Let’s change the experiment again. This time, the government gives everyone a $300 tax cut.

Yes you have seen this one before.

This tax cut is based on last year’s taxes, so no incentives/disincentives to work.

But there are possible impacts on wealth.

Yes you have seen this one before.
If people have a bequest motive, no change.

No change in wealth, just an issue on when you write a check to the government.

If people do not have a bequest motive, wealth is up.

Prices up, interest rates unsure (but probably up).

But the change is probably pretty small.
A one time increase in government spending pushes prices up, and probably interest rates as well.

If people have a bequest motive, it makes no difference whether the increase is financed by taxation or borrowing (ignoring the disincentive effects of taxes).

With no bequest motive, it may make a small difference.

A tax cut makes no difference if there is a bequest motive.

With no bequest motive, it may make a small difference.
Long Run Effects

- Let’s go back to our tax-financed spending increase.
- This is a temporary change.
- Its effects will eventually dissipate.

That means the change if initially inflationary, will be deflationary as the impact wears off.
There is a permanent increase in government spending. We will assume a foolish project. Because it is a permanent increase it must be financed by taxation.

Any disincentive effects are small: people move along their LR labor supply curve.
The proof is complicated, but the two will exactly offset each other.

Ergo

No change in Y curve!

Prices up, interest rates down.

Over time, though, interest rates unchanged, prices up more.
End