CHAPTER **12**

Fiscal Policy

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Multiple Choice Questions

Fiscal policy; definitions

1. In the Employment Act of 1946, the Federal government:
   A) applied the unemployment compensation program to intrastate workers.
   B) agreed to subsidize unemployed workers to the extent of 50 percent of their average incomes.
   C) committed itself to accept some degree of responsibility for the general levels of employment and prices.
   D) agreed to hire, through public works programs, any employees who cannot find jobs with private industry.

2. Fiscal policy is carried out primarily by:
   A) the Federal government.
   B) state and local governments working together.
   C) state governments alone.
   D) local governments alone.

3. Discretionary fiscal policy refers to:
   A) any change in government spending or taxes that destabilizes the economy.
   B) the authority that the President has to change personal income tax rates.
   C) changes in taxes and government expenditures made by Congress to stabilize the economy.
   D) the changes in taxes and transfers that occur as GDP changes.

4. Countercyclical discretionary fiscal policy calls for:
   A) surpluses during recessions and deficits during periods of demand-pull inflation.
   B) deficits during recessions and surpluses during periods of demand-pull inflation.
   C) surpluses during both recessions and periods of demand-pull inflation.
   D) deficits during both recessions and periods of demand-pull inflation.

5. Fiscal policy refers to the:
   A) manipulation of government spending and taxes to stabilize domestic output, employment, and the price level.
   B) manipulation of government spending and taxes to achieve greater equality in the distribution of income.

C) altering of the interest rate to change aggregate demand.
D) fact that equal increases in government spending and taxation will be contractionary.

6. Discretionary fiscal policy is so named because it:
A) is undertaken at the option of the nation's central bank.
B) occurs automatically as the nation's level of GDP changes.
C) involves specific changes in *T* and *G* undertaken expressly for stabilization at the option of Congress.
D) is invoked secretly by the Council of Economic Advisers.

7. Expansionary fiscal policy is so named because it:
A) involves an expansion of the nation's money supply.
B) necessarily expands the size of government.
C) is aimed at achieving greater price stability.
D) is designed to expand real GDP.

8. Contractionary fiscal policy is so named because it:
A) involves a contraction of the nation's money supply.
B) necessarily reduces the size of government.
C) is aimed at reducing aggregate demand and thus achieving price stability.
D) is expressly designed to contract real GDP.

Discretionary fiscal policy

9. A politically conservative economist who favors smaller government would recommend:
A) tax cuts during recession and reductions in government spending during inflation.
B) tax increases during recession and tax cuts during inflation.
C) tax cuts during recession and tax increases during inflation.
D) increases in government spending during recession and tax increases during inflation.

10. If the MPS in an economy is .1, government could shift the aggregate demand curve rightward by $40 billion by:
A) increasing government spending by $4 billion.
B) increasing government spending by $40 billion.
C) decreasing taxes by $4 billion.
D) increasing taxes by $4 billion.

11. If the MPC in an economy is .8, government could shift the aggregate demand curve rightward by $100 billion by:
A) increasing government spending by $25 billion.
B) increasing government spending by $80 billion.
C) decreasing taxes by $25 billion.
D) decreasing taxes by $100 billion.

12. A politically liberal economist who favored expanded government would recommend:
A) tax cuts during recession and reductions in government spending during inflation.
B) tax increases during recession and tax cuts during inflation.
C) tax cuts during recession and tax increases during inflation.
D) increases in government spending during recession and tax increases during inflation.

13. If the MPS in an economy is .4, government could shift the aggregate demand curve leftward by $50 billion by:
    A) reducing government expenditures by $125 billion.
    B) reducing government expenditures by $20 billion.
    C) increasing taxes by $50 billion.
    D) increasing taxes by $250 billion.

14. If the MPC in an economy is .75, government could shift the aggregate demand curve leftward by $60 billion by:
    A) reducing government expenditures by $12 billion.
    B) reducing government expenditures by $60 billion.
    C) increasing taxes by $15 billion.
    D) increasing taxes by $20 billion.

15. Discretionary fiscal policy will stabilize the economy most when:
    A) deficits are incurred during recessions and surpluses during inflations.
    B) the budget is balanced each year.
    C) deficits are incurred during inflations and surpluses during recessions.
    D) budget surpluses are continuously incurred.

16. The effect of a government surplus on the equilibrium level of GDP is substantially the same as:
    A) a decrease in saving.
    B) an increase in saving.
    C) an increase in consumption.
    D) an increase in investment.

17. Assume the economy is at full employment and that investment spending declines dramatically. Under these conditions government fiscal policy should be directed toward:
    A) an equality of tax receipts and government expenditures.
    B) an excess of tax receipts over government expenditures.
    C) an excess of government expenditures over tax receipts.
    D) a reduction of subsidies and transfer payments and an increase in tax rates.

18. Suppose that the economy is in the midst of a recession. Which of the following policies would be consistent with active fiscal policy?
    A) a Congressional proposal to incur a Federal surplus to be used for the retirement of public debt
    B) a reduction in agricultural subsidies and veterans' benefits
    C) a postponement of a highway construction program
    D) a reduction in Federal tax rates on personal and corporate income

19. Assume that aggregate demand in the economy is excessive, causing demand-pull inflation. Which of the following would be most in accord with appropriate government fiscal policy?
    A) an increase in Federal income tax rates
    B) an increase in the size of income tax exemptions for each dependent
    C) passage of legislation providing for the construction of 8,000 new school buildings
    D) an increase in soil conservation subsidies to farmers

20. In a certain year the aggregate amount demanded at the existing price level consists of $100 billion of consumption, $40 billion of investment, $10 billion of net exports, and $20 billion of government purchases. Full-employment GDP is $120 billion. To obtain price level stability under these conditions the government should:
    A) increase tax rates and reduce government spending.

B) discourage personal saving by reducing the interest rate on government bonds.
C) increase government expenditures.
D) encourage private investment by reducing corporate income taxes.

21. In a certain year the aggregate amount demanded at the existing price level consists of $100 billion of consumption, $40 billion of investment, $10 billion of net exports, and $20 billion of government purchases. Full-employment GDP is $200 billion. To obtain full employment under these conditions the government should:
A) encourage personal saving by increasing the interest rate on government bonds.
B) decrease government expenditures.
C) reduce tax rates and increase government spending.
D) discourage private investment by increasing corporate income taxes.

22. An appropriate fiscal policy for a severe recession is:
A) a decrease in government spending.
B) a decrease in tax rates.
C) appreciation of the dollar.
D) an increase in interest rates.

23. An appropriate fiscal policy for severe demand-pull inflation is:
A) an increase in government spending.
B) depreciation of the dollar.
C) a reduction in interest rates.
D) a tax rate increase.

24. Suppose that in an economy with a MPC of .5 the government wanted to shift the aggregate demand curve rightward by $80 billion at each price level to expand real GDP. It could:
A) reduce taxes by $160 billion.
B) increase government spending by $80 billion.
C) reduce taxes by $40 billion.
D) increase government spending by $40 billion.

25. In an aggregate demand-aggregate supply diagram, equal decreases in government spending and taxes will:
A) shift the AD curve to the right.
B) increase the equilibrium GDP.
C) not affect the AD curve.
D) shift the AD curve to the left.

26. Suppose that in an economy with a MPC of .8 the government wanted to shift the aggregate demand curve leftward by $40 billion at each price level to remedy demand-pull inflation. It could:
A) increase taxes by $10 billion.
B) reduce government spending by $40 billion.
C) reduce government spending by $5 billion.
D) increase taxes by $20 billion.

27. Which of the following represents the most expansionary fiscal policy?
A) a $10 billion tax cut
B) a $10 billion increase in government spending
C) a $10 billion tax increase
D) a $10 billion decrease in government spending

28. Which of the following represents the most contractionary fiscal policy?
A) a $30 billion tax cut
B) a $30 billion increase in government spending
C) a $30 billion tax increase
D) a $30 billion decrease in government spending

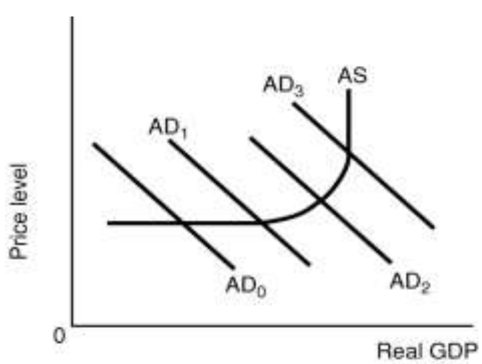
29. A contractionary fiscal policy is shown as a:
A) rightward shift in the economy's aggregate demand curve.
B) rightward shift in the economy's aggregate supply curve.
C) movement along an existing aggregate demand curve.
D) leftward shift in the economy's aggregate demand curve.

30. A expansionary fiscal policy is shown as a:
A) rightward shift in the economy's aggregate demand curve.
B) movement along an existing aggregate demand curve.
C) leftward shift in the economy's aggregate supply curve.
D) leftward shift in the economy's aggregate demand curve.

31. A tax reduction of a specific amount will be more expansionary, the:
A) smaller is the economy's MPC.
B) larger is the economy's MPC.
C) smaller is the economy's multiplier.
D) less the economy's built-in stability.

32. A specific reduction in government spending will dampen demand-pull inflation by a greater amount, the:
A) smaller is the economy's MPC.
B) flatter is the economy's aggregate supply curve.
C) smaller is the economy's MPS.
D) less the economy's built-in stability.

Use the following to answer questions 33-36:



33. Refer to the above diagram. A contractionary fiscal policy would be most appropriate if the economy's present aggregate

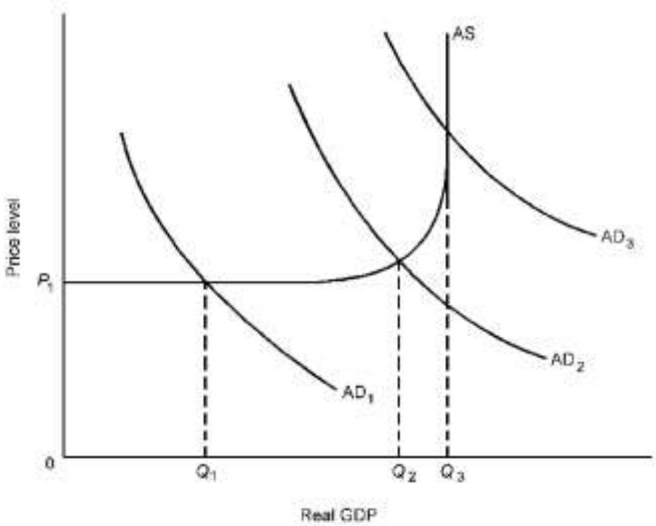
demand curve were at:
A) AD_0
B) AD_1
C) AD_2
D) AD_3

34. Refer to the above diagram. An expansionary fiscal policy would be most appropriate if the economy's present aggregate demand curve were at:
A) AD_0
B) AD_1
C) AD_2
D) AD_3

35. Refer to the above diagram. If the economy's present aggregate demand curve is AD_2:
A) the most appropriate fiscal policy is an increase of government expenditures or a reduction of taxes.
B) the most approprite fiscal policy is a reduction of government expenditures or an increase of taxes.
C) government should not undertake either an expansionary or a contractionary fiscal policy.
D) the economy is achieving its full capacity output.

36. Refer to the above diagram. Assume tht the initial aggregate demand curve is AD_1 and the government undertakes fiscal policy that shifts the aggregate demand curve to AD_2. If the horizontal distance between AD_1 and AD_2 is \$100 billion, the change in real GDP in this situation:
A) would be less than \$100 billion.
B) would be \$100 billion.
C) would be more than \$100 billion.
D) cannot be measured without knowing the size of the economy's multiplier.

Use the following to answer questions 37-45:



37. Refer to the above diagram. The Q_3 level of real GDP is best described as:

A) the full-capacity level of real GDP.
B) the full-employment level of real GDP.
C) a below full-employment level of real GDP.
D) a level of real GDP where there is substantial unemployment.

38. Refer to the above diagram. The Q_2 level of real GDP appears to be:
A) the full-capacity level of real GDP.
B) the full-employment level of real GDP.
C) a level of real GDP where there is substantial unemployment.
D) the wealth-maximizing level of real GDP.

39. Refer to the above diagram. The Q_1 level of real GDP represents:
A) the full-capacity level of real GDP.
B) the full-employment level of real GDP.
C) an inflationary level of real GDP.
D) a recessionary level of real GDP.

40. Refer to the above diagram. If aggregate demand curve AD_1 describes the current situation, appropriate fiscal policy would be to:
A) increase taxes and reduce government spending to shift the aggregate demand curve rightward to AD_2.
B) reduce taxes on businesses to shift the aggregate supply curve leftward.
C) reduce taxes and increase government spending to shift the aggregate demand curve from AD_1 to AD_2.
D) do nothing since the economy appears to be achieving full-employment real GDP.

41. Refer to the above diagram. If aggregate demand curve AD_3 describes the current situation, appropriate fiscal policy would be to:
A) do nothing since the economy appears to be achieving full-employment real output.
B) increase taxes and reduce government spending to shift the aggregate demand curve leftward from AD_3 to AD_2.
C) increase taxes on businesses to shift the aggregate supply curve rightward to reduce the price level.
D) increase taxes and reduce government spending to shift the aggregate demand curve from AD_3 to AD_1.

42. Refer to the above diagram. If aggregate demand curve AD_2 describes the current situation, appropriate fiscal policy would be to:
A) do nothing since the economy appears to be achieving full-employment real output.
B) increase taxes and reduce government spending to shift the aggregate demand curve rightward from AD_2 to AD_3.
C) increase taxes on businesses to shift the aggregate supply curve rightward to reduce the price level.
D) reduce taxes and increase government spending to shift the aggregate demand curve from AD_2 to AD_1.

43. Refer to the above diagram. The shift of the aggregate demand curve from AD_3 to AD_2 is consistent with:
A) an expansionary fiscal policy.
B) a major recession.
C) a contractionary fiscal policy.
D) demand-pull inflation.

44. Refer to the above diagram. The shift of the aggregate demand curve from AD_1 to AD_2 is consistent with:
A) an expansionary fiscal policy.
B) a major recession.

C) a contractionary fiscal policy.
D) severe demand-pull inflation.

45. Refer to the above diagram. The shift in the aggregate demand curve from AD_3 to AD_2 could result from which of the following fiscal policy actions?
A) a tax reduction
B) a tax reduction accompanied by an even larger reduction in government spending
C) a tax increase accompanied by an even larger increase in government spending
D) an increase in government spending

Financing deficits; disposing of surpluses

46. Which of the following fiscal actions would be the most effective in curbing inflation?
A) incurring a budget deficit by borrowing from the public
B) incurring a budget surplus which is used to retire debt held by commercial banks
C) incurring a budget surplus and impounding that surplus
D) incurring a budget surplus which is used to retire debt held by the public

47. If the government increases its spending during recession to assist the economy, the funds for such expenditures must come from some source. Which of the following sources would be the most expansionary?
A) additional taxes on personal incomes
B) creating new money
C) borrowing from the public
D) additional taxes on corporate profits

48. The greatest expansionary impact of a budget deficit will occur when the:
A) government finances the deficit by obtaining newly printed money.
B) government borrows the money from the general public.
C) economy is operating in the intermediate range of its aggregate supply curve.
D) marginal propensity to save for the economy is high.

49. The greatest anti-inflationary impact of a budget surplus will occur when the Federal government:
A) uses the surplus funds to pay off its outstanding debt.
B) impounds the surplus funds and lets them stand idle.
C) uses the surplus funds to expand transfer payments.
D) gives the surplus funds to the states through federal grants.

50. Other things equal, which of the policies will have the most expansionary effect on the economy?
A) a balanced budget
B) a budget surplus held as an idle money balance
C) a budget deficit financed by creating new money
D) a budget surplus used for debt retirement

51. Other things equal, which of the policies will have the most contractionary effect on the economy?
A) a balanced budget
B) a budget surplus held as an idle money balance
C) a budget deficit financed by creating new money
D) a budget surplus used for debt retirement

Built-in stabilizers

52. Built-in stability means that:
    A) an annually balanced budget will offset the procyclical tendencies created by state and local finance and thereby stabilize the economy.
    B) with given tax rates and expenditures policies, a rise in domestic income will reduce a budget deficit or produce a budget surplus while a decline in income will result in a deficit or a lower budget surplus.
    C) Congress will automatically change the tax structure and expenditure programs to correct upswings and downswings in business activity.
    D) government expenditures and tax receipts automatically balance over the business cycle, though they may be out of balance in any single year.

53. If Congress adjusted our tax system so that the MPC was reduced, the
    A) economy would become more inflation prone.
    B) economy would become less stable.
    C) stability of the economy would be unaffected.
    D) economy would become more stable.

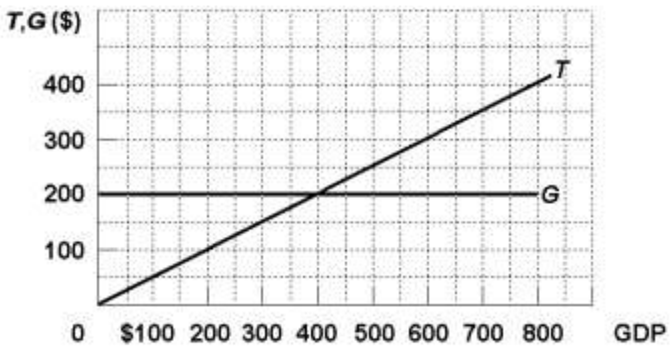
54. A major advantage of the built-in or automatic stabilizers is that they:
    A) simultaneously stabilize the economy and reduce the absolute size of the public debt.
    B) automatically produce surpluses during recessions and deficits during inflations.
    C) require no legislative action by Congress to be made effective.
    D) guarantee that the Federal budget will be balanced over the course of the business cycle.

55. Which of the following best describes the built-in stabilizers as they function in the United States?
    A) The size of the balanced-budget multiplier varies inversely with the level of GDP.
    B) Personal and corporate income tax collections automatically fall and transfers and subsidies automatically rise as GDP rises.
    C) Personal and corporate income tax collections and transfers and subsidies all automatically vary inversely with the level of GDP.
    D) Personal and corporate income tax collections automatically rise and transfers and subsidies automatically decline as GDP rises.

56. The effectiveness of the built-in or automatic stabilizers is limited because:
    A) the stabilizers produce budget surpluses during recessions.
    B) transfer payments and subsidies increase during inflation and decrease during recessions.
    C) the offset the stabilizers provide to a change in private spending is less than the change in private spending.
    D) the stabilizers raise the general price level regardless of the phase of the business cycle.

57. Which of the following statements is *correct*?
    A) Built-in stability only partially offsets fluctuations in economic activity.
    B) Built-in stability works in halting inflation, but it cannot alleviate unemployment.
    C) Built-in stability can be relied on to eliminate completely any fluctuation in economic activity.
    D) Built-in stability has eliminated the need for discretionary fiscal policy.

Use the following to answer questions 58-63:



58. Refer to the above diagram in which *T* is tax revenues and *G* is government expenditures. All figures are in billions. This diagram portrays the idea of:
    A) progressive taxation.
    B) built-in stability.
    C) the balanced-budget multiplier.
    D) discretionary fiscal policy.

59. Refer to the above diagram in which *T* is tax revenues and *G* is government expenditures. All figures are in billions. The tax system of this economy is such that:
    A) it is regressive.
    B) it is progressive.
    C) tax revenues equal 50 percent of GDP.
    D) it tends to destabilize the economy.

60. Refer to the above diagram in which *T* is tax revenues and *G* is government expenditures. All figures are in billions. The equilibrium level of GDP in this economy:
    A) is $400.
    B) is greater than $400.
    C) is less than $400.
    D) cannot be determined from the information given.

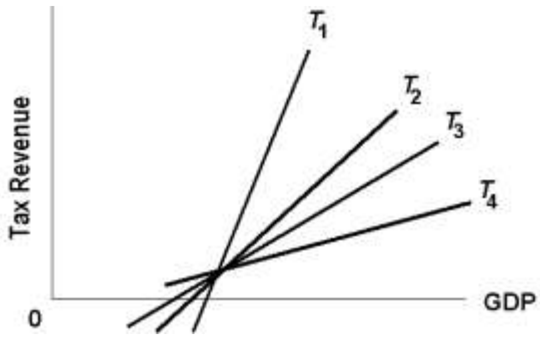
61. Refer to the above diagram in which *T* is tax revenues and *G* is government expenditures. All figures are in billions. If GDP is $400:
    A) there will be a budget deficit.
    B) there will be a budget surplus.
    C) the budget will be balanced.
    D) the macroeconomy will be in equilibrium.

62. Refer to the above diagram in which *T* is tax revenues and *G* is government expenditures. All figures are in billions. The budget will entail a deficit:
    A) at all levels of GDP.
    B) at any level of GDP above $400.
    C) at any level of GDP below $400.
    D) only when GDP is stable.

63. Refer to the above diagram in which *T* is tax revenues and *G* is government expenditures. All figures are in billions. In this economy:
    A) tax revenues and government spending both vary directly with GDP.

B) tax revenues vary directly with GDP, but government spending is independent of GDP.
C) tax revenues and government spending both vary inversely with GDP.
D) government spending varies directly with GDP, but tax revenues are independent of GDP.

Use the following to answer questions 64-66:

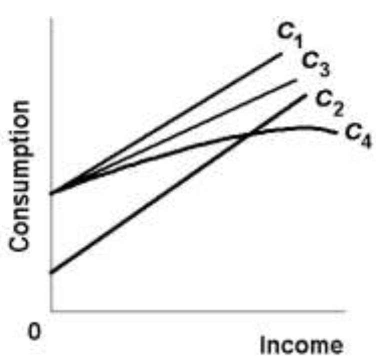


64. Refer to the above diagram. Which tax system has the *most* built-in stability?
A) T_4
B) T_3
C) T_2
D) T_1

65. Refer to the above diagram. Which tax system has the *least* built-in stability?
A) T_4
B) T_3
C) T_2
D) T_1

66. Refer to the above diagram. Which tax system will generate the largest cyclical deficits?
A) T_4
B) T_3
C) T_2
D) T_1

Use the following to answer questions 67-70:



67. (Advanced analysis) Refer to the above diagram, in which C_1 is the before-tax consumption schedule. The consumption schedule represented by C_2 reflects:
A) a higher MPC than is embodied in C_1.
B) a regressive tax system.
C) a proportional tax system.
D) a progressive tax system.

68. (Advanced analysis) Refer to the above diagram, in which C_1 is the before-tax consumption schedule. The consumption schedule represented by C_3 reflects:
A) a progressive tax system.
B) a proportional tax system.
C) a regressive tax system.
D) a higher MPC than is embodied in C_1.

69. (Advanced analysis) Refer to the above diagram, in which C_1 is the before-tax consumption schedule. The consumption schedule represented by C_4 reflects:
A) a progressive tax system.
B) a proportional tax system.
C) a regressive tax system.
D) a higher MPC than is embodied in C_1.

70. (Advanced analysis) Refer to the above diagram, in which C_1 is the before-tax consumption schedule. Other things being equal, the economy would enjoy the greatest built-in stability with consumption schedule:
A) C_1.
B) C_2.
C) C_3.
D) C_4.

Use the following to answer questions 71-74:

Answer the next question(s) on the basis of the following before-tax consumption schedule for a closed economy:

Gross domestic product (GDP)	**Consumption (C)**
$ 0	$ 40
100	120
200	200
300	280
400	360

71. Refer to the above data. If a lump-sum tax (the same tax amount at each level of GDP) of $40 is now imposed in this economy, the consumption schedule will be:

(a) GDP	(a) C	(b) GDP	(b) C	(c) GDP	(c) C	(d) GDP	(d) C
$ 0	$ 8	$ 0	$ 0	$ 0	$ 10	$ 0	$ 0
100	88	100	80	100	90	100	60
200	168	200	160	200	170	200	120
300	248	300	240	300	250	300	180
400	320	400	320	400	310	400	240

72. Refer to the above data. If a lump-sum tax (the same tax amount at each level of GDP) of $40 is imposed in this economy, the tax system:
A) is regressive.
B) is proportional.
C) is progressive.
D) may be either proportional or progressive.

73. Refer to the above data. If a lump-sum tax (the same tax amount at each level of GDP) of $40 is imposed in this economy, the marginal propensity to consume is:
A) .8 before taxes and .6 after taxes.
B) .8 both before and after taxes.
C) .6 before taxes and .8 after taxes.
D) .8 before taxes and .4 after taxes.

74. Refer to the above data. If a lump-sum tax (the same tax amount at each level of GDP) of $40 is imposed in this economy, we can conclude that the tax:
A) enhances the economy's built-in stability.
B) reduces the economy's built-in stability.
C) neither increases nor decreases built-in stability.
D) increases the MPC and therefore increases the size of the multiplier.

Use the following to answer questions 75-78:

(Advanced analysis) Answer the next question(s) on the basis of the following before-tax consumption schedule for an economy:

Gross domestic product (GDP)	Consumption (C)
$100	$140
200	200
300	260
400	320
500	380

75. Refer to the above data. If a 10 percent proportional tax on income is imposed, the consumption schedule will now be:

(a)		(b)		(c)		(d)	
GDP	**C**	**GDP**	**C**	**GDP**	**C**	**GDP**	**C**
$100	$134	$100	$144	$100	$134	$100	$146
200	188	200	212	200	194	200	218
300	242	300	278	300	254	300	286
400	296	400	344	400	324	400	352
500	350	500	410	500	374	500	412

76. Refer to the above data. The 10 percent proportional tax on income would cause:
    A) both consumption and saving to decrease by larger and larger absolute amounts as GDP rises.
    B) both consumption and saving to decrease by smaller and smaller absolute amounts as GDP rises.
    C) consumption to decrease by larger amounts and saving to decrease by smaller amounts as GDP rises.
    D) no change in the amounts consumed and saved at each level of GDP.

77. Refer to the above data. The 10 percent proportional tax on income would:
    A) reduce the MPC from .6 to .54.
    B) not affect the size of the MPC.
    C) reduce the MPC from .6 to .5.
    D) increase the MPC from .6 to .64.

78. Refer to the above data. A 10 percent proportional tax on income would:
    A) affect neither the size of the multiplier nor the stability of the economy.
    B) increase the size of the multiplier and make the economy more stable.
    C) increase the size of the multiplier and make the economy less stable.
    D) reduce the size of the multiplier and make the economy more stable.

Full-employment budget

79. The full-employment budget refers to:
    A) the inflationary impact that the automatic stabilizers have in a full-employment economy.
    B) that portion of a full-employment GDP that is not consumed in the year it is produced.
    C) the size of the Federal government's budgetary surplus or deficit when the economy is operating at full employment.
    D) the number of workers who are underemployed when the level of unemployment is 4 to 5 percent.

80. The full-employment budget tells us:
    A) that in a full-employment economy the Federal budget should be in balance.
    B) that tax revenues should vary inversely with GDP.
    C) what the size of the Federal budget deficit or surplus would be if the economy was at full employment.
    D) the actual budget deficit or surplus realized in any given year.

81. Which of the following statements is *correct*?
    A) The full-employment budget and the actual budget differ because the latter does not take government transfer payments into account.
    B) The full-employment budget is less likely to show a deficit than is the actual budget.
    C) The full-employment budget and the actual budget will show the same size deficit or surplus in any given fiscal year.
    D) The full-employment budget is more likely to show a deficit than is the actual budget.

82. If the economy has a full-employment budget surplus, this means that:
   A) the public sector is exerting an expansionary impact on the economy.
   B) tax revenues would exceed government expenditures if full employment were achieved.
   C) the actual budget is necessarily also in surplus.
   D) the economy is actually operating at full employment.

83. The actual budget deficit of the Federal government in 1991 was about $269 billion. On the basis of this information it:
   A) can be concluded that the economy was faced with serious inflation in 1991.
   B) cannot be determined whether fiscal policy had an expansionary or a contractionary impact in 1991.
   C) can be concluded that fiscal policy was contractionary in 1991.
   D) can be concluded that fiscal policy was expansionary in 1991.

84. When current government expenditures equal current tax revenues and the economy is achieving full employment:
   A) the full-employment budget has neither a deficit nor a surplus.
   B) the full-employment budget may have either a deficit or a surplus.
   C) fiscal policy is contractionary.
   D) nominal GDP and real GDP are equal.

85. When current government expenditures exceed current tax revenues and the economy is achieving full employment:
   A) the full-employment budget has neither a deficit nor a surplus.
   B) the full-employment budget has a deficit.
   C) fiscal policy is contractionary.
   D) nominal GDP and real GDP are equal.

86. When current tax revenues exceed current government expenditures and the economy is achieving full employment:
   A) the full-employment budget has neither a deficit nor a surplus.
   B) the full-employment budget may have either a deficit or a surplus.
   C) the full-employment budget has a surplus.
   D) nominal GDP and real GDP are equal.

87. Suppose the government purposely changes the economy's full-employment budget from a deficit of 3 percent of real GDP to a surplus of 1 percent of real GDP. The government is engaging in a(n):
   A) expansionary fiscal policy.
   B) contractionary fiscal policy.
   C) neutral fiscal policy.
   D) high-interest rate policy.

88. Suppose the government purposely changes the economy's full-employment budget from a deficit of 0 percent of real GDP to a deficit of 3 percent of real GDP. The government is engaging in a(n):
   A) expansionary fiscal policy.
   B) contractionary fiscal policy.
   C) neutral fiscal policy.
   D) low-interest rate policy.

89. Suppose the government cuts taxes to keep the economy's full-employment budget in balance when the economy is expanding. The government is engaging in a(n):
   A) contractionary fiscal policy.
   B) expansionary fiscal policy.
   C) low-interest rate policy.

D) neutral fiscal policy.

Use the following to answer questions 90-93:

Year	Actual budget, percent of GDP (- deficits; + surpluses)	Full-employment budget, percent of GDP (- deficits; + surpluses)
1998	0	0
1999	- 3	0
2000	- 5	- 2
2001	- 2	- 2
2002	+2	+1

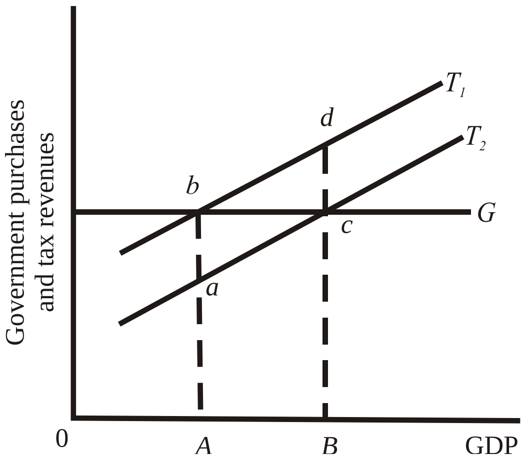
90. Refer to the above table. The changes in the budget conditions between 1998 and 1999 best reflect:
A) demand-pull inflation.
B) an expansionary fiscal policy.
C) a recession.
D) a contractionary fiscal policy.

91. Refer to the above table. The changes in the budget conditions between 1999 and 2000 best reflect:
A) demand-pull inflation.
B) an expansionary fiscal policy.
C) a tax increase.
D) a contractionary fiscal policy.

92. Refer to the above table. The changes in the budget conditions between 2000 and 2001 best reflect:
A) demand-pull inflation.
B) cost-push inflation.
C) an expansion of real GDP and an automatic increase in tax revenues.
D) a contractionary fiscal policy.

93. Refer to the above table. The changes in the budget conditions between 2001 and 2002 best reflect a(n):
A) recession.
B) expansionary fiscal policy.
C) tax increase.
D) contractionary fiscal policy.

Use the following to answer questions 94-100:



94. Refer to the above diagram. Assume that G and T_1 are the relevant curves and that the economy is currently at B, which is its full-employment GDP. This economy has a:
A) full-employment budget surplus only.
B) full-employment budget deficit only.
C) full-employment budget surplus and an actual budget surplus.
D) full-employment deficit and an actual budget deficit.

95. Refer to the above diagram. Assume that G and T_1 are the relevant curves, the economy is currently at A, and the full-employment GDP is B. This economy has a:
A) full-employment budget surplus.
B) full-employment budget deficit.
C) actual budget deficit.
D) actual budget surplus.

96. Refer to the above diagram. Assume that G and T_1 are the relevant curves, the economy is currently at A, and the full-employment GDP is B. This economy has a:
A) full-employment budget deficit.
B) actual budget deficit.
C) actual budget surplus.
D) neither a surplus nor deficit in the actual budget.

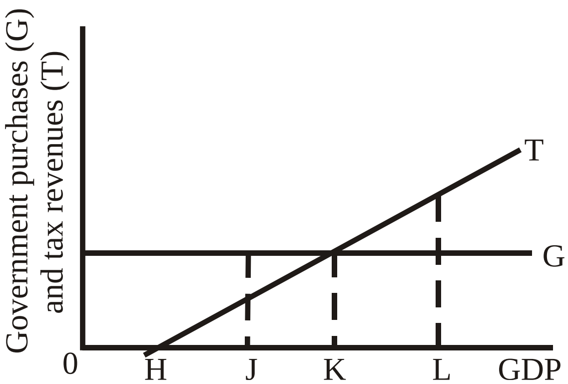
97. Refer to the above diagram. Assume that G and T_2 are the relevant curves, the economy is currently at A, and the full-employment GDP is B. This economy has a:
A) full-employment budget surplus.
B) actual budget deficit.
C) full-employment budget deficit.
D) actual budget surplus.

98. Refer to the above diagram. Assume that G and T_1 are the relevant curves, the economy is currently at B, and the full-employment GDP is A. This economy has a:
A) full-employment budget surplus.
B) actual budget deficit.
C) full-employment budget deficit.
D) actual budget surplus.

99. Refer to the above diagram. Discretionary fiscal policy designed to slow the economy is illustrated by:
A) the shift of curve T_1 to T_2 .
B) the shift of curve T_2 to T_1.
C) a movement from *a* to *c* along curve T_2.
D) a movement from *d* to *b* along curve T_1.

100. Refer to the above diagram. Discretionary fiscal policy designed to expand GDP is illustrated by:
A) the shift of curve T_1 to T_2.
B) the shift of curve T_2 to T_1.
C) a movement from *a* to *c* along curve T_2.
D) a movement from *d* to *b* along curve T_1.

Use the following to answer questions 101-103:



101. If the full-employment GDP for the above economy is at *L*, the:
A) actual budget will have a deficit.
B) full-employment budget will have a deficit.
C) actual budget will have a surplus.
D) full-employment budget will have a surplus.

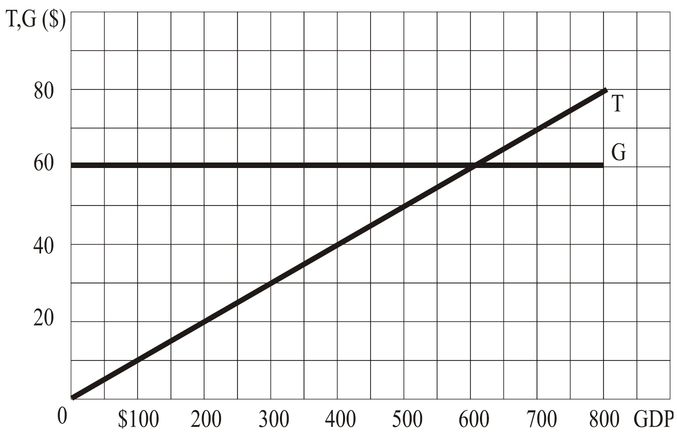
102. With the expenditures programs and the tax system shown in the above diagram:
A) the public budget will be expansionary at all GDP levels above *K*, and contractionary at all GDP levels below *K*.
B) the public budget will be a destabilizing force at all levels of GDP.
C) deficits will occur at income levels below *K*, and surpluses above *K*.
D) deficits will occur at income levels below *H*, and surpluses above *H*.

103. Refer to the above diagram. The degree of built-in stability in the above economy could be increased by:
A) reducing government purchases so that the purchases line shifts downward but parallel to its present position.
B) changing the tax system so that the tax line is shifted downward but parallel to its present position.
C) changing the tax system so that the tax line has a greater slope.
D) altering the government expenditures line so that it has a positive slope.

104. An effective expansionary fiscal policy will:
A) reduce a cyclical deficit, but necessarily increase the actual deficit.

B) reduce a full-employment.
C) increase the full-employment deficit but reduce the cyclical deficit.
D) always result in a balanced actual budget once full-employment is achieved.

Use the following to answer questions 105-110:



105. Refer to the above diagram where *T* is tax revenues and *G* is government expenditures. All figures are in billions of dollars. If the full-employment GDP is $400 billion while the actual GDP is $200 billion, the actual budget deficit is:
A) $200 billion.
B) $20 billion.
C) $40 billion.
D) $60 billion.

106. Refer to the above diagram where *T* is tax revenues and *G* is government expenditures. All figures are in billions of dollars. If the full-employment GDP is $400 billion while the actual GDP is $200 billion, the full-employment budget deficit is:
A) $40 billion.
B) zero.
C) $60 billion.
D) $20 billion.

107. Refer to the above diagram where *T* is tax revenues and *G* is government expenditures. All figures are in billions of dollars. If the full-employment GDP is $400 billion while the actual GDP is $200 billion, the cyclical deficit is:
A) $40 billion.
B) $20 billion.
C) zero.
D) $60 billion.

108. Refer to the above diagram where *T* is tax revenues and *G* is government expenditures. All figures are in billions of dollars. If the full-employment GDP is $400 billion while the actual GDP is $200 billion, the:
A) actual budget deficit exceeds the full-employment budget deficit.
B) actual budget deficit is less than the full-employment budget deficit.
C) full-employment deficit exceeds the cyclical deficit.
D) cyclical deficit exceeds the full-employment deficit.

109. Refer to the above diagram where *T* is tax revenues and *G* is government expenditures. All figures are in billions of dollars. If the full-employment GDP and actual GDP are each $400 billion, this economy will realize a:
   A) full-employment deficit of $20 billion.
   B) cyclical deficit of $20 billion.
   C) cyclical surplus of $20 billion.
   D) full-employment deficit of zero.

110. Refer to the above diagram where *T* is tax revenues and *G* is government expenditures. All figures are in billions of dollars. If the full-employment and actual GDP are each $400 billion, government can balance its budget by:
   A) increasing *T* by $40 billion.
   B) reducing *G* by $20 billion.
   C) reducing *T* by $20 billion.
   D) increasing *T* by $10 billion and reducing *G* by $20 billion.

111. Economists refer to a budget deficit that exists when the economy is achieving full employment as a:
   A) cyclical deficit.
   B) full-employment budget.
   C) natural deficit.
   D) nonrecurring deficit.

112. When the economy is at full employment:
   A) one cannot generalize in comparing the actual and the full-employment budgets.
   B) the full-employment budget will show a surplus and the actual budget will show a deficit.
   C) the actual budget will show a surplus and the full-employment budget will show a deficit.
   D) the actual and the full-employment budgets will be equal.

113. If government increases the size of its full-employment surplus, we can:
   A) assume that government is causing interest rates to rise.
   B) not determine government's impact on the economy without also knowing the status of the actual budget.
   C) assume that government is having a contractionary effect on the economy.
   D) assume that government is having an expansionary effect on the economy.

Problems, criticisms, complications

Use the following to answer questions 114-116:

Answer the next question(s) on the basis of the following sequence of events involving fiscal policy:

1) The composite index of leading indicators turns downward for three consecutive months; (2) Economists reach agreement that the economy is moving into a recession; (3) A tax cut is proposed in Congress; (4) The tax cut is passed by Congress and signed by the President; (5) Consumption spending begins to rise, aggregate demand increases, and the economy begins to recover.

114. Refer to the above information. The operational lag of fiscal policy is reflected in events:
   A) 1 and 2.
   B) 2 and 3.
   C) 3 and 4.
   D) 4 and 5.

115. Refer to the above information. The recognition lag of fiscal policy is reflected in events:
A) 1 and 2.
B) 2 and 3.
C) 3 and 4.
D) 4 and 5.

116. Refer to the above information. The administrative lag of fiscal policy is reflected in events:
A) 1 and 2.
B) 2 and 3.
C) 3 and 4.
D) 4 and 5.

117. Which of the following best describes the idea of a political business cycle?
A) Politicians are more willing to cut taxes and increase government spending than they are to do the reverse.
B) Fiscal policy will result in alternating budget deficits and surpluses.
C) Politicians will use fiscal policy to cause output, real incomes, and employment to be rising prior to elections.
D) Despite good intentions, various timing lags will cause fiscal policy to reinforce the business cycle.

118. The political business cycle refers to the possibility that:
A) incumbent politicians will be reelected regardless of the state of the economy.
B) politicians will manipulate the economy to enhance their chances of being reelected.
C) there is more inflation during Democratic administrations than during Republican administrations.
D) recessions coincide with election years.

119. The crowding-out effect suggests that:
A) tax increases are paid primarily out of saving and therefore are not an effective fiscal device.
B) increases in government spending financed through borrowing will increase the interest rate and thereby reduce investment.
C) it is very difficult to have excessive aggregate spending in the U.S. economy.
D) consumer and investment spending always vary inversely.

120. The crowding out effect suggests that:
A) government spending is increasing at the expense of private investment.
B) imports are replacing domestic production.
C) private investment is increasing at the expense of government spending.
D) consumption is increasing at the expense of investment.

121. Assume the government purposely incurs a budget deficit that is financed by borrowing. As a result, interest rates rise and the volume of private investment spending declines. This illustrates:
A) the equation-of-exchange effect.
B) the paradox of thrift.
C) the crowding-out effect.
D) the wealth effect.

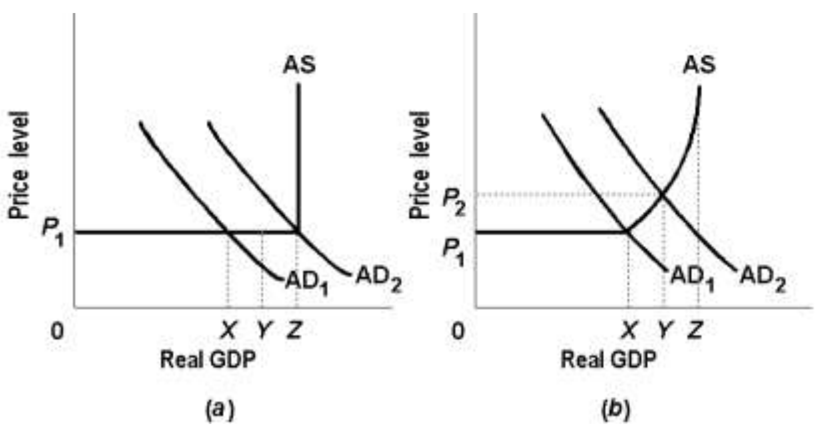
122. The financing of a government deficit increases interest rates and, as a result, reduces investment spending. This statement describes:
A) the supply-side effects of fiscal policy.
B) built-in stability.

C) the crowding-out effect.
D) the net export effect.

123. Suppose the economy is operating within the intermediate range of the aggregate supply curve and government increases both expenditures and taxes by $20 billion. We would expect:
A) no change in domestic output or the price level.
B) both the domestic output and the price level to rise.
C) the domestic output to fall, but the price level to rise.
D) the domestic output to rise, but the price level to fall.

124. If an expansionary fiscal policy were to shift the aggregate demand curve rightward within the intermediate range of the aggregate supply curve:
A) tax revenues would fall because of built-in stability.
B) the price level would fall.
C) the effect of the fiscal policy on real GDP would be strengthened.
D) the effect of the fiscal policy on real GDP would be weakened

Use the following to answer questions 125-127:



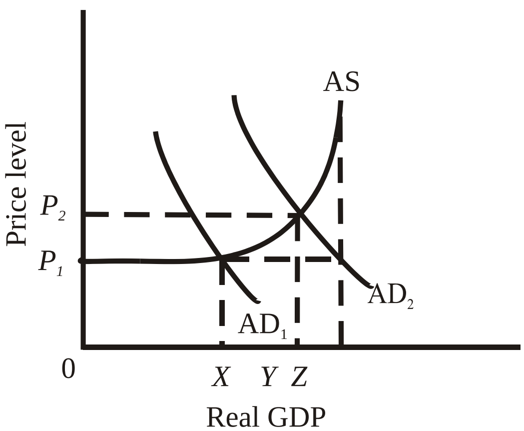
125. Refer to the above diagrams. The multiplier associated with fiscal policy that increases aggregate demand from AD_1 to AD_2 is less in graph *b* than in *a* because:
A) inflation occurs in *b* and not in *a*.
B) the economy is in the vertical range of aggregate supply in *a* and not in *b*.
C) graph *a* represents a closed economy while *b* depicts an open economy.
D) graph *a* represents an open economy while *b* depicts a closed economy.

126. Refer to the above diagrams. Suppose that government undertakes fiscal policy designed to increase aggregate demand from AD_1 to AD_2 and thereby to increase GDP from *X* to *Z*. In terms of graph *a*, which of the following might explain why GDP increases to *Y* rather than to *Z* ?
A) inflation
B) an increase in stock prices
C) a net export effect
D) a ratchet effect

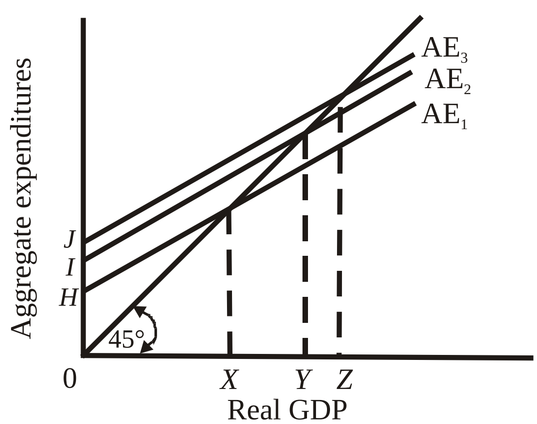
127. Refer to the above diagrams. A second correct answer to the previous question would be:
A) a depreciation of the dollar.
B) a reduction in tariffs imposed by our trading partners.
C) a decrease in the saving schedule.
D) a crowding-out effect.

Fiscal policy; AD-AS and AE model

Use the following to answer questions 128-132:



(a)



(b)

128. Refer to the above diagrams. In choosing your answers assume that fiscal policy has increased aggregate demand from AD_1 to AD_2, as shown in the top diagram. This fiscal policy might have entailed:
A) an increase in personal income tax rates.
B) a reduction in personal income tax rates.
C) a reduction in government expenditures.
D) a reduction in government transfer payments.

129. Refer to the above diagrams. In choosing your answers assume that fiscal policy has increased aggregate demand from AD_1

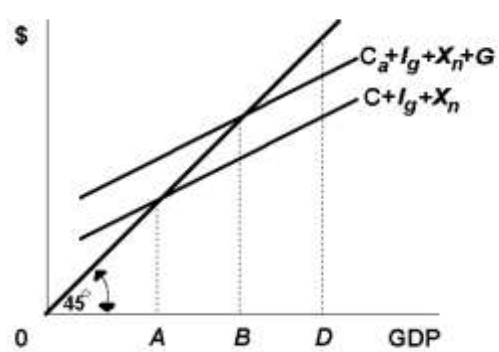
to AD_2, as shown in the top diagram. Assuming there are no crowding out or net export effects, this fiscal policy will increase GDP from *X* to:
A) *Y* and leave the price level constant at P_1 .
B) *Z* and raise the price level to P_2 .
C) *Z* and leave the price level constant at P_1 .
D) *Y* and raise the price level from P_1 to P_2.

130. Refer to the above diagrams. In choosing your answers assume that fiscal policy has increased aggregate demand from AD_1 to AD_2, as shown in the top diagram. The fiscal policy action implied in the upper graph is reflected in the shift of the aggregate expenditures schedule shown in the lower graph from:
A) AE_1 to AE_3.
B) AE_1 to AE_2.
C) AE_3 to AE_2.
D) AE_2 to AE_1.

131. Refer to the above diagrams. In choosing your answers assume that fiscal policy has increased aggregate demand from AD_1 to AD_2, as shown in the top diagram. The situation in the lower graph might best be explained as follows:
A) The fiscal policy would have increased the aggregate expenditures schedule from AE_1 to AE_2, but the rise in the price level elevated the schedule to AE_3.
B) The fiscal policy would have increased the aggregate expenditures schedule from AE_1 to AE_2, but aggregate supply increased such that the schedule rose to AE_3.
C) The fiscal policy had no effect; the aggregate expenditures schedule has remained at AE_2.
D) The fiscal policy would have shifted the aggregate expenditures schedule from AE_1 to AE_3, but the schedule rose only to AE_2 because of the wealth, interest-rate, and foreign purchases effects of the price level rise.

132. Refer to the above diagrams. In choosing your answers assume that fiscal policy has increased aggregate demand from AD_1 to AD_2, as shown in the top diagram. Without a price level rise the multiplier in this economy would have been ______, but with the rise it was ______.
A) 0*Y* / *HI* ; 0*Z* / *HJ*
B) *XY* / *HI* ; *YZ* / *IJ*
C) *XZ* / *HJ* ; *XY* / *HJ*
D) *HJ* / *XZ* ; *HI* / *XY*

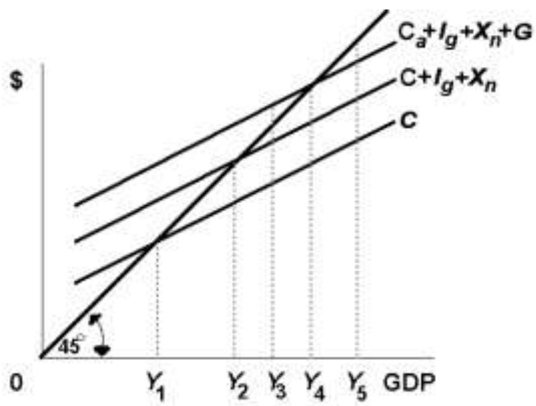
Use the following to answer questions 133-134:



133. Refer to the above diagram. If the full-employment level of GDP is *D*, then it would be appropriate fiscal policy for government to:
A) decrease spending and increase taxes.
B) decrease spending and decrease taxes.
C) increase spending and increase taxes.
D) increase spending and decrease taxes.

134. Refer to the above diagram. If the full-employment level of GDP is *A*, then it would be appropriate fiscal policy for government to:
A) decrease spending and increase taxes.
B) decrease spending and decrease taxes.
C) increase spending and increase taxes.
D) increase spending and decrease taxes.

Use the following to answer questions 135-138:



135. In the above diagram it is assumed that investment, net exports, and government purchases:
A) are leakages from the circular flow.
B) are independent of the level of GDP.
C) vary inversely with GDP.
D) vary directly with GDP.

136. Refer to the above diagram. The equilibrium level of GDP is:
A) Y_5.
B) Y_4.
C) Y_3.
D) Y_2.

137. Refer to the above diagram. If the full-employment GDP is Y_5, government should:
A) incur neither a deficit nor a surplus.
B) cut taxes and government spending by equal amounts.
C) reduce taxes and increase government spending.
D) increase taxes and reduce government spending.

138. Refer to the above diagram. If the full-employment GDP is Y_3, government should:
   A) incur neither a deficit nor a surplus.
   B) increase taxes and government spending by equal amounts.
   C) reduce taxes and increase government spending.
   D) increase taxes and reduce government spending.

Fiscal policy; open economy complications

139. An expansionary U.S. fiscal policy that drives up U.S. interest rates is most likely to:
   A) decrease the foreign demand for dollars and appreciate the international value of the dollar.
   B) decrease the foreign demand for dollars and depreciate the international value of the dollar.
   C) increase the foreign demand for dollars and appreciate the international value of the dollar.
   D) increase the foreign demand for dollars and depreciate the international value of the dollar.

140. A contractionary U.S. fiscal policy that reduces domestic interest rates is most likely to:
   A) depreciate the international value of the dollar and increase U.S. net exports.
   B) depreciate the international value of the dollar and decrease U.S. net exports.
   C) appreciate the international value of the dollar and increase U.S. net exports.
   D) appreciate the international value of the dollar and decrease U.S. net exports.

141. Which one of the following best describes the net export effect associated with an expansionary U.S. fiscal policy?
   A) domestic interest rate falls, foreign demand for dollars rises, dollar appreciates, and net exports increase.
   B) domestic interest rate falls, foreign demand for dollars rises, dollar appreciates, and net exports fall.
   C) domestic interest rate rises, foreign demand for dollars falls, dollar depreciates, and net exports increase.
   D) domestic interest rate rises, foreign demand for dollars increases, dollar appreciates, and net exports decline.

142. The higher domestic interest rate resulting from an expansionary U.S. fiscal policy will tend to:
   A) increase domestic investment spending.
   B) increase U.S. exports.
   C) increase domestic consumption spending.
   D) decrease U.S. exports.

143. An expansionary U.S. fiscal policy might unintentionally cause demand-pull inflation if:
   A) the dollar unexpectedly appreciates while the expansionary policy is in place.
   B) the dollar unexpectedly depreciates while the expansionary policy is in place.
   C) the policy produces severe crowding out.
   D) our trading partners experience recession during the time of the fiscal policy action.

144. International flows of financial capital in response to interest rate changes in the United States:
   A) weaken domestic fiscal policy through an offsetting net export effect.
   B) strengthen domestic fiscal policy through a supporting net export effect.
   C) strengthen domestic fiscal policy through an offsetting net export effect.
   D) do none of the above.

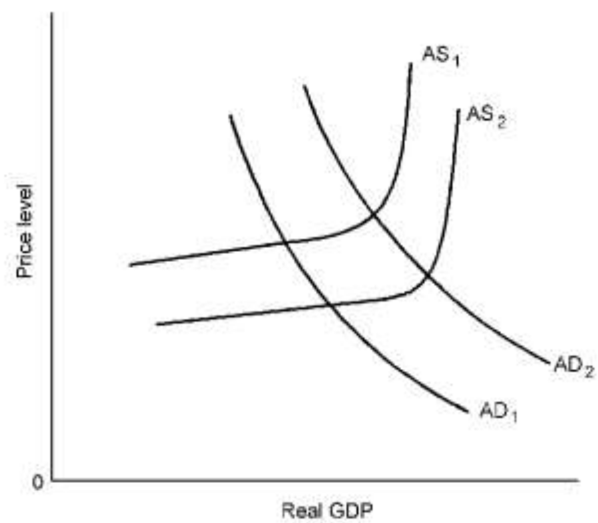
145. All else equal, a contractionary U.S. fiscal policy which reduces domestic interest rates tends to:
   A) increase U.S. imports.
   B) increase the international value of the dollar.
   C) reduce the foreign demand for U.S. dollars.

D) aggravate an existing U.S. trade deficit.

Supply-side aspects

146. If the economy is encountering inflation, supply-side economists might recommend:
A) that fiscal policy not be used.
B) wage and price controls.
C) tax reductions to increase the size of the full-employment GDP.
D) a tax increase to reduce disposable income and consumption.

147. Supply-side economists argue that a major effect of tax cuts is to:
A) lower real GDP and increase the price level.
B) shift the aggregate supply curve rightward.
C) shift the aggregate demand curve leftward.
D) shift the aggregate supply curve leftward.



148.

Refer to the above diagram. Supply-side economists argue that a tax rate increase will shift:
A) AD_1 to AD_2.
B) AD_2 to AD_1.
C) AS_1 to AS_2.
D) AS_2 to AS_1.

149. Supply-side economists argue that tax cuts will:
A) increase saving and investment.
B) increase incentives to work.
C) enhance entrepreneurial risk-taking.
D) do all of the above.

150. Supply-side economists argue that tax rate cuts will:
A) always reduce tax revenues.
B) may increase tax revenues.

C) always increase budget deficits.
D) have no effect on tax revenues.

Last Word Questions

151. (Last Word) Which of the following is *not* an item in the list of leading economic indicators?
A) changes in mutual fund balances
B) the length of the average work week
C) the money supply
D) the value of the index of consumer expectations

152. (Last Word) The composite index of leading indicators is useful for:
A) predicting potential GDP.
B) determining the natural rate of unemployment.
C) developing discretionary fiscal policy.
D) forecasting aggregate supply shocks.

153. (Last Word) Which one of the following is one of the leading economic indicators?
A) index of consumer expectations
B) the unemployment rate
C) the consumer price index
D) Federal income tax collections

True/False Questions

154. Expansionary fiscal policy is so-named because it involves an expansion of the nation's money supply.

155. If the MPC in the economy is .75, government could shift the aggregate demand curve rightward by $30 billion by cutting taxes by $10 billion.

156. A contractionary fiscal policy shifts the aggregate demand curve leftward and may or may not reduce real GDP.

157. The greatest impact of a tax cut will occur when government borrows from the public rather than prints money to finance the resulting budget deficit.

158. Demand-pull inflation can be restrained by increasing government spending and reducing taxes.

159. Built-in stability is synonomous with discretionary fiscal policy.

160. The actual budget may be in deficit while the full-employment budget is in surplus.

161. An increase in the cyclical deficits will automatically increase the full-employment budget deficit.

162. Tax revenues automatically increase during economic expansions and decrease during recessions.

163. The operational lag of fiscal policy refers to the time that elapses between the beginning of a recession or inflation and the certain awareness that it is actually happening.

164. The crowding-out effect refers to the possibility that deficit spending may motivate people to increase their saving in anticipation of higher future taxes.

165. If fiscal policy leads to higher interest rates, the dollar may appreciate and net exports fall.

166. Fiscal policy will generate some inflation if aggregate demand increases in the horizontal range of aggregate supply.