Reading 14

# FISCAL POLICY

1. (A) **the supply of money and credit.**

   **Explanation**

   Monetary policy attempts to influence economic growth and inflation by increasing or decreasing the money supply and the availability of credit in the economy. Taxes and government spending are tools of fiscal policy. Monetary and fiscal policy can both influence currency exchange rates, but this is not typically their primary goal or tool.

   **(Module 14.1, LOS 14.a)**

2. (C) **a high proportion of government debt owed to the country's citizens.**

   **Explanation**

   That a government owes its own citizens much of its outstanding debt is an argument against being concerned about fiscal deficits. Arguments for being concerned about fiscal deficits include the need for higher future taxes and the potential for government borrowing to increase interest rates and crowd out private investment.

   **(Module 14.1, LOS14.b)**

3. (A) **Improvements in quantitative methods have made the occurrence of recessions or expansions quite predictable.**

   **Explanation**

   One problem in achieving proper timing in fiscal policy is the inability to accurately predict a recession or expansion.

   **(Module 14.2, LOS 14.d)**

4. (A) **impact lag.**

   **Explanation**

   The time it takes for a fiscal policy action, once implemented, to have its effect on the economy is referred to as impact lag. Recognition lag is the time it takes policymakers to realize a fiscal policy response is needed. Action lag is the time it takes policy makers to discuss, enact, and implement fiscal policy measures.

   **(Module 14.2, LOS 14.d)**

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5. (A) **Correct Incorrect**

**Explanation**

Necco is correct because the multiplier effect is stronger for government expenditures versus government taxes. All of the increase in government spending enters the economy as increased expenditure, whereas only a portion of the tax increase results in lessened expenditure (determined by the marginal propensity to consume), because part of the tax increase will come from the savings of the taxpayer (determined by the marginal propensity to save). Packard is incorrect; the effect on real GDP of an increase in government spending combined with equal increase in taxes will be positive because the multiplier effect is stronger for government spending versus the tax increase.

**(Module 14.2, LOS 14.c)**

6. (B) **active decisions regarding spending and taxing to affect economic growth.**

**Explanation**

Discretionary fiscal policy, in contrast to automatic stabilizers, refers to active decisions by the government to affect economic growth through changes in government spending and taxation. Buying or selling securities in the open market is an example of monetary policy.

**(Module 14.1, LOS 14.b)**

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7. (B) **exert a stabilizing influence on an economy.**

**Explanation**

Proper timing of discretional policy is needed to reduce economic instability. If timed incorrectly, the fiscal policy change could increase rather than reduce economic instability.

**(Module 14.2, LOS 14.d)**

8. (C) **greater government deficits will drive up interest rates, thereby reducing Private investment.**

**Explanation**

The crowding-out effect refers to a reduction in private borrowing and investment as a result of higher interest rates generated by budget deficits that are financed by borrowing in the private loanable funds market.

**(Module 14.1, LOS 14.b)**

9. (A) **increase in a fiscal surplus.**

**Explanation**

An increase in a fiscal surplus or a decrease in a fiscal deficit is contractionary. An increase in a fiscal deficit or a decrease in a fiscal surplus is expansionary.

**(Module 14.2, LOS 14.d)**

**10. (B) Both are expansionary.**

**Explanation**

Expansionary fiscal policy increases a budget deficit or decreases a budget surplus. Contractionary fiscal policy decreases a budget deficit or increases a budget surplus.

**(Module 14.2, LOS 14.d)**

**11. (A) enlarge the budget deficit (or reduce the surplus).**

**Explanation**

During a recession unemployment is high, so the government will pay out more in unemployment compensation at the exact time that tax receipts from corporations and individuals are low. This will increase the size of the deficit and also maintain aggregate demand during recessionary periods.

**(Module 14.1, LOS 14.b)**

**12. (A) decrease transfer payments to households.**

**Explanation**

Decreasing spending or increasing taxes are contractionary fiscal policy actions. Increasing spending or decreasing taxes are expansionary.

**(Module 14.2, LOS 14.d)**

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**13. (C) fiscal policy.**

**Explanation**

Fiscal policy refers to actions by a government to influence economic activity through changes in taxes and government spending.

**(Module 14.1, LOS 14.a)**

**14. (C) impact lag in discretionary fiscal policy.**

**Explanation**

This is an example of discretionary fiscal policy involving impact lag because it takes time for the impact of the change in taxing and spending to be felt throughout the economy.

**(Module 14.2, LOS 14.d)**

**15. (B) Ricardian equivalence.**

**Explanation**

If Ricardian equivalence holds, private savings will increase in anticipation of the future taxes required by a fiscal deficit. The crowding-out effect of government borrowing on private investment and the reduction in long-term economic growth due to higher future taxes argue in favour of being concerned about the size of a fiscal deficit.

**(Module 14.1, LOS 14.b)**

**16. (C) Increase Increase**

**Explanation**

The amount of the spending program exactly offsets the amount of the tax increase, leaving the budget unaffected (balanced budget). The multiplier effect is stronger for government spending versus the tax increase. Therefore, the balanced budget multiplier will be positive. All of the government spending enters the economy as increased expenditure, whereas only a portion of the tax increase results in lessened expenditure (determined by the marginal propensity to consume), because part of the tax increase will come from the savings of the taxpayer (determined by the marginal propensity to save).

**(Module 14.2, LOS 14.c)**

**17. (C) contractionary.**

**Explanation**

When the central bank increases short-term interest rates, it is attempting to decrease the growth rate of money and credit in an economy, and policy is said to be contractionary, restrictive, or tight. Accommodative or expansionary monetary policy attempts to increase the growth rate of money and credit (e.g., by decreasing short-term interest rates).

**(Module 14.1, LOS 14.a)**

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**18. (B) an automatic fiscal policy stabilizer.**

**Explanation**

Unemployment compensation automatically rises and falls with the business cycle; therefore it is an example of an automatic fiscal policy stabilizer.

**(Module 14.1, LOS 14.b)**

**19 (C) a budget deficit during a recession and a budget surplus during an Inflationary expansion.**

**Explanation**

Automatic stabilizers such as unemployment compensation, corporate profits tax, and the progressive income tax run a deficit during a business slowdown but run a surplus during an economic expansion. Therefore, they automatically implement countercyclical fiscal policy without the delays associated with policy changes that require legislative action.

**(Module 14.1, LOS 14.b)**

**20. (A) action lag.**

**Explanation**

The time it takes for fiscal policy actions to be proposed, approved, and implemented is referred to as action lag.

**(Module 14.2, LOS 14.d)**

**21. (A) concerns taxes and government spending, while monetary policy concerns the money supply.**

**Explanation**

The distinction between fiscal and monetary policy is that a country's government determines fiscal policy through taxes and spending, but its central bank determines monetary policy by controlling the money supply. Both fiscal and monetary policy can be used to promote economic growth and price stability. Either fiscal policy or monetary policy can be expansionary or contractionary.

**(Module 14.1, LOS 14.a)**

**22. (B) increases in transfer payments and decreases in tax revenues that result from an economic contraction without new legislation.**

**Explanation**

Automatic stabilizers refers the increase (decrease) in transfer payments such as unemployment compensation and the decrease (increase) in tax revenue that result from a decrease (increase) in the level of economic activity. These effects tend to move the fiscal budget toward a deficit when economic activity decreases and toward surplus when economic activity increases, and tend to dampen economic cycles.

**(Module 14.1, LOS 14.b)**

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**23. (B) recognition lag.**

**Explanation**

Recognition lag refers to the time it takes for fiscal policy makers to determine the need for a policy action. Action lag is the time it takes policymakers to discuss, enact, and implement fiscal policy measures. Impact lag is the time it takes for a fiscal policy measure to have its effect on the economy.

**(Module 14.2, LOS 14.d)**

**24. (C) both fiscal and monetary policy.**

**Explanation**

Both monetary and fiscal policies are used by policymakers with the goals of maintaining stable prices and producing positive economic growth.

**(Module 14.1, LOS 14.a)**

**25. (B) fiscal policy only.**

**Explanation**

Fiscal policy can be used as a tool for redistribution of income and wealth, through a variety of taxation and spending policies.

**(Module 14.1, LOS 14.a)**

**26. (A) both fiscal policy and monetary policy.**

**Explanation**

Both fiscal and monetary policies are used to maintain stable prices and produce economic growth. Fiscal policy does so by mechanisms that involve spending and taxation, and monetary policy uses central bank tools to modify the availability of money and credit.

**(Module 14.1, LOS 14.a)**

**27. (A) aid in increasing GDP and employment if the economy is operating at less Than potential GDP.**

**Explanation**

One potential argument against being concerned about the size of fiscal deficits is that a deficit can help increase GDP and employment if output is below potential GDP and the spending does not divert capital from productive uses. Higher deficits that lead to crowding out or higher future taxes that result in lower long-term economic growth are arguments for concern about the size of fiscal deficits.

**(Module 14.1, LOS 14.b)**

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**28. (A) budget deficit will increase the real interest rate and thereby retard private investment.**

**Explanation**

Increased budget deficits will increase the demand for loanable funds and lead to higher interest rates and thus lower private investment. Crowding-out implies that an increase in government spending will choke off private investment and reduce the intended impact of fiscal policy changes on aggregate demand.

**(Module 14.1, LOS 14.b)**

**29. (B) reduce government expenditures on major government construction projects.**

**Explanation**

Discretionary fiscal policy refers to the federal government's decisions regarding government spending and taxing. A reduction in government spending on major government construction projects is likely to lead to a reduction in aggregate demand and less pressure on prices, reducing inflation.

**(Module 14.2, LOS 14.c)**

**30. (B) Ricardian equivalence.**

**Explanation**

Ricardian equivalence suggests that it does not matter whether a government finances its spending with debt or a tax increase because the effect on the total level of demand in the economy is the same. Arguments for being concerned about the size of the fiscal deficit include the crowding-out effect of government borrowing taking the place of private sector borrowing and the negative effects on work incentives and entrepreneurship from higher future taxes.

**(Module 14.1, LOS 14.b)**