The New York Times

The Opinion Pages

A Note On The Ricardian Equivalence Argument Against Stimulus (Slightly Wonkish)

December 26, 2011 1:30 pm

There have been a lot of shockingly bad performances among macroeconomists in this crisis; but if I had to pick the one that is most startling, it is the way freshwater economists have demonstrated that they don't understand one of their own doctrines, that of Ricardian equivalence.

Ricardian equivalence says that what determines consumption is the lifetime present value of after-tax income, and hence that, say, a temporary tax cut won't stimulate spending, because people will figure that whatever they gain now will be offset by higher taxes later. It is a dubious doctrine even done right; many people are liquidity constrained, and very few people have the knowledge or inclination to estimate the impact of current government budgets on their lifetime tax liability.

But even if you assume that the doctrine is right, it does NOT imply that government spending on, say, infrastructure will be met by offsetting declines in private spending. In other words, Robert Lucas was betraying a complete misunderstanding of his own doctrine when he said this:

> If the government builds a bridge, and then the Fed prints up some money to pay the bridge builders, that's just a monetary policy. We don't need the bridge to do that. We can print up the same amount of money and

> buy anything with it. So, the only part of the stimulus package that's stimulating is the monetary part.
>
> …
>
> But, if we do build the bridge by taking tax money away from somebody else, and using that to pay the bridge builder — the guys who work on the bridge — then it's just a wash. It has no first-starter effect. There's no reason to expect any stimulation. And, in some sense, there's nothing to apply a multiplier to. (Laughs.) You apply a multiplier to the bridge builders, then you've got to apply the same multiplier with a minus sign to the people you taxed to build the bridge. And then taxing them later isn't going to help, we know that.

This remark was followed, by the way, by a smear against Christy Romer:

> Christina Romer — here's what I think happened. It's her first day on the job and somebody says, you've got to come up with a solution to this — in defense of this fiscal stimulus, which no one told her what it was going to be, and have it by Monday morning.
>
> So she scrambled and came up with these multipliers and now they're kind of — I don't know. So I don't think anyone really believes. These models have never been discussed or debated in a way that that say — Ellen McGrattan was talking about the way economists use models this morning. These are kind of schlock economics.
>
> Maybe there is some multiplier out there that we could measure well but that's not what that paper does. I think it's a very naked rationalization for policies that were already, you know, decided on for other reasons.

I've tried to explain why Lucas and those with similar views are all wrong several times, for example here. But it just occurred to me that there may be an even more intuitive way to see just how wrong this is: think about what happens when a family buys a house with a 30-year mortgage.

Suppose that the family takes out a $100,000 home loan (I know, it's hard to find houses that cheap, but I just want a round number). If the house is newly built, that's $100,000 of spending that takes place in the economy. But the family has also taken on debt, and will presumably spend less because it knows that it has to pay off that debt.

But the debt won't be paid off all at once — and there's no reason to expect the family to cut its spending *right now* by $100,000. Its annual mortgage payment will be something like $6,000, so maybe you would expect a fall in spending by $6000; that offsets only a small fraction of the debt-financed purchase.

Now notice that this family is very much like the representative household in a Ricardian equivalence economy, reacting to a deficit financed infrastructure project like Lucas's bridge; in this case the household really does know that today's spending will reduce its future disposable income. And even so, its reaction involves very little offset to the initial spending.

How could anyone who thought about this for even a minute — let alone someone with an economics training — get this wrong? And yet as far as I can tell almost everyone on the freshwater side of this divide did get it wrong, and has yet to acknowledge the error.

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Ricardian Confusions (Wonkish)

March 10, 2011 6:59 pm

Via Mark Thoma, Antonio Fatas criticizes the chief economist of the World Bank for getting the implications of Ricardian equivalence for fiscal policy all wrong.

I've been on this case for a while. Let me repost most of it:

> It's one thing to have an argument about whether consumers are perfectly rational and have perfect access to the capital markets; it's another to have the big advocates of all that perfection *not understand the implications of their own model.*
>
> So let me try this one more time.
>
> Here's what we agree on: if consumers have perfect foresight, live forever, have perfect access to capital markets, etc., then they will take into account the expected future burden of taxes to pay for government spending. If the government introduces a new program that will spend $100 billion a year forever, then taxes must ultimately go up by the present-value equivalent of $100 billion forever. Assume that consumers want to reduce consumption by the same amount every year to offset this tax burden; then consumer spending will fall by $100 billion per year to compensate, wiping out any expansionary effect of the government spending.
>
> But suppose that the increase in government spending is temporary, not permanent — that it will increase spending by $100 billion per year for only

1 or 2 years, not forever. This clearly implies a lower future tax burden than $100 billion a year forever, and therefore implies a fall in consumer spending of less than $100 billion per year. So the spending program IS expansionary in this case, EVEN IF you have full Ricardian equivalence.

Is that explanation clear enough to get through? Is there anybody out there?

Apparently not — at least not at the World Bank.

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Ricardian Consumers and Fiscal Policy Once Again

John Cochrane wrote:

> Economist Debates: Keynesian principles (http://www.economist.com/debate/days/view/283): The basic Keynesian analysis... is simply wrong. Professional economists abandoned it 30 years ago when Bob Lucas, Tom Sargent and Ed Prescott pointed out its logical inconsistencies.... Robert Barro's Ricardian equivalence theorem was one nail in the coffin. This theorem says that [fiscal] stimulus cannot work because people know their taxes must rise in the future...

Kevin Quinn comments:

> This is surely disingenuous on Cochrane's part - I hope it is, at any rate. Ricardian equivalence, it is true, implies that deficit-financed tax cuts cannot affect demand. Deficit-financed temporary increases in Government spending, on the other hand, can. Consumption falls today, because the present value of future taxes is higher by the amount of the spending increase, but not by as much as G rises. The reduction in the present value of life-time income implies that the [present value of the] *sum* of reductions in current and *future* consumption will be equal to the increase in G, so the reduction today will be small.
>
> Moreover, if the spending is for public investment with a return equal to the private rate of return, life-time income is unaffected and there is no fall in consumption at all. And if the rate of return is greater than the private return, C will increase along with G!...

One of the strangest and most bizarre misconceptions of the modern Chicago School is this belief: that because in Ricardian-equivalence situations tax changes do not affect aggregate demand that Ricardian-equivalence means that government purchase changes do not affect aggregate demand either. As Kevin explains, that is simply not the case. And I cannot imagine how anybody could have ever concluded that it *was* the case.

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