Multiple Choice Questions

1. 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.

2. 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.
3. Refer to the above diagram. Which tax system has the most built-in stability?
A. \( T_4 \)
B. \( T_3 \)
C. \( T_2 \)
D. \( T_1 \)

4. Refer to the above diagram, in which \( Q_f \) is the full-employment output. 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.
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.

5. 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.

6. 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 consumption.
C. an increase in saving.
D. an increase in investment.

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

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

<table>
<thead>
<tr>
<th>Gross Domestic Product (GDP)</th>
<th>Consumption (C)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0</td>
<td>$40</td>
</tr>
<tr>
<td>100</td>
<td>120</td>
</tr>
<tr>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td>300</td>
<td>280</td>
</tr>
<tr>
<td>400</td>
<td>360</td>
</tr>
</tbody>
</table>

8. 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. .6 before taxes and .8 after taxes.
C. .8 both before and after taxes.
D. .8 before taxes and .4 after taxes.
9. Suppose the price level is fixed, the MPC is .5, and the GDP gap is a negative $100 billion. To achieve full-employment output (exactly), government should:
A. increase government expenditures by $100 billion.
B. increase government expenditures by $50 billion.
C. reduce taxes by $50 billion.
D. reduce taxes by $200 billion.

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

11. The Federal budget surplus is found by:
A. subtracting government revenue plus government borrowing from government spending in a particular year.
B. cumulating the difference between government spending and tax revenues over all years since the nation's founding.
C. subtracting government revenues from government spending on noninvestment goods in a particular year.
D. subtracting government spending from government tax revenue in a particular year.

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

<table>
<thead>
<tr>
<th>Security</th>
<th>Amount (in billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Treasury bills</td>
<td>$220</td>
</tr>
<tr>
<td>Corporate bonds</td>
<td>1.40</td>
</tr>
<tr>
<td>Treasury notes</td>
<td>0.80</td>
</tr>
<tr>
<td>Corporate stock</td>
<td>2.00</td>
</tr>
<tr>
<td>U.S. saving bonds</td>
<td>0.60</td>
</tr>
<tr>
<td>Treasury bonds</td>
<td>1.00</td>
</tr>
</tbody>
</table>

13. Other things equal, an increase of Treasury bonds from $100 billion to $120 billion in the above economy would:
A. not change the size of the public debt.
B. increase the public debt from $460 billion to $480 billion.
C. increase the public debt from $400 billion to $420 billion.
D. decrease the public debt by $20 billion.
14. 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(n):
A. standardized budget deficit.
B. actual budget deficit.
C. actual budget surplus.
D. neither a surplus nor deficit in the actual budget.

15. An effective expansionary fiscal policy will:
A. reduce a cyclical deficit, but necessarily increase the actual deficit.
B. reduce the standardized deficit.
C. increase the standardized deficit but reduce the cyclical deficit.
D. always result in a balanced actual budget once full-employment is achieved.

16. The crowding-out effect of expansionary fiscal policy 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.

17. An appropriate fiscal policy for severe demand-pull inflation is:
A. an increase in government spending.
B. a reduction in interest rates.
C. depreciation of the dollar.
D. a tax rate increase.
18. 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. standardized budget surplus only.
B. standardized budget deficit only.
C. standardized budget surplus and an actual budget surplus.
D. standardized deficit and an actual budget deficit.

19. The true size of Federal budget deficits may be understated because:
A. a portion of government spending is public investment.
B. inflation reduces the real value of the public debt.
C. Social Security surpluses are included as government tax revenues in measuring the budget deficit.
D. foreign holdings of the debt have recently increased.

20. (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 regressive tax system.
C. a proportional tax system.
D. a higher MPC than is embodied in $C_1$.

21. 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.
22. The most likely way the public debt burdens future generations, if at all, is by:
A. reducing the current level of investment.
B. causing deflation.
C. causing future unemployment.
D. reducing real interest rates.

23. The crowding-out effect of expansionary fiscal policy 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. saving is increasing at the expense of investment.

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

25. Assume the economy is at full employment and that investment spending declines dramatically. If the goal is to restore full employment, 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.

26. What percentage of the U.S. public debt is held by Federal agencies and the Federal Reserve?
A. 51 percent
B. 58 percent
C. 49 percent
D. 26 percent

27. 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. a movement from $a$ to $c$ along curve $T_2$.
C. the shift of curve $T_2$ to $T_1$.
D. a movement from $d$ to $b$ along curve $T_1$. 
Answer the next question(s) using the following budget information for a hypothetical economy. Assume that all budget surpluses are use to pay down the public debt.

<table>
<thead>
<tr>
<th>Year</th>
<th>Government spending</th>
<th>Tax revenues</th>
<th>GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$450</td>
<td>$425</td>
<td>$2000</td>
</tr>
<tr>
<td>2</td>
<td>500</td>
<td>450</td>
<td>3000</td>
</tr>
<tr>
<td>3</td>
<td>600</td>
<td>500</td>
<td>4000</td>
</tr>
<tr>
<td>4</td>
<td>640</td>
<td>620</td>
<td>5000</td>
</tr>
<tr>
<td>5</td>
<td>680</td>
<td>580</td>
<td>4800</td>
</tr>
<tr>
<td>6</td>
<td>600</td>
<td>620</td>
<td>5000</td>
</tr>
</tbody>
</table>

28. Refer to the above data. A budget surplus occurred in year:
A. 2
B. 3
C. 4
D. 6

29. If government increases the size of its standardized 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.

30. Suppose the government purposely changes the economy's standardized 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. neutral fiscal policy.
C. contractionary fiscal policy.
D. low-interest rate policy.

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2. C    12. C    22. A
7. B    17. D    27. A
10. C   20. B   30. A