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ARE INCREASES IN GOVERNMENT SPENDING NEUTRAL? EVIDENCE FROM LATIN-AMERICAN HOUSEHOLDS

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Using a dynamic optimization model, Ricardian Equivalence (RE) is empirically tested for Argentina, Brazil, Chile and Mexico. The system of equations obtained in the theoretical model is solved using Generalized Method of Moments and Full Information Maximum Likelihood. Results indicate that the null hypothesis concerning RE cannot be rejected for Argentina, Brazil, and Chile but is strongly rejected for Mexico. Therefore, when the fiscal authority seeks to stimulate economic activity by means of tax reductions and increases in government spending, the outstanding effect might be only a rise in private savings for the first three countries.

JEL classification codes: E62, H30, H60
Key words: fiscal policy, Ricardian Equivalence, public debt

I. Introduction

In an environment of recurrent economic instability, due to currency crises, changes in exchange rate regimes, confidence crises, sudden stops, and other events with important impacts on economic activity, a major concern of Latin-American policy makers is the relationship between fiscal policy and aggregate demand. Stabilization plans launched during the recent period have attributed a decisive role to fiscal policy. However, this role might not be as effective if Ricardian

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Equivalence (RE) holds. Under RE, a temporary tax cut, for instance, would not affect personal consumption, since the increase in disposable income would be compensated by a rise in personal savings to neutralize expected increases in future taxes in order to maintain a balanced government budget.

Another implication of RE is associated to the interaction between fiscal and monetary policies. The regime of monetary policy dominance, under which fiscal policy is passive, is essentially Ricardian. In this case, the monetary authority is not forced to monetize the public debt, and is free to pursue inflation stabilization as its major policy objective. In fact, existence of Ricardian Equivalence is taken for granted in most models which seek to derivate optimal monetary policy rules.

The goal of this paper is to test if RE holds for the major Latin-American countries, namely Argentina, Brazil, Chile, and Mexico in the period from the first quarter of 1996 to the fourth quarter of 2007. These countries were chosen for their economic and political importance in the region. In addition, they have experienced distinct arrangements for their fiscal policies during the recent period and, to avoid negative effects of international crises on the domestic economies, usually follow the common practice of adopting expansionary fiscal policies. Such measures might not have the expected effects if RE holds in these countries.

The landmark on the Ricardian Equivalence literature is Barro (1974), who was the first author to model RE and state a clear hypothesis needed to confirm its validity. However, the relationship between debt issuance and taxation was first called Ricardian Equivalence by Buchanan (1976). David Ricardo believed that the government choice to issue debt or to tax is irrelevant, since debt can be viewed as a postponement of taxes. Elmendorf and Mankiw (1998) addressed the issue of public debt and its macroeconomic effects, comparing RE to the Modigliani and Miller (1958) theorem. Accordingly, corporate financing decisions are similar to government financing decisions in public sector economics. In theory, none of them matters.

Theoretically, RE requires restrictive assumptions. It requires individuals that behave as if they have infinite horizons; complete capital markets; rational and farsighted consumers; non-distortionary or lump-sum taxes; no uncertainty regarding income and future taxes; and a balanced government budget.

Some of these hypotheses have been lately relaxed, yielding restricted versions of RE. For instance, Divino and Orrillo (2008) demonstrate the validity of RE in a general equilibrium model with incomplete markets, provided that the risk-free payoff is in the asset span. Hayford (1989) shows that RE holds in the presence of liquidity constraints when default implies partial payment of debt (positive

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