Econ 601: Basic Economic Analysis
Assignment #8

Topic: Government Spending and Fiscal Policy

Text Questions

1. Changes in the level of economic activity are related to changes in the spending of households, businesses, government units, and buyers in the foreign sector.

a. How do personal consumption expenditures, investment spending, government purchases of goods and services, and net exports compare in terms of relative size and stability?

b. How are personal consumption expenditures affected by taxes, transfer payments, saving, and borrowing?

c. How is investment spending affected by changes in the interest rate?

d. Why are government expenditures on goods and services a direct injection and government expenditures on transfer payments not a direct injection into the spending stream?

e. What effects do transactions in the foreign sector have on domestic levels of output, employment, and income?

f. Under what circumstances would an increase in total spending lead primarily to an increase in output, and under what circumstances would it lead primarily to an increase in prices?

2. What is the multiplier effect, and how is it related to nonincome-determined spending and the circular flow of economic activity? What happens to the multiplier effect when the percentage of additional earned income not spent increases? Why does this happen?

3. In each of the following cases, calculate the change that occurs in the level of output as a result of the multiplier effect.

a. Government purchases of goods and services increase by $600 million, and 20% of additional income received is not spent.

b. Household spending from borrowing declines by $1 billion, and 30% of additional income received is not spent.

c. Investment spending increases by $800 million, and 75% of additional income received is spent.

d. Investment spending increases by $2 billion at the same time that US exports decrease by $1.5 billion, and 60% of additional income received is spent.

e. Household purchases from transfer payments increase by $500 million when the economy is at full employment, and 2/3 of additional income received is spent.
4. Determine whether each of the following taxes is progressive, proportional, or regressive.

a. A sales tax of 7% on medicine.

b. A state income tax with 3 brackets: 5% for income under $20,000, 8% for income between $20,000 and $100,000; and 15% for income over $100,000.

c. A property tax of $2.85 per $100 of assessed property.

d. A tax of $8 on room occupancy in all hotels in a city.

e. A tax of 3% on all wages earned in a city.

f. A sales tax of 5% on utilities.

g. A federal tax of $2 per pack of cigarettes

5. Explain whether the economy will expand, contract, stay the same, or inflate with each of the following fiscal actions taken alone.

a. Congress votes a $150 tax credit to each taxpayer.

b. Households are taxed an extra 15%, and the government does not spend all these additional tax dollars.

c. Households are taxed an extra 15%, and the government spends the entire amount on purchases of goods and services.

d. Congress allows many new income tax deductions when the economy is at full employment.

e. Although Congress intends to balance the budget, a deficit occurs.

f. At the end of a war, defense expenditures drop dramatically but are replaced by domestic spending programs for health and education.

g. Congress decides to decrease defense expenditures with no increase in other spending programs.

**Short Answer (BE BRIEF!)**

1. Explain how and why each of the following would affect aggregate expenditures. The “how” part of your answer should describe the direction of the effect and the component of expenditure affected. The “why” should explain the economic logic of the effect.

   a. An increase in the expected future level of output.

   b. An increase in the expected future level of income.

   c. An increase in the exchange rate (dollar appreciates)

   d. An increase in the money supply.

2. A central feature of short-run adjustment macroeconomic adjustment is the multiplier process.

   a. Explain the basics mechanics of the process.

   b. Explain the factors that determine the magnitude of the process.

   c. Suppose that investment in the economy is positively related to the current level of output (i.e., firms increase their investment when output rises). How will this affect the multiplier?