Policy Implications of Sunspot Models

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Abstract

I develop a two-period and an infinite-period model of an one-sector increasing returns-to-scale economy with a government sector. From the two-period case the conclusions can be drawn, that a benevolent government may have an incentive to set taxes in such a way that indeterminacy is generated, although the taxes are not used in any useful manner. Furthermore, a time-consistency is likely to arise. In the infinite-period case, the government can prohibit indeterminacy with capital and labor income taxation, and has an incentive to do so in the case of a sole wage tax. If it can also pay subsidies, the outcome of the Ramsey problem is strongly advocated. This includes paying a subsidy to capital income, and leads to a stabilization of the economy with the used calibration.