Chapter 12

FISCAL POLICY

FUNDAMENTAL QUESTIONS

1. How can fiscal policy eliminate a GDP gap?

   Fiscal policy can eliminate a GDP gap by increasing government spending (which directly increases aggregate demand) or by decreasing taxes (which increases consumption). The changes in government spending and taxes have a multiplier effect on income.

2. How has U.S. fiscal policy changed over time?

   Government spending has increased from 3 percent of the GDP before the Great Depression to approximately 19 percent of the GDP.

3. What are the effects of budget deficits?

   Budget deficits can be harmful to the economy. If the deficit is financed by borrowing, interest rates may be driven up and private domestic investment may be crowded out. Higher interest rates make U.S. financial instruments attractive to foreigners, and the resulting increase in the demand for dollars may cause the dollar to appreciate. The appreciation of the dollar decreases net exports. Greater interest costs as a result of the deficit may decrease national wealth if the debt is held by foreign residents and the debt did not increase investment and productive capacity in the United States.

4. How does fiscal policy differ across countries?

   Industrial countries spend more of their budgets on social programs than do developing countries, and they depend more on direct taxes and less on indirect taxes as sources of revenue.

Key Terms

crowding out
discretionary fiscal policy
automatic stabilizer
progressive tax
transfer payment
value-added tax (VAT)

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Quick-Check Quiz

Section 1: Fiscal Policy and Aggregate Demand

1. Which of the following affects aggregate demand only *indirectly*?
   a. consumption
   b. investment
   c. taxes
   d. government spending
   e. net exports

2. Taxes affect the level of aggregate demand primarily through changing the level of ___________, which alters ___________.
   a. disposable income; consumption
   b. disposable income; investment
   c. disposable income; government spending
   d. government spending; consumption
   e. government spending; investment

3. A(n) ___________ in government spending or a(n) ___________ in taxes lowers the level of expenditures at every price and shifts the aggregate demand curve to the ___________.
   a. decrease; increase; right
   b. decrease; increase; left
   c. increase; decrease; right
   d. increase; decrease; left
   e. decrease; decrease; left

4. Assuming no effects on aggregate supply, if the government decreases government spending and increases taxes in an attempt to reduce the federal government budget deficit, aggregate demand will shift to the ___________, the price level will either remain constant or ___________, and the level of national income will ___________.
   a. left; increase; increase
   b. left; increase; decrease
   c. left; decrease; increase
   d. left; decrease; decrease
   e. right; decrease; decrease

5. A decrease in taxes may cause aggregate supply to shift to the ___________, causing the level of prices to ___________ and the level of national income to ___________.
   a. right; fall; rise
   b. right; fall; fall
   c. right; rise; rise
   d. left; fall; rise
   e. left; rise; fall

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6. Government spending financed by __________ will have a greater expansionary effect than government spending financed by __________ if the public __________ base current spending on future tax liabilities.
   a. taxes; issuing money; does
   b. taxes; borrowing; does not
   c. taxes; borrowing; does
   d. borrowing; taxes; does
   e. borrowing; taxes; does not

7. Increases in government spending financed by __________ may drive __________ interest rates and decrease __________.
   a. taxes; up; consumption
   b. taxes; down; consumption
   c. borrowing; down; investment
   d. borrowing; up; investment
   e. borrowing; down; net exports

8. Expansionary fiscal policy refers to
   a. decreasing government spending and decreasing taxes.
   b. decreasing government spending and increasing taxes.
   c. increasing government spending and increasing taxes.
   d. increasing government spending and decreasing taxes.
   e. increasing government spending and increasing the money supply.

9. An increase in government spending
   a. has the same effect on aggregate demand as an increase in taxes.
   b. will result in a lower level of prices if the aggregate supply curve is horizontal.
   c. shifts aggregate demand to the right.
   d. decreases aggregate expenditures.
   e. is not likely to result in higher prices or a higher level of real GDP.

10. If the aggregate supply curve slopes up before reaching potential real GDP,
   a. the effect of government spending on real GDP is enhanced.
   b. the government must increase its spending by more than the recessionary gap to reach potential real GDP.
   c. the government must increase its spending by the amount of the recessionary gap to reach real GDP.
   d. prices will remain constant as government spending increases.
   e. prices will decrease as government spending increases.

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11. Which of the following statements is true?
    a. If the price level rises as real GDP rises, the multiplier effects of any given change in aggregate expenditures are larger than they would be if the price level remained constant.
    b. Spending and tax multipliers overestimate the change in expenditures needed to close a recessionary gap.
    c. If aggregate supply shifts in response to an increase in government spending financed by an increase in taxes, the effects of government spending may be enhanced.
    d. David Ricardo stated that the effects of a deficit financed by an increase in taxes are different from the effects of a deficit financed by borrowing.
    e. The spending multiplier overestimates the expansionary effect of an increase in government spending unless the economy is in the Keynesian region of short-run aggregate supply.

12. Suppose the equilibrium level of income is below the full employment level of income. The economy is in a recession, and the *Wall Street Journal* reports fears of deflation. Hence, the government decides to implement a policy that will act to increase national output and prices. This can be accomplished by
    a. decreasing government spending such that aggregate expenditures are reduced.
    b. decreasing taxes and government spending by the same amount such that aggregate supply is increased and aggregate demand is decreased.
    c. increasing government spending such that aggregate demand is increased.
    d. raising average tax rates such that aggregate supply is decreased.
    e. decreasing transfer payments such that aggregate expenditures increase.

Section 2: Fiscal Policy in the United States

1. Discretionary fiscal policy refers to
    a. government spending at the discretion of the president.
    b. government spending at the discretion of the Congress.
    c. elements of fiscal policy that automatically change in value as national income changes.
    d. government spending at the discretion of the president and the Congress.
    e. changes in government spending and taxation aimed at achieving an economic policy goal.

2. Which of the following is *not* a harmful effect of government deficits?
    a. lower private investment as a result of crowding out
    b. lower net exports as a result of the appreciation of the dollar
    c. increased investment caused by foreign savings placed in U.S. bonds
    d. an increase in saving caused by anticipated future increases in taxes
    e. an increase in imports

3. Which of the following is *not* an example of an automatic stabilizer?
    a. unemployment insurance
    b. lump-sum taxes
    c. progressive taxes
    d. food stamps
    e. welfare benefits

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4. The following tax table represents a ___________ tax schedule.

Income	Tax Payment
$100	$ 45
200	80
300	105
400	120

a. regressive
b. progressive
c. proportional
d. lump-sum
e. constant rate

5. Which of the following is *not* an expected result of government budget deficits?
a. increases in saving
b. increases in imports
c. decreases in investment
d. increases in consumption
e. decreases in exports

6. To maintain a given equilibrium, which of the following would *not* offset a decrease in the federal deficit?
a. a decrease in consumption
b. an increase in investment
c. a decrease in savings
d. a decrease in imports
e. an increase in exports

Section 3: Fiscal Policy in Different Countries

1. Which of the following statements is false?
a. Historically, government spending has played an increasingly larger role over time in industrial countries.
b. Government plays a larger role in investment spending in developing countries.
c. Developed countries rely more on their governments to provide the infrastructure of the economy than do developing countries.
d. State-owned enterprises account for a larger percentage of economic activity in developing countries than in developed countries.
e. Industrial nations spend a larger percentage of their budgets on social programs than do developing countries.

2. Which of the following statements is true?
a. Developing countries rely more heavily on direct taxes than do developed countries.
b. Developing countries rely more heavily on indirect taxes than do developed countries.
c. Developing countries rely more heavily on personal income taxes than do developed countries.
d. Developing countries rely more heavily on social security taxes than do developed countries.
e. Developed countries rely more heavily on import and export taxes than do developing countries.

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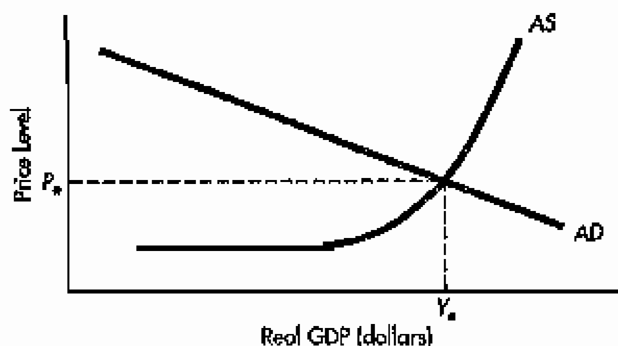
Practice Questions and Problems

Section 1: Fiscal Policy and Aggregate Demand

1. Fiscal policy is changing __________ and __________.
2. The __________ gave the federal government the responsibility for creating and maintaining low inflation and unemployment.
3. Assume the economy is in equilibrium at Y_e. In an attempt to reduce the federal government budget deficit, the government reduces government spending and increases taxes. Further assume that changes in fiscal policy *will* affect aggregate supply and that the change in aggregate demand will be greater than the change in aggregate supply. Show the effects of deficit reduction on the graph below.



   a. Aggregate demand will shift to the __________ (right, left), and aggregate supply will shift to the __________ (right, left).
   b. The equilibrium level of national income will __________ (rise, fall), and the equilibrium price level will __________ (rise, fall).
4. Taxes affect aggregate expenditures indirectly by changing __________; this change alters __________.
5. Increases in government spending may drive interest rates __________, thereby __________ investment.
6. If government spending increases by the same amount as taxes, the effect is __________ (expansionary, contractionary).
7. An increase in government spending or a decrease in taxes causes the aggregate demand curve to shift to the __________.
8. When prices go up, the multiplier effect of an increase in spending is __________ (enhanced, reduced). The spending and tax multipliers __________ (understate, overstate) the effect of a change in aggregate expenditures.

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9. List the three ways government spending may be financed.

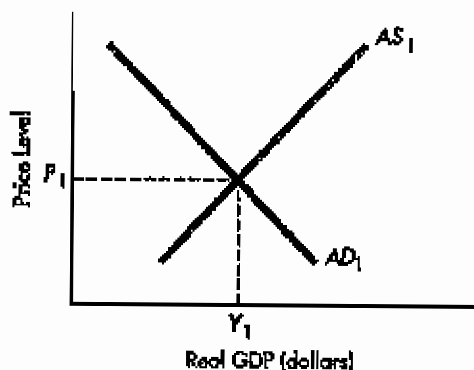
____

____

____

10. An increase in taxes may shift aggregate supply to the ___________ .

11. The graph below shows equilibrium at Y_1 and P_1. Show the effect of government spending financed by taxes if the aggregate supply curve *is* affected by the change in taxes.



12. A government borrows funds by ___________ (buying bonds from, selling bonds to) the public.

13. ___________ refers to the notion that the effects on the economy are the same whether the government finances its spending through tax increases or through borrowing.

14. Ricardian equivalence assumes that aggregate demand will decrease as a result of government spending financed by borrowing because people will increase ___________ to pay for future taxes.

15. An increase in government spending that reduces private spending is called ___________ .

16. Crowding out may occur if government borrowing drives up ___________ .

Section 2: Fiscal Policy in the United States

1. Fiscal policy in the United States is a product of the budget process, which involves the ___________ and ___________ branches of government.

2. As part of the budget process, federal agencies submit their budgets to the ___________ (OMB), which reviews and modifies each agency's requests and consolidates all of the proposals into a single budget.

3. The ___________ (CBO) reports to Congress on the validity of the economic assumptions made in the president's budget.

4. The federal budget is determined as much by ___________ as by economics.

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5. List the two kinds of fiscal policy.

____

____

6. __________ refers to changes in government spending and taxation aimed at achieving a policy goal.
7. __________ are elements of fiscal policy that automatically change in value as national income changes.
8. Historically, except in times of war, the federal government deficit increased the most during __________.
9. Government deficits can harm the economy by dampening __________ and __________.
10. As income falls, automatic stabilizers __________ spending.
11. __________ are taxes that are a flat dollar amount regardless of income.
12. With __________ taxes, as income rises, so does the rate of taxation.
13. With __________ taxes, the tax rate falls as income rises.
14. With __________ taxes, the tax rate is constant as income rises.
15. Look at the tax payment schedules below. Which is progressive? __________ Regressive? __________ Proportional? __________

Income	A Tax Payment	B Tax Payment	C Tax Payment
$100	$10	$ 50	$ 10
200	20	80	30
300	30	90	60
400	40	100	100

16. __________ taxes are an example of an automatic stabilizer.
17. A __________ is a payment to one person that is funded by taxing others.
18. In the first half of the 1990s, federal spending was about __________ percent of the GDP.

Section 3: Fiscal Policy in Different Countries

1. Government plays a bigger role in investment spending in the __________ (developing, industrial) countries. Give two reasons why this should be so.

____

____

2. Low-income countries __________ (do, do not) spend a greater percentage of their budgets on social programs as compared with industrialized countries.

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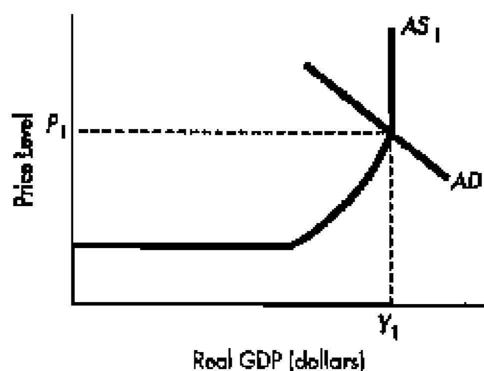
3. The relative cost of an education is __________ (higher, lower) in developing countries than it is in industrial countries.
4. __________ taxes are taxes on individuals and firms.
5. __________ taxes are taxes on goods and services.
6. __________ taxes are hard to collect in developing countries because so much of household production is for personal consumption.
7. In general, developing countries rely more heavily on __________ (direct, indirect) taxes than do developed countries.
8. VAT stands for __________, an indirect tax imposed on each sale at each stage of production.

Thinking About and Applying Fiscal Policy

I. Reducing the Deficit

Your text discusses the possible harmful effects of budget deficits. Since a budget deficit results from government spending that is greater than tax revenues, reducing the deficit implies reducing government spending, increasing taxes, or both. But, to quote Publius Syrus, "There are some remedies worse than the disease" (Maxim 301). Since reducing government spending and increasing taxes reduce aggregate demand, the economy might be thrown into a recession if spending cuts and tax increases are adopted.

1. Consider the graph below, where the economy is at equilibrium at P_1 and Y_1. Show what will happen if spending cuts and tax increases are implemented.



What will happen to equilibrium real GDP and price level?

____

____

____

____

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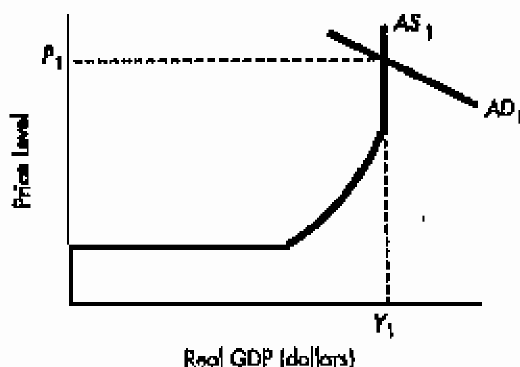
2. Now consider an economy operating in the vertical region of the aggregate supply curve. Can you draw a curve that illustrates tax increases and spending cuts but does *not* throw the economy into a recession?



What will happen to real GDP?

____

____

____

____

II. Clinton's Economic Stimulus Package

a. Former President Clinton's initial 1993 budget was referred to as an "economic stimulus package." From what you know about fiscal policy, if the president's goal was economic stimulus, you would expect this package to consist of increases in __________ and decreases in __________ .

b. The plan was also referred to as a "deficit reduction plan." Why might the president want to reduce the deficit?

____

____

____

c. If the goal is to reduce the deficit, __________ would be increased and __________ would be decreased.

d. Does it seem possible to reduce the deficit while stimulating the economy at the same time?

____

____

____

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c. The president proposed halving capital-gains taxes for investors in some small businesses, and would have expanded the bill's proposed write-off for small businesses' equipment purchases. These tax breaks are intended to __________ (increase, decrease) which component of aggregate expenditures? What effect would that change have on real GDP?

____

____

____

III. Using Fiscal Policy to *Stabilize* the Economy

Assume you are a member of Congress. You receive the following data on the economy:

	Year-Ago Quarter	Last Quarter	Estimate for Quarter Now Ending
Real GDP (in billions of 1987 dollars)	3,906	4,148	4,279
Consumer price index	217	222	228
Unemployment rate	6.7%	5.6%	4.9%

You also know that the index of leading economic indicators is rising.

a. On the basis of these statistics, this economy is at which stage of the business cycle: trough, expansion, peak, or contraction? Briefly defend your answer.
b. Fiscal policy should be used to (increase/decrease) aggregate demand. *Circle one.*
c. What fiscal policy would you recommend? Be specific!

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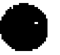
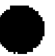

Chapter 12 Homework Problems

Name ____

1. What is fiscal policy, and what parts of the government determine what fiscal policy will be?

2. What are the three ways the government can finance a budget deficit?

3. If the government wants to stimulate the economy (increase equilibrium real GDP), how should it change government spending and taxes?

4. Use the aggregate demand–aggregate supply model to describe why the fiscal policy you recommended above will increase equilibrium GDP.

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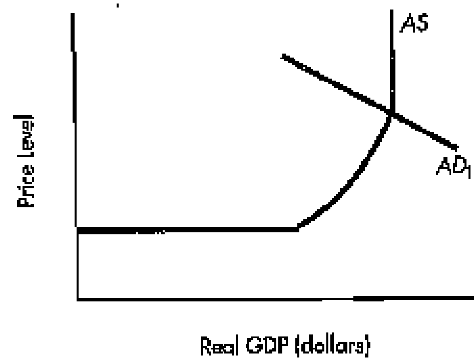
5. In 1965, the U.S. government began spending more money on both the "War on Poverty" and the war in Vietnam, without a corresponding increase in taxes. Suppose that in 1965 the U.S. economy was in the position shown on the diagram below.



a. Sketch in the expected effect of the 1965 increase in government spending. What will happen to the price level and real GDP?

b. If the deficit were financed by borrowing within the United States, what would be the effect on investment?

If your instructor assigns these problems, write your answers above, then tear out this page and hand it in.

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Answers

Quick-Check Quiz

Section 1: Fiscal Policy and Aggregate Demand

1. c; 2. a; 3. b; 4. d; 5. a; 6. e; 7. d; 8. d; 9. c; 10. b; 11. e; 12. c
If you missed any of these questions, you should go back and review Section 1 of Chapter 12.

Section 2: Fiscal Policy in the United States

1. e; 2. c; 3. b; 4. a; 5. d; 6. a
If you missed any of these questions, you should go back and review Section 2 of Chapter 12.

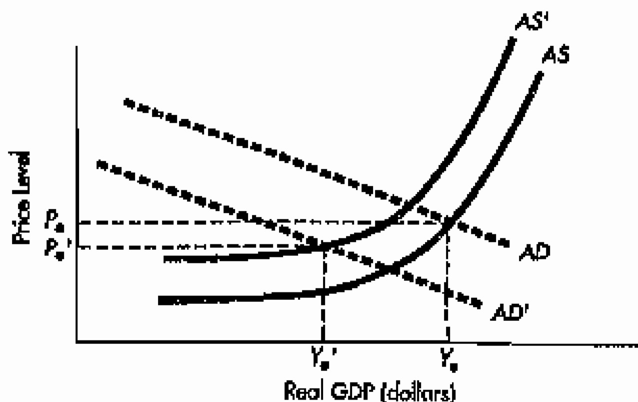
Section 3: Fiscal Policy in Different Countries

1. c; 2. b
If you missed either of these questions, you should go back and review Section 3 of Chapter 12.

Practice Questions and Problems

Section 1: Fiscal Policy and Aggregate Demand

1. taxation; government spending
2. Employment Act of 1946
3.



   a. left; left
   b. fall; fall
4. disposable income; consumption
5. up; decreasing
6. expansionary
7. right
8. reduced; overstate

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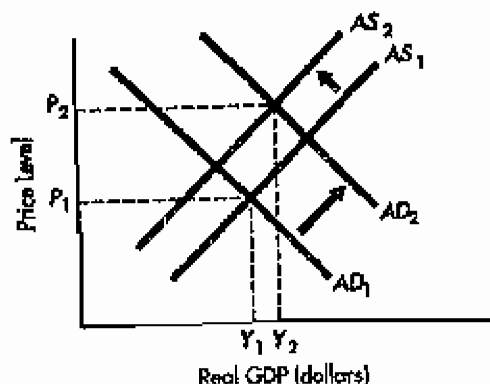
9. taxes
   change in government debt (borrowing)
   change in the stock of government-issued money
10. left
11.



12. selling bonds to
13. Ricardian equivalence
14. saving
15. crowding out
16. interest rates

Section 2: Fiscal Policy in the United States

1. legislative; executive
2. Office of Management and Budget
3. Congressional Budget Office
4. politics
5. discretionary fiscal policy
   automatic stabilizers
6. Discretionary fiscal policy
7. Automatic stabilizers
8. recessions
9. investment; net exports
10. increase
11. Lump-sum taxes
12. progressive
13. regressive
14. proportional

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15. C; B; A
    To determine what kind of tax it is, we must first calculate the tax *rate* at each level of income.

	A		B		C	
Income	Tax Payment	Tax Rate	Tax Payment	Tax Rate	Tax Payment	Tax Rate
$100	$10	.10	$ 50	.50	$ 10	.10
200	20	.10	80	.40	30	.15
300	30	.10	90	.30	60	.20
400	40	.10	100	.25	100	.25

Since A's tax *rate* is constant at .10, A is a proportional tax schedule. B's tax *rate* decreases with income, so B is a regressive tax. C's tax *rate* increases with income, so C is a progressive tax schedule.

Note: If you look at just the *dollar* amount of taxes paid, all three schedules look "progressive" because the dollar amount of tax payments increases as income increases. But we classify these taxes according to how the tax *rate* changes as income increases.

16. Progressive
17. transfer payment
18. 24

Section 3: Fiscal Policy in Different Countries

1. developing. State-owned enterprises account for a larger percentage of economic activity in developing countries as compared with industrial countries. Also, developing countries rely on their governments, as opposed to private investment, to build their infrastructure.
2. do not
3. higher
4. Direct
5. Indirect
6. Personal income
7. indirect
8. value-added tax

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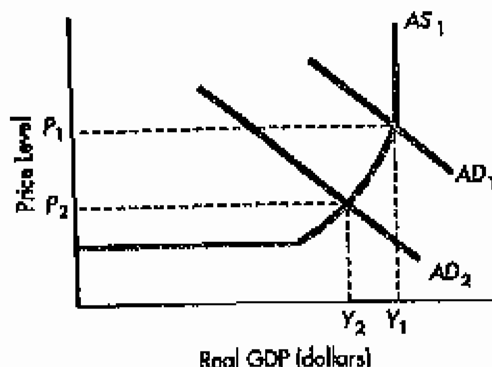
Thinking About and Applying Fiscal Policy

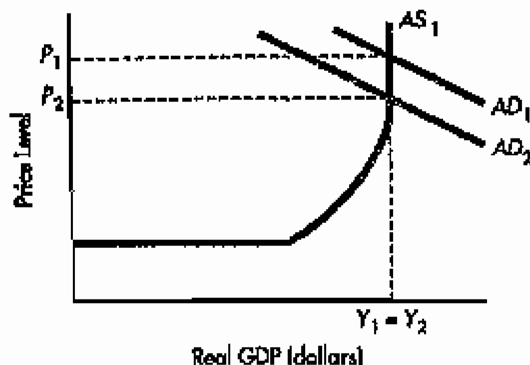
I. Reducing the Deficit

1.



Government spending cuts and tax increases both decrease aggregate demand. If the economy is operating in the Keynesian or intermediate regions, decreasing aggregate demand will decrease real GDP. If the economy is in the intermediate range, the price level will decline. If it is in the Keynesian region, there will be no change in the price level. These are the dire results that the economic analysts fear.

2.



If the economy is operating in the vertical region of short-run aggregate supply (above), a decrease in aggregate demand may bring only a decrease in the price level with no decrease in real GDP.

II. Clinton's Economic Stimulus Package

a. government spending; taxes

b. Many economists argue that deficits raise interest rates, which in turn can depress investments and net exports. Decreases in investment and net exports reduce aggregate demand, which conflicts with the president's goal of stimulating the economy.

c. taxes; government spending

d. Since economic stimulus calls for increasing government spending and decreasing taxes, and deficit reduction calls for decreasing government spending and increasing taxes, the two goals seem incompatible.

e. These tax breaks are intended to increase investment, thereby increasing aggregate demand and equilibrium real GDP.

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III. Using Fiscal Policy to Stabilize the Economy

a. Expansion. Unemployment has been decreasing while inflation and real GDP have been increasing. Since the index of leading economic indicators is rising, the economy probably has not reached its peak.

b. Fiscal policy should be used to decrease aggregate demand. Remember that the goal is to smooth out the ups and downs of the business cycle.

c. To decrease aggregate demand, taxes must be raised and government spending must be lowered.

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