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Nathan B. Oman: GOP tax policy should ditch Keynes for Hayek

By Nathan B. Oman , For the Deseret News

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Members of the Congressional Black Caucus, from left, Rep. Bobby Scott, D-Va., Rep. Barbara Lee, D-Calif., Del. Donna Christensen, D-V.I., and Rep. Donald Payne, D-N.J., right, speak against President Obama's proposed tax cuts, Friday, Dec. 10, 2010, on Capitol Hill in Washington. (Associated Press)

Republicans like tax cuts, but they are not clear on why. Sometimes they rely on arguments drawn from the pro-government economist John Maynard Keynes, while sometimes they rely on the thought of the pro-market economist Friedrich Hayek. Ditching Keynes for Hayek would go a long way toward solving America's economic woes.

GOP politicians often defend tax cuts as leaving more money in people's pockets, money they will spend, thereby "jump starting" the economy. This is essentially Keynesian demand management. Tax cuts are a kind of

government-created economic stimulus, like building highways or buying aircraft carriers.

The Hayekian argument, in contrast, looks to investment rather than consumption. According to Hayek, we allocate capital through either the market or politics. Allocate capital well, and you have prosperity. Allocate it badly, and you have low growth and unemployment.

Markets will always allocate capital better than politicians. The recent housing boom and bust, which was fueled by government policies, subsidies, and tax incentives designed to push money into home building, is a case in point. The billions poured into Arizona and Florida McMansions could have been invested to greater effect elsewhere. To be sure, markets aren't perfect, but individual investors have better incentives and better information than politicians.

Tax cuts are thus good not because they stimulate spending, but because they, at least potentially, reduce the proportion of the economy governed by political fiat rather than the market. What really matters, however, is not tax rates but the size of the government relative to the economy. On the Keynesian view, tax cuts that result in deficits are good because they increase consumption. On the Hayekian view, however, such tax cuts do nothing to limit capital misallocation by the state.

Under George W. Bush, government spending averaged 35 percent of GDP. Since President Obama came to office, government spending as a share of GDP has increased by 15 to 21 percent relative to the previous administration. Some of this increase is a result of the recession. Even if government spending is constant, when GDP shrinks government spending as a share of GDP rises. GDP, however, has been expanding, albeit anemically, since June 2009.

Rather, the rise in spending comes in large part from the enthusiasm of President Obama and his

party for the government allocation of resources. This can be seen most starkly in the president's environmental policy, which has focused mainly on the government as green venture capitalist, spending money on favored businesses and projects. The obsession with "green jobs," however, is but a single example of an administration besotted with the virtues of government "investment."

The results have been economic duds like the Chevy Volt or Solyndra. The real cost of these projects extends beyond the sticker price to the taxpayer. It also comes from the foregone growth that could have happened had that capital been allocated more efficiently by markets rather than the White House.

Focusing on the share of the economy consumed by the state rather than tax rates per se has two surprising implications for Republican politicians. First, tax increases should be acceptable if they are coupled with spending cuts that decrease the government's total share of GDP. Second, tax loopholes that are designed to push investment to politically favored projects ought not to be defended in the name of lower taxes.

In place of a single-minded focus on cutting taxes, the GOP ought to take the Hayekian approach of shrinking the size of the state.

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