Fiscal multipliers in the most aged country: Empirical evidence and theoretical interpretation*

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Abstract

This study investigates how population aging impacts the effectiveness of a government spending shock. We estimate a panel VAR model with prefectural data in Japan, the world’s fastest aging country and reveal that a government spending shock becomes less effective as the aging rate increases. Subsequently, we construct a New Keynesian model with workers and retirees, which can replicate our empirical findings. This highlights the role of the supply-side channel through which workers facing a liquidity constraint can benefit from increased disposable income, in generating the state-dependent effect of the government spending shock. Our theoretical finding may suggest that promoting labor market participation by elderly people could increase the effectiveness of a government spending shock amid a rapidly aging society.

JEL Classification Number: E62, C11, C23.

Key words: Population aging, Panel VAR model, New Keynesian model, Fiscal policy.

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*This research was funded by Grant-in-Aid for Young Scientists 19K13652 and the Nomura Foundation. Errors, if any, are entirely the author’s responsibility.
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