OPINION

Want Growth? Try Stable Tax Policy

By John B. Taylor

The two-month payroll tax cut being debated in Washington reduces to the absurd the recent revival of short-term Keynesian stimulus programs. That such a temporary cut would stimulate the recovery and get employment growing defies common sense.

There is no hard evidence that the temporary payroll tax cut of this year stimulated the economy, and another one for the first two months of next year will obviously do even less. In fact, economic growth declined after this year's temporary tax cut was implemented, so proponents need to appeal to dubious "things-would-have-been-worse" arguments.

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Like the one-time rebate of 2001, the temporary tax cut of 2008, the cash-for-clunkers and stimulus payments of 2009, or similar policies tried back in the 1970s, these temporary policies consistently fail to stimulate sustainable recoveries. And as this history shows, extending the temporary reduction from two months to six months or even to 12 months would be at best a marginal improvement.

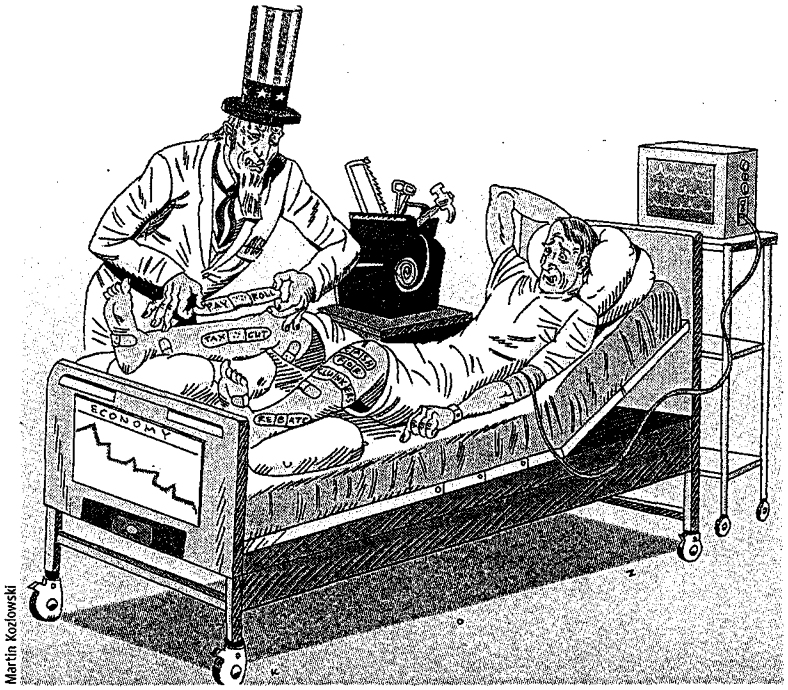
Even economists who claim that these policies stimulate—such as those at forecasting firm Macroeconomic Advisers—admit that they cost jobs as they are turned off, leaving the recovery no better off. Republican presidential candidates Michele Bachmann and Mitt Romney are right to call the payroll tax scheme, respectively, a "temporary gimmick" and "just a Band-Aid."

But the policies are worse than doing nothing at all. Rather than stimulate the economy, they hold the economy back by creating policy unpredictability and by distracting Washington from crucial long-term reforms that are key to restoring economic growth and creating jobs.

Indeed, this type of temporary tax change is making the entire tax system unpredictable. According to the Joint Committee on Taxation, the payroll tax cut is only one of 84 tax provisions expiring this year, about the same as in 2009 and in 2010. This is 10 times greater than the number of provisions that expired in 1999. As shown in a paper presented this October by economists Scott Baker and Nicholas Bloom of Stanford University and Steven Davis of the University of Chicago Booth School of Business, this increase in policy uncertainty is one of the factors slowing economic growth.

Many of these temporary changes, such as the "three year depreciation for race horses two years old or younger," serve special interests, illustrating their unfairness and economic inefficiency as well as unpredictability. The "temporary and targeted" mantra in support of stimulus packages has wrought an on-again, off-again discretionary fiscal policy in which Congress puts virtually the whole tax system up for grabs each year.

Some claim that such policy unpredictability is not a problem, arguing that an obvious lack of demand rather than policy uncertainty is holding the economy back. But demand is low in part because firms are reluctant to hire workers or invest long term not knowing what tax rates and other provisions will be. Demand for investment will increase if policy unpredictability is reduced. And consumption demand will increase if workers' incomes increase on a more permanent basis, which requires a sustainable recovery with much lower unemployment, not the current short-termism of stimulus packages.



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Others say that these temporary stimulus policies actually work by pointing to the Reagan tax cuts. But the 1980s tax cuts were not temporary—they lowered tax rates permanently, and that is why they were so effective.

Extending the payroll tax cut from two months to six or 12 months does not reduce policy uncertainty by much. People who now say that we need another temporary tax cut to avoid a devastating tax hike will certainly say the same thing at the end of those six or 12 months, creating the same partisan debates and unpredictability and also raising serious doubts about the future of Social Security, which is of course funded from the payroll tax.

A more promising and lasting approach would be to take on payroll tax reform as part of Social Security reform. Though not feasible in the las two weeks of the year, taking a small step in that direction would be a big positive step for the economy.

Currently there is significant debate over whether Social Security can be reformed without a future increase in the payroll tax. Many of the reform proposals put forth last year by the Congressional Budget Office (CBO) in its report on "Social Security Policy Options" call for such an increase. So it is not surprising that many firms and workers expect a permanent increase in the payroll tax down the road, regardless of temporary measures. A credible bipartisan agreemen not to include a payroll tax increase a: part of future Social Security reform would effectively be a permanent tax cut.

There are many reforms that do no require a tax increase. One, put forth by the CBO in its report, would simply keep real benefits adjusted for inflation from rising in the future as they are now expected to do. In this "golden rule" reform, each generation transfers to the next generation the same real benefit that it received fror previous generations.

There are other reforms worth considering, including shifting future benefits toward those with lower lifetime earnings. But the point is to take some action now that creates more policy predictability and thereby brings about a robust sustainable recovery.

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