To starve or not to starve the beast?

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ABSTRACT

For thirty years, prominent voices have advocated a policy of starving the beast – cutting taxes to force government spending cuts. This paper analyzes the macroeconomic and welfare consequences of this policy using a two-country general equilibrium model. Under several strong assumptions, the policy, if fully implemented, produces domestic output and welfare gains accompanied by losses elsewhere. But negative effects can easily arise in the presence of longer policy implementation lags, utility-enhancing government spending, and productive government capital. Overall, the analysis finds no support for the idea that starving the beast is a foolproof way towards higher output and welfare.

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1. Introduction

For thirty years, prominent voices have endorsed a policy of "starving the beast" (henceforth referred to as STB) – cutting taxes to induce budget deficits in the hope that, over time, the deficits force reductions in government spending. Nobel Laureates Milton Friedman and Gary Becker have been among the proponents of this view. The STB approach has also been supported by a number of US Presidents. For example, in 1981, President Reagan said:

> There were always those who told us that taxes couldn't be cut until spending was reduced. Well, you know, we can lecture our children about extravagance until we run out of voice and breath. Or we can cure their extravagance by simply reducing their allowance.[3]

The 2001 and 2003 tax cuts introduced by President Bush were also consistent with this approach.

However, there is little consensus on how tax cuts affect government spending. Some studies provide evidence that tax cuts in the United States tend to be followed by spending cuts (Bohn, 1991; Auerbach, 2000; Barro, 2003). Others suggest that tax cuts usually fail to restrain government spending. Focusing on US data, Romer and Romer (2009) find "no support for the hypothesis that tax cuts restrain government spending; indeed, [the findings] suggest that tax cuts may actually

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 [3] Reagan (1981).

increase spending." Their results also indicate that tax cuts tend to induce subsequent legislated tax increases. Krugman (2003) and Niskanen (2006) discuss similar findings.[4]

There is also no consensus regarding the macroeconomic and welfare consequences of implementing a STB approach. On the one hand, it could be beneficial in the ideal case in which it reduces entirely wasteful government spending. In particular, lowering such spending could free up resources for private consumption, and the associated lower tax rates could reduce distortions in the economy. On the other hand, it could be costly if the spending cuts arrive with a considerable lag, implying a permanent increase in government debt and real interest rates. Also, lower government spending may itself entail welfare losses if agents attach a nonzero utility value to it, or if it augments the productivity of private factors of production.

A systematic analysis of these trade-offs is the main contribution of this paper. Our analysis is based on experiments conducted in a two-country New Keynesian model. Ricardian equivalence does not hold in the model because consumers have finite lifetimes, or finite planning horizons, as in Blanchard (1985), Weil (1989), and Yaari (1965).[5] The existence of finitely-lived households in our model introduces an important source of non-Ricardian behavior, and gives fiscal policy a non-trivial role.

Our assumption of finite planning horizons is particularly relevant for our investigation because one of the main concerns about STB centers on higher debt levels leading to higher real interest rates, which is an equilibrium feature of this type of overlapping generations model.[6] The assumption of finite planning horizons distinguishes our analysis from other studies that examine related policy reforms, including House and Shapiro (2006), Leeper and Yang (2008), and Forni et al. (2010). While these studies provide some evidence of the trade-offs discussed above, their different theoretical setup, with the assumption of infinite horizons, downplays the negative effects of higher government debt on economic activity through higher equilibrium real interest rates.

We employ a simple open economy set-up to capture the fact that U.S. fiscal deficits are financed to a significant extent by foreign saving.[7] The model employs a set of nominal and real rigidities that are commonly used in the modern business cycle literature. These rigidities have the advantage of yielding plausible impulse responses at shorter horizons. The model also specifies a wide menu of fiscal policy tools, which allow us to study a number of different trade-offs involved in adopting the STB approach.

To assess the effects of the STB approach, we study policy reform scenarios in which immediate or gradual cuts in the tax revenue-to-GDP ratio, implemented through reductions in different tax rates, are met by delayed and gradual reductions in different types of public spending, with the delay in spending cuts leading to a permanent increase in debt. Tax cuts that are followed by an increase in government debt and delayed spending cuts can be motivated by early theories of the strategic use of public debt accumulation (Persson and Svensson, 1989; Alesina and Tabellini, 1990) and delayed stabilizations (Alesina and Drazen, 1991). In particular, by raising budget deficits and debt, such tax cuts would be designed to put pressure on future policymakers to implement spending cuts, with debt stabilization playing the role of a dynamic public good in a non-cooperative political game.

We evaluate the STB scenarios in two ways. First, we examine whether the principal macroeconomic variables such as GDP and consumption, both in the United States and in the rest of the world, respond positively to this policy. Second, we assess social welfare effects, summarized using a compensating consumption variation statistic. Here, we investigate how the welfare assessment of STB depends on the rate at which the utility of future generations is discounted. In addition, we explore how the welfare effects depend on the degree to which government spending directly contributes to household welfare or to productivity.

We find that STB only yields welfare gains under ideal circumstances. These include cuts to particularly distortionary types of taxation, a successful and rapid implementation of tax cuts and spending cuts, and the successful identification of spending categories that reduce neither welfare nor productivity. If, on the other hand, the tax cuts are implemented with a lag, or if the spending cuts are either aborted or come very late, as suggested by Romer and Romer (2009), the impact on output and welfare becomes negative and large. The same is true if, as suggested by a number of studies that we will discuss below, government spending directly raises either household welfare or aggregate productivity.

Our results for the output effects of STB are broadly consistent with the welfare results. Medium- to long-run output effects are positive if STB involves rapid cuts to distortionary taxes and rapid subsequent cuts to wasteful government spending. If the tax cuts are phased in rather than occurring immediately, their short-run stimulative effects are smaller and more short-lived, and the positive long-run output effects are preceded by a prolonged period of below-trend output. If the spending cuts come slowly or never, or if they reduce productive rather than wasteful government spending, medium- to long-run output declines. The most important shortcoming of the output metric is that it does not distinguish between those spending cuts that reduce household utility and those that do not. This distinction can imply very large welfare differences.

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[4] Auerbach et al. (2006) argued that paying for the tax cuts implemented by the Bush Administration via expenditure restraint alone would be politically difficult.

[5] For recent examples of studies using this model class, see Ganelli (2005), Farmer (2010), and Chadha and Nolan (2007). As pointed out by Weil (1989), the critical feature of the Blanchard (1985) model is not the finite planning horizon of existing households per se, but rather the fact that after a household's death new agents are born and inherit the liabilities of previous generations.

[6] The assumption is supported by recent empirical evidence, as discussed below.

[7] See Kumhof and Laxton (2013).