

Starving the Leviathan: A Dynamic Analysis of Balanced Budget Rules

Abstract

This paper analyzes the case for using Balanced Budget Rules to rein in fiscally irresponsible governments. Underlying the analysis is the political economy model of Battaglini and Coate (2008) which predicts that governments will accumulate inefficiently high debt levels. The analysis predicts that imposing a BBR will reduce debt and lead to lower average taxes and higher average public spending levels. In the short run, citizens will be worse off as public spending is reduced and taxes are raised to bring down debt. In the long run, the benefits of lower average taxes and higher average public spending must be weighed against greater volatility in taxes and less responsiveness to public good needs. To quantify the trade offs involved, the model is calibrated to the U.S. economy and the impact of a BBR is simulated. While average debt levels are reduced by 46% and long run welfare is increased by 1.74%, imposing a BBR at current debt levels will reduce citizens' welfare.

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