

Ricardian Equivalence

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When President Bush signed an “economic stimulus” package in February 2008, the hope was that getting hundreds of dollars to every taxpayer in the form of a rebate could help boost the economy. But the money to fund this plan has to come from somewhere. Without reducing government spending, a tax rebate would mean an increase in the budget deficit.

A government sometimes spends beyond its revenues in an effort to rouse a slumping economy. Commissioning roads and bridges, for instance, increases demand for construction workers, services, and supplies. That translates into higher incomes and purchases of other goods and services that, in turn, put more spending power in other people’s wallets. The same argument applies to a policy of cutting taxes or tax rebates. Lower taxes mean that people can take home a bigger chunk of their income, which might encourage them to spend more.

But an alternative view in economics — Ricardian equivalence — suggests that such deficit spending is no free lunch. Named by Robert Barro of Harvard University (its main proponent) after 19th century economist David Ricardo, the theory of Ricardian equivalence claims that people will tend to save rather than consume the extra income arising from such spending. This is because people understand that whatever amount a government overspends today has to be repaid in the future in the form of higher taxes, thus unraveling a government’s efforts to stimulate the economy. If a tax cut today merely postpones a tax increase until tomorrow, then there would be little reason for people to loosen their purse strings now.

To understand this logic, suppose that a government has a balanced budget and wants to inject billions of dollars through a tax cut that would give every household \$1,000. If a government’s expenditures are already equal to its revenues, it must finance this policy by borrowing money and promising to pay back the principal and interest several years from now. Recognizing that this will show up as a future tax liability, forward-looking households will likely put away the \$1,000 in the bank and let it earn interest. The proceeds of this saving should be just enough to pay for an anticipated rise in taxes.

For this view to hold, a number of assumptions must be satisfied. First, most consumers must be of the type to think far ahead when deciding how much to consume and save, as well as understand some notion of the implications of

Ricardian equivalence. Critics say that might be a stretch. After all, it is quite reasonable to assume that some people are shortsighted and fail to recognize that taxpayers ultimately pay for a government’s debt.

Moreover, a person can hardly be blamed for not taking into account a tax liability that may come only decades from now. For instance, a government can issue a 30-year bond to finance the deficit spending. Consumers may not care about what happens that far in the future, especially if the liability will likely fall on forthcoming generations. But Barro argues that people leave bequests precisely because they care about

their children’s welfare, and so would not want to consume more today at their children’s expense. Thus consumers think over a much longer, almost indefinite, horizon. If true, the Ricardian view should hold.

But a borrowing constraint can weaken Ricardian equivalence. If a person wishes to consume more today knowing that his future income can pay for his current purchases, then all he has to do is borrow money from a bank. As such, a tax cut would not alter his spending decisions because he can count on

borrowed funds to smoothen his consumption. However, if for some reason he is unable to find a lender, then his consumption today is limited by the cash he has on hand. In this case, he may be more inclined to spend the extra cash from a tax cut.

This could be especially true for poorer people. A study published in the *American Economic Review* by David Johnson, Jonathan Parker, and Nicholas Souleles on the impact of the 2001 tax rebates on household expenditures finds that families with low levels of liquid assets and income spent more of their rebates than the average household. In general, the authors find that a typical household spent 20 percent to 40 percent of their rebates on non-durable goods during the three-month period they received their checks. About two-thirds of the rebate was spent during this period and the next three months. Ricardian equivalence predicts that rebate spending should have been close to zero.

However, the overall evidence is inconclusive. Indeed, economists still call on the theory of Ricardian equivalence to debate the effectiveness of the 2008 tax rebate. Many seem to think that it is at least partially true. Government deficit spending may stimulate the economy, but the impact would be somewhat subdued in the Ricardian view. **RF**



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