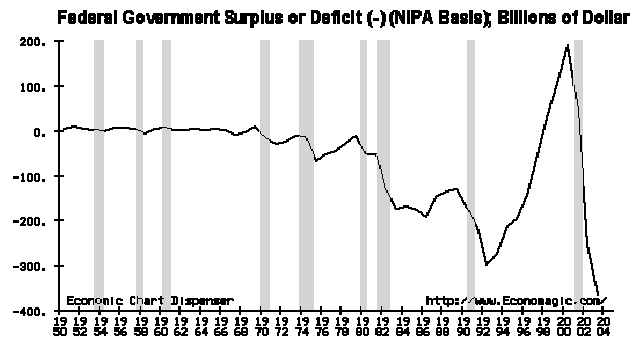


Budget deficits



Example contd

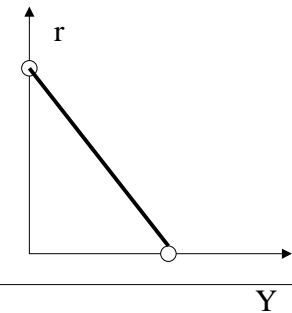
- $Y = 250 + 0.75(Y - 200) + 1000 - 50r + 200$

- $Y = 250 + 0.75Y - 50r + 1050$

- $r = (-0.25Y + 1300)/50$

$Y = 0, r = 1300/50$

$r = 0, Y =$



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Another example

- Suppose Y is fixed at 5000
- $C = 250 + 0.75(Y - T)$; $I = 1000 - 50r$
- $Y = C + I + G$
- $5000 = 250 + 0.75(Y - T) + 1000 - 50r + G$
- What effect does tax cut of 50 have on r and I ?

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Example contd

- Is budget balanced? If so, then replace G w/ T
- $5000 = 250 + 0.75(5000 - T) + 1000 - 50r + T \rightarrow [=G]$
- $r = 0.005 T$
- Higher T implies higher r ; higher r implies lower I ; tax cut (and spending cut) reduces r & raises I
- Cutting both spending and taxes

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Tax cut but no spending cut

- $C = 250 + 0.75 (Y - T)$; $I = 1000 - 50r$
- $5000 = 250 + 0.75 (Y - T) + 1000 - 50r + G$ [= 200]
- What effect does tax cut with no spending cut have on r and I ?
- say G stays fixed at 200 but T falls from 200 to 150 [budget not balanced any more]
- $r = 0.015Y - 0.015T - 71$
- Now raising taxes reduces r (raises I); opposite effect of previous example

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Yet another example

- $C = 250 + 0.75 (Y - T)$; $T = 200$
- $I = 1000 - 50r$
- r is fixed at 1.
- What happens to GDP when govt. spending increases but taxes do not?
- $Y = 250 + 0.75 (Y - 200) + 1000 - 50 + G$
- $Y = 1050/0.25 + G/0.25$
- As $G \uparrow$, $Y \uparrow$
- How responsive is changes in Y to changes in G ?

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