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Keynesian Policies Have Failed

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Lawmakers are considering extending temporary payroll tax cuts. But the policy is based on faulty Keynesian theories and misplaced confidence in the government's ability to micromanage short-run growth.

In textbook Keynesian terms, federal deficits stimulate growth by goosing "aggregate demand," or consumer spending. Since the recession began, we've had a lot of goosing — deficits were $459 billion in 2008, $1.4 trillion in 2009, $1.3 trillion in 2010, and $1.3 trillion in 2011. Despite that huge supposed stimulus, unemployment remains remarkably high and the recovery has been the slowest since World War II.

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Yet supporters of extending payroll tax cuts think that adding another $265 billion to the deficit next year will somehow spur growth. That "stimulus" would be on top of the $1 trillion in deficit spending that is already expected in 2012. Far from helping the economy, all this deficit spending is destabilizing financial markets, scaring businesses away from investing, and imposing crushing debt burdens on young people.

For three years, policymakers have tried to manipulate short-run economic growth, and they have failed. They have put too much trust in macroeconomists, who are frankly lousy at modeling the complex workings of the short-run economy. In early 2008, the Congressional Budget Office projected that economic growth would strengthen in subsequent years, and thus completely missed the deep recession that had already begun. And then there was the infamously bad projection by Obama's macroeconomists that unemployment would peak at 8 percent and then fall steadily if the 2009 stimulus plan was passed.

Some of the same Keynesian macroeconomists who got it wrong on the recession and stimulus are now claiming that a temporary payroll tax break would boost growth. But as Stanford University economist John Taylor has argued, the supposed benefits of government stimulus have been "built in" or predetermined by the underlying assumptions of the Keynesian models.

Policymakers should ignore the Keynesians and their faulty models, and instead focus on reforms to aid long-run growth, which economists know a lot more about. Cutting the corporate tax rate, for example, is an overdue reform with bipartisan support that would enhance America's long-run productivity and competitiveness.

If Congress is intent on cutting payroll taxes, it should do so within the context of long-run fiscal reforms. One idea is to allow workers to steer a portion of their payroll taxes into personal retirement accounts, as Chile and other nations have done. That reform would feel like a tax cut to workers because they would retain ownership of the funds, and it would begin solving the long-term budget crisis that looms over the economy.