

Fiscal Policy, Government debt and Private Consumption (by Lorenzo Pozzi).

Summary.

Member states of the European Economic and Monetary Union (EMU) are de facto left with only fiscal policy as an instrument to stabilise the economy. It is therefore important that fiscal policy is an effective instrument. We define effectiveness as the extent to which changes in taxes and/or government expenditures affect output. In this dissertation the focus lies mainly on the effects of fiscal policy on private consumption as a major component of aggregate demand. Further, we question whether the effectiveness of fiscal policy is influenced by the level of government debt.

To evaluate the effects of fiscal policy the benchmark is the so-called 'Ricardian Equivalence theorem'. This theorem states that fiscal policy (through taxes) has no impact on the economy. Crucial assumptions on which this theorem is based are that consumers are rational and perfectly informed and take into account current and future government activity. They do not have a precautionary savings motive and do not face liquidity constraints. Interestingly, in the literature, Ricardian consumers and ineffective fiscal policy are often associated with high debt countries (e.g. Belgium, Italy). The contributions in my dissertation can only partially confirm this view.

In a first contribution, I estimate a consumption function for Belgium which is based on a model that incorporates two alternatives to Ricardian Equivalence. The estimation results suggest that Belgian consumers are not myopic with respect to current and future government activity. Full Ricardian Equivalence is nevertheless rejected since it cannot be rejected that consumers have a precautionary savings motive. This analysis thus suggests that fiscal policy in Belgium is effective. In a second contribution the focus lies on liquidity constraints and on the potential effect of government debt on the incidence of these constraints. Results suggest that, for a panel of OECD countries in the 90s, a high government debt leads to more credit constraints. Liquidity constraints imply an increased effectiveness of fiscal policy since they tend to augment the correlatedness between private consumption and disposable income. A tax decrease will then strongly increase the liquidity constrained consumers' disposable income and consumption. However, given the result that liquidity constraints may be endogenous to government debt, a tax decrease and a coinciding debt increase may augment the number of credit constrained consumers. More consumers will then be prevented from following their optimal desired consumption path and consumption could decrease.

A third contribution is more theoretical and concerns the effects of government expenditures on private consumption. I consider a new framework in which consumers may be imperfectly informed about the aggregate economy but nevertheless be aware that the government must respect a budget constraint. A final contribution focuses on a methodological issue, i.e. the estimation of consumers' degree of relative risk aversion using a small sample.

As a general conclusion to this dissertation I can state that I do not question the effectiveness of fiscal policy. However, the results also suggest that high debt countries may have Ricardian characteristics. Given the current worldwide economic downturn, governments in some EMU countries could be tempted to abandon the requirements of the Stability Pact so as to increase the possibilities of using the fiscal policy instrument to fight the economic crisis. Given the controversy in the literature on the effects of the Stability Pact, it is difficult to judge whether this would be a sensible decision. Given some of the conclusions of this dissertation however,

we feel that governments should be cautious to abandon fiscal rules. Even if our results do not suggest that fiscal policy is ineffective, in the long run the accumulation of debt that results from it may change the reaction of economic agents to fiscal policy and diminish its effectiveness.