



The Hunger Artist, or, How to Think About Government Spending and Taxes

By: John Carney – November 27th, 2012

Despite all din about divisiveness in the District of Columbia, there's actually one aspect of taxes and spending on which Republicans and Democrats generally agree.

Unfortunately, as is all too often the case in politics, consensus here is an indicator of error and bipartisanship a signal of sloppy thinking.

The idea that joins the Democrats and Republicans is the following: higher government revenues facilitate higher government spending. In fact, the opposite is true. Lower taxes generally accompany higher spending.

Republicans have long subscribed to some version of the "Starve the Beast" theory. Under this theory, depriving the government of revenue by cutting taxes puts a crimp in government spending. You shrink the size of government by reducing its funding.

Democrats largely believe the same thing, minus the enthusiasm for cutting spending. They argue that tax cuts amount to redistributing wealth upwards, cutting programs for the poor while padding the bank accounts of the rich. The underlying idea is the same: taxes are the source of spending, they rise or fall together.

History, however, tells a very different story about spending and taxes.

Falling revenues are typically accompanied by rising spending; while rising revenues are accompanied by falling spending. In other words, the "beast" of government spending doesn't require a meal of taxes to grow. It thrives, in fact, on a starvation diet.

Government is a hunger artist.*

Part of this pattern is caused by broader economic facts. A slower economy and higher unemployment reduces tax revenues, while the automatic stabilizers such as unemployment benefits increase spending. But that doesn't explain the entire increase. Something else is going on.

“The ‘starve the beast’ strategy may simply not work as a political equilibrium. We have in mind that policy-makers 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,” explained Peter Orszag and William Gale in a 2004 paper critical of the Bush tax cuts.

William Niskanen of the Cato Institute agrees. In a 2006 paper taking issue with a version of the beastly illusion put forward by Gary Becker and Milton Friedman, Niskanen argued that “starve the beast does not work.” One of the reasons it fails, Niskanen explained, is that it is just implausible on the level of economic theory.

Orthodox price theory, of which Friedman and Becker are among the leading exponents, is unambiguous in concluding that reducing the price of a good or service increases the amount demanded. Reducing the current tax burden of federal spending has much the same effect as a price control, increasing the amount demanded relative to that supplied from current revenues, an effect that Friedman and Becker have consistently and correctly opposed in private markets.

In other words, tax cuts make government seem cheap. So the people's representatives vote to give us more of it.

Once we clear away the confusion that tax cuts impose fiscal constraints on government spending—or that tax hikes finance spending growth—much of the debate over taxes and spending is revealed to be bunk.

When conservatives argue that a tax hike will fuel more government spending, they're just wrong. And so are the liberals who argue that tax hikes “for the wealthy” deprive the needy of funds.

The irony is that the use of “fiscal responsibility” rhetoric by both sides likely fuels the retrograde movements of taxes and spending. Republican concerns about spending and debt contribute to the belt-tightening that leads to higher taxes, while Democrat worries about revenues and debt lead to spending cuts.

This would be a grand comic escapade if the consequences of this misunderstanding weren't so serious. The problem with the illusion of the Starving Beast is that it can quite easily result in policy errors, such as permitting too much government spending during booms and too much "belt-tightening" during busts.