The Impact of Government Spending on the Private Sector: Crowding-out versus Crowding-in Effects

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INTRODUCTION

The theoretical and empirical literature has provided in the last year extensive analysis on the effect of government spending on economic activity. Despite this, there is no consensus on the effects of government spending on private consumption and investment (both in the short and in the long term) neither from a theoretical nor from an empirical point of view.

Indeed, from a theoretical perspective, the effect of an increase of government spending on those variables can be of both signs. The Real Business Cycle (RBC) model predicts a decline in private consumption in response to a rise in government spending: with infinitely-lived Ricardian households, an increase in government spending lowers the present value of after-tax income, and thus generates a negative wealth effect on consumption (Aiyagari et al., 1990; Baxter and King, 1993; Christiano and Eichenbaum, 1992). In contrast, the IS-LM model predicts that consumption should rise in response to a positive government spending shock: when consumers behave in a non-Ricardian fashion, their consumption is a function of their current disposable income, thus an increase in income will generate an increase in private consumption (Blanchard, 2003).

Similarly to consumption, the two theories also predict different outcomes for investment. The RBC model claims that an increase of government consumption will have a positive effect on investment: an increase of government consumption induces a rise in employment which, if sufficiently persistent, leads to a rise in the expected return to capital and, therefore, may trigger a rise in investment. On the contrary, the IS-LM model predicts that investment should decline in

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response to a positive government spending shock: an increase in government consumption (if not followed by an accommodating increase of money supply) leads to an increase in the interest rate, which in turn will translate into a decrease in investment.

From this discussion it emerges that the predictions of the above mentioned theories are orthogonal to each other. These contrasting views gave rise to several empirical studies attempting to assess the impact of public expenditures on consumption and private investment. Unfortunately, the predictions of the empirical evidence are also quite mixed in support of one theory or the other as can be seen from Table 1.

The main purpose of this paper is to contribute to the empirical literature by analyzing the impact of changes in government spending on private consumption and investment. By doing this, we provide an additional test on whether government spending generates ″crowding-out″ or ″crowding-in″ effects on the private sector. In addition, we can also discriminate between the standard RBC and IS-LM model.

While most of the tests of the "crowding-out" versus "crowding-in" hypothesis that have been carried in previous papers focus on a time series or cross-country approach, this work extends such analysis to a panel data set of 145 countries from 1960 to 2007.[1] The results show that government spending produces important crowding-out effects, by negatively affecting both private consumption and investment. The empirical evidence also suggests that neither the prediction of the standard RBC model nor the one of IS-LM model can be taken overall as valid. In fact, our results are in contrast with the RBC prediction of a rise in investment and with the IS-LM prediction of a rise in consumption.

In addition, we analyze possible asymmetries of the effect of government consumption on private consumption and investment. In particular, we test: i) whether the effect varies among regions; and ii) whether it depends on to the phase of the economic cycle. We find that the effect varies substantially among regions, but it does not seem to depend on the phase of the economic cycle.

We show that all results are economically and statistically significant, and robust to several econometric techniques.

The rest of the paper is organized as following. Section two describes the data. Section three shows the empirical methodology used to assess the "crowding-out" *versus* the "crowding-in" effects and discusses the major results. Section four provides additional robustness results and addresses the existence of

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1. Atukeren (2005) also analyzes the issue of crowding-out effects but from a different perspective in that the author looks at the linkages between public and private investments and emphasizes the role of the share of government involvement in the economy. Similarly, Gonzalez-Paramo and De Cos (2005) finds that public ownership negatively affects productivity, while privatization has a positive effect on efficiency.

Table 1.

References

Authors (Year)	Methodology	Country	Effect on Consumption	Effect on Investment
Afonso and Sousa (2011a)	VAR	US, UK, Germany and Italy	Not significant	Negative
Afonso and Sousa (2011b)	VAR	Portugal	Negative	Negative
Argimón et al.(1997)	Panel	OECD		Positive
Aschauer (1989)	Time series	US	–	Positive
Barro (1991)	Cross-country	Developed and Developing countries	–	Negative
Biau and Girard (2005)	VAR	France	Positive	Positive
Blanchard and Perotti (2002)	VAR	US	Positive	Positive
Burnside et al. (2004)	Narrative	US	Not significant	Positive
Coenen and Straub (2005)	VAR	Euro area	Negative	–
Easterly and Rebelo (1993)	Time series and cross country	US, and Developed and Developing countries	–	Positive
Edelberg et al. (1999)	Narrative Approach	US	Negative	Positive
Erenburg (1993)	Time Series	US	–	Positive
Erenburg and Wohar (1995)	Time Series	US	–	Positive
Fatás and Mihov (2001)	VAR	US	Positive	Not significant
Giordano et al. (2007)	VAR	Italy	Positive	Positive
Grier and Tullock (1989)	Cross-country	Developed and Developing countries	–	Positive
Hepke-Falk et al. (2006)	VAR	Germany	Positive	Positive
Karras (1994)	Time Series	Developed and Developing countries	Positive	
Mountford and Uhlig (2009)	VAR	US	Not Significant	Negative
Perotti (2004)	VAR	Australia, Canada, Germany and UK	Positive	Not significant
Ramey and Shapiro (1998)	Narrative Approach	US	Negative	–

potential asymmetries on the effect of government consumption on private consumption and investment. Finally, Section five concludes with the main findings and suggestions for further research.

I. DATA

This section provides a summary description of the data employed in the empirical analysis.

The data cover 145 countries and are obtained from the World Bank's World Development Indicators for the time period 1960–2007.

We consider annual data for GDP, private consumption, private investment and government spending. Due to data availability (both in terms of time and country dimension), we decided to proxy private investment and government spending by using gross fixed capital formation and public consumption (which represents the largest share of total government spending), respectively. All variables are expressed in real per capita terms, where we use the GDP deflator to convert nominal in real constant terms.

The focus of the analysis is on the existence of "crowding-in" *versus* "crowding-out" effects of government spending. Consequently, we study the impact of changes in the ratio of government spending to GDP on the growth of real per capita private consumption and private investment.

Table A in the Appendix provides the list of the countries used in the study and Table 2 summarizes the descriptive statistics of the above-mentioned variables. We can see that the private sector is a very important component of GDP: private consumption represents almost two thirds (68.22%) of GDP, while the ratio of private investment to GDP corresponds to an average of 21.55%. By its turn, government consumption represents 15.47% of GDP.

Over the overall sample, real per capita private consumption grew at an annual rate of 1.34% while the growth rate of private investment was 0.72%. Despite the lower growth rate, private investment exhibited a much larger volatility as expressed by the standard deviation. The change in government spending in percentage of GDP was negative (−0.02).

Table 2.

Summary Statistics

Variable	# Observations	Mean	Standard Deviation
Private Consumption (% of GDP)	5023	68.22	16.76
Private Investment (% of GDP)	4472	21.55	8.78
Government Spending (% of GDP)	5014	15.47	6.34
Private Consumption Growth	4870	1.34	8.06
Private Investment Growth	4322	0.72	21.62
Change in Government Spending (% of GDP)	5014	−0.02	1.62

Table 3.

Correlation Coefficients

Variable	Private Consumption (% of GDP)	Private Investment (% of GDP)	Change in Government Spending (% of GDP)
Private Consumption (% of GDP)	1		
Private Investment (% of GDP)	0.25	1	
Change in Government Spending (% of GDP)	−0.23	−0.07	1

Finally, Table 3 summarizes the correlation coefficients between the growth rate of private consumption, the growth rate of private investment and the change in the ratio of government spending to GDP. It shows that although private consumption and private investment are positively correlated, their correlations with government spending are negative and small.

II. EMPIRICAL METHODOLOGY AND RESULTS

We analyze the relationship between private consumption growth and the change in the ratio of government spending to GDP, and estimate a model similar to the empirical specification used in Romer and Romer (2007) to estimate the impact of tax changes on economic activity:

$$\frac{\Delta C_{i,t}}{C_{i,t}} = \nu_i + \mu_t + \sum_{j=0}^{J} \beta_j \Delta \left(\frac{G_{i,t-j}}{Y_{i,t-j}} \right) + \varepsilon_{i,t}. \tag{1}$$

We also look at the impact of a change in the government spending to GDP ratio on private investment growth by estimating the following model:

$$\frac{\Delta I_{i,t}}{I_{i,t}} = \nu_i + \mu_t + \sum_{j=0}^{J} \beta_j \Delta \left(\frac{G_{i,t-j}}{Y_{i,t-j}} \right) + \varepsilon_{i,t}. \tag{2}$$

In the above specifications, C represents private consumption, I is the private investment, Y is the GDP, the β's are parameters to be estimated, i is indexing over countries and t over time, ν and μ represent country- and time-specific effects, Δ is the first difference operator, J is the number of lags (set equal to four), and ε is the error term.

Panel A and Panel B in Table 4 present the results for the estimation of, respectively, equations (1) and (2). The columns of the tables show the results obtained using different econometric specifications, namely: i) OLS with time fixed effects; ii) OLS with country fixed effects; iii) OLS with both country and time fixed effects; and iv) country Random effects estimator.

Table 4.

Effects of Government Spending on Private Consumption and Investment Growth – *Baseline Model*

	Panel A. Consumption					Panel B. Investment				
	OLS	OLS	OLS	FE	RE	OLS	OLS	OLS	FE	RE
$\Delta\left(\dfrac{G_t}{Y_t}\right)$	-1.25*** (0.16)	-1.23*** (0.17)	-1.24*** (0.17)	-1.23*** (0.07)	-1.24*** (0.07)	-0.59** (0.30)	-0.62** (0.33)	-0.61** (0.32)	-0.62*** (0.20)	-0.61*** (0.19)
$\Delta\left(\dfrac{G_{t-1}}{Y_{t-1}}\right)$	-0.11 (0.12)	-0.10 (0.12)	-0.11 (0.13)	-0.10 (0.07)	-0.12* (0.07)	-0.38 (0.31)	-0.43 (0.32)	-0.42 (0.33)	-0.43** (0.20)	-0.40** (0.20)
$\Delta\left(\dfrac{G_{t-2}}{Y_{t-2}}\right)$	-0.27** (0.11)	-0.24** (0.12)	-0.26** (0.13)	-0.24*** (0.07)	-0.25*** (0.07)	-0.48** (0.23)	-0.57** (0.24)	-0.53** (0.24)	-0.57*** (0.19)	-0.53*** (0.19)
$\Delta\left(\dfrac{G_{t-3}}{Y_{t-3}}\right)$	-0.17* (0.11)	-0.15 (0.12)	-0.17* (0.11)	-0.15** (0.07)	-0.16* (0.11)	-0.39** (0.22)	-0.49** (0.22)	-0.46** (0.22)	-0.49*** (0.19)	-0.43*** (0.19)
$\Delta\left(\dfrac{G_{t-4}}{Y_{t-4}}\right)$	-0.11 (0.09)	-0.10 (0.09)	-0.11 (0.09)	-0.10 (0.07)	-0.10 (0.07)	-0.03 (0.21)	-0.13 (0.23)	-0.11 (0.23)	-0.13 (0.19)	-0.07 (0.18)
Time FE	Yes	No	Yes			Yes	No	Yes		
Country FE	No	Yes	Yes			No	Yes	Yes		
R²	0.10	0.13	0.16	0.07	0.07	0.04	0.05	0.07	0.01	0.01

Notes: "OLS" denotes Ordinary Least Squares, "RE" refers to Random Effects. Estimated standard errors in parentheses. ***, ** and * denote statistical significance at the 1%, 5% and 10% significance levels.

Starting with the analysis of the effect of government consumption on private consumption (Panel A), we can immediately see that it is negative and statistically significant. The results also suggest that not only contemporaneous changes in the government consumption-GDP ratio matter, but also its past lags (specifically, the 2nd and 3rd ones). In particular, the cumulative effect of government spending on private consumption is about 1.9 %, of which about 1.2% captured by contemporaneous changes in the government consumption-GDP ratio and 0.7 % by its lags. This result can be interpreted as follows: an increase of government consumption by 1 % of real GDP immediately reduces consumption by approximately 1.2%, with the decline continuing for about four years when the cumulative decrease in consumption has reached approximately 1.9 %. The result is broadly robust to both country and time effects, and both to Fixed and Random effects specification.

In Panel B, we report the results obtained estimating the investment equation (2). Similarly to what we obtained for private consumption, both current and lagged changes in government consumption-GDP ratio have a negative and significant effect on private investment, with a cumulative effect of approximately 1.8%. The main difference between the effect on consumption and investment is that, while contemporaneous change in the government consumption-GDP ratio seems to have a bigger effect on consumption, lagged changes are more detrimental for investment.

IV. ROBUSTNESS ANALYSIS AND ASYMMETRIC EFFECTS

4.1 Exogeneity

Since our measure of the change in the ratio of government spending to GDP may not be completely exogenous, there is the risk that the estimated β's in models (1) and (2) are biased (and inconsistent).

A first attempt to address this issue is carried out by eliminating the contemporaneous change in the ratio of government spending to GDP in models (1) and (2). In fact, since both the growth rate of consumption (and investment) and our independent variable are (for the vast majority of the countries in the sample) stationary and not persistent, we should expect that the lagged values of our independent variables are not influenced by the current value of consumption (and investment) growth rates.

Following this approach, we revise models (1) and (2) to:

$$\frac{\Delta C_{i,t}}{C_{i,t}} = v_i + \mu_t + \sum_{j=1}^{J} \beta_j \Delta\left(\frac{G_{i,t-j}}{Y_{i,t-j}}\right) + \varepsilon_{i,t} \qquad (3)$$

and

$$\frac{\Delta I_{i,t}}{I_{i,t}} = v_i + \mu_t + \sum_{j=1}^{J} \beta_j \Delta \left(\frac{G_{i,t-j}}{Y_{i,t-j}} \right) + \varepsilon_{i,t}. \tag{4}$$

respectively, thereby simply excluding the contemporaneous change in the ratio of government spending to GDP from the original equations. Due to space constraints, in Table 5, we only report the estimated sums of the β's obtained with this analysis, and we compare them with the ones obtained previously (Table 5). Looking at the table, we can still see that government consumption crowds-out both private consumption and investment. However, as already pointed out in the previous section, the cumulative effect of lags of changes in government consumption-GDP ratio (Panel B) is lower than the one due to contemporaneous changes (Panel A). In particular, the cumulative effect of (lagged) changes in government consumption-GDP ratio on private consumption (investment) is approximately 0.10% (0.35%).

A second attempt to correct for possible endogeneity problems is carried out by using the GMM estimator proposed by Blundell and Bond (1998). The results reported in the table clearly show that the estimated impact of government spending on both private consumption and investment is qualitatively (in terms of sign) and quantitatively (in terms of magnitude) unchanged.

4.2 Serial correlation

Another possible problem with specifications (1) and (2) is the presence of serial correlations. To tackle this issue, we modify models (1) and (2) to:

$$\frac{\Delta C_{i,t}}{C_{i,t}} = w_i + v_t + \sum_{j=1}^{J} \alpha_j \left(\frac{\Delta C_{i,t-j}}{C_{i,t-j}} \right) + \sum_{j=0}^{J} \beta_j \Delta \left(\frac{G_{i,t-j}}{GDP_{i,t-j}} \right) + u_{i,t} \tag{5}$$

and

$$\frac{\Delta I_{i,t}}{I_{i,t}} = w_i + v_t + \sum_{j=1}^{J} \alpha_j \left(\frac{\Delta I_{i,t-j}}{I_{i,t-j}} \right) + \sum_{j=0}^{J} \beta_j \Delta \left(\frac{G_{i,t-j}}{GDP_{i,t-j}} \right) + u_{i,t} \tag{6}$$

where we add lags of the dependent variables to the set of explanatory variables, so that α's are parameters to be estimated.

The results (Table 5, Panel C) confirm the robustness of the previous findings and, therefore, suggest that our original specifications do not suffer from serial correlation..

Table 5.

Effects of Government Spending on Private Consumption and Investment Growth – Robustness Checks

	Consumption						Investment					
	OLS Time FE	OLS Country FE	OLS Time-Country FE	FE	RE	GMM	OLS Time FE	OLS Country FE	OLS Time & Country FE	FE	RE	GMM
Panel A. Baseline												
$\sum_{j=0}^{4}\Delta\left(\frac{G_{i,t-j}}{Y_{i,t-j}}\right)$	-0.38***	-0.36***	-0.38***	-0.36***	-0.37***	-0.41***	-0.37***	-0.44***	-0.42***	-0.44***	-0.40***	-0.45***
	(0.06)	(0.06)	(0.06)	(0.04)	(0.03)	(0.06)	(0.12)	(0.14)	(0.15)	(0.10)	(0.10)	(0.12)
R^2	0.06	0.09	0.12	0.03	0.03		0.04	0.04	0.07	0.01	0.01	
Panel B. Exogeneity												
$\sum_{j=1}^{4}\Delta\left(\frac{G_{i,t-j}}{Y_{i,t-j}}\right)$	-0.12**	-0.09	-0.09	-0.09**	-0.11***	-0.10*	-0.29**	-0.37***	-0.34**	-0.37***	-0.34***	-0.36**
	(0.06)	(0.06)	(0.06)	(0.04)	(0.04)	(0.06)	(0.13)	(0.14)	(0.15)	(0.10)	(0.10)	(0.15)
R^2	0.03	0.07	0.09	0.00	0.00		0.03	0.04	0.07	0.00	0.00	
Panel C. Serial Correlation												
$\sum_{j=0}^{4}\Delta\left(\frac{G_{i,t-j}}{Y_{i,t-j}}\right)$	-0.41**	-0.39**	-0.41**	-0.39**	-0.40**		-0.36***	-0.36***	-0.36***	-0.36***	-0.36***	
	(0.06)	(0.06)	(0.06)	(0.03)	(0.03)		(0.13)	(0.13)	(0.13)	(0.13)	(0.13)	
R^2	0.07	0.11	0.14	0.04	0.04		0.03	0.05	0.08	0.00	0.01	
Panel D. Identification												
$\sum_{j=0}^{4}\Delta\left(\frac{G_{i,t-j}}{Y_{i,t-j}}\right)$	-0.34**	-0.35**	-0.36**	-0.35**	-0.35**		-0.15	-0.16	-0.17	-0.16	-0.15	
	(0.08)	(0.09)	(0.09)	(0.05)	(0.10)		(0.19)	(0.23)	(0.23)	(0.13)	(0.12)	
R^2	0.06	0.13	0.15	0.03	0.03		0.03	0.07	0.09	0.01	0.01	

Notes: "OLS" denotes Ordinary Least Squares, "RE" refers to Random Effects, "GMM" denotes Generalized Method of Moments. Estimation method Blundell and Bond (1998). Estimated standard errors in parentheses. ***, ** and * denote statistical significance at the 1%, 5% and 10% significance levels. Baseline refers to models (1) and (2). Exogeneity refers to models (3) and (4) where only lagged growth rates of government consumption are considor+ed; Serial correlation refers to models (5) and (6), where lagged growth rates of the dependent variables are included; Identification refers to model (7) and (8) where current and lagged growth rates of the budget deficit are included.

4.3 Identification problem

We repeat our empirical exercise using the changes in the deficit-GDP ratio as an additional control:

$$\frac{\Delta C_{i,t}}{C_{i,t}} = \nu_i + \mu_t + \sum_{j=0}^{J} \beta_j \Delta \left(\frac{G_{i,t-j}}{Y_{i,t-j}} \right) + \sum_{j=0}^{J} \beta_j \Delta \left(\frac{D_{i,t-j}}{Y_{i,t-j}} \right) + \varepsilon_{i,t}. \tag{7}$$

$$\frac{\Delta I_{i,t}}{I_{i,t}} = \nu_i + \mu_t + \sum_{j=0}^{J} \beta_j \Delta \left(\frac{G_{i,t-j}}{Y_{i,t-j}} \right) + \sum_{j=0}^{J} \beta_j \Delta \left(\frac{D_{i,t-j}}{Y_{i,t-j}} \right) + \varepsilon_{i,t}. \tag{8}$$

The inclusion of this variable allows us to control for a possible misspecification of the model. In fact, to the extent that changes in government revenue and spending are correlated, our results could be capturing the effect of tax changes on the economic activity. For instance, Cebula (1978) emphasizes the importance of the government size in producing crowding-out effects. Thus, the inclusion of the deficit allows us to overcome this identification problem.

This approach has, however, a potential caveat: if changes in government revenue and spending are not correlated, then changes in government spending may be correlated with changes in deficit which would lead to multicollinearity problems.

The results are reported in Panel D of Table 5 and once again confirm the existence of crowding-out effects.[2]

4.4 Asymmetric regional effects

The analysis presented so far has shown robust evidence on the existence of crowing-out effects. But is the effect similar for different regions and countries? To answer this question, we replicate the estimations for specific geographical areas and countries. Table 6 presents the results for eight different areas: i) Africa, ii) Asia and Pacific, iii) Europe, iv) Middle-East, v) North America, vi) South America and West Indies, vii) OECD, and viii) Developing Countries.

We find that the effect varies substantially between areas. In particular, while there are statistically significant crowding-out effects in Africa, Europe and South America, government spending does not seem to have (statically) significant affects in the other areas considered.

We also assess whether the effect is different between developed (OECD) and developing countries. The results suggest that the impact of government

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2. The absence of statistically significance of the estimated coefficients in the investment equation is due to the high correlation (0.15 for the entire sample) between our explanatory variables.

Table 6.

Effects of Government Spending on Private Consumption and Investment Growth – *Asymmetric Regional Effects*

	Africa	Asia and Pacific	Europe	Middle East	North America	South America and West Indies	OECD	Developing countries
				Panel A. Consumption				
$\sum_{j=0}^{4}\Delta\left(\dfrac{G_{i,t-j}}{Y_{i,t-j}}\right)$	−0.36*** (0.06)	−0.13 (0.16)	−0.39*** (0.17)	0.02 (0.19)	−0.09 (0.24)	−0.66*** (0.15)	−0.59*** (0.07)	−0.37*** (0.06)
R^2	0.09	0.20	0.25	0.24	0.49	0.17	0.27	0.11
				Panel B. Investment				
$\sum_{j=0}^{4}\Delta\left(\dfrac{G_{i,t-j}}{Y_{i,t-j}}\right)$	−0.22 (0.22)	−0.52 (0.44)	−0.49*** (0.23)	0.22 (0.37)	−0.74 (0.61)	−0.91*** (0.28)	−1.50*** (0.20)	−0.37*** (0.15)
R^2	0.08	0.19	0.18	0.29	0.52	0.18	0.22	0.08

Notes: We estimate the model using "OLS" denotes Ordinary Least Squares and including both country and time effects. Estimated standard errors in parentheses. ***, ** and * denote statistical significance at the 1%, 5% and 10% significance levels.

Table 7.

Panel A. Effects of Government Spending on Private Consumption Growth – *Asymmetries Across Countries*

	Australia	Austria	Belgium	Canada	Czech Republic	Denmark	Finland
$\sum_{j=0}^{4} \Delta \left(\dfrac{G_{i,t-j}}{Y_{i,t-j}} \right)$	−0.81* (0.45)	−0.63 (0.44)	−0.59*** (0.17)	−0.44** (0.18)	−0.25 (0.48)	−0.14 (0.70)	−0.97** (0.38)
R^2	0.17	0.08	0.26	0.26	0.05	0.01	0.28
	France	Germany	Greece	Hungary	Ireland	Italy	Japan
$\sum_{j=0}^{4} \Delta \left(\dfrac{G_{i,t-j}}{Y_{i,t-j}} \right)$	−0.37** (0.17)	−0.71*** (0.17)	−0.37 (0.32)	−0.94 (0.60)	−0.31 (0.21)	−0.26 (0.23)	−0.99*** (0.16)
R^2	0.19	0.30	0.04	0.19	0.13	0.03	0.58
	Korea	Luxembourg	Mexico	New Zealand	Norway	Poland	Portugal
$\sum_{j=0}^{4} \Delta \left(\dfrac{G_{i,t-j}}{Y_{i,t-j}} \right)$	−1.00 (0.84)	−0.33 (0.59)	−3.11*** (0.98)	1.36*** (0.40)	−0.21 (0.29)	−0.43** (0.17)	−0.36 (0.53)
R^2	0.25	0.02	0.27	0.43	0.101	0.18	0.02
	Slovak Republic	Spain	Sweden	Switzerland	Turkey	United Kingdom	United States
$\sum_{j=0}^{4} \Delta \left(\dfrac{G_{i,t-j}}{Y_{i,t-j}} \right)$	−0.27 (0.31)	−0.81** (0.37)	−0.76*** (0.18)	−1.03*** (0.25)	−3.46** (1.23)	−0.68*** (0.23)	−0.11 (0.18)
R^2	0.03	0.21	0.49	0.40	0.32	0.27	0.01

Notes: We estimate the model using "OLS" denotes Ordinary Least Squares and including both country and time effects. Estimated standard errors in parentheses. ***, ** and * denote statistical significance at the 1%, 5% and 10% significance levels.

spending on both private consumption and investment is more detrimental in the OECD group. However, also among OECD countries there seems to be some degree of heterogeneity. In fact, analyzing the results in Table 7, it emerges that the "crowding-out" effects of government consumption are largest in relatively less developed countries (such as Mexico and Turkey) and in those countries with a high share of government spending (such as Finland, Sweden and Norway).

4.5 Asymmetric effects over the business cycle

The effect of government spending on economic activity may also differ between different phases of the economic cycles (Perotti, 2004). To address this issue, we now look at the effects of government spending on the private sector conditioning on the information about the business cycle. To be more specific, we construct the following dummy variables: $og^+ = 1$ if $og > 0$, and 0 otherwise and $og^- = 1$ if $og < 0$, and 0 otherwise, where og is a measure of output gap,

Table 7.

Panel B. Effects of Government Spending on Private Investment Growth – *Asymmetries Across Countries*

	Australia	Austria	Belgium	Canada	Czech Republic	Denmark	Finland
$\sum_{j=0}^{4}\Delta\left(\dfrac{G_{i,t-j}}{Y_{i,t-j}}\right)$	−1.66 (1.39)	−0.30 (1.05)	−0.86 (1.19)	−1.56*** (0.56)	−0.66 (0.88)	−1.23 (1.38)	−3.95*** (1.17)
R^2	0.03	0.00	0.03	0.29	0.05	0.06	0.41
	France	Germany	Greece	Hungary	Ireland	Italy	Japan
$\sum_{j=0}^{4}\Delta\left(\dfrac{G_{i,t-j}}{Y_{i,t-j}}\right)$	−0.92 (0.66)	−1.40*** (0.46)	0.88 (1.13)	−1.21 (0.73)	−0.13 (0.66)	−0.70** (0.36)	−2.56*** (0.73)
R^2	0.10	0.15	0.03	0.12	0.00	0.04	0.36
	Korea	Luxembourg	Mexico	New Zealand	Norway	Poland	Portugal
$\sum_{j=0}^{4}\Delta\left(\dfrac{G_{i,t-j}}{Y_{i,t-j}}\right)$	−2.67* (1.57)	−1.00 (3.24)	−5.75* (2.85)	−3.01 (2.23)	−1.91* (1.06)	−0.22 (1.21)	−0.96 (1.62)
R^2	0.10	0.01	0.15	0.13	0.13	0.00	0.02
	Slovak Republic	Spain	Sweden	Switzerland	Turkey	United Kingdom	United States
$\sum_{j=0}^{4}\Delta\left(\dfrac{G_{i,t-j}}{Y_{i,t-j}}\right)$	−1.08 (1.12)	−2.23* (1.20)	−2.19** (0.87)	−1.88 (1.88)	−11.84** (4.50)	−1.28** (0.59)	−1.86*** (0.53)
R^2	0.02	0.18	0.36	0.07	0.34	0.16	0.25

Notes: We estimate the model using "OLS" denotes Ordinary Least Squares and including both country and time effects. Estimated standard errors in parentheses. ***, ** and * denote statistical significance at the 1%, 5% and 10% significance levels.

constructed as the difference between our series and its trend (computed using the HP filter with a smoothness parameter equal to 6.25 as suggested by Ravn and Uhlig, 2002).

Then, we interact the dummy variables with the change in the ratio of government spending to GDP, that is, we estimate the following models:

$$\frac{\Delta C_{i,t}}{C_{i,t}} = w_i + v_t + \sum_{j=0}^{J}\beta_j^{+}\Delta\left(\frac{G_{i,t-j}}{GDP_{i,t-j}}\right)og^{+} + \sum_{j=0}^{J}\beta_j^{-}\Delta\left(\frac{G_{i,t-j}}{GDP_{i,t-j}}\right)og^{-} + u_{i,t} \quad (9)$$

and

$$\frac{\Delta I_{i,t}}{I_{i,t}} = w_i + v_t + \sum_{j=0}^{J}\beta_j^{+}\Delta\left(\frac{G_{i,t-j}}{GDP_{i,t-j}}\right)og^{+} + \sum_{j=0}^{J}\beta_j^{-}\Delta\left(\frac{G_{i,t-j}}{GDP_{i,t-j}}\right)og^{-} + u_{i,t} \quad (10)$$

where β_j^{+} and β_j^{-} measure the effect of government spending during upturns and downturns, respectively. Table 8 summarizes the results and shows that the effect

Table 8.

Effects of Government Spending on Private Consumption and Investment Growth – Asymmetric Effects Over the Business Cycle

	Panel A. Consumption					Panel B. Investment				
	OLS	OLS	OLS	FE	RE	OLS	OLS	OLS	FE	RE
$\sum_{j=0}^{4} \Delta \left(\dfrac{G_{t,t-j}}{Y_{t,t-j}} \right) og^+$	−0.41*** (0.08)	−0.39*** (0.08)	−0.40*** (0.08)	−0.39*** (0.05)	−0.41*** (0.05)	−0.38** (0.17)	−0.47** (0.33)	−0.43** (0.19)	−0.47*** (0.13)	−0.43*** (0.12)
$\sum_{j=0}^{4} \Delta \left(\dfrac{G_{t,t-j}}{Y_{t,t-j}} \right) og^-$	−0.35** (0.08)	−0.33** (0.08)	−0.35** (0.08)	−0.33** (0.05)	−0.33** (0.05)	−0.35** (0.14)	−0.41** (0.19)	−0.40** (0.19)	−0.41*** (0.14)	−0.37** (0.13)
Time FE	Yes	No	Yes			Yes	No	Yes		
Country FE	No	Yes	Yes			No	Yes	Yes		
R^2	0.06	0.09	0.12	0.03	0.03	0.04	0.04	0.07	0.01	0.01
$\sum_{j=0}^{J} \beta_j^+ = \sum_{j=0}^{J} \beta_j^-$ (p-value)	(0.64)	(0.57)	(0.75)	(0.33)	(0.24)	(0.89)	(0.79)	(0.91)	(0.73)	(0.72)

Notes: "OLS" denotes Ordinary Least Squares, "RE" refers to Random Effects. Estimated standard errors in parentheses. ***, ** and * denote statistical significance at the 1%, 5% and 10% significance levels. $og^+ = 1$ during upturns, and zero otherwise; $og^- = 1$ during downturns, and zero otherwise.

of government spending on both private consumption and investment does not significantly vary according to different phases of the cycles.[3]

V. CONCLUSIONS

We contribute to the empirical literature on the effect of government spending on economic activity, by assessing the impact of changes in government spending-GDP ratio on (the short-term growth rates) of private consumption and investment. We do this by analysing a panel sample of 145 countries from 1960 to 2007.

The results of our paper suggest that government spending produces important crowding-out effects, by negatively affecting both private consumption and investment. Consequently, the predictions of both the standard RBC and IS-LM models cannot be taken overall as valid: our results are in contrast with the RBC prediction of a rise in investment, and with the IS-LM prediction of a rise in consumption.

We find that the cumulative effect of government spending on private consumption (investment) is about 1.9 % (1.8 %), of which about 1.2 % (0.6 %) is captured by the contemporaneous change in the government consumption-GDP ratio and 0.7% (1.2%) by its lags. This result is interpreted as follows: an increase of government consumption by 1% of real GDP immediately reduces consumption (investment) by approximately 1.2% (0.6%), with the decline continuing for about four years when the cumulative decrease in consumption has reached approximately 1.9% (1.8%). The result is broadly robust to both country and time effects, and different econometric specifications.

In addition, we show that the effect of government consumption on private consumption and investment does not depend on the phase of the business cycle, but differ substantially among regions.

The differentiated effects of government consumption on private consumption and investment among geographical areas are extremely important and need to be further investigated. In particular, it would be interesting to assess to which extent the effect of government spending on consumption and investment depends on political and institutional variables (e.g. democracy, corruption, political stability) as well as macro economic variables (income, interest rates, degree of openness). We leave this challenging avenue for future research.

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3. The results are quantitavely unchanged if we use the average growth rate as the measure of trend instead of the HP trend.

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APPENDIX.

Table A.

Country Sample

Country list			
Albania	Denmark	Lesotho	Slovak Republic
Algeria	Djibouti	Luxembourg	Slovenia
Artigua and Barbuda	Dominica	Macao	Solomon Islands
Argentina	Dominican Republic	Macedonia	Somalia
Armenia	Ecuador	Madagascar	South Africa
Australia	Egypt	Malawi	Spain
Austria	El Salvador	Malaysia	Sri Lanka
Azerbaijan	Estonia	Mali	St. Kitts and Nevis
Bahamas	Ethiopia	Malta	St. Vincent and the
Bangladesh	Finland	Mauritania	Grenadines
Barbados	France	Mauritius	Sudan
Belarus	Gabon	Mexico	Swaziland
Belgium	Gambia	Moldova	Sweden
Belize	Germany	Morocco	Switzerland
Benin	Ghana	Mozambique	Syrian Arab
Bhutan	Greece	Namibia	Republic
Bolivia	Grenada	Netherlands	Tajikistan
Botswana	Guatemala	New Zealand	Tanzania
Brazil	Guinea	Nicaragua	Thailand
Brunei Darussalam	Guinea-Bissau	Niger	Togo
Bulgaria	Guyana	Nigeria	Trinidad and Tobago
Burkina Faso	Haiti	Norway	Tunisia
Cambodia	Honduras	Pakistan	Turkey
Cameroon	Hong Kong	Panama	Uganda
Canada	Hungary	Papua New Guinea	Ukraine
Cape Verde	Iceland	Paraguay	United Arab
Chad	India	Peru	Emirates
Chile	Indonesia	Philippines	United Kingdom
China	Iran	Poland	United States of
Colombia	Ireland	Portugal	America
Comoros	Italy	Puerto Rico	Uruguay
Congo, Dem. Rep.	Japan	Romania	Venezuela
Congo, Rep.	Jordan	Russian Federation	Yemen
Costa Rica	Kazakhstan	Rwanda	Zambia
Côte d'Ivoire	Kenya	Sao Tome e Principe	Zimbabwe
Croatia	Korea	Senegal	
Cyprus	Kyrgyz Republic	Seychelles	
Czech Republic	Latvia	Sierra Leone	

THE IMPACT OF GOVERNMENT SPENDING ON THE PRIVATE SECTOR

SUMMARY

We contribute to the empirical literature on the effect of government spending on economic activity, by assessing the impact of changes in government spending-GDP ratio on (the short-term growth rates of) private consumption and investment. We do this by analysing a panel sample of 145 countries from 1960 to 2007. The results of our paper suggest that government spending produces important crowding-out effects, by negatively affecting both private consumption and investment. The result is broadly robust to both country and time effects, and different econometric specifications. In addition, we show that the effect of government consumption on private consumption and investment does not depend on the phase of the business cycle, but differs substantially among regions. The differentiated effects of government consumption on private consumption and investment among geographical areas are extremely important and need to be further investigated. In particular, it would be interesting to assess to which extent the effect of government spending on consumption and investment depends on political and institutional variables (e.g. democracy, corruption, political stability) as well as macroeconomic variables (income, interest rates, degree of openness). We leave this challenging avenue for future research.