Does fiscal policy matter?
The Solow-Blinder Theorem - I

Introduction

- Before Keynes, it was thought that government spending and taxation are not the effective policy instruments.

- And, changes in these variables will not be able to make an impact on aggregate demand and employment.

- Classicals believed that in a full employment scenario, a rupee increase in government expenditure can only replace a rupee of private spending (crowds out private expenditure by the same amount).

- Therefore, the overall equilibrium remain unaltered.

Keynesian views

- As Keynes argued that income earned may not necessarily be equal to the consumption and
- Due to wage rigidity, unemployment may persist.
- Therefore, economies do not always be in equilibrium.
- He emphasised the role of macroeconomic effects of government expenditure and taxation.
- He agued that a rupee additional government expenditure would raise national income by more than one rupee due to application of multiplier effects.

Does fiscal policy matter?

- After resurgence of monetarists, monetary policy and its effect on macroeconomic variables again came into the lime light.

- With this, crowding out effect also came to the forefront, and once again a question was being asked does fiscal policy matter?

- Solow and Blinder (1972) attempted to provide answer of this question with their analysis which is later known as the Solow-Blinder Theorem.

The ‘crowing-out effect’

- To understand the whole debate which Solow and Blinder took forward, it is very important to understand the meaning of crowding out and its various levels.
- The first level of crowding out is the government engages itself in economic activities which would otherwise be provided by the private sector.
- Thus, government investment of Rs. 1 exactly replaces the private sector by the same amount.
- However, total amount of investment in productive activities remain the same. It means government investment has exactly replaced private investment and overall investment has not changed.

Crowding Out

- The second type of crowding out is inherent in the Keynesian macroeconomics.
- The additional government expenditure (deficit spending) which the government spend on productive activities will be financed through issuing of government debt/securities (not through issuing new currency).
- These government securities compete with other private sector financial instruments i.e. debenture and bonds.
- As government bonds are treated as risk free, these will put upward pressure on interest rates in the financial securities market.
- The increase in interest rates will reduce private investment expenditure.
- And, if interest elasticity of investment is high, then this fall would be much greater.
- Thus, expansionary effects of the additional government spending would be curtailed by the decline in private investment expenditure.

- Although, theoretically there is no question about the applicability of second type of crowding out. However, what would be extent of impact of this crowding out on the economy is still a debatable question.

- The empirical evidences suggest that interest elasticity of investment is positive, however, the value may differ from economy to economy.

- Thus, this is sure that there will be some crowding out.

- However, the monetarist claims that in the case of bond-financed government expenditure the crowding out will be such that fiscal policy change will not have any impact on the economy.

- Means fiscal policy does not matter and it is powerless.

Third type of Crowding out

- The third type of crowding out which Solow-Blinder emphasized in their work is the main basis on which they proved that fiscal policy does matter.

- To understand, the third type of crowding out, we first need to revisit our understanding of

- the concept of wealth;

- relationship between wealth and consumption;

- relationship between wealth and demand for money.

Wealth, Consumption and Demand for money

- In economics, wealth is the total market value of all the physical and financial assets of an individual, firm or an organisation.

- Increase in bond holdings will increase the value of wealth held by an individual.

- Wealth is positively associated with the consumption. Increase in wealth will lead to increase in demand for consumption goods.

- Not only this, the higher wealth level also leads to higher demand for money (in terms of either cash or bond holdings).

Wealth, Consumption and Demand for money

- On the one hand, the wealth affects the consumption demand, thus, the aggregate demand (Product market equilibrium).
- The increase in wealth would shift IS curve towards right.
- On the other hand, the wealth also affects the demand for money (money market equilibrium).
- The increase in wealth would shift LM curve to the left side.
- The main part of the theory would be covered in the second part of the lecture.

For any additional query

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