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Do public investments crowd out private investments? Fresh evidence from Fiji

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Abstract

In this paper, we investigate whether government investment crowds out or crowds in private investment for Fiji over the period 1950–2001. We begin by searching endogenously for break points in the data series using the Zivot and Andrews [J. Business Economic Stat. 10 (1992) 251–270] test. Upon finding that 1975 is the statistically significant break date, we divide the sample into two. Using the error correction mechanism test, we find that government and private investments are cointegrated over the period 1950–1975, but not for the period 1976–2001. We also find that in the former period government investment has crowded in private investment, while in the latter period the relationship between government and private investments has been statistically weak.

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1. Introduction

From a policy point of view, the impacts of private investment and government investment on each other are important. The literature on development economics

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perceives public investment as crucial, for it is seen as a driving force for private investment, which in turn drives economic growth. Ashauer (1987) argues on neoclassical grounds that an expansion of public investment should induce an increase in the rate of return to private capital, stimulating private investment expenditure. In a similar light, provision of capital goods such as infrastructure has the potential of raising the marginal productivity of capital and, hence, exerting a complementary effect on private investment. If this is true then one can claim that public investment is complementary to private investment. This is tantamount to claiming that public investment exerts a ‘crowding in’ effect on private investment. However, if public investment exerts a negative impact on private investment then the former is seen as a substitute good. This can result if higher public investment exceeds capital accumulation above the level required by private sector agents on an ex ante basis as individuals seek to re-establish an optimal intertemporal allocation of resources (Ashauer, 1989). Interpreted differently, this is testimony to the ‘crowding out’ of private investment by public investment.

The central aim of this paper is to investigate whether public investment ‘crowds out’ or ‘crowds in’ private investment in Fiji. This has not only become an important question in the literature on development economics but it has also generated an immense level of interest among policy-makers in Fiji, particularly in view of the inability of the Fijian economy to generate the required level of private investment to simulate growth. Over the last decade, Fiji’s private investment has been mediocre – averaging a mere 3.5% of gross domestic product (GDP) per annum. This has become a cause for alarm for Fijian policy-makers given the prognosis of the government that, for Fiji to achieve its targeted growth rate of 5% per annum, it needs to generate private investments of 25% of GDP per annum (Kubuabola, 2002:18). Noticeably, public investment in Fiji has grown appreciably over the last couple of decades. For instance, over the period 1976–2001, public investment grew at a rate of 3% per annum. These trends warrant an investigation into whether public investment is ‘crowding out’ or ‘crowding in’ private investment in Fiji. We believe that the answer to this question has the potential to influence policy-making.

In investigating the private investment and government investment nexus for Fiji, this study differs from existing studies in four novel ways. First, we investigate the nexus for a small developing economy for the first time; hence, the results from this study are likely to add to our understanding of the ‘crowding out’ and ‘crowding in’ nature of government investment. Second, we use the error correction mechanism test of Banerjee, Dolado, and Mestre (1998) extended by Pesaran, Shin, and Smith (2001) not used previously in this literature. The test has been shown to function efficiently in small sample sizes such as the one in the present study. Third, we are concerned about the robustness of our long-run results in relation to the impact of government investment on private investment, given the importance for policy-making. In this light, we depart from the existing literature in that, to ascertain robustness, we use three different estimators shown to produce robust results in small sample sizes such as in the present study. We use the autoregressive distributed lag (ARDL) approach, the dynamic ordi-

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