Topics for Today

1.) The Effects of Fiscal Policy

2.) Ricardian Equivalence

3.) Govt. Spending & the Current Acct.

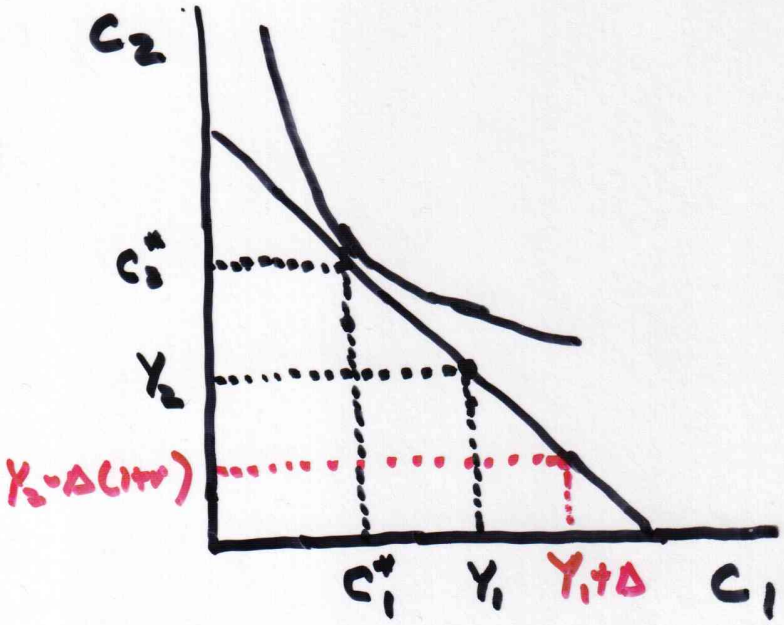
4.) Stochastic Infinite Horizon Models of the Current Acct. (Separate Slides)

The Effects of Fiscal Policy

- When studying the effects of fiscal policy it is useful to distinguish between the effects of government spending (i.e., changes in G), and the effects of how a given amount of spending is financed (i.e, changes in taxes)

- Under certain conditions, changes in the timing of taxes are irrelevant. This irrelevancy proposition is known as Ricardian Equivalence

- Suppose taxes decrease by Δ
  $\Rightarrow$ Future taxes must increase by $(1+r)\Delta$



The tax cut just shifts the household's (after-tax) endowment to the lower right. It doesn't change the budget constraint itself, and so therefore, doesn't change the household's choices.

Ricardian Equivalence

Ricardian Equiv. ≡ Government's Intertemporal Budget Constraint + Fisherian Model of Consumption

Govt. Intertemporal Budget

$$G_1 + \frac{G_2}{1+r} \equiv T_1 + \frac{T_2}{1+r}$$

Consumers Budget Constraint

$$C_1 + \frac{C_2}{1+r} \equiv Y_1 - T_1 + \frac{Y_2 - T_2}{1+r}$$

$$\equiv Y_1 + \frac{Y_2}{1+r} - \left(T_1 + \frac{T_2}{1+r}\right)$$

PV of Govt. spending

Note, $T_1 + \frac{T_2}{1+r}$ doesn't change unless govt. spending changes. Deficit financed tax cuts, which just re-arrange the timing of taxes, do not affect the consumer's budget constraint, and therefore, consumption.

Caveats to Ricardian Equivalence

1.) Myopia. Maybe households are too short-sighted to realize their taxes will be higher in the future.

2.) Selfishness. Maybe people don't care about what happens after they die.

3.) Imperfect Capital Markets. Maybe governments + households face different interest rates.

4.) Distorting Taxes.

Government Spending

- Unlike tax policy, changes in G definitely impact the household sector, since they influence the resources available to the private sector.

  $G\uparrow \Rightarrow$ Household wealth $\downarrow$

  $G\downarrow \Rightarrow$ Household wealth $\uparrow$

- We know that Fisherian/PIH households will spread out the effects of govt. spending. For example, an anticipated increase in future govt. spending will cause current household consumption to fall

- Consequently, when studying the effects of govt. spending on saving it is important to know whether the spending change is perceived to be temporary or permanent.

Examples

1.) $\Delta G_1 > 0$ $\quad \Delta G_2 = 0$

} Temporary Increase in Govt. Spending

$C_1 \downarrow$ (but not as much as $G_1 \uparrow$)

$\Rightarrow$ Current Aggregate Saving $\downarrow$

[i.e., $(Y - C - G) \downarrow$]

$\Rightarrow CA \downarrow$

2.) $\Delta G_1 = 0$ $\quad \Delta G_2 > 0$

} Anticipated Increase in Future Govt. Spending

$C_1 \downarrow$

$\Rightarrow$ Current Aggregate Saving $\uparrow$

$\Rightarrow CA \uparrow$

3.) $\Delta G_1 = \Delta G_2 > 0$

} Permanent Increase in Govt. Spending

$C_1 \downarrow$ by the same amount as $G_1 \uparrow$

$\Rightarrow$ No effect on Aggregate Saving

$\Rightarrow \Delta CA = 0$