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# Government Spending Effects in Low-Income Countries<sup>☆</sup>

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## Abstract

Despite the voluminous literature on fiscal policy, very few papers focus on low-income countries (LICs). This paper develops a New Keynesian small open economy model to show, analytically and numerically, that several prevalent features of LICs—dependence on external financing, public investment inefficiency, and a low degree of home bias in public investment—play important roles in government spending effects. External financing increases the resource envelope, mitigating the crowding out effects, but it tends to appreciate the real exchange rate, lowering traded output. Although capital scarcity in LICs implies high returns to public capital, low marginal investment efficiency can substantially dampen the output multiplier. Also, public investment may not be effective in stimulating output in the short run, as LICs often rely on imports to a large extent to carry out public investment projects, weakening its role as a short-run demand stimulus.

*Keywords:* fiscal policy, low-income countries, public investment, fiscal multipliers, small open DSGE models, aid

*JEL codes:* E62, O23, F41

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