Fiscal Policy

- What the government spends and how it taxes is very important.
  - The “Foolish Project” is an illustrative ploy
  - Taxes have all sorts of incentive effects

Fiscal Policy

- We talk here about solely its use to manage Business Cycles.
  - That is, can spending and taxing per se drive business cycles

Can Spending Cause a Business Cycle

- Suddenly we go to war.
The End of the War

The war ongoing for some time, comes to an end.

Examples

Wars are often marked by rapid expansion of government demand and “boom times”

Ends are usually accompanied by downturns

The Extension

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No longer.
Managing Business Cycles with Fiscal Policy

Why

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Lags. Consider how long it takes to get an increase in spending through the legislative process and the contracting process.

Multiplier

Small response. Suppose \( \Delta G = 10 \text{ B} \).

Once people believed \( \Delta C \approx 20 \text{ B} \).

Today, research suggests that \( \Delta C \) could be negative, for people see wealth going down.

Tax Cuts

Suppose we give everyone \$300. Very little impact on consumption demand.

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A Permanent Change

Consider a permanent increase of \$10 billion in government spending. Wealth is down by the present value of \$10 billion per year.

A permanent increase of \$10 billion should result in a reduction of \$10 billion per year in consumption, an exact offset.

Conclusion

Tax and Spending Policy Matters. A lot. But don’t use fiscal policy to manage business cycles.