

“Crowding Out Effects of Government Spending”: A Comment

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This paper presents a review of the current state of macroeconomic theory concerning the impact of Government spending on economic activity. The models presented reflect the current approach in theoretical analysis of economic activity, incorporating such features as:

- A general, rather than partial, equilibrium approach to model building;
- Agents' behaviour is modelled as the result of the solution of an optimisation problem — maximising utility or profits. This contrasts with earlier approaches in which, in many cases, the postulated behaviour of agents was not derived as a solution to an optimisation problem (e.g., the Keynesian consumption function);
- The models are set in an intertemporal framework rather than the static approach previously employed;
- Expectations are assumed to be rational instead of the assumption of static or adaptive expectations previously employed;
- The impact of market clearing or non-clearing is explicitly accounted for.

This approach, which undoubtedly represents a significant theoretical improvement on the earlier postulational approach to macro modelling, involves a greater degree of complexity and is more demanding in terms of mathematics than the models usually presented in undergraduate textbooks. The authors are, therefore, presented with a difficult task in attempting to make this material accessible to a wider audience. The paper meets this

challenge well and provides a thorough, comprehensive and well-structured survey of the subject.

In relation to the theme of this conference, the main result of the paper is that reductions in Government spending reduce output at least in the short term. In the Keynesian approach, this result follows straightforwardly from the impact on aggregate demand, although the negative effects are ameliorated somewhat by Ricardian effects on consumer wealth. In the new classical approach, reductions in Government spending raises — via its effect on future tax liabilities — consumer wealth resulting in a fall-off in labour supply, employment, and, therefore, output. Of course, in this case, lower output does not necessarily mean a lower level of welfare. Both approaches covered in this paper thus imply that cuts in government spending unambiguously result in lower output, ruling out the phenomenon of “expansionary fiscal contraction”. However, this conclusion may not be valid for the Irish experience post-1986 for a number of reasons.

First, the rôle of expectations and “animal spirits” may not be adequately handled in these models. The expansionary fiscal contraction hypothesis asserts that, at the time, the corrections in the fiscal imbalance resulted in a once-off surge in confidence which boosted investment and consumer spending. This reflected the specific circumstances of the time — an explosive debt-GNP ratio and its adverse impact on confidence — and does not imply that reductions in spending will always and everywhere result in a boost to output. The discrete change in confidence which occurred after 1986, which arguably reflected “animal spirits” rather than a rational calculation of future tax liabilities, may not be well captured in the sort of models examined in this paper.

Second, the interaction between fiscal, monetary and exchange rate policy is not adequately incorporated into the models presented in the paper. Given the experience up to 1987 — real interest rates greater than the GNP growth rate and an explosive path for the debt-GNP ratio — it may be argued, following the reasoning of Sargent and Wallace (1981), that there was a distinct possibility that the authorities would be compelled at some point in the future to inflate their way out of the debt. Clearly, the path of the debt-GNP ratio pre-1987 was not, over the longer term, consistent with the maintenance of the ERM exchange rate commitment. In this situation, the probability of a large devaluation resulted in a significant risk premium attaching to the Irish currency. The strong fiscal adjustment after 1986 halted and later reversed the explosive growth in the debt-GNP ratio which reduced the risk premium attaching to the Irish currency facilitating a reduction in interest differentials *vis-à-vis* Germany (OECD, 1990) which boosted output. This process is not adequately captured in the real economy models considered in

the paper, which do not incorporate monetary sectors.

Thirdly, the usefulness of any theoretical model in explaining real developments generally, and in particular Ireland's experience since 1986, cannot be determined *a priori*. The model in question must be confronted with the data in a rigorous empirical analysis to examine whether the data is consistent with the predictions of the model. Since the present paper is for the most part a theoretical paper which does not test the different models against Irish data, it is not at all clear that the results obtained can be applied to the Irish experience. This, of course, is no criticism of the authors who have confined their attention to a survey of the theoretical literature, but it does mean that the relevance of the results to the Irish situation is questionable.

REFERENCES

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