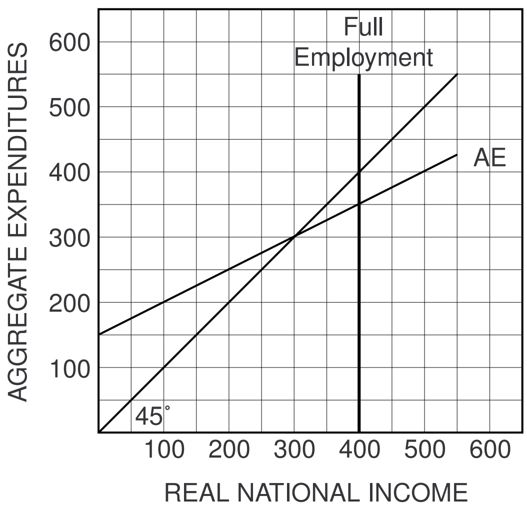
Two Ways to Analyze Fiscal Policy

In Figure 32.1, assume an estimated full-employment national income of $400 billion for the economy and a horizontal SRAS.

Figure 32.1
Aggregate Expenditure Function for a Hypothetical Economy



1. What will be the actual national income level in equilibrium? ____________

2. Given a marginal propensity to consume of 0.50, how much of an increase in aggregate expenditure would be needed to move the economy to full employment? (Hint: Calculate the MPC from the diagram using the rise divided by the run. Then calculate the multiplier that will operate on any change in AE.) ____________

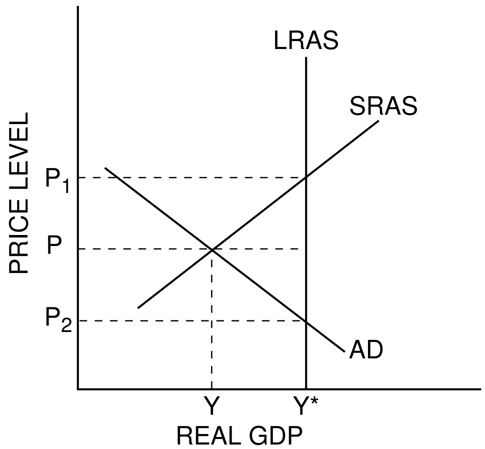
3. How much will GDP increase if aggregate expenditure increases by $50 billion? Why?

4. What fiscal policy measures are available to deal with this situation?

5. Draw in a new AE curve showing the elimination of the gap between the current equilibrium income and the full-employment level of income through the use of fiscal policy. Explain completely the policy you employed.

Adapted from Dascomb R. Forbush and Fredric G. Menz, *Study Guide and Problems to Accompany Lipsey, Steiner and Purvis, Economics,* 8th ed. (New York: HarperCollins Publishing Co., 1987), p. 369.

Figure 32.2
Diagram of a Persistent Gap



6. Assume a persistent gap between current equilibrium income, Y, and full-employment income, Y*, as shown in Figure 32.2.

   (A) If the government decided not to implement any fiscal policy, the unemployment of resources would eventually lead to a decrease in factor prices. Show diagrammatically that this could eliminate the gap. Label the new curve $SRAS_1$. The new price level would be ______________ .

   (B) A second possibility would be to depend on a smaller shift of aggregate supply and have a modest shift in aggregate demand by a discretionary fiscal stimulus so that the price level was maintained at P. Show these two changes in the graph. Label the curves $SRAS_2$ and AD_1.

   (C) A third possibility is that government would seek changes in taxes and/or expenditures that would rapidly bring the economy to full employment. Show this diagrammatically. Label the curve AD_2.

7. Assume that a hypothetical economy is currently at an equilibrium national income level of $1 trillion, but the full-employment national income is $1.2 trillion. Assume the government's budget is currently in balance at $200 billion and the marginal propensity to consume is 0.75. Fill in the answer blanks or underline the correct words in parentheses.

   (A) The gap between the equilibrium income and full employment is _____________ .

   (B) The value of the multiplier is _____________.

   (C) Aggregate expenditures would have to be *(increased / decreased)* by ____________ billion to eliminate the gap.

   (D) The government could attempt to eliminate the gap by holding taxes constant and *(increasing / decreasing)* expenditures by __________ billion.

   (E) Alternatively, the government could attempt to eliminate the gap by holding expenditures constant and *(increasing / decreasing)* its tax receipts by _________ billion.