

Quiz essay questions economics

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Sh Give a brief definition of fiscal policy? What are its economic goals? What is the Council of Economic Advisers? 3 “ The Employment Act of 1946 is no more than a vague and ill-defined commitment by the Federal government to assist in the achievement of full employment. ” Do you agree? Explain.

Explain the effect of a discretionary cut in taxes of \$40 billion on the economy when the economy’s marginal propensity to consume is

By how much is output likely to expand if the economy is operating in the horizontal range of its aggregate supply curve and there are no complications to this fiscal policy? How does this discretionary fiscal policy differ from a discretionary increase in government spending of \$40 billion? 5.

Explain the effect of a discretionary increase in government spending of \$50 billion on the economy when the economy’s marginal propensity to consume is . 75. By how much is output likely to expand if the economy is operating in the horizontal range of its aggregate supply curve and there are no complications to this fiscal policy? . Explain the aspects of expansionary and contractionary fiscal policy. During which phases of the business cycle would each be appropriate? Differentiate between discretionary fiscal policy and nondiscretionary or built-in stabilization policy. Describe two ways the Federal government can finance a deficit and explain which would have the more expansionary effect. Describe two ways the Federal government could retire debt in the event of a budget surplus and explain which would have the most contractionary impact. What is the anti-inflationary or contractionary effect of a budget surplus?

Explain how a small budget surplus could actually be somewhat expansionary rather than contractionary. 197 Chapter 12 New 12. Comment

on the statement: “ Increasing government spending is preferred to a cut in taxes when the U. S. government seeks to fight a recession. ” 13. Explain what is meant by a built-in stabilizer and give two examples. “ The more progressive a tax system, the greater is the economy’s built-in stability. ” Explain this statement for both recessionary and peak phases of the business cycle. 15. Explain how the below graph illustrates the built-in stability of a progressive tax structure. In Year 1, the full-employment budget showed a deficit of about \$100 billion and the actual budget showed a deficit of \$150 billion one year. In Year 2, the full employment budget showed a deficit of about \$125 billion and the actual budget showed a deficit of \$150 billion. Based on these data, what can be concluded about the direction of fiscal policy? 17. What is the difference between the actual deficit, the full-employment deficit, and the cyclical deficit? 18. What does the “ full-employment budget” measure and of what significance is this concept?

Complete the table below by stating whether the direction of discretionary fiscal policy was contractionary (C), expansionary (E), or neither (N), given the hypothetical budget data for an economy. . In what fundamental way do the spending-taxation decisions of government differ from the consumption-saving plans of households?

Why is this difference significant? New 21. Comment on the statement: “ Discretionary fiscal policy offers an ideal approach to dealing with the nation’s economic problems. It is without problems, criticisms, or complications. ” New 22. Explain the six problems, criticisms, or complications that arise in the implementation of fiscal policy. New 23. Explain the problems giving rise to this statement: “ You would think the

government would want to do something to improve economic conditions when the economy is in trouble, but the government is slow to act. New 24. How do expectations about the future by households and businesses affect the effectiveness of fiscal policy? Cite examples. 25. “ If economic forecasting was a more exact science, the business cycle could be entirely corrected by fiscal measures. ” Do you agree? 26. Explain the crowding-out effect. 27. Using the below graph, illustrate the possible impact of a crowding-out effect of a fiscal policy by drawing in the relevant aggregate demand shifts. Label and explain any shifts in the demand curve shown. 199 Chapter 12 28.

Explain how the net-export effect would reduce the effectiveness of fiscal policy. New 29. What fiscal policy is most likely to be invoked during a period of recession and high unemployment? A period of rapid inflation? What political, investment, and international problems might the U. S. Congress encounter in enacting these policies and putting them into effect? 30. (Last Word) What is the purpose of the Conference Board’s index of leading economic indicators? 31. (Last Word) Why is the index of leading economic indicators a composite index of ten economic statistics and not just one? 00 Fiscal Policy B. Answers to Short-Answer, Essays, and Problems 1. Give a brief definition of fiscal policy? What are its economic goals? Fiscal policy is the use of the federal budget to achieve full employment, control inflation, and stimulate economic growth. The changes to the federal budget can be made through increases or decreases in government spending or through increases or decreases in tax revenues. What is the Council of Economic Advisers?

The Council of Economic Advisors is responsible for assisting and advising the president on economic affairs. One of its principal responsibilities is to prepare an annual report for the president that is submitted to Congress that describes the state of the economy and recommends economic policies to achieve full employment, control inflation, and encourage economic growth. . “ The Employment Act of 1946 is no more than a vague and ill-defined commitment by the Federal government to assist in the achievement of full employment. Do you agree? Explain. To agree with this statement does not diminish the importance of the Employment Act of 1946. The Constitution has also been called vague and ill-defined, but that does not diminish its importance. This act committed the Federal government to following policies which would attempt to stabilize prices and promote full employment and established the CEA and JEC to assist in this task. While specific policies were not outlined, the intention of the act is clear it is a responsibility of the Federal government to assist in this effort.

That had not been an explicit on-going policy before 1946. Explain the effect of a discretionary cut in taxes of \$40 billion on the economy when the economy's marginal propensity to consume is . 75. By how much is output likely to expand if the economy is operating in the horizontal range of its aggregate supply curve and there are no complications to this fiscal policy? How does this discretionary fiscal policy differ from a discretionary increase in government spending of \$40 billion? If MPC is . 75, the multiplier is 4.

A tax cut of \$40 billion will result in initial increase in consumption of \$30 billion ($. 75 \times \40 billion). This initial increase in spending will ultimately result in an increase in consumption spending of \$120 billion because of the

multiplier process. In contrast, an initial increase in government spending of \$40 billion will ultimately increase consumer spending by \$160 billion ($4 \times \40) because none of the initial increase is siphoned off as savings as would be the case with a \$40 billion tax cut.

Explain the effect of a discretionary increase in government spending of \$50 billion on the economy when the economy's marginal propensity to consume is .75. By how much is output likely to expand if the economy is operating in the horizontal range of its aggregate supply curve and there are no complications to this fiscal policy? If MPC is .75, the multiplier is 4. An initial increase of \$50 billion government spending will result in a total increase in output of \$200 billion. Explain the aspects of expansionary and contractionary fiscal policy.

During which phases of the business cycle would each be appropriate? 201 Chapter 12 Expansionary fiscal policy refers to increases in government spending or decreases in taxes or both, so that the net effect on aggregate demand is an increase in net government spending. Contractionary fiscal policy is the opposite: an increase in taxes or decrease in government spending or both, so that the net effect on aggregate demand is a decrease in net government spending. Expansionary policy would most likely be used during a recession (or trough) phase.

A contractionary policy would most likely be employed near the peak of the business cycle as the economy reaches full-employment GDP and the potential for inflation accelerates. Differentiate between discretionary fiscal policy and nondiscretionary or built-in stabilization policy. Discretionary fiscal policy is the deliberate manipulation of taxes and government spending by <https://assignbuster.com/quiz-essay-questions-economics/>

the Congress to alter real domestic output and employment, to control inflation, and to stimulate economic growth during a particular period of time.

Nondiscretionary fiscal policy, on the other hand, is the change in government expenditures or taxes which occurs automatically as a result of existing laws. In particular, personal income taxes have progressive rates and will slow spending and inflation as GDP expands; when GDP declines, taxes will decrease by a more than proportionate amount allowing incomes and spending to decline at a slower rate than GDP. There are also many transfer payment programs which become effective when incomes decline or unemployment occurs to reduce the decline in disposable income.

Conversely, these programs automatically are reduced when the economy expands and unemployment declines and spending increases. Describe two ways the Federal government can finance a deficit and explain which would have the more expansionary effect. The government can borrow money from the private sector in which case it will be competing with private business borrowers for funds. If planned investment spending is "crowded out," the impact of expansionary deficits will be offset by the decline in investment spending.

The government can also finance a deficit by issuing new money which essentially means that the Federal Reserve has financed the deficit. This type of financing would be more expansionary than borrowing from the private sector. Describe two ways the Federal government could retire debt in the event of a budget surplus and explain which would have the most contractionary impact. The government could use a budget surplus to pay off

existing debt which would “ recycle” funds back into the economy and potentially offset the decline in government spending.

Alternatively, the government could impound the surplus funds, or allow them to stand idle, which means these funds are not injected into the economy and would have a more contractionary effect than the first alternative. What is the anti-inflationary or contractionary effect of a budget surplus? The anti-inflation effect of a budget surplus depends on what the government does with the surplus. The budget surpluses may be used for debt reduction. In this case, bonds 202 Fiscal Policy are bought back by the government and money is pumped back into the economy.

Interest rate will tend to fall, and this may increase consumer and investment spending, thus offsetting some of the contractionary effect of the budget surplus. The government may also impound funds (not spend them). This action will be more contractionary because it actually removes spending from the economy that would have been spent otherwise. Explain how a small budget surplus could actually be somewhat expansionary rather than contractionary. This could be the unlikely result of what the government decides to do with the surplus.

If it is used to retire existing debt, then the surplus is pumped right back into the economy and with the multiplier effect this additional liquid wealth in the hands of individuals could lead to an increase in aggregate demand and GDP.. Comment on the statement: “ Increasing government spending is preferred to a cut in taxes when the U. S. government seeks to fight a recession. ” The statement is a normative one. Either action, increased

government spending or taxation, can be used to fight a recession. The policy choice will depend on the preferences of the individual.

Those individuals who want to fight a recession with an increase in government spending may want to preserve the size of government in the economy and have specific government programs they would like to see funded. Those individuals who prefer a tax cut may want to reduce the size of government and give people more money and the freedom to spend it as they choose. Explain what is meant by a built-in stabilizer and give two examples. Built-in stabilizers are changes in tax revenues or government spending which occur automatically during different phases of the business cycle.

For example, the progressive income tax will dampen any expansion of aggregate demand in the recovery peak phases; and will dampen any decline in income and aggregate demand during a recession as taxes are automatically reduced by a greater proportion than the decline in personal income. There are also government spending programs which increase during recessionary periods automatically as incomes decline or are lost. The so-called "safety net" programs include unemployment compensation, welfare programs, and food stamp spending.

These spending programs are automatically reduced during a recovery peak phase which would dampen aggregate demand and inflationary pressures automatically." The more progressive a tax system, the greater is the economy's built-in stability. " Explain this statement for both recessionary and peak phases of the business cycle. A progressive tax would take a progressively greater proportion of rising incomes during the peak phase of

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the business cycle which means it would dampen spending increases and aggregate demand which, in turn, reduces inflationary pressures.

On the other hand, a progressive tax would take proportionately less away from declining incomes during a recessionary phase allowing disposable income to fall less rapidly than real GDP. Therefore, aggregate demand would decline less rapidly than GDP and the magnitude of the spending decline that might occur in the absence of the tax would be reduced.

Chapter 12 15. Explain how the below graph illustrates the built-in stability of a progressive tax structure. The graph illustrates how net taxes are negative as GDP declines which will add to aggregate demand.

When GDP expands, tax revenues increase which dampens aggregate demand. In Year 1, the full-employment budget showed a deficit of about \$100 billion and the actual budget showed a deficit of \$150 billion one year. In Year 2, the full employment budget showed a deficit of about \$125 billion and the actual budget showed a deficit of \$150 billion. Based on these data, what can be concluded about the direction of fiscal policy? Fiscal policy was expansionary because the full-employment budget deficit increased from one year to the next.

The actual deficit is composed of the full-employment portion and the cyclical portion. The full-employment portion of the actual budget deficit rose from \$100 to \$125 billion. The cyclical portion is determined by taking the actual deficit and subtracting the full-employment portion from it. The cyclical portion of the actual deficit fell from \$50 billion to \$25 billion. The actual budget deficit did not change, but it does not provide a good indication of the direction of fiscal policy. Only the full-employment budget tells the direction

of fiscal policy. What is the difference between the actual deficit, the full-employment deficit, and the cyclical deficit? The actual budget deficit for any year consists of the full-employment and the cyclical deficit. The full-employment deficit is the difference between government expenditures and tax collections which would occur if there were full employment output. The cyclical deficit is the portion of the actual deficit that arises because the economy is in recession and is produced by this downturn in the business cycle.

During a recession, a cyclical deficit often occurs because tax revenues fall as incomes fall and government expenditures increase as more is spent for government transfer payments and other programs. The cyclical deficit occurs because of the operation of these automatic stabilizers. What does the “ full-employment budget” measure and of what significance is this concept? The full-employment budget refers to the budget deficit or surplus that would result with existing tax and spending programs if the economy were operating at full-employment.

In other words, tax revenues and government spending are estimated at the level that would result if full employment existed. 204 Fiscal Policy Some economists believe that the full-employment budgetary deficit or surplus is what should determine the expansionary or contractionary nature of fiscal policy rather than the actual budgetary deficit or surplus. If the full-employment budget is not in deficit, then expansionary fiscal policy is not being followed according to this view even if the actual budget is in deficit. text: Complete the table below by stating whether the direction of

discretionary fiscal policy was contractionary (C), expansionary (E), or neither (N), given the hypothetical budget data for an economy.

In what fundamental way do the spending-taxation decisions of government differ from the consumption-saving plans of households? Why is this difference significant? The spending-taxation decisions of government are made in a political environment in which the majority must be satisfied, or satisfied enough to continue to vote for its elected representatives. Furthermore, since the government does not have a limited life and always has the ability to tax, deficit-spending and debt do not have the same significance to governments that they do to individual households.

Households face a much more uncertain future with regard to their power to raise revenue (income) and therefore must plan their spending and saving to coincide with their lifetime earnings expectations. The difference is significant because so many people try to draw an analogy between government spending policies and household spending plans when it is usually not appropriate to do so.

Comment on the statement: “ Discretionary fiscal policy offers an ideal approach to dealing with the nation’s economic problems. It is without problems, criticisms, or complications. Discretionary fiscal policy does offer government policymakers potential tools (changing taxes or government spending) to use for stimulating the economy during a recession or for contracting the economy during a period of high inflation. Fiscal policy, however, is not without its problems, criticisms, or complications. First, there are timing problems in getting it implemented at the right time so it will be effective. Second, there are political problems in getting it accepted because

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it takes time to get the actions passed through Congress and signed by the President.

Third, there are expectations problems because policies may be reversed in the future. Fourth, the taxing and spending decisions of the Federal government may be partially offset by the taxing and spending decisions of state and local governments. Fifth, some economists are concerned that expansionary fiscal policy that requires the Federal government to borrow money will raise interest rates and crowd out investment spending, thus reducing 205 Chapter 12 the expansionary effect of the fiscal policy. Sixth, there are complications arising from the connection of the domestic economy to the world economy.

Aggregate demand shocks from abroad or a net export effect may increase or decrease the effectiveness of a given fiscal policy Explain the six problems, criticisms, or complications that arise in the implementation of fiscal policy. First there is a timing problem. Three lags are identified under the “ timing problem” category. There is a lag in recognizing the phase of the business cycle; there is an administrative lag in deciding which policies to follow; there is an operational lag in terms of the impact of the policy once it is implemented.

Second, there are political considerations in the adoption of fiscal policy. There is some evidence of a political business cycle where particular expansionary policies are followed in election years whether or not economic conditions merit them. Third, there is an expectations complication. If businesses and households expect that the fiscal policy will be reversed in

the future, they may not change their behavior in the way that would be expected if the fiscal policy was permanent.

Fourth, the taxing and spending decisions of state and local governments may counteract or reduce the effectiveness of fiscal policy decisions at the federal level. The U. S. government may enact an expansionary fiscal policy by increasing its budget deficit, but state and local governments often have to balance a budget and economic conditions may force them to adopt a contractionary policy that partially offset what the federal government is seeking to achieve.

Fifth, there is concern about possible offsetting effects of government borrowing crowding out private spending that would occur in the absence of the government deficit; and an offsetting net export effect which partly counteracts expansionary policy or contractionary policy. Sixth, there are complications to domestic fiscal policy from the national economy's connection to the world economy. Economic shock from abroad can have an effect on the nation's imports and exports. The net export effect can reduce the intended effects of fiscal policy. New 23. Explain the problems giving rise to this statement: " You would think the government would want to do something to improve economic conditions when the economy is in trouble, but the government is slow to act. " Fiscal policy is subject to timing problems. There are three timing lags that limit the speed with which fiscal policy can be enacted and effective. First, there is a lag in recognizing the phase of the business cycle to determine when the government might want to provide help.

Second, there is an administrative lag in decision-making that involves deciding which specific policies should be adopted. Third, there is an operational lag because the adoption of policies takes time to have an effect on output and employment. How do expectations about the future by households and businesses affect the effectiveness of fiscal policy? Cite examples. If households or businesses expect that the fiscal policy changes are only temporary, they may not change their behavior in the expected way.

For example, if tax cuts are enacted to stimulate consumer spending, some consumers may not change their 206 Fiscal Policy spending habits if they think the tax change is only temporary. In the future, they will have to pay more in taxes, so they might increase their saving. Similarly, businesses may not invest in new plants and equipment if they get a tax cut, if they expect taxes in the future to rise or the fiscal policy to be ineffective. “ If economic forecasting was a more exact science, the business cycle could be entirely corrected by fiscal measures. Do you agree? Exact forecasting, if possible, would still not solve all of the problems encountered in trying to correct the business cycle. There is also the problem of timing the enactment and application of fiscal policy, not to mention the coordination of monetary policy and international economic policies, or reduced private spending (“ crowding out”). Explain the crowding-out effect. The crowding-out effect is the notion that government borrowing to finance a deficit may crowd out or reduce private borrowing.

To the extent that this occurs, the expansionary impact of fiscal policy is reduced because increased demand by the government is partially offset by

reduced demand in private investment. Using the below graph, illustrate the possible impact of a crowding-out effect of a fiscal policy by drawing in the relevant aggregate demand shifts. Label and explain any shifts in the demand curve shown. Expansionary fiscal policy increases demand from AD1 to AD2, but this crowds out some private investment spending that offsets the increase to some extent causing AD2 to decrease to AD3.

See graph below. Explain how the net-export effect would reduce the effectiveness of fiscal policy. 207 Chapter 12 If an expansionary fiscal policy brings with it higher interest rates, this could increase the demand for American dollars by foreign investors seeking to earn the higher U. S. returns. This appreciation of the dollar makes U. S. goods and services more expensive to foreigners and foreign imports less expensive to Americans. The net export category of aggregate demand will be reduced which would reduce the impact of expansionary fiscal policy. A contractionary fiscal policy could have the opposite effect causing net exports to increase that again reduces the desired effect of the contractionary fiscal policy. What fiscal policy is most likely to be invoked during a period of recession and high unemployment? A period of rapid inflation? What political, investment, and international problems might the U. S. Congress encounter in enacting these policies and putting them into effect?

During recession and high unemployment, the government would most likely initiate an expansionary fiscal policy. A contractionary fiscal policy would most likely be called for during a period of rapid inflation, especially if it seems to be demand-pull inflation. Several problems are likely to arise in enacting either of these policies. Timing lags in recognition, implementation,

and impact are one concern. Another has to do with political realities. A contractionary policy has many unpopular aspects to it because it calls for raising taxes and for cutting government spending.

There are also unique problems associated with expansionary policy: crowding out is one potential result that would reduce the expansionary effect of the policy. In both cases, the net-export part of aggregate demand is likely to move in a direction that would tend to offset the policy. (Last Word) What is the purpose of the Conference Board's index of leading economic indicators? The index of leading indicators is a monthly index of economic statistics that are used to forecast the direction of real GDP.

Changes in the index provide an indication of the future direction of the economy and are useful to policy makers in developing responses to deteriorating conditions in the economy. The rule of thumb is that three successive decreases or increases in the index indicate a change of direction in the economy. . (Last Word) Why is the index of leading economic indicators a composite index of ten economic statistics and not just one? Each of the economic statistics used to prepare the index may increase or decrease in any month and thus give false or contradictory signals about the direction of the economy.

It is less likely that all these economic indicators, taken together, will give as many false signals about the direction of the economy as one indicator will. Thus the composite index is more reliable than any one indicator. The composite index, however, is not infallible and can also give false indications about the direction of the economy because of changes in the structure of

the economy or developments that are not covered by the indicators that make up the index.