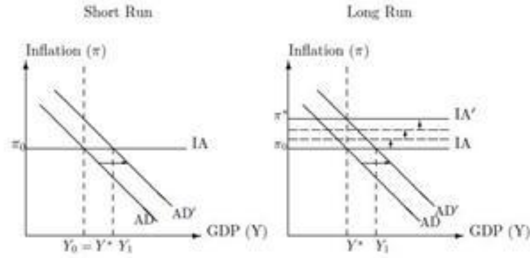
## II. EXPANSIONARY FISCAL POLICY

- For illustration purposes, we will first focus on the recent election year promise by George W. Bush to cut taxes.
- The first task is to look at what would happen to the economy as a result of the tax cut. For analytical ease we begin with an economy that is currently at potential output. The impact of the tax cut is to shift out the AD curve.
- The key to determining the intermediate and long run effects is the relationship between current output and potential output. Since the short run equilibrium is above potential output, inflation will rise,




- So the impact of expansionary fiscal policy is to raise output in the short run but will not have any effect on long run output and will only succeed in raising inflation in the long run.
- Note that the assumption that the economy was in steady state at the time that the tax cut was implemented is key to the analysis. If the economy had been in recession at the time of the tax cut (as in the case of the first tax cut) then the long-term impact would have been to stave off a recession and would have left inflation unchanged.