

Name: _____ Date: _____

Answer Key: Macroeconomic Tightrope: The Fiscal Policy Survival Challenge for College Scholars

Scholars calculate multipliers, evaluate Ricardian equivalence, and analyze automatic stabilizers to navigate the complexities of modern sovereign debt and countercyclical interventions.

1. An economy is currently operating with a significant recessionary gap. If the marginal propensity to consume (MPC) is 0.8 and the government increases spending by \$200 billion, what is the theoretical total increase in aggregate demand, assuming no crowding out?

Answer: C) \$1 trillion

The spending multiplier formula is $1/(1-MPC)$. With an MPC of 0.8, the multiplier is $1/0.2 = 5$. Therefore, $\$200 \text{ billion} * 5 = \1 trillion .

2. According to the Ricardian Equivalence proposition, debt-financed government spending is more effective at stimulating aggregate demand than tax-financed spending because consumers do not anticipate future tax increases.

Answer: B) False

Ricardian Equivalence suggests that debt-financed spending is ineffective because rational consumers anticipate future taxes to pay off the debt and increase their savings accordingly, neutralizing the stimulus.

3. When the government increases borrowing to fund a deficit, it may drive up interest rates, leading to a reduction in private investment. This phenomenon is known as _____.

Answer: B) Crowding Out

Crowding out occurs when government deficit spending increases the demand for loanable funds, raising interest rates and discouraging private sector investment.

4. Which of the following acts as an 'automatic stabilizer' in the context of a sudden economic downturn?

Answer: C) An increase in total unemployment insurance payouts without new legislation

Automatic stabilizers are structural features of the budget, like unemployment benefits and progressive taxes, that automatically offset fluctuations in economic activity without new policy action.

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5. If a government maintains a secondary budget deficit while the economy is at full employment (Potential GDP), this deficit is specifically categorized as a _____ deficit.

Answer: C) Structural

A structural deficit (or full-employment deficit) is the portion of the budget deficit that would exist even if the economy were operating at its potential output.

6. In a closed economy with a balanced budget, the 'Balanced Budget Multiplier' is equal to 1, meaning an equal increase in taxes and spending will increase GDP by the same amount as the initial spending increase.

Answer: A) True

The balanced budget multiplier is exactly 1 because the positive effect of government spending ($1/[1-MPC]$) outweighs the negative effect of the tax increase ($-MPC/[1-MPC]$).

7. During a period of high inflation and over-employment (an inflationary gap), which fiscal policy stance would a Keynesian economist most likely recommend?

Answer: C) Reducing government procurement and increasing tax rates

Contractionary fiscal policy involves reducing spending and/or increasing taxes to shift aggregate demand to the left and reduce inflationary pressures.

8. The time it takes for policymakers to recognize that an economic gap exists and actually implement a fiscal change is known as the _____ lag.

Answer: C) Inside

The 'inside lag' consists of the recognition lag (noticing the problem) and the administrative/legislative lag (taking action). The 'outside lag' is the time for the policy to affect the economy.

9. Discretionary fiscal policy refers exclusively to the automatic changes in tax receipts and welfare spending that occur as the economy enters a recession.

Answer: B) False

Discretionary fiscal policy requires deliberate action by the legislature (e.g., passing a new law), whereas automatic changes are termed 'automatic stabilizers.'

10. Which curve illustrates the relationship between tax rates and total tax revenue, suggesting that beyond a certain point, higher rates may actually decrease revenue?

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Answer: B) The Laffer Curve

The Laffer Curve is a supply-side concept used to argue that if tax rates are too high, they disincentivize work and investment, ultimately leading to lower total tax collections.