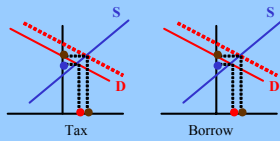


## Debt and Taxes



## Does Deficit Financing Make a Difference?

- The Government is going to spend \$100 on a one time project
  - Plan A is to hit people with a \$100 tax bill so the government runs on a pay-as-you-go basis.
  - Plan B is to borrow the money.

## Does Deficit Financing Make a Difference?

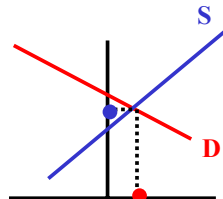
- The Government is going to spend \$100 on a one time project
  - Plan A is to hit people with a \$100 tax bill so the government runs on a pay-as-you-go basis.
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- Does it make a difference?
  - Maybe
  - And Maybe Not

## Does Deficit Financing Make a Difference?

- The Government is going to spend \$100.
    - Plan A is to hit people with a \$100 tax bill so
  - Does it make a difference?
    - Maybe
    - And Maybe Not
- Let's first see the conventional wisdom and then see what really happens
- money.

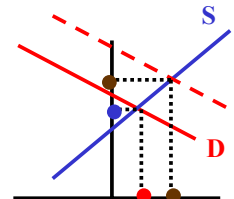
## If the Government Borrows

- Our familiar demand and supply of loans graph, showing how interest rates and the balance on current account are determined.

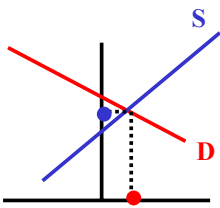


## If the Government Borrows

- If the government borrows, the demand for loans shifts to the right. Interest rates rise and the BCA becomes even more negative.

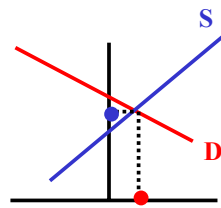


## If the Government Taxes

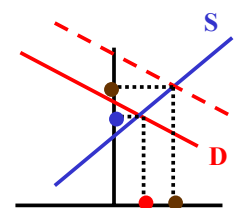


- On the other hand, if the government taxes, no change in the demand for loans and no change in interest rates or the BCA.

## So the Choice Is...

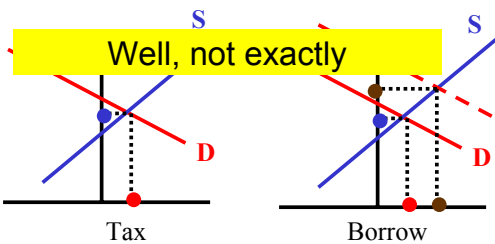


Tax



Borrow

## So the Choice Is...

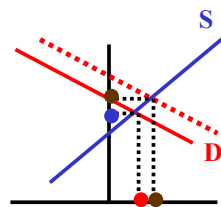


Well, not exactly

Tax

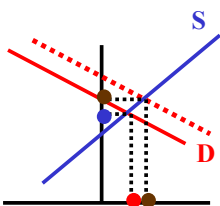
Borrow

## If the Government Taxes



- Z declines by \$100 and people reduce consumption by (say) \$10.
- The private demand for loans rises by  $\$90 = \$100 - \$10$

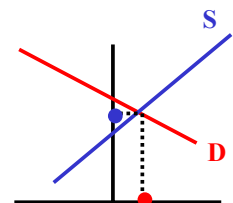
## If the Government Taxes



- Z declines by \$100 and people reduce consumption by \$10.
- **Interest rates rise and the BCA becomes more negative**  
 $\$90 = \$100 - \$10$

## If the Government Borrows

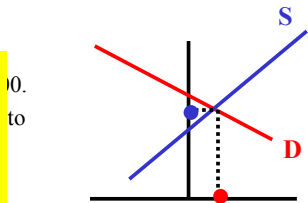
- The government demand for loans surely rises by \$100.
- But what happens to the private sector?



## If the Government Borrows

- The government

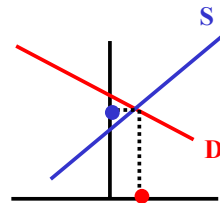
If taxpayers must pay the \$100 back, then their wealth has declined by \$100 and C will fall by \$10



## If the Government Borrows

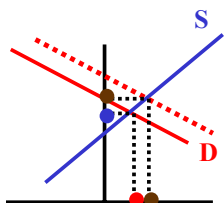
- The government

If taxpayers must pay the \$100 back, then their wealth has declined by \$100 and C will fall by \$10  
 In short the net demand for loans rises by  
 $\$90 = \$100 - \$10$   
 fall by \$10



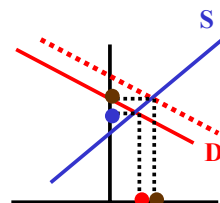
## If the Government Taxes

- The shift in the demand for loans is exactly the same. Interest rates rise and the BCA becomes even more negative.

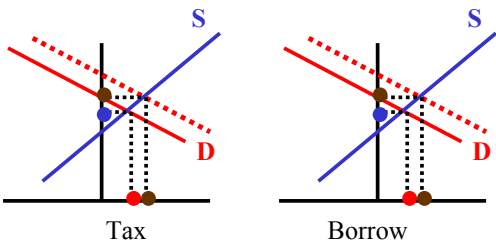


## If the Government Taxes

- The shift in the demand for loans is exactly the same. And, the changes are exactly the same as when the government borrowed



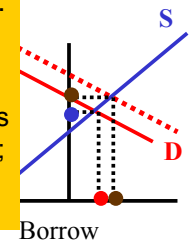
## So the Choice Is...



## So the Choice Is...

Ricardian Equivalence: (after David Ricardo)

The real tax is the spending. When the tax is collected does not matter; deficit financing is no big deal.



End

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