is unpopular. The role of a president is to sell it politically, as real change we can believe in.

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