Deficit-financed fiscal policy and economic growth

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Abstract

In this paper, we develop an endogenous growth model with deficit-financed productive government spending and examine the effect of increasing income tax rate and cutting productive government spending by proposing a numerical example. The model can be reduced to a simple AK growth model by endogenizing fiscal stabilizing coefficient. In this model, labor supply equilibrates the economy, which affects the growth rate, the debt-to-GDP ratio, and the degree of fiscal discipline. We find that increasing tax rate and cutting productive government spending hinder economic growth and worsen the fiscal situation. The policy implication of this paper is that, if the primary balance is surplus, the government can be compatible with recovering economic growth and achieving fiscal consolidation by conducting active fiscal policy measure.

Keywords: Fiscal policy, National debt, Economic growth, Labor-leisure choice
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