Chapter 16 Fiscal Policy Answers

1. Fiscal policy includes decisions about:

a. taxes, banking regulations, and the money supply.
b. government spending, banking regulations, and the money supply.
c. taxes, government spending, and the money supply.
d. taxes, banking regulations, and government borrowing.
e. taxes, government spending, and government borrowing.

2. The goal of expansionary fiscal policy is to shift the ________ curve to the ________.

a. aggregate demand; left
b. aggregate demand; right
c. short-run aggregate supply; right
d. short-run aggregate supply; left
e. long-run aggregate supply; left

3. During which of the following situations would the government most likely have an expansionary fiscal policy?

a. When the volume of imports is unusually low.
b. When the economy is in the upswing phase of a business cycle.
c. When the inflation rate is running unusually high.
d. When the level of economic output is running unusually high.
e. When the unemployment rate is running unusually high.

4. Assume that the government is currently balancing the national budget so that outlays equal tax revenues. Then the economy slips into recession, and the government decides to increase government spending by $50 billion. The government must pay for this increased spending by borrowing; it must sell $50 billion worth of Treasury bonds. As a result, the federal budget will:

a. be in deficit by less than $50 billion.
b. be in surplus by at least $50 billion.
c. remain balanced.
d. be in surplus by $50 billion.
e. be in deficit by at least $50 billion.

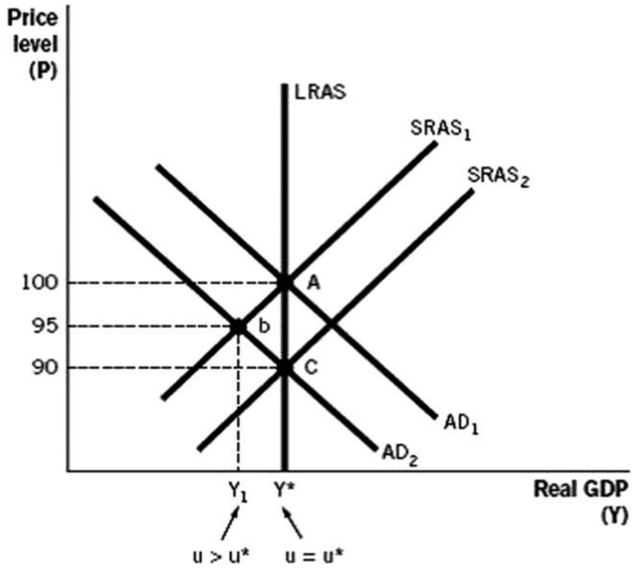
5. During recessionary periods, ________ generally increase(s) and ________ generally fall(s).

a. outlays; tax revenue
b. government borrowing; outlays
c. tax revenue; government borrowing
d. tax revenue; outlays
e. the inflation rate; outlays

6. During economic expansions, ________ generally increase(s) and ________ generally fall(s).

a. outlays; tax revenue
b. government borrowing; outlays
c. **tax revenue; government borrowing**
d. tax revenue; the inflation rate
e. the inflation rate; outlays

7. Which of the following would be the theoretical outcome of contractionary fiscal policy in the following aggregate demand–aggregate supply model, where LRAS is long-run aggregate supply, AD is aggregate demand, and SRAS is short-run aggregate supply?



a. **The AD curve would shift from AD_1 to AD_2.**
b. The SRAS curve would shift from $SRAS_2$ to $SRAS_1$.
c. The SRAS curve would shift from $SRAS_1$ to $SRAS_2$.
d. The AD curve would shift from AD_1 to AD_2 at the same time that the SRAS curve would shift from $SRAS_1$ to $SRAS_2$.
e. The AD curve would shift from AD_2 to AD_1.

8. If the economy, starting at full-employment output, begins to enter into an expansion, one would expect Congress and the President to institute a(n) ________ policy.

a. expansionary fiscal
b. expansionary monetary
c. **contractionary fiscal**
d. contractionary monetary
e. countercyclical monetary

9. The goal of a contractionary fiscal policy is to shift the ________ curve to the ________.

a. **aggregate demand; left**
b. aggregate demand; right
c. short-run aggregate supply; right
d. short-run aggregate supply; left
e. long-run aggregate supply; left

10. The Economic Stimulus Act of 2008 focused on ________, whereas the American Recovery and Reinvestment Act of 2009 focused on ________.

a. monetary policy; fiscal policy
b. fiscal policy; monetary policy
c. **taxes; government spending**
d. government spending; taxes
e. contractionary fiscal policy; expansionary fiscal policy

11. Assume that the government is currently balancing the national budget so that outlays equal tax revenues. Then the economy starts to expand, and the government decides to decrease government spending by $50 billion. As a result, the federal budget will:

a. be in deficit by at least $50 billion.
b. **be in surplus by at least $50 billion.**
c. remain balanced.
d. be in surplus by less than $50 billion.
e. be in deficit by at least $50 billion.

12. An increase in taxes or a decrease in spending during an economic expansion can:

a. increase the budget deficit but pay off some of the government debt.
b. **work to decrease the budget deficit and pay off some of the government debt.**
c. work to decrease the budget deficit but will not pay off any of the government debt.
d. increase the budget deficit and increase the size of the government debt.
e. work to decrease the budget deficit and increase the government debt.

13. A government might want to reduce aggregate demand if it believes that:

a. there has been a reduction in long-run aggregate supply.
b. there has been a reduction in short-run aggregate supply.
c. the current unemployment rate is above the natural rate.
d. **the current rate of economic growth will lead to higher inflation.**
e. the economy is currently producing below full-employment output.

14. Countercyclical fiscal policy attempts to:

a. prevent economies from falling into recession.
b. prevent economies from entering into expansion.
c. **minimize expansions and recessions in the business cycle.**
d. maximize expansions and minimize recessions in the business cycle.
e. maximize expansions and maximize recessions in the business cycle.

15. If the unemployment rate rises above the natural rate of unemployment:

a. **the government will want to impose an expansionary fiscal policy.**
b. the government will want to impose a contractionary fiscal policy.
c. the government will be able to collect additional tax revenues.
d. the Federal Reserve will want to impose a contractionary monetary policy.
e. there will be worries about rising inflation.

16. If the marginal propensity to consume is equal to 0.4, the spending multiplier is equal to ________.

a. 0.33
b. 0.40
c. 0.60
d. **1.67**
e. 2.50

17. With fiscal policy, an implementation lag typically happens because:

a. the central bank makes fiscal policy decisions only once a year.
b. it is difficult to determine when the economy is turning up or down.
c. **one or more governing bodies must approve government spending or new tax policies.**
d. it takes time for the complete effects of fiscal policy to materialize.
e. fiscal policy can only be changed by executive order.

18. Progressive tax rates, taxes on corporate profits, unemployment compensation, and welfare programs are all examples of what are called:

a. crowding-out factors.
b. **automatic stabilizers.**
c. discretionary constraints.
d. self-triggered balancers.
e. cyclical mechanisms.

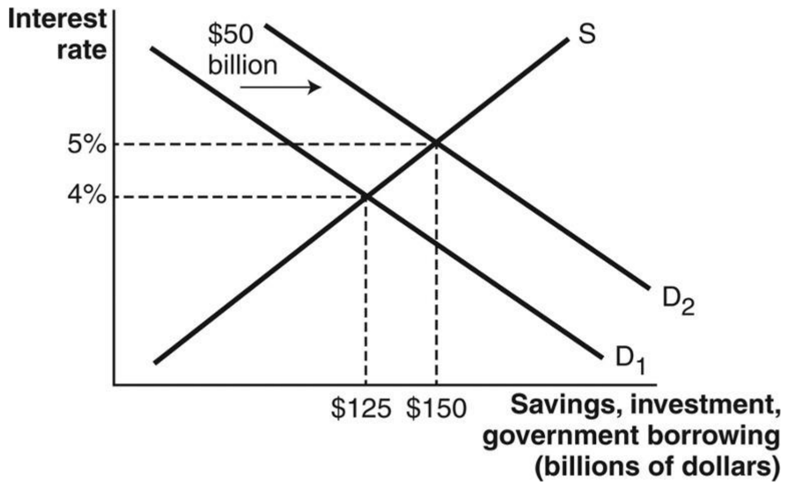
19. When the government borrows, the ________ loanable funds curve shifts to the right, causing the interest rate to ________, which causes private investment to ________.

a. **demand for; rise; fall**
b. demand for; fall; rise
c. supply of; rise; fall
d. supply of; fall; rise
e. demand for; rise; rise

20. If lags cause the effects of fiscal policy to be delayed for a long period of time:

a. the policy will magnify recessions and eliminate expansion.
b. there is no way the policy can smooth out the business cycle.
c. the policy will magnify expansions and eliminate recessions.
d. fiscal policy will do nothing to the economy.
e. **there is a risk that the policy can actually magnify fluctuations in the business cycle.**

Refer to the following graph to answer the next question.



21. According to the graph, the amount of private savings after government borrowing shifts the demand for loanable funds is:

a. $25 billion.
b. $50 billion.
c. $150 billion.
d. $175 billion.
e. $200 billion.

22. Which of the following is an example of an action where crowding-out could occur?

a. The government invests in education, shifting the long-run aggregate supply curve to the right.
b. The government lowers taxes, but spending does not increase.
c. The government increases spending but does not increase taxes, and the size of the deficit increases.
d. The government adopts a balanced budget amendment.
e. The government pays $2 million to workers who have lost their jobs in the form of unemployment compensation.

23. Supply-side fiscal policy explains how taxes and government spending can affect:

a. aggregate demand.
b. short-run aggregate supply.
c. long-run aggregate supply.
d. the demand for loanable funds.
e. the supply for loanable funds.

24. Supply-side fiscal policy will lead to a(n):

a. outward rotation of the long-run aggregate supply curve.
b. rightward shift of the aggregate demand curve.
c. rightward shift of the long-run aggregate supply curve.
d. inward rotation of the long-run aggregate supply curve.
e. leftward shift of the long-run aggregate supply curve.

25. Policies that focus on education usually:

a. come at the expense of private spending on education and so reduce aggregate supply over time.
b. involve tax cuts and so increase short-run aggregate supply.
c. involve large-scale government spending and so increase aggregate demand.
d. involve large-scale cuts in government spending and so decrease aggregate demand.
e. increase effective labor resources and thus increase aggregate supply over time.

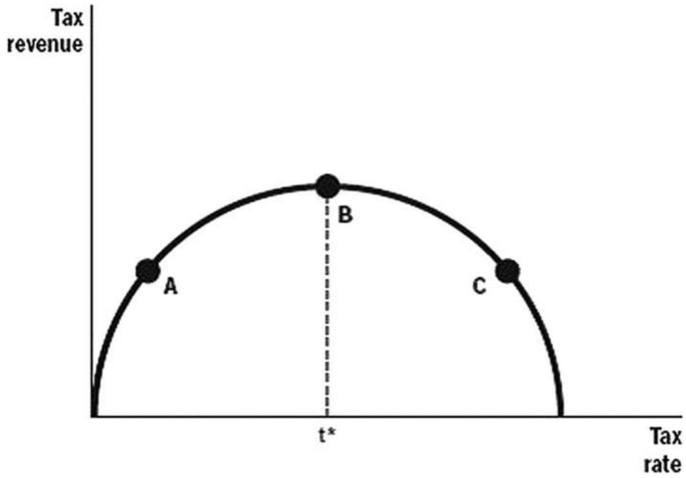
26. One argument for tax cuts when the government is running a budget deficit is that lower:

a. tax revenue will reduce the budget deficit.
b. marginal tax rates will incentivize employers to hire more workers.
c. corporate tax rates will incentivize people to work and thus increase the overall tax revenue.
d. marginal tax rates will incentivize people to work and thus increase the overall tax revenue.
e. marginal tax rates will decrease aggregate supply.

27. The Laffer curve is an illustration of the relationship between:

a. monetary policy and fiscal policy.
b. the price level and real output.
c. tax rates and tax revenues.
d. government spending and taxes.
e. nominal and real GDP over time.

Refer to the following graph to answer the next question.



28. Which point(s) would see tax revenues increase if the tax rate increased?

a. Only A
b. Only B
c. A and B
d. A and C
e. B and C

29. Which point(s) would see tax revenues decrease if the tax rate increased?

a. Only A
b. Only B
c. A and B
d. A and C
e. B and C

30. During a recession, the government's tax revenues tend to ________, its budget deficit tends to ________, and the level of the national debt tends to ________.

a. decrease; decrease; increase
b. decrease; increase; increase
c. decrease; increase; decrease
d. increase; increase; decrease
e. increase; decrease; increase

31. During a recession, consumption falls, causing the aggregate demand curve to shift to the ________. In response, the government can increase government spending to shift the ________.

a. left; aggregate demand (AD) curve to the right
b. left; short-run aggregate supply (SRAS) curve to the right
c. right; AD curve to the left
d. right; SRAS curve to the right
e. left; long-run aggregate supply (LRAS) curve to the right

32. Country X is in the midst of a recession. If the government pursues expansionary fiscal policy, then, in the long run, the price level will ________. If it does not pursue expansionary fiscal policy, then, in the long run, the price level will ________.

a. decrease; decrease
b. increase; decrease
c. increase; increase
d. decrease; remain unchanged
e. remain unchanged; increase

33. Country X is in the midst of a recession. The government is likely to pursue a(n) ________ fiscal policy to shift the ________.

a. expansionary; long-run aggregate supply (LRAS) curve to the right
b. expansionary; short-run aggregate supply (SRAS) curve to the right
c. expansionary; aggregate demand (AD) curve to the right
d. contractionary; AD curve to the right
e. contractionary; SRAS curve to the right

34. Country Y is in the midst of an expansion. If the government wants actual output to equal potential output, then the government should pursue a(n) ________ fiscal policy and shift the ________ curve.

a. expansionary; aggregate demand (AD)
b. contractionary; long-run aggregate supply (LRAS)
c. contractionary; short-run aggregate supply (SRAS)
d. contractionary; AD
e. expansionary; SRAS

35. An economy's full-employment output is equal to $252 billion, and its current output is equal to $255 billion. To return the economy to long-run equilibrium, the government should:

a. increase spending by $3 billion.
b. decrease spending by $3 billion.
c. increase spending by more than $3 billion.
d. increase spending by less than $3 billion.
e. <u>decrease spending by less than $3 billion.</u>

36. If people decide to save a smaller percentage of their incomes, then the value of the spending multiplier will ________ and changes in government spending will have ________ impact on gross domestic product.

a. decrease; a larger
b. decrease; a smaller
c. <u>increase; a larger</u>
d. increase; a larger
e. not change; the same

37. Suppose that people decide to save 40% of each additional dollar of their income. The value of the marginal propensity to consume is ________ and the value of the spending multiplier is ________.

a. 0.4; 4
b. 0.4; 5
c. 0.6; 1.25
d. 0.6; 2
e. <u>0.6; 2.5</u>

38. Suppose the marginal propensity to consume is equal to 0.4. If the government lowers tax rates and tax revenue falls by $50 billion, then disposable income will increase by________ billion and consumption spending will initially increase by ________ billion (before the multiplier effect kicks in).

a. $50; $30
b. <u>$50; $20</u>
c. $30; $20
d. $20; $30
e. $30; $50

39. The government decides to strengthen the federal unemployment benefit package by increasing the average monthly payment. In the future, as a result, recessions are likely to be ________ and expansions are likely to be ________.

a. less severe; more expansionary
b. more severe; less expansionary
c. more severe; more expansionary
d. <u>less severe; less expansionary</u>
e. about the same; about the same

40. Countercyclical fiscal policy involves changing government spending to shift the ________ curve, whereas supply-side fiscal policy involves changing government spending to shift the ________ curve.

a. aggregate demand (AD); short-run aggregate supply (SRAS)
b. long-run aggregate supply (LRAS); AD
c. AD; AD
d. AD; LRAS
e. LRAS; LRAS

41. If time lags cause the effects of fiscal policy to be delayed for a year or more, there is a risk that:

a. the policy will have no effect at all.
b. the effect will be delayed by much longer, up to a decade.
c. a policy meant to be expansionary will have contractionary effects, and vice versa.
d. a policy meant to benefit the domestic economy will mainly benefit foreign economies.
e. a policy meant to lessen the extremes of the business cycle will instead magnify them.

42. The aggregate demand–aggregate supply model shows that there is no need for government intervention to encourage the economy to move back toward full-employment output. Why then do we see active fiscal policy almost every time the economy is not experiencing full-employment output?

Answer: The aggregate demand–aggregate supply model shows that the economy can move itself back to full employment in the long run when all prices adjust. We may want to adjust fiscal policy because this self-adjustment process can take a very long time. The purpose of fiscal policy is not to eliminate recessions but to try to limit the length and severity of the recessions.

43. What are the two ways to conduct typical fiscal policy, and how do these policies affect the components of aggregate demand?

Answer: The two ways to conduct typical fiscal policy are by changing government spending and by changing taxes. An increase or decrease in government spending will directly influence aggregate demand because government spending is one of the components of aggregate demand. An increase in taxes will decrease consumption (if the tax increase targets individuals) or investment (if the tax decrease targets firms).

44. Tie fiscal policy initiatives to budget deficits and surpluses.

Answer: The government budget is represented as the difference between tax revenue and government spending. Expansionary fiscal policy inevitably leads to increases in budget deficits (by increasing government spending and/or lowering taxes) and the national debt during economic downturns. In contrast, contractionary fiscal policy leads to decreases in the budget deficit (by decreasing government spending and/or raising taxes), and, if continued long enough, a contractionary policy can lead to budget surpluses.

45. You have just been chosen as an advisor to the President. After years of constant growth, the U.S. economy is beginning to fall into a recession. What type of fiscal policy

will you suggest to the President, and why?

Answer: You should recommend an expansionary fiscal policy to the President. Expansionary fiscal policy, defined as an increase in government spending or decrease in taxes, is intended to increase overall production in the economy and, in turn, increase overall income. By implementing an expansionary fiscal policy, the effects of a recession can, in theory, be limited.

46. If the marginal propensity to consume (MPC) equals 0.7 and government spending increases by $300 billion, what is the total impact on spending in the economy?

Answer: The total impact on spending would be $1 trillion, calculated by first finding the spending multiplier according to the equation: 1/(1 - MPC). When MPC = 0.7, the spending multiplier is 1/(1 – 0.7) = 3.33. When we multiply this answer by the initial spending of $300 billion, we find the total impact on spending to be $1,000 billion, or $1 trillion.

47. Assume the economy is in short-run equilibrium and there is less than full-employment output. Also assume that the marginal propensity to consume (MPC) is equal to 0.45.

A) What is the value of the government spending multiplier in this case?

Answer: The government spending multiplier in this case is 20/11, or about 1.82. It is calculated as ms = 1/(1 - MPC), which here becomes 1/(1 - 0.45) = 1/0.55 = 20/11.

B) Given the size of the multiplier, what would be the implied change in income (gross domestic product) from a government stimulus spending package of $440 billion?

Answer: The implied change in income from this stimulus spending would be (20/11) × $440 billion = $800 billion.

48. Your friend, who is not an economist, tells you that he heard in the media that "the government can safely increase spending and decrease taxes to avoid recessions." As an economist, how would you respond to this?

Answer: The government does have tools it can use to attempt to limit the effects of a recession, but by no means can it safely evade recessions. Fiscal policy, when used correctly, can limit the effects of both recessions and expansions. However, there are many shortcomings of fiscal policy, including time lags, crowding-out, and savings shifts.

49. Give two examples of automatic stabilizers and explain why they are an important component of fiscal policy.

Answer: Examples of automatic stabilizers include progressive income tax rates, taxes on corporate profits, unemployment compensation, and welfare programs. Automatic stabilizers are important components of fiscal policy because automatic stabilizers limit the adverse effects of the recognition lag and implementation lag when it comes to fiscal policy. Because automatic stabilizers automatically kick in when the economy hits a recessionary or expansionary period (i.e., they do not need to be voted on and approved every time), they help control these lags.

50. Give two examples of fiscal policy initiatives that focus on the supply side of the economy and discuss what these initiatives do to the aggregate demand–aggregate supply model.

Answer: Research and development tax credits, policies that focus on education, lower corporate profit tax rates, and lower marginal income tax rates are all examples of fiscal policy initiatives that focus on the supply side of the economy. In theory, these initiatives will shift the long-run aggregate supply (LRAS) curve to the right, increasing the full-employment output because these initiatives increase the incentive for production activities and attempt to increase labor productivity.