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Does the Crowding-In Effect of Public Spending on Private Consumption Undermine Neoclassical Models?

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Abstract

Empirical evidence from vector autoregressions (VARs) showing that public spending shocks crowd in private consumption has been seen as evidence against standard neoclassical models of the business cycle. We show that a standard real business cycle model in which all agents including the government optimize is compatible with the results from the empirical literature. A VAR estimated using artificial data simulated from the model indicates that, under standard assumptions to identify public spending shocks, an increase in public spending is associated with an increase in private consumption and the real wage. The implied impulse responses are qualitatively and quantitatively similar to those in the empirical literature.

JEL classification: E2, E3, H3

Keywords: Optimal public spending, Business cycles, Public spending shocks, Crowding in

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