Ch11

Analytical Problems

4. An increase in government purchases shifts the *IS* curve up and to the right and the *AD* curve up and to the right to return the economy to full employment, instead of waiting for the price level to fall to get there. The advantage of doing so, according to Keynesians, is that full employment is restored quickly, whereas if the price level must adjust, it may take a long time for full employment to be restored. In the short run, the fiscal expansion does not affect the real wage, since it is an efficiency wage. However, it increases employment and it increases current and future taxes to pay for the higher government spending. The effect on consumption is ambiguous, with the rise in output raising consumption, while the rise in taxes reduces consumption. In the long run, at full employment, the lasting effects of the fiscal expansion are to decrease consumption, because of the higher real interest rate and the higher taxes, with more of the economy's output devoted to government purchases and less to the private sector.

   Whether a program of fiscal stimulus in response to a recession is worthwhile depends on the benefits of the government purchases and on how long it takes the economy to return to a full-employment equilibrium by a change in the price level. The more beneficial are government purchases, the more likely such a program is to increase economic welfare. The longer the free market takes to restore equilibrium, the more likely such a program is to increase economic welfare.