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:


Less conclusive with regard to consumption, savings and investment.

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.

Source: Bureau of Economic Analysis
More on this when we discuss the Blinder-Sims articles.