The Argument

- **The myth:**
  - Increased Government Spending causes inflation.
- **The reality:**
  - It is a complicated story.

An Example

Suppose the government decides to increase spending by $X.

A one period spending increase on a foolish project

Financed by a surcharge on last year’s tax bill
Fiscal Policy-Part 1

Why this Choice?

We know beneficial products (a new highway) can have a beneficial effect, raising A or K.

We also know that taxes on wages, consumption, etc. can have disincentive effects.

Here we are looking at spending per se.

What Happens

Y is up by $X because of the government’s spending.

Y is down by <$X because of reduced wealth and consumption.

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The auctioneer notes that $D_Y - S_Y = X - Y > 0$.

The Shift in the Y Curve

The M Curve

With wealth down, Money Demand is down. Ergo, the M curve shifts up and to the left.

This is a familiar case, “Spending Foolishly”.
The Shift in the Y Curve

We know $P$ is up, $r$ is uncertain.

As drawn, $r$ is up; economists think this is the likely outcome.

This is sometimes referred to as demand pull inflation (or cost push inflation).

Changing the Experiment

We assumed that there was an increase in Government Spending, financed by taxation. Could different financing scenarios lead to different results?

Suppose the government just borrowed $X$. Could different financing scenarios lead to different results?
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If people have a bequest motive, no change?

Suppose the government just borrowed $X.

Here there is a difference, albeit a small one.

Borrowing, No Bequest Motive

End

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