Exercise 1

a. The tax on consumption will raise the effective price; it will now take \((1 + \tau_c)\) to purchase consumer goods. The household budget constraint can be written as:

\[(1 + \tau_c)C + \frac{1}{P}\Delta B + \Delta K = \frac{w}{P}L^L + \tau(B/P + K) + V - T\]

b. The tax on consumption reduces the effective opportunity cost of leisure in terms of current (and future) consumer goods. The labor supply would decrease by the substitution effect.

c. The reduction in the labor supply found in part b would reduce the marginal product of capital services, just as in the earlier case. Capacity utilization rates and real interest rates would fall.

d. This change introduces intertemporal substitution effects. Current consumption is less expensive than future consumption, so current consumption increases and real savings decreases. A tax on asset income would have a similar effect on real savings, because it would reduce the opportunity cost of current consumption.