Macroeconomics – problem set assignment

Economics

This effect is a movement along the production function in the downward direction, as seen in Figure 4(b). Tracing the change over to the aggregate output market shown in Figure 4(c), the aggregate supply curve shifts to the left for every r from Yell s to Y as . The labor market and the aggregate output market are linked via the firms production function. Figure 4: The Real International Model (a) The Labor Market (b) The Production Function (c) The Aggregate Goods Market Figure g: A Decrease in Lump-sum Taxes from TTL to TO be seen in the graph of the labor market in Figure 4(a).

A decrease in lump- consequence, the firm produces less output at fixed level ofBÏ 4 2 3) Next, we study the effect of such a tax decrease on the international consumption choice in isolation; therefore, use the " consumption today consumption tomorrow" diagram to illustrate the effects of a lump-sum tax decrease on the optimal consumption path, c and c . Make sure you illustrate income and substitution effects.

To make your life simple, assume that the government keeps government spending in both periods as before and borrows what it needs in such a way that taxes are not raised in the lifetime f the currently living consumers to pay off the debt. The government essentially rolls over this debt. (10) We now analyze the effect of the lump-sum tax cut on the international consumption choice in isolation. A permanent lump-sum tax cut raises a consumers net income both today (I. E. Y -?? T increases) and tomorrow (I. E. Y -?? T increases), thereby moving the consumer's endowment point from El to EH in Figure 5.

Clearly, a consumers lifetime wealth increases, and the distance between the new budget line and the old budget line is equal to the change in the lump-sum tax. Since r is unchanged by the lump-sum tax cut, there is no obstruction effect. The lump-sum tax cut creates a pure income effect, however, and the consumer responds by raising consumption in both periods. The effect of this tax cut is characterized by the movement from point A to point B in Figure 5. As the equilibrium level of consumption rises in both periods the indifference curve shifts out from II to 12 , resulting in a higher level of utility for the consumer.