

Testing Ricardian Equivalence

At first glance, should be easy- data is readily available:

1. Deficits
2. interest rates
3. savings

But – big problem:

Ricardian Equivalence involves a particular thought experiment: a deficit financed tax cut.

- Government expenditures are held constant.
- Current deficit may signal future govt. exp.

Sorting all this out in the data is very difficult.

➤ Conclusion – there is no conclusion.

➤ My opinion – the majority of economists find the assumptions of Ricardian Equivalence too strong:

1. active bequest motives
2. perfect capital markets
3. perfect foresight (or rational expectations)

Yet – econometric studies find support for Ricardian Equivalence

Empirical Evidence

Interest rates are not sensitive to deficits:

C. Plosser (1982, 1987)

P. Evans (1987a, 1987b).

Less conclusive with regard to consumption, savings and investment.

Carroll and Summers (1987) examine Canada and US: deficits did not affect aggregate saving: public and private savings moved inversely.

Empirical Evidence

Israel experience from 1983 – 1987 is
interesting

1983:

National savings rate = 13% Private = 17%, Public = -4%.

1984:

Large deficit so that Public savings = -11%. Private savings increased to 26% so national savings increased to 15%.

1985:

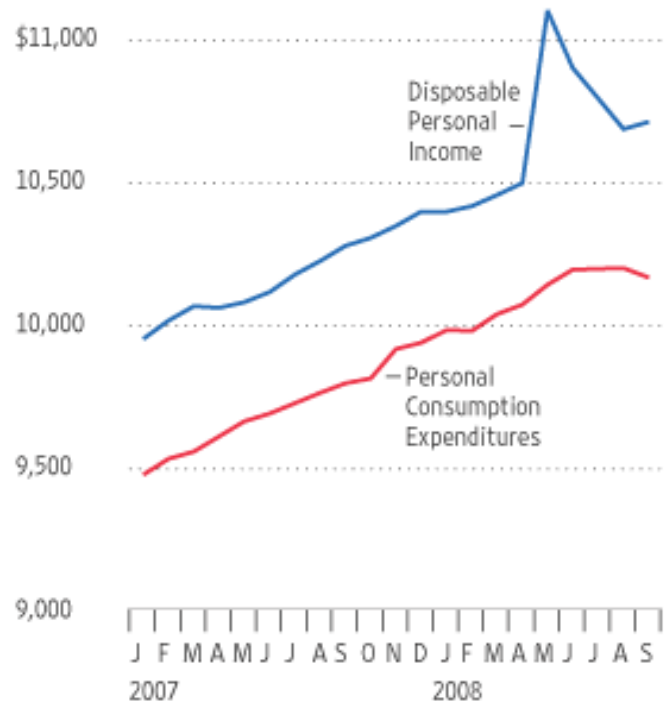
Budget reform resulted in public savings increasing to 0%. Private savings fell to 18% and then 15% in 1986.

Over the 4 years, national savings remained relatively
constant.

Empirical Evidence – from John Taylor

Recent tax rebates known to be temporary.

Rebates Failed to Jump-Start Consumption



Source: Bureau of Economic Analysis

More on this when we discuss the Blender-Sims articles.