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By William G. Gale and Peter R. Orszag

Bush Administration Tax Policy: Starving the Beast?

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I. Introduction

This is the seventh installment in a series that summarizes and evaluates tax policy in the Bush administration.[1] Prominent public supporters of the tax cuts are sometimes willing to acknowledge, at least privately, the weakness of many of the various public justifications for the policies, including the supposed effect on long-term growth or as a short-term stimulus. The supporters will nonetheless maintain that the tax cuts were still a good idea because the ''real'' purpose was to contain the size of government. This article examines links between the enacted tax cuts and the goal of ''starving the beast'' — that is, holding down government spending.

The notion that the Bush tax cuts were justified by an effort to ''starve the beast'' is really several statements rolled into one: First, that reductions in revenues are the best way to control spending; second, that the structure of the Bush tax cuts was justified by the goal of controlling spending; third, that the tax cuts actually did reduce spending; and fourth, that spending was too high in 2001 or was going to be too high in subsequent years in the absence of the tax cuts. In assessing those claims, we reach the following conclusions:[2]

- It is at best unclear whether tax cuts are effective in restraining spending. The data appear more consistent with the view that once fiscal discipline erodes on one side of the budget, it tends to erode on the other side, too.
- Aiming to reduce spending does not justify regressive tax cuts. In fact, because most spending cuts would be regressive, a tax cut aimed at reducing spending could, on fairness grounds, be reasonably expected to compensate by being progressive.
- It is hard to believe that the tax cuts were effective in reducing spending, as spending has risen significantly in defense, nondefense, and entitlement categories.
- Regardless of the legitimacy of starving the beast as a justification for the original 2001 tax cuts, the theory does not apply to the case for making the tax cuts permanent because the government will face budget deficits in the medium and long term even in the absence of extending the tax cuts.

II. Are Tax Cuts the Best Way to Cut Spending?

The ''starve the beast'' strategy may simply not work as a political equilibrium. We have in mind that policymakers jointly go through periods of fiscal restraint and fiscal largesse, and the restraint or largesse occurs simultaneously on both the tax and spending sides. That is, periods of fiscal largesse tend to generate declines in taxes and increases in spending (as shares of gross domestic product). Periods of fiscal discipline tend to provide declines in spending and increases in taxes.

If this characterization is correct, then granting large tax cuts to some groups in an effort to starve the beast would make it less politically feasible to rein in the desires of other constituencies to obtain increases in spending programs. To be sure, sustained large tax cuts that are not accompanied by spending reductions may eventually induce a fiscal crisis. That fiscal crisis, in turn, could subsequently restain spending. It might, however, simply lead to demands to reverse the tax cuts. After all, a transparently self-imposed crisis is different from a crisis imposed by external forces.

In short, abandoning fiscal discipline on one side of the budget could induce a period of fiscal irresponsibility on both sides of the budget. As a result, it is not even clear whether tax cuts encourage spending increases or

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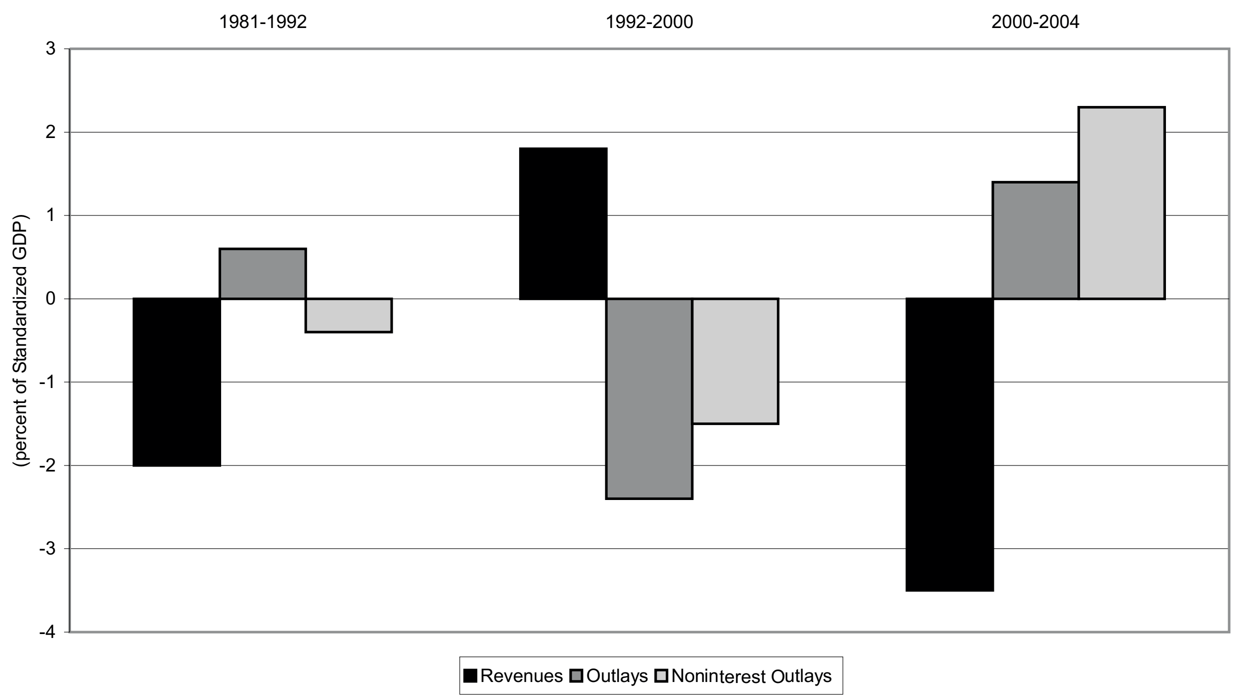
[1]The previous installments are Gale and Orszag (2004a, b, c, d, e, and f.).

[2]We do not address whether spending cuts would represent sound policy. If tax cuts do reduce government spending or if spending is reduced some other way, an important question is what other effects that decline creates. Barro (1991) and others find cross-country evidence that higher government spending reduces economic growth, but a number of caveats apply since the results differ across developing and developed countries (Grier and Tullock 1989), and across types of spending. A number of econometric problems make disentangling the economic effects of government spending particularly difficult (Slemrod 1995). Spending may also affect other aspects of economic well-being (e.g., the environment) or the distribution of income. A full analysis of spending should account for all of those issues.

(Footnote continued in next column.)

Figure 1: Change in Standardized Federal Revenue and Outlays as a Percent of Standardized GDP, 1981-2004



Source: CBO (2004a, b).

restraint, let alone whether they encourage sufficient restraint to offset the entire revenue loss from the tax cut itself.

This ''coordinated fiscal discipline'' view implies that starving the beast will not work, and is supported by several suggestive pieces of evidence. First, in practice, budget rules and legislative agreements have proven effective in reducing spending and balancing the budget only when restrictions were placed on both tax cuts and spending increases at the same time. The rules imposed in 1990 and extended in 1993 and 1997 imposed restraints on both sides of the budget. Tax cuts and mandatory spending increases had to be paid for with other tax increases or mandatory spending cuts. Discretionary spending was subject to caps. Likewise, the budget deals that were enacted in 1990 and 1993 involved both spending cuts and revenue increases. There is no U.S. evidence of fiscal balance being obtained solely through spending reductions (with the possible exception of reductions in military expenses after a war ended).

Second, the voting records of signers of the ''no new taxes'' pledge are hard to reconcile with a ''starve the beast'' theory (Gale and Kelly 2004). The pledge signers voted overwhelmingly in favor of the Bush administration's tax cuts. In light of those votes, the deteriorating budget outlook, and the fact that they have removed tax increases as a potential fiscal solution, the signers might be expected to be vigilant against spending increases. Yet 86 percent of signers who voted favored the Medicare prescription drug bill, and almost three quarters supported the pork-laden 2004 highway bill. Those records are inconsistent with the ''starve the beast'' theory because the same people who voted for permanent tax cuts also voted for permanent spending increases, and did so at a time of projections of falling long-term revenues.

Third, the starve the beast theory suggests that revenues and spending are positively correlated (for example, lower revenues generate lower spending), whereas the coordinated fiscal discipline view implies that revenues and spending are negatively correlated. Figure 1 shows that descriptive data since 1981 generally display the pattern suggested by coordinated discipline.[3] Even after controlling for the business cycle, changes in

[3]Figure 1 reports spending and revenue data that have been ''standardized'' — that is, with business cycle effects removed. Business cycle considerations will induce a negative correlation between taxes and spending: in good times, taxes are higher as a share of GDP because the tax system is progressive, and spending is lower as a share of GDP because the burdens of welfare and unemployment insurance and related programs are smaller. We define standardized noninterest outlays as standardized aggregate outlays less actual net interest payments.

spending and changes in taxes are negatively correlated over three major periods. Between 2000 and 2004, revenues fell relative to GDP but spending rose.[4] Between 1992 and 2000, revenue rose and spending fell. Between 1981 and 1992, revenues fell and total outlays rose. All of these patterns above are inconsistent with the ''starve the beast'' view.[5] Thus, lower revenues have proven to be neither necessary (witness the 1990s) nor sufficient (witness the 1980s and the period since 2000) to reduce federal spending.

Indeed, it is hard to believe that spending would actually have increased by much more than it did between 2000 and 2004 if the tax cuts had not been enacted. Discretionary spending rose from 6.3 percent of GDP in 2000 to 7.6 percent in 2003 and 7.7 percent in 2004, while a massive new entitlement program (the Medicare prescription drug benefit) was also created. All of these spending increases occurred during a period with several, large downward revisions to the technical and economic components of the budget forecast.

The formal econometric evidence on whether tax reductions are followed by subsequent spending reductions is mixed.[6] Evidence does suggest that larger budget deficits constrain both spending increases and tax reductions (Auerbach 2004 and Bohn 1991). This evidence, though, does not distinguish between the two views noted above. In particular, the evidence does not imply that revenue reductions will automatically induce spending reductions. The reason is that the evidence is based on historical experiences in which both spending reductions and tax increases were considered jointly as part of fiscal restraint packages. Therefore, the evidence may not apply to a scenario in which the entire adjustment is constrained to occur on the spending side as the starve the beast approach would demand.

At the very least, then, it should be clear that there is no compelling evidence that tax cuts constrain spending. The consequences, however, of cutting taxes and then not cutting spending could be severe. To the extent that the starve-the-beast strategy is employed but does not work, the eventual outcome could be a full-blown fiscal crisis as described in Rubin, Orszag, and Sinai (2004).

Fortunately, there are other ways to impose fiscal discipline and reduce spending, if that is the goal, that are both more likely to be effective and less risky if they fail than the tax cuts advocated by ''starve the beast'' supporters. One approach would be to place more emphasis in the budget process on the long-term fiscal imbalance facing the nation or the adjusted 10-year budget measures discussed above. Like tax cuts, this would reduce the reported surplus or increase the reported deficit. Unlike tax cuts, however, reforming budget procedures would provide a more accurate picture of the government's finances, it would not encourage unaffordable tax cuts (or unaffordable spending increases) and it would not create deeper fiscal problems if it failed to restrain spending. Thus, if the goal is to restrict spending, budget reform would likely be at least as effective and significantly less risky than tax cuts (Gale and Potter 2002).

An even more effective and more direct approach to restaining spending would be to reimpose the budget rules that were present from 1990 to 2002. These rules put caps on discretionary spending and required that increases in entitlement spending or cuts in taxes had to be financed with cuts in other entitlements or tax revenue increases. The fact that the Bush administration and the Congresses that (a) passed the 2001, 2002, 2003, and 2004 tax cuts, and (b) increased spending on defense, nondefense discretionary, and entitlement spending, allowed the spending rules to expire suggests that the tax cuts were not motivated by an effort to restrict spending.

III. Does 'Starve the Beast' Justify Bush's Tax Cuts?

Even if the starve-the-beast strategy ''worked'' in the sense that tax cuts restrained government spending and that such a restraint was desirable, the result would not justify the Bush administration tax cuts or efforts to make them permanent, for two reasons. First, many components of government spending predominantly benefit low- and middle-income households (Steuerle 2001). On fairness grounds, a tax cut whose goal or effect is to cut spending should offset the negative impact on low- and middle-income households by giving them a disproportionately large share of the tax cut. The 2001 and 2003 tax cuts, however, do just the opposite — they tilt benefits toward high-income households as discussed below.

Second, whatever resonance ''starve the beast'' had in 2001, when the government ran current, cash flow surpluses, the government by 2003 was running substantial deficits, so the argument that the tax cuts were necessary to dissipate a surplus that would otherwise have been spent was simply not applicable. Likewise, and even more importantly, with the country facing systematic medium- and long-term deficits, a ''starve the beast'' motivation for making the tax cuts permanent ignores the budgetary context in which those tax cut extensions would be occurring.

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[4]Only half of the increase in noninterest spending was due to increased defense and homeland security in response to the terrorist attacks and the wars in Afghanistan and Iraq.

[5]There is one data pattern that is at least not inconsistent with the theory. Between 1981 and 1992, as revenue fell, standardized noninterest spending fell, too, but only by 0.4 percent of GDP. That can hardly be taken as evidence of effective fiscal discipline, though. The ratio of public debt to GDP almost doubled, from 26 percent in 1981 to 48 percent in 1992, the largest peacetime growth in the debt ever other than during the Depression.

[6]Manage and Marlow (1986) find that tax reductions trigger spending cuts, while Andersen, Wallace, and Warner (1986) and von Furstenberg, Green, and Jeong (1986) find no robust relationship between tax changes and subsequent spending changes.

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