Practice Problems: Fiscal Policy and Deficits

Econ520. Spring 2016. Prof. Lutz Hendricks. April 19, 2016

Blanchard / Johnson, Macroeconomics, 6th ed., ch. 23

1 The government budget constraint

The budget constraint states: present value of taxes = present value of spending + initial debt. You should be able to explain what this implies:

1. why debt can grow without ever being repaid;
2. why stabilizing debt requires primary surpluses;
3. why changing the timing of tax collection does not affect its present value (which suggests Ricardian Equivalence may kick in);
4. why a current tax cut must be followed by a future tax increase or spending cut of equal present value.

2 Effects of public debt

1. Suppose the Euro Zone forgives a large chunk of Greek debt. How would this affect output, interest rates, investment, etc in the short run and medium run. Use an AS/AD diagram.

   A: We really should use an open economy model for this, but here is an approximation. The government can permanently cut taxes without cutting spending. This follows from the government budget constraint. Effectively, this is a fiscal expansion. AD shifts right. Short-run Y rises.

   What this analysis gets wrong: interest rates rise in response to a fiscal expansion, but not in response to debt forgiveness. What is missing is the increase in public saving associated with debt forgiveness.

2. How would the answer change if the debt forgiven was owned by domestic households rather than foreigners?

   A: Now we get an additional wealth effect, which reduces consumption. If Ricardian Equivalence holds, the net effect is 0! It's just putting money from one pocket into another.
