Government spending, capital accumulation and the optimal policy rule: The role of public service capital

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Abstract


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The second-best government consumption expenditure is decided on the basis that the marginal utility of consumption is equal to the discounted sum of the marginal utility of the government’s flow spending. © 2006 Elsevier B.V. All rights reserved.

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### 1. Introduction

The impact of government consumption expenditure on private consumption and private capital formation has long been a subject of analysis and debate. Neoclassical growth models, such as those of Djajić (1987) and Ihori (1990), have concluded that an unanticipated permanent increase in government consumption spending will immediately crowd out private consumption one-for-one and will leave the capital stock and output constant at all points of time. Subsequently, Turnovsky and Fisher (1995), Palivos and Yip (1996), and Chang (1999) have introduced endogenous labor supply and Chang et al. (1998) have introduced the endogenous rate of time preference to examine the validity of the full crowding-out effect of government spending. They find that an unanticipated permanent fiscal policy will affect both the steady-state equilibrium and the short-run transitional behavior of private consumption and the capital stock.

One common element of these studies is that they set up their models with the flow specification of government consumption expenditure in the utility function. Evidently, such a specification of government consumption expenditure does not fit in with the reality. The typical examples of utility-enhancing public goods, such as public libraries, national defense, national parks, hospitals, highways and transportation programs, which have been presented in recent neoclassical growth frameworks, are stock variables by nature. By taking government expenditure on national parks as an example, the flow specification of government expenditure in the utility function implies that only newly-established national parks can raise the public’s satisfaction, and that national parks previously established do not contribute any utility to the agents. Obviously, it is more plausible for public services to enter into the utility function in the manner of a stock variable, rather than a flow variable.

In fact, Arrow and Kurz (1970, xiii) have put forward the view: “some government capital contributes directly to consumer satisfaction, and it would be more general to let U [utility] depend on ... per capita government capital.” Turnovsky and Fisher (1995, p. 753) also make a similar suggestion, claiming that “[a]n alternative approach would be to allow the government also to accumulate stocks of durable consumption goods and physical infrastructure capital. This formulation has much to recommend in terms of added realism, in that many utility-enhancing public goods, such as national parks, and production-enhancing public goods, such as roads, are likely to impact on the economy through their accumulated stocks, rather than their current flows.” However, they still treat utility-enhancing public goods as a flow variable in their analysis. To the
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