Reading Homework 1: Fiscal Theory
Written answers due in Class, Tuesday April 16

Carefully read the following 2 papers and answer the associated questions. I will also ask you questions about them in lecture.

I. Baxter, Marianne, and Robert G. King, "Fiscal Policy in General Equilibrium," *American Economic Review*, **83** (1993), 315–334.

Questions about the Baxter-King (BK) model and results:

1. In the BK model, what is the direct effect of basic government purchases on the marginal utility of private consumption?
2. Comparing a temporary to a permanent increase in government spending (financed with lump sum taxes), which leads to the larger impact (i.e. year 0) effect on labor input? What is the economic reason?
3. Why do real wages fall in response to an increase in government spending?
4. In which case does an increase in basic government purchases lead to a greater rise in output, lump sum taxation or distortionary taxes? Explain the economics.
5. Much of today's policy debate is about "infrastructure spending." Does the Baxter-King model incorporate this type of spending? If so, how is it modeled?
6. Discuss the mechanisms by which government spending on public capital has different effects from basic government purchases.

II. Woodford, Michael. "Simple Analytics of the Government Expenditure Multiplier." *American Economic Journal: Macroeconomics* 3, no. 1 (2011): 1-35.

Questions about Woodford:

1. Comparing Woodford's neoclassical benchmark to Baxter-King's neoclassical model, what key variable omission allows Woodford to solve things analytically? Given what you know from Baxter-King, do you think that is an important omission?
2. How does the benchmark New Keynesian multiplier differ from the neoclassical multiplier?
3. What role does monetary policy play in the size of the multiplier?
4. What set of circumstances leads to the greatest multipliers?
5. How does the combination of the persistence of the zero lower bound state and the persistence of the government spending shock affect the size of the multiplier?