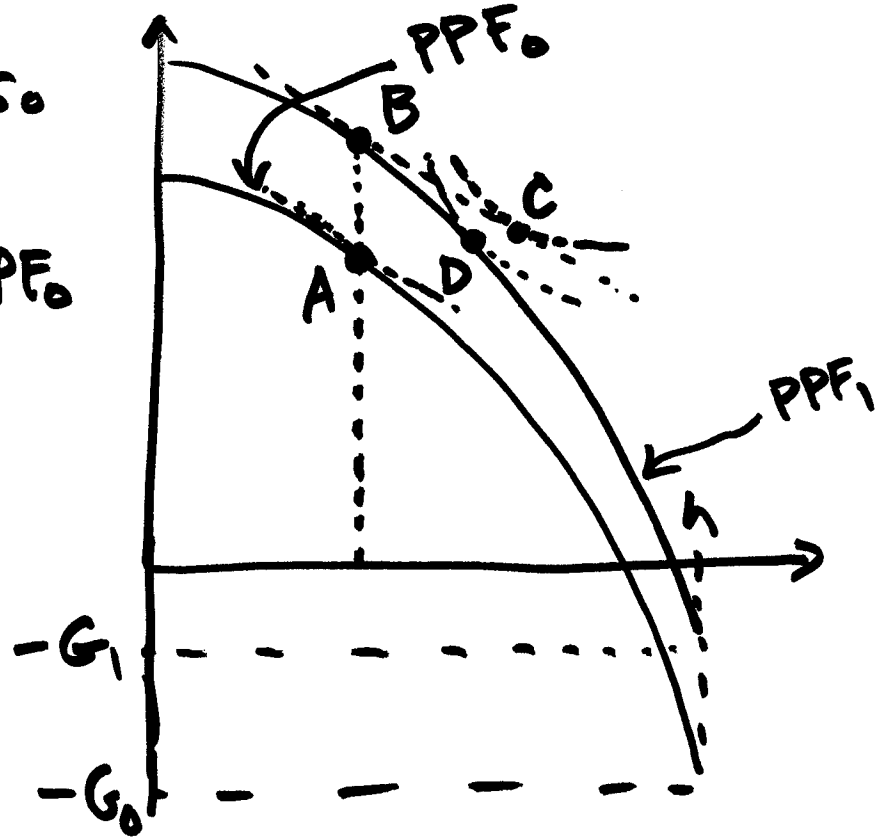


Quiz 4

1. Use the model we have developed in class (and in the book) to determine the effects of a reduction of (lump sum) taxes and an equal reduction of government spending. Use the model to help you predict the effects on output, consumption, employment, and the real wage. [Include an appropriate diagram along with your description.]

Start from pt A, (so there is an indiff curve tangent to PPF_0 at A). Faced w/ hypothetical budget line tangent to PPF_1 at B,



Consumer would choose more L and C than at B (due to normality of goods); i.e., some choice like C . Thus, optimum must be right of B (at D, say). We

have $Y_1 < Y_0, C_1 > C_0, N_1 < N_0,$
 $W_1 > W_0. [\downarrow Y, \uparrow C, \downarrow N, \uparrow W]$

2. Based on your answer to Question 1, do you think that the fluctuation of taxes over time is an important force driving business cycles? Support your answer.

This analysis tells us that, if G drove b-cycles, ^A
(or T)

① • G and T would be pro cyclical

② • C would be counter cyclical.

③ • N would be ~~counter~~ pro cyclical.

④ • W would be counter-cyclical.

① does not seem to fit the data, and ② and ④ are definitely wrong. This is not a good explanation for observed cycles.